

PHILIPPINES ECONOMIC UPDATE

October 2016

*Outperforming the Region and
Managing the Transition*



WORLD BANK GROUP

Macroeconomics and Fiscal Management Global Practice
East Asia and Pacific Region

OUTPERFORMING THE REGION AND MANAGING THE TRANSITION

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PREFACE

The *Philippines Economic Update (PEU)* provides a brief summary of key economic and social developments, important policy changes and the evolution of external conditions over the past six months. It also presents findings from recent World Bank studies on the Philippines, situating them in the context of the country's long-term development trends and assessing their implications for its medium-term economic outlook. The PEU covers issues ranging from macroeconomic management to financial market dynamics to the complex challenges of poverty reduction and social development. It is intended to serve the needs of a wide audience, including policymakers, business leaders, financial firms and investors, and analysts and professionals engaged in the social and economic development of the Philippines.

The PEU is a biannual publication of the World Bank's Macroeconomics and Fiscal Management Global Practice (MFM GP), in partnership with the Poverty & Equity, Finance & Markets, Social Protection & Labor GPs. This edition was prepared under the guidance of Birgit Hansl (Lead Economist and Program Leader) and Ndiame Diop (Practice Manager for the MFM GP's Philippines Office). The team consisted of Kevin Chua (Economist and Task Team Leader) and Kevin Cruz (Research Analyst) from the MFM GP, Jan Rutkowski (Lead Economist) and Pablo Ariel Acosta (Senior Economist) from the Social Protection & Labor GP, Nataliya Mylenko (Senior Financial Sector Specialist) from the Finance & Markets GP, and Sharon Faye Alariao Piza (Economist) from the Poverty & Equity GP. The report was edited by Sean Lothrop (Consultant). The graphic designer was Robert Waiharo (Consultant). Peer reviewers included Eric Le Borgne (Lead Economist) and Rafael Moreno (Senior Economist). Logistics and publication support were provided by Maria Consuelo Sy and Ayleen Ang (Team Assistant). The Manila External Communications Team, comprising David Llorito (Communications Officer), Justine Letargo (Online Communications Officer) and Geralyn Rigor (Program Assistant), prepared the media release, dissemination plan and web-based multimedia presentation.

The team would like to thank Mara Warwick (Country Director for the Philippines) for her advice and support. The report benefited from the advice, comments and views offered by various stakeholders in the World Bank, as well as the government, the business community, labor associations, academic institutions and civil society. The team is very grateful for their contributions and perspectives. The findings, interpretations and conclusions expressed in the PEU are those of the staff who prepared it and do not necessarily reflect the views of the World Bank's management, its executive board, or any national government. This report went to press on September 30, 2016.

If you wish to be included in the email distribution list for the PEU and related publications, please contact Maria Consuelo Sy (msy@worldbank.org). For questions and comments regarding the content of this publication, please contact Birgit Hansl (bhansl@worldbank.org). Questions from the media should be addressed to David Llorito (dllorito@worldbank.org).

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

EXECUTIVE SUMMARY

The Philippines has emerged as one of the most dynamic economies in the East Asia region. Despite a challenging global economic environment, the Philippine economy has grown at a rapid pace over the past five years, supported by sound macroeconomic fundamentals and a highly competitive workforce. Strong capital investment and robust domestic demand have helped secure the Philippines' position as the leading growth performer among major economies in East Asia and the Pacific. Public spending rose by more than 10 percent during the first half of 2016, as the government continued to implement its ambitious investment program. Services and industry remained the primary engines of growth, while the lingering effects of El Niño further diminished agricultural output and a weaker-than-expected global recovery continued to hinder the export sector. Nevertheless, the GDP growth rate rose from 5.5 percent in the first half of 2015 to 6.9 percent in the first half of 2016, enabling the Philippines to outperform regional peers such as China, Indonesia, Malaysia, Thailand, and Vietnam.

Meanwhile, the country is transitioning to a new economic policy framework. The Duterte administration took office on June 30th after winning a peaceful democratic election marked by record voter turnout. The previous administration made major achievements in securing macroeconomic stability, promoting public sector transparency and focusing fiscal resources on pro-poor infrastructure projects and social services, and the new president's economic team has prepared a 10-point socioeconomic agenda designed to reinforce private sector confidence in the continuity of the existing macroeconomic framework. The preliminary agenda is intended to bolster the government's current fiscal, monetary and trade policy stances, while prioritizing tax administration reforms. Despite these

reassurances, however, a degree of uncertainty remains regarding the ultimate direction of macroeconomic policy. The most pressing short-term challenge will be to successfully manage the economic transition and provide the right signals to investors and businesses. Over the longer term, policymakers will need to explore innovative strategies for sustaining high growth rates as the returns to the country's present economic model inevitably diminish.

The Philippines' current monetary and fiscal policies have effectively supported growth. Although core inflation is gradually rising, inflation rates remain below the central bank's 2-4 percent target band. The central bank lowered its key policy rate by 100 basis points to 3.0 percent in June. High domestic liquidity is reflected in increasing credit growth, especially to the real estate and construction sectors, but also to households. Meanwhile, election-related outlays combined with efforts to improve budget execution significantly boosted public spending. This increase in expenditures outpaced revenue growth, resulting in a fiscal deficit of 1.7 percent of GDP in the first half of 2016. This reversed a budget surplus of 0.2 percent of GDP recorded during the same period in the previous year. However, the fiscal deficit remained within the statutory limit of 2 percent of GDP and was almost entirely financed by domestic borrowing. Moreover, the country's debt burden slid from 44.9 percent of GDP at end-2015 to 43.0 percent in mid-2016.

The economic outlook is optimistic, with risks tilted to the upside. The substantial improvements in macroeconomic stability achieved over the past decade, combined with low and stable inflation rates, prudent fiscal management, sustained current-account surpluses and comfortable levels of international reserves, have established the necessary conditions for further robust growth.

Over the near term, the Philippines is poised to benefit from the completion of several large public infrastructure projects, which are expected to boost private investment. Improved infrastructure, solid remittance inflows and significant social spending should continue to support the growth of household consumption. If remaining budget-execution bottlenecks are successfully addressed in the next few months, and if uncertainties regarding the specifics of the reform agenda are quickly resolved, the annual GDP growth rate could exceed the 6.2 percent currently projected for 2017-2018.

While the near-term outlook is highly positive, the Philippines' growth model is subject to medium-term risks. These include the continued failure of external demand to meet expectations and/or a decrease in remittance inflows, both of which stem from the slow and uneven recovery of advanced economies and China's ongoing economic rebalancing. Conversely, an accelerating recovery among high-income economies could lead to higher interest rates in the US and EU, potentially tightening external borrowing conditions and diverting the attention of international investors. On the domestic front, medium-term risks include the persistent vulnerability of the agricultural sector, as well as unresolved constraints on private investment, such as limits on foreign investment and technology transfer, a lack of competition in major sectors and structural deficiencies in the business environment. Finally, ensuring that growth is inclusive will continue to pose a major cross-cutting challenge to Philippine policymakers—one that is likely to intensify as the country's evolving economy increasingly shifts to more skill- and capital-intensive forms of production.

Enhancing the inclusiveness of growth is a stated priority of the new administration. The Philippines has made some progress in its fight against extreme poverty. According to recent estimates, the extreme poverty rate decreased gradually from 10.6 percent in

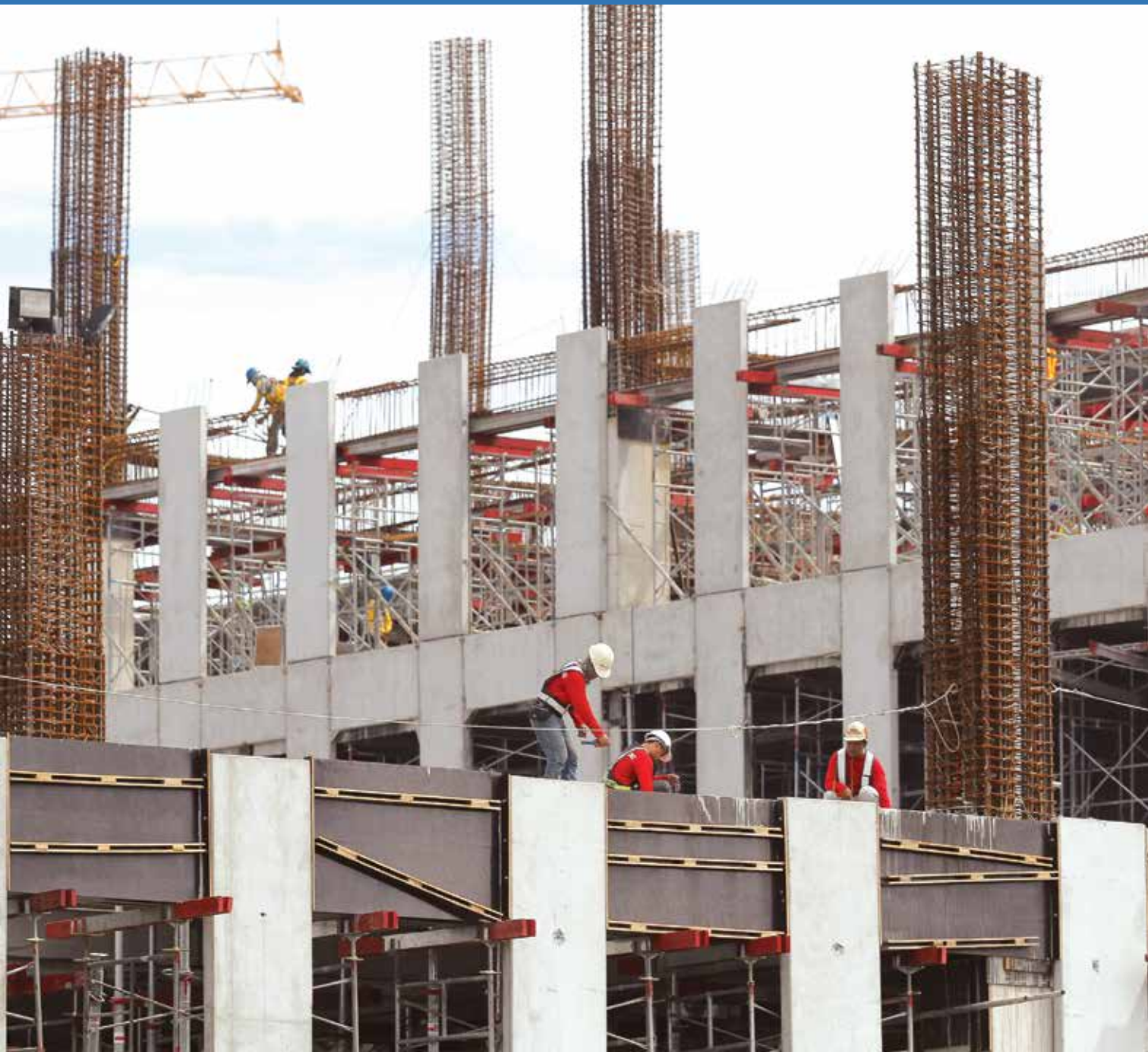
2012 to 8.4 percent in 2015 as real household income grew. While frequent natural disasters, including a record number of typhoons between 2013 and 2015, undermined welfare gains, the government's social protection programs mitigated their impact. Overall, income growth among the country's poorer households exceeded the national average, reducing income inequality. As the Philippine economy continues to develop, the challenge of ensuring inclusive growth will become more complex, and investment in human capital will be necessary to ensure that the nation's workforce is able to meet a rising demand for skilled labor. The new administration is committed to continued investment in education, job skills, public health and social assistance in order to promote a transformative and inclusive growth pattern. The government is currently engaged in a process of stakeholder consultation as it develops the next six-year Philippine Development Plan, which is expected to provide guidance on both short- and medium-term policy priorities for achieving this ambitious goal.

The government's fiscal agenda calls for higher rates of public investment, which will require a commensurate increase in revenue mobilization. The new administration aims to accelerate the creation of high-quality jobs through greater public investment in infrastructure, education and healthcare. To finance this agenda, the authorities are planning a comprehensive tax reform effort designed to make the Philippine tax system more equitable, efficient and competitive in the region. This edition of the Philippines Economic Update includes a special focus section, which examines critical policy issues related to the government's tax reform program. It evaluates the value-added tax and the excise tax on petroleum. The design and administration of these taxes have important implications for fiscal equity, economic efficiency and budgetary sustainability, and the focus section assesses each in terms of its prospective impact on the government's stated development objectives.

PART I:

RECENT ECONOMIC AND POLICY DEVELOPMENTS

The Philippine economy grew 6.9 percent, year-on-year, in the first six months of 2016, exceeding China's growth rate of 6.7 percent. Strong domestic demand drove overall growth, supported by an increase in public spending in the run-up to the recent elections. Public spending rose by more than 10 percent during the first half of 2016, as the government continued to implement its ambitious investment program. Services and industry remained the primary engines of growth, while the lingering effects of El Niño further diminished agricultural output. Meanwhile, anemic external demand continued to inhibit the performance of the export sector.



1.1 Growth: A Robust Expansion Continues Despite a Weak External Environment

During the first half of 2016, as its major trading partners continued to struggle with an uncertain recovery and a difficult rebalancing, the Philippines emerged as the strongest performer among its East Asian peers. The Philippine economy expanded by 6.9 percent, year-on-year, in the first six months of 2016, up from 5.5 percent in the first half of 2015. The country continues to defy global trends, as growth in other emerging markets and developing countries remains subdued, while the recovery among advanced economies has largely failed to meet expectations. Global trade growth remains sluggish,¹ and commodity prices have stabilized at low levels. Though capital flows appear to have steadied, they experienced several bouts of volatility at the start of 2016 and in the wake of the UK's vote to leave the EU, commonly known as "Brexit." Yet despite this challenging global environment, surging domestic demand and high rates of capital investment drove the continued expansion of the Philippine economy, enabling it to outpace all of its major regional peers—including China, Vietnam, Indonesia, Thailand, Malaysia and Mongolia—during the first half of the year.

Robust capital formation, bolstered by pre-election investment frontloading, played a key role in the recent expansion. Capital formation was the principal engine of growth in the first six months of 2016, followed closely by private consumption (Figure 1). As in previous election years, businesses frontloaded investment in the first two quarters to hedge against political

uncertainties. The rate of capital formation rose from 16.7 percent in the first half of 2015 to 27.1 percent in the first half of 2016. Investment in durable equipment expanded by 41.1 percent, while investment in construction grew by 13.6 percent. This resulted in the Philippines catching up to the investment levels in the region.² Whether this increase in investment will generate significant consumption spillovers in subsequent quarters remains uncertain, as investments in construction and durable equipment tend to primarily benefit owners of land and capital, real estate managers and construction workers, with a more modest impact on the middle-income households that have the highest propensity to consume.

Private consumption grew at its fastest pace since 2012, as households benefitted from low inflation and interest rates, strong remittances inflows and a high degree of economic confidence. Household consumption grew by 7.2 percent year-on-year in the first half of 2016. Inflation averaged just 1.3 percent, boosting real household purchasing power, while low interest rates supported an expansion in consumer lending. Strong remittance inflows further bolstered household consumption,³ as the share of overseas workers continued to increase. A healthy job market, stable commodity prices, sufficient government social assistance and enthusiasm for the new government dramatically increased consumer confidence, and survey data from the second quarter of 2016 showed Filipino consumers to be the most optimistic in the world.⁴

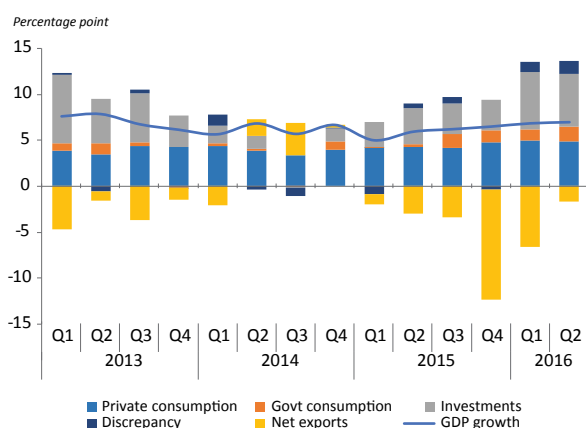
¹ The WTO recently lowered its 2016 forecast for global merchandise trade growth to 1.7 percent. See: WTO (2016).

² In the first half of the year, Philippine gross fixed investment reached 23.7 percent of GDP, higher than the average of 20.3 percent in 2010-2015. In comparison, the six-year average is 24.8 percent of GDP in Malaysia, 25.3 percent in Thailand, and 32.1 percent in Indonesia.

³ According to the Bangko Sentral ng Pilipinas' Consumer Expectations Survey for the first and second quarters of 2016, 97 percent of surveyed households used remittances for food and other household consumption, 41 percent reported using remittances to increase savings, and only 5.5 percent reported using remittances for investment.

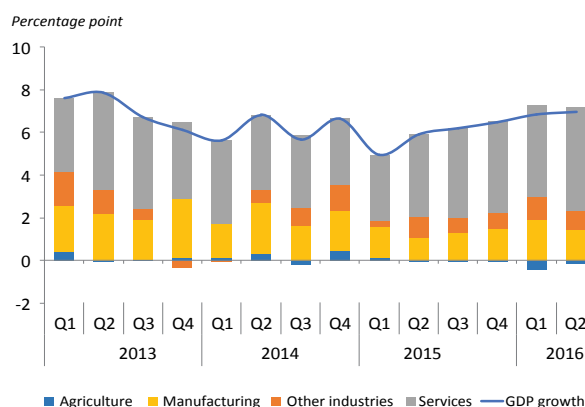
⁴ BSP Consumer Expectations Surveys, Q1 and Q2 2016; Quarterly Nielsen Global Survey of Consumer Confidence and Spending Intentions, Q2 2016; and the Social Weather Stations Survey, June 2016.

Figure 1: Consumption and investment drove demand-side growth during the first half of 2016, while net exports struggled



Source: Philippine Statistics Authority

Figure 2: Services and industry remained the primary engines of supply-side growth, but the agricultural sector contracted



Source: Philippine Statistics Authority

However, the global economic recovery remains weaker than expected, and net exports have contributed negatively to growth for six consecutive quarters.⁵ Exports expanded by 7.0 percent, year-on-year, in the first half of 2016, while imports grew by 19.9 percent. Exports of electronic components, which comprised more than half of total merchandise exports, grew by 8.3 percent, year-on-year, during the first half of 2016, up from 16.7 percent in the same period of 2015. The combination of a sluggish recovery among advanced economies and China's ongoing economic rebalancing continue to dampen demand for Philippine manufactures, which largely explains the disappointing performance of exports. Key agricultural exports remained weak, reflecting the poor overall output of the agriculture and fisheries sector. Meanwhile, investments in capital goods and the purchase of intermediate inputs drove import growth. Imports of office, electrical and telecommunications equipment rose as local industries expanded their productive capacity, while imported electronic components and semiconductors were used

to assemble electronics for export as part of a regional value chain.

On the production side, the service sector continued to thrive, and its growth rate accelerated from 2015. The service sector, which accounts for three-fifths of total economic output, grew by 8.0 percent, year-on-year, contributing 4.2 percentage points to overall growth in the first half of 2016 (Figure 2). Robust domestic consumption fueled the country's wholesale and retail trade, which expanded by 8.3 percent, while high domestic liquidity and rising demand for property supported growth in the finance and real estate subsectors.⁶ The rapid expansion of business services reflects the continued development of the country's information technology and business-process outsourcing (IT-BPO) industry, which is expected to create 225,000 new jobs and generate US\$25 billion in revenue in 2016. The IT-BPO industry has also had considerable spillover effects on other sectors such as trade, real estate and construction.

⁵ The net exports discussion in the growth section pertains to values at constant 2000 prices, which is different from the discussion on balance of payments, where net exports pertain to values at current prices.

⁶ <http://www.bworldonline.com/content.php?section=Letter%20to%20the%20Editor&title=letter--philippines-not-facing-a-real-estate-bubble-bsp-says&id=130621>

Manufacturing output continued to grow despite anemic export demand, but low global commodity prices caused the mining and quarrying sector to contract. Manufacturing grew by 7.2 percent in the first half of 2016, compared to just 5.3 percent in the previous year, pushing the overall growth rate of the secondary sector to 7.9 percent. Strong domestic demand supported the growth of manufacturing, while low oil prices reduced the cost of electricity⁸ and fuel. Other industrial subsectors also expanded rapidly; construction grew by 11.6 percent, and electricity, gas, and water utilities grew by 9.8 percent. However, the mining and quarrying subsector contracted by 0.7 percent, largely due to a reduction

in nickel ore output caused by low global commodity prices.⁹

The agricultural sector contracted by 3.3 percent in the first half of the year due to the lingering effects of El Niño, which diminished crop production by 5.6 percent and fishery output by 5.9 percent. Decades of underinvestment have contributed to both the low productivity of the agricultural sector and its vulnerability to extreme weather conditions. Formal lending to the sector remains low at just 4.0 percent of the total bank lending portfolio. Domestic credit constraints are exacerbated by the near-total absence of foreign investment in the sector over the past three years.

1.2 Financial Markets and Monetary Policy: Accommodative Financial and Monetary Conditions Are Facilitating Growth

Strong credit growth, especially lending to the real estate and construction sectors and to households, has contributed to the ongoing economic expansion. The credit-to-GDP ratio gradually increased to 45.7 percent in mid-2016, reflecting abundant domestic liquidity. But while the credit-to-GDP ratio has increased steadily over the past five years, it remains below the levels of peer countries, suggesting that the credit supply has room for further growth.

The composition of bank lending portfolios reflects the structure of the economy and recent sectoral growth dynamics. Together, real estate, construction and household consumption accounted for one-third of outstanding loans (Figure 3). Salary loans increased by 47.0 percent, year-on-year, in the first half of 2016, and motor vehicle loans rose by 33.4 percent, though each began from a low base. Lending to priority sectors such as

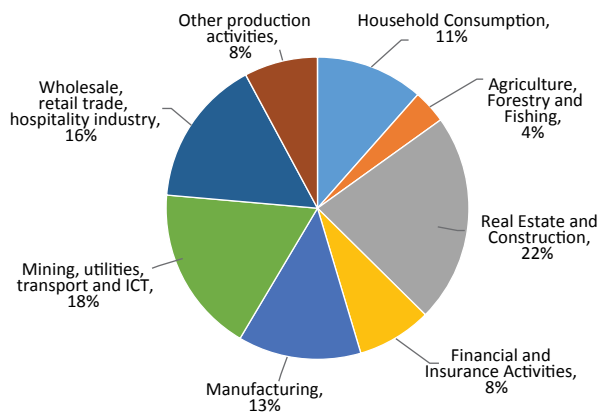
agriculture, however, remained weak despite mandatory targets (Box 1). After contracting through most of 2015 and 2016 (Figure 4), lending to the agricultural sector represented just 3.3 percent of total bank loans in June 2016. Overall, the extended period of strong nominal loan growth would appear to justify the central bank's continued focus on enhanced risk management.

With inflation rates well below the central bank's target, the authorities have pursued an accommodative monetary policy. Headline inflation rates in the first seven months of the year averaged 1.4 percent, while core inflation averaged 1.7 percent. Rising food prices pushed the headline inflation rate from 0.8 percent in July 2015 to 1.9 percent in July 2016, as an increase in meat, vegetables and sugar prices more than offset a decline in the price of rice caused by a strong harvest and low import prices. The continuing slump in global

⁷ <http://www.rappler.com/business/industries/174-outsourcing/125889-information-technology-bpm-bpo-dole-jobs>

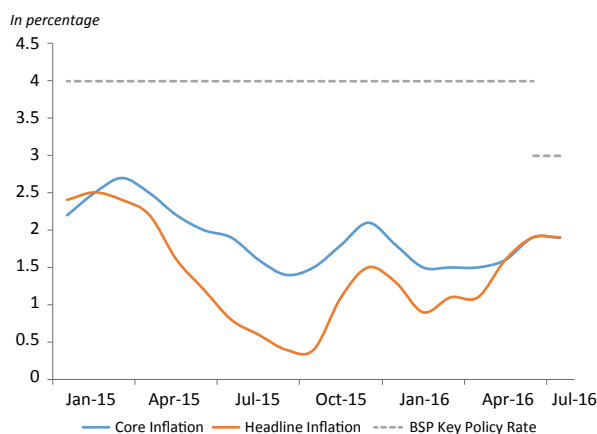
⁸ The average electricity tariff fell from PHP4.89/kwh in the second quarter of 2015 to PHP3.90/kwh in the second quarter of 2016 due to lower oil prices.

⁹ <http://news.abs-cbn.com/business/03/09/16/ph-miners-to-cut-nickel-ore-output-exports-as-price-slides>

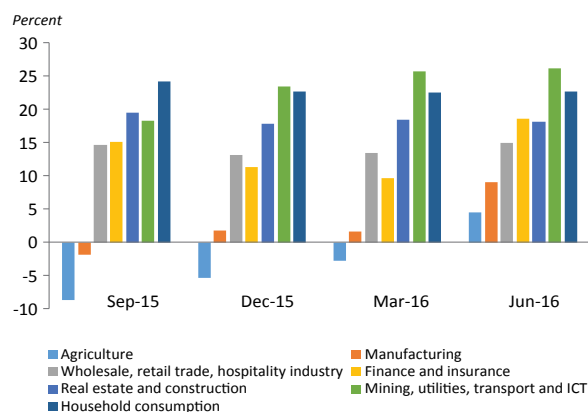
Figure 3: Real estate and construction represent the largest share of outstanding loans...

Source: BSP

crude oil prices eased inflationary pressures, and core inflation remained broadly stable at 1.9 percent between July 2015 and July 2016. Overall inflation levels remained below the central bank's 2-4 percent target band. Faced with low inflation the central bank further lowered the key policy rate by 100 basis points to 3.0 percent in June. (Figure 5).¹⁰ The growth

Figure 5: In June the central bank reduced the key policy rate as inflation remained low

Source: BSP

Figure 4: ...while credit growth to agriculture and manufacturing has been weak.

Source: BSP

of the broad money supply (M2) accelerated to roughly 12 percent in the first quarter and 14 percent in the second quarter of 2016, year-on-year.

The Philippine financial system remains stable and well capitalized. The share of nonperforming loans declined from 2.4 percent of total loans in June 2015 to 2.2 percent in June 2016. Philippine banks are well capitalized, and at 16.0 percent the capital-adequacy ratio is well above the 10 percent regulatory minimum set by the central bank. Total outstanding loans reached 6.9 trillion Philippine pesos (PHP) in June 2016, a 16.0 percent year-on-year increase driven by the surging demand of a growing economy. In addition, banks' return on equity remained stable at 10.0 percent in June 2016, while the share of interest income to total operating income increased from 70.0 to 74.0 percent as the growth of non-interest income slowed. Meanwhile, net interest margins remained unchanged at 3.3 percent.

¹⁰ The lower key policy rate coincided with the shift to the Interest Rate Corridor (IRC) system. The central bank has stated that the IRC reforms were primarily operational in nature and were not intended to materially affect prevailing monetary policy settings upon implementation. Inflation indicators for August indicate increasing pressure from core inflation, leaving little room for further monetary loosening.

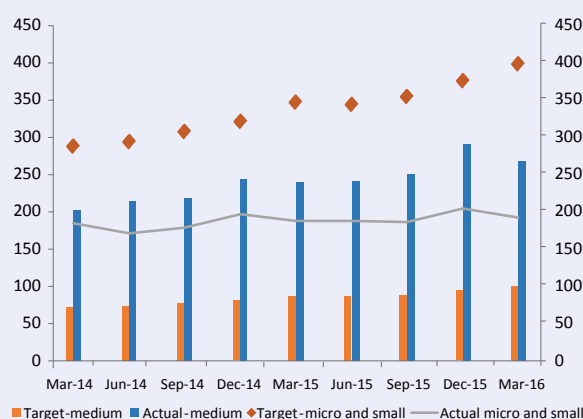
Box 1 Mandatory lending targets

Philippine law sets mandatory targets for lending to the agricultural sector and to micro, small and medium enterprises (MSMEs), with the objective of improving access to finance in these underserved sectors. Republic Act 10000, known as the Agri-Agra Law,¹¹ requires that all banks allocate 25 percent of their total loanable funds to borrowers in the agriculture and fisheries sector, and at least 10 percent of loanable funds must be devoted to beneficiaries of agrarian reform programs. Republic Act 9501, the so-called “Magna Carta for MSMEs,”¹² requires that all banks allocate at least 8 percent of their loan portfolio to micro and small enterprises and at least 2 percent to medium enterprises.

An analysis of bank compliance with mandatory lending targets reveals that the banking system as a whole has struggled to expand lending to MSMEs and the agricultural sector. Over the past five years lending to micro and small enterprises grew by an average of 3 percent per year, and lending to medium enterprises grew by 13 percent, while lending to agriculture declined. At the same time, the total lending portfolio expanded at an average rate of 25 percent annually. Despite the lending targets, the pace of credit growth in priority sectors was significantly lower than that of the overall lending portfolio. The Philippine experience with lending targets is not unique, and the international evidence reveals that similar targets are frequently ineffective.

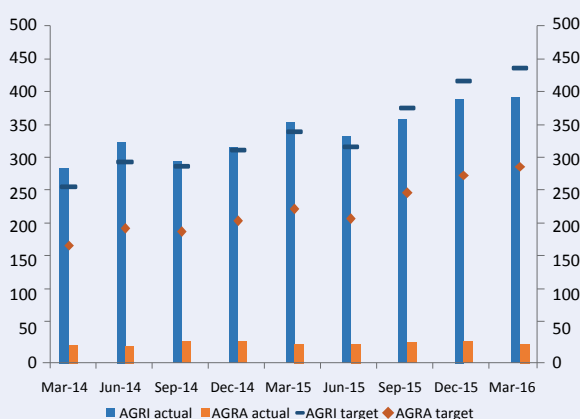
Lending to the agricultural sector and MSMEs, especially micro and small firms, is inherently risky and requires a specialized approach to product development and risk management. Mandating that all lenders allocate a given share of their total loans to targeted firms and sectors does not necessarily create incentives for new specialized lenders to enter the market or for banks that already lend to targeted borrowers to expand their operations. The authorities could better leverage specialization by allowing lenders that focus on MSMEs or the agricultural sector to “trade” their excess loans to more traditional lenders.

Figure 6: Lending to micro and small enterprises has stagnated at about 50 percent of the target level



Source: BSP

Figure 7: Lending to the agricultural sector remains low, especially lending to agrarian-reform beneficiaries



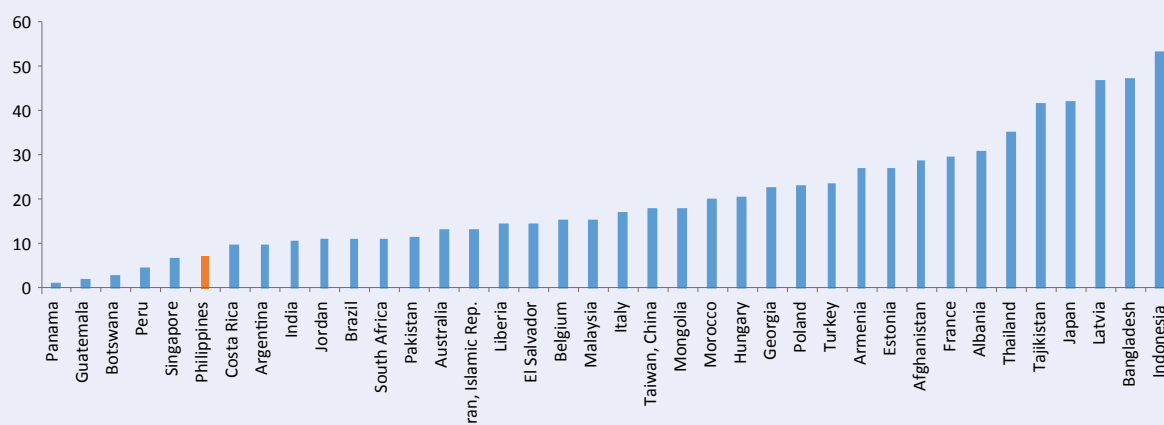
Source: BSP

¹¹ Republic Act No 10000. An Act Providing for an Agriculture and Agrarian Reform Credit and Financing System Through Banking Institutions. <http://www.bsp.gov.ph/regulations/laws/RA10000.pdf>

¹² Republic Act No. 9501. Magna Carta for Micro, Small, and Medium Enterprises (MSMEs). http://www.lawphil.net/statutes/repacts/ra2008/ra_9501_2008.html

Market dynamics are further undermining banks' ability to meet agricultural lending targets. The declining share of agricultural lending across the financial system at least partially reflects decreasing demand due to the sector's low growth rate. Accelerating growth in agriculture and among MSMEs will require addressing structural obstacles as well as financial constraints. When well designed and properly managed, alternative risk-mitigation instruments such as guarantees and insurance have proven effective. While the Philippines has a number of institutions dedicated to providing such guarantees and insurance products for MSMEs and agricultural producers, they will not be able to fulfill their potential unless all elements of the financial system—including credit information, collateral registration, contract enforcement, equity financing and risk-mitigation mechanisms—can be more fully developed.

Figure 8: Lending to MSMEs represents a relatively small share of total lending in the Philippines



Source: BSP, WB staff calculations

1.3 Exchange-Rate Dynamics and the External Sector: International Reserves Are at a Record High Despite a Trade Deficit

The Philippine peso continued to weaken in the first nine months of 2016 as the ongoing US economic recovery heightened anticipation regarding the normalization of US interest rates. Month-on-month exchange-rate movements fluctuated from PHP/US\$47.5 at the beginning of the year to PHP/US\$46.3 in April, and the peso's value declined again in July. Previous episodes of volatility reflected unstable oil prices, a shift to a more accommodative monetary policy in Japan, the outcome of the UK's "Brexit" referendum and pre-election uncertainty. The peso continued to depreciate after the election and in August, the peso depreciated by 1.2 percent, year-

on-year, while the real effective exchange rate depreciated by 3.6 percent in the same period. In September its lowest level in seven years, by the time this report went to press, the peso had depreciated by 3.2 percent year-on-year. The peso's general weakening is likely due to the slowly rebounding US economy and the pending normalization of US interest rates. Despite the weaker peso, international demand for Philippine exports remained modest as China's economic rebalancing, coupled with slow growth among major advanced economies, continued to dampen global merchandise trade (Box 2).

Although the trade deficit widened, the balance of payments (BOP) remained in surplus. The BOP surplus plummeted by 62 percent, from US\$1.68 billion in the first half of 2015 to US\$634 million in the first half of 2016 (Table 1). The widening trade deficit also weakened the current-account balance, which has been in deficit since January. Rising service exports, mainly in the IT-BPO and tourism industries, and robust remittances partially

offset the poor performance of merchandise exports. Sustained demand for skilled Filipino workers in overseas labor markets continues to generate strong and stable remittance inflows. However, the growth of new hires abroad decreased in the first six months of the year, with a precipitous 55.6 percent year-on-year drop in sea-based new hires outpacing a slight 0.9 percent year-on-year increase in land-based new hires.

Table 1: The balance of payment, 2013 to 2016

	H1 2014		H2 2014		H1 2015		H2 2015		H1 2016	
	In millions US\$ / In percentage of GDP									
Current account	4,071	3.0	6,684	4.5	5,257	3.7	2,437	1.6	778	0.5
Goods	(8,028)	(5.9)	(9,302)	(6.2)	(9,528)	(6.7)	(13,781)	(9.2)	(16,395)	(11.2)
Services	1,261	0.9	3,315	2.2	2,330	1.6	3,310	2.2	3,577	2.4
Primary Income	96	0.1	631	0.4	851	0.6	1,005	0.7	1,409	1.0
Secondary Income	10,742	7.9	12,040	8.1	11,603	8.1	11,903	8.0	12,187	8.3
Capital and Financial accounts	(4,942)	(3.6)	(4,582)	(3.1)	(1,489)	(1.0)	(1,620)	(1.1)	240	0.2
Capital account	55	0.0	53	0.0	52	0.0	58	0.0	80	0.1
Financial account	4,996	3.7	4,635	3.1	1,541	1.1	1,678	1.1	(160)	(0.1)
Direct investment	(829)	(0.6)	1,843	1.2	103	0.1	(239)	(0.2)	(2,149)	(1.5)
Net acquisition of financial assets	2,102	1.6	4,651	3.1	2,253	1.6	3,445	2.3	2,042	1.4
Net incurrence of liabilities ^{1/}	2,931	2.2	2,807	1.9	2,150	1.5	3,684	2.5	4,191	2.9
Portfolio investment	2,162	1.6	547	0.4	2,907	2.0	2,459	1.6	2,097	1.4
Financial derivatives		-		-	(30)	(0.0)	35	0.0	62	0.0
and other investments	3,664	2.7	2,245	1.5	(1,439)	(1.0)	(577)	(0.4)	(170)	(0.1)
Net unclassified items ^{2/}	(3,274)	(2.4)	(817)	(0.5)	(2,083)	(1.5)	116	0.1	(385)	(0.3)
Overall BOP position	(4,144)	(3.1)	1,286	0.9	1,684	1.2	933	0.6	634	0.4
Memo:										
Basic Balance	4,900	3.6	4,841	3.2	5,153	3.6	2,676	1.8	2,927	2.0

^{1/} Net incurrence of liabilities refers to net foreign direct investment to the Philippines.

^{2/} The term "Net unclassified items" is a balancing figure. There are two methods of computing the BOP position: the first approach uses account, capital account less financial account. The two measures do not necessarily tally. The BSP uses the first approach to determine the overall BOP position.

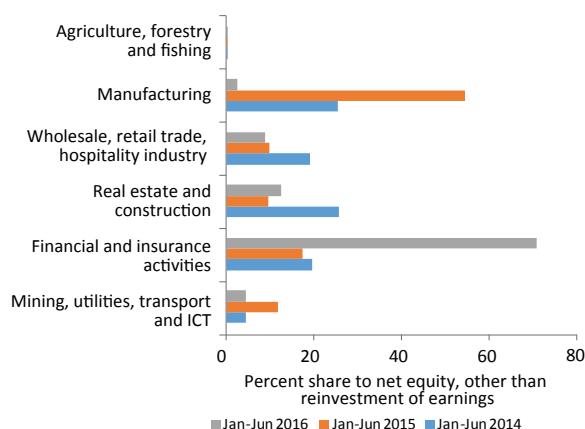
¹³ Moving forward, the softer demand for overseas Filipino workers from the Middle East amidst low oil prices, and the de-risking activities in foreign banks remain a risk for the sustained growth of remittances in 2016. These risks were discussed in the April 2016 edition of the *Philippines Economic Update*.

The Philippines registered a US\$0.2 billion net inflow in both the financial and capital accounts in the first half of the year. This is a reversal from the US\$1.5 billion net outflows recorded in the same period last year, driven by strong direct investment as net FDI inflows doubled to US\$4.2 billion in January-June compared to the same period a year ago. Seventy percent of new FDI went to the financial sector, largely a result of the full liberalization of the country's banking industry, and 12.3 percent to the real estate and construction sectors (Figure 9). The country continues to enjoy investment grade ratings from all three major credit rating agencies.¹⁴ Despite this strong performance, FDI in the Philippines remains among the lowest in the region, as the country's long foreign investment negative list has limited FDI growth. Meanwhile, portfolio investments registered net outflows given the higher net acquisition of

foreign assets by residents compared to foreign portfolio investments entering the country.

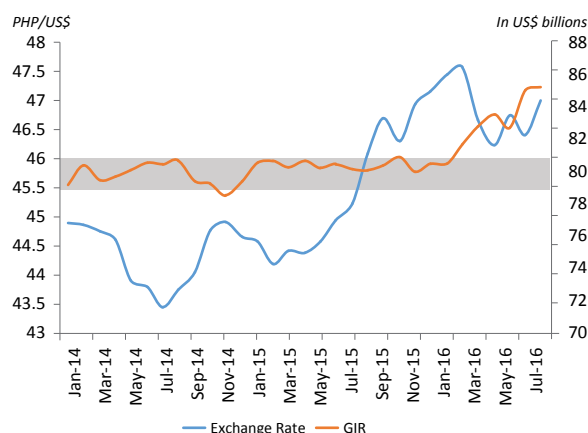
By midyear the BOP surplus had pushed gross international reserves (GIR) to an all-time high. GIR reached a record US\$85.3 billion at end-June, equivalent to 10.4 months of goods imports. Roughly 85 percent of GIR are in the form of foreign investment, 10 percent are in gold, and the balance are in various foreign currencies, Special Drawing Rights and reserves positions at the IMF. The volume of GIR grew by 5.8 percent, year-on-year, from US\$80.6 billion in June 2015 to US\$85.3 billion in June 2016. This stands in stark contrast to 2014 and 2015, when the volume of GIR remained in a narrow band around US\$80 billion (Figure 10). Because it serves as a vital buffer against external shocks, the rising stock of GIR is an important indication of robust economic fundamentals.

Figure 9: Most FDI has focused on the financial and manufacturing sectors



Source: BSP

Figure 10: The peso depreciated, and gross international reserves reached record highs



Source: BSP

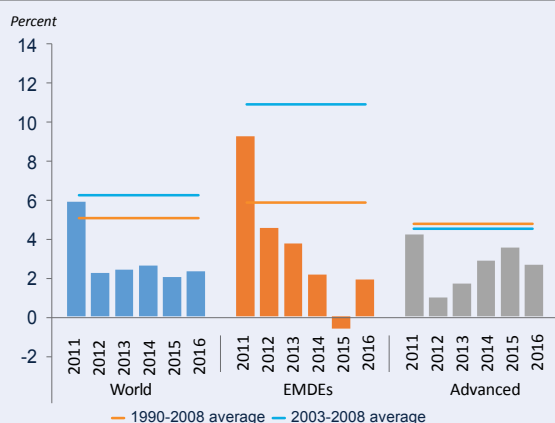
¹⁴ Standard & Poor maintained the country's BBB Stable long-term sovereign credit rating on September, 2016. In addition, Fitch Ratings currently rates the Philippines as BBB-positive investment grade and Moody's Investor Service rates the Philippines as Baa2 stable investment grade.

Box 2 The poor performance of global merchandise trade and the resilience of service exports

Low international commodity prices, China's shift towards a slower but more sustainable growth path, and an anemic recovery among advanced economies continue to undermine the growth of global merchandise trade. The trade slowdown has reflected a combination of structural and cyclical headwinds, with the latter accounting for about two-thirds of the observed deceleration in global trade last year.¹⁵ Lower commodity prices have resulted in falling real incomes and sharp currency depreciations among commodity exporters, substantially reducing their merchandise imports. This import contraction has been particularly pronounced in Brazil and Russia, but a general slowdown has been observed across most commodity exporters. Since commodity exporters purchase about 20 percent of the exports produced by other emerging markets and developing economies, falling commodity prices have also had an adverse impact on non-commodity exporters. Meanwhile, China's economic rebalancing has reduced its demand for industrial commodities and intermediate goods. Subdued industrial activity and low rates of capital investment in the manufacturing sectors in the US and euro zone compounded this trend. Feeble global investment—reflecting mediocre growth, deleveraging pressures in advanced economies, and a maturing credit cycle in EMDEs—could continue to cap the growth of goods trade throughout 2016.

The global trade in services appears to be more resilient to low oil prices than the merchandise trade, as it is more closely linked to consumer spending and income growth among major oil importers. The services trade now accounts for one-fifth of the total global trade volume and half of global trade value-addition.¹⁶ While barriers to the services trade have fallen globally, important obstacles remain in many smaller economies.¹⁷ Over time, the share of services in global trade is expected to continue to increase, especially IT-BPO and other IT-based sectors.¹⁸

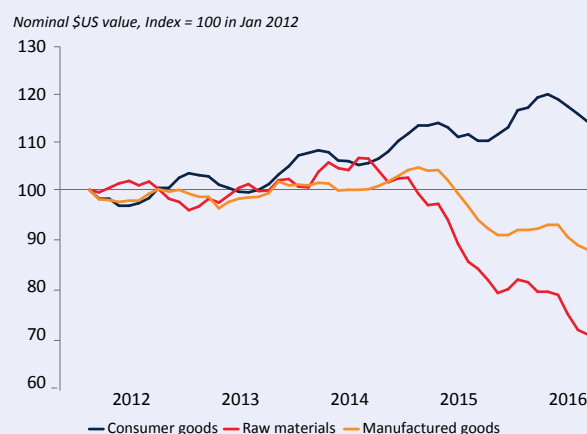
Figure 11: Global import growth has remained broadly stable as a recovery in advanced economies has offset a decline in emerging markets and developing countries



Source: World Bank

Notes: A. Goods and services import volume. 2016 is a forecast.

Figure 12: Low oil prices and China's rebalancing are reducing global commodity and manufacturing imports, but contributing to a rise in goods imports



Source: Haver Analytics

¹⁵ Constantinescu, Mattoo and Ruta, 2016.

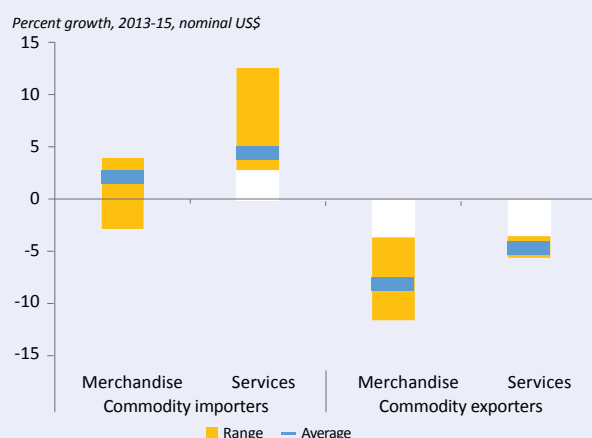
¹⁶ Hollweg *et al.*, 2015.

¹⁷ Anderson *et al.*, 2015.

¹⁸ Freund, 2016; Manyika *et al.*, 2016.

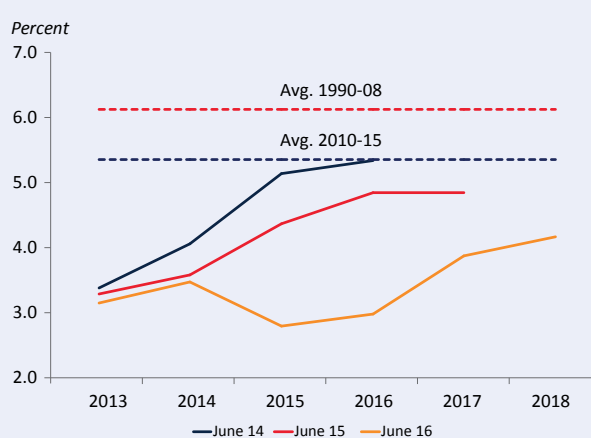
Despite the resilience of services, global trade growth is expected to remain weak in 2016. Following a pattern of repeated and significant downward revisions, global trade forecasts for 2016-17 have been lowered once again,¹⁹ reflecting evidence of a deteriorating relationship between global trade and economic activity. After growing roughly in line with global economic output in 2015, global trade growth is expected to marginally outperform global economic growth during the forecast period. Over the medium term, maturing supply chains, slowing trade liberalization and persistent weakness in global investment are expected to hinder global trade growth. Lingering weaknesses in the global merchandise trade diminish the scope for productivity gains through specialization and the diffusion of technologies in global value chains.²⁰ This process is expected to cause global trade growth to fall back in line with global economic growth. A shift from truly global supply chains to regional ones could accelerate this process.²¹

Figure 13: Services are outperforming merchandise exports, especially among commodity importers



Source: World Trade Organization

Figure 14: Forecasts for global trade growth have been repeatedly revised downward over the past three years



Source: World Bank

Sources: World Bank, World Trade Organization, CPB Netherlands Bureau for Economic Policy Analysis, UN Comtrade.

A. Goods and non-factor services import volume. 2016 is a forecast.

B. Major commodity importers are United States, China, and Euro Area. Consumer goods are defined as Foods, Tobacco, Beverages, and Automobile Vehicles. Raw materials are defined as Crude Materials, Mineral Fuels, Animals and Vegetable Oils, Chemical and Related Products. Industrial goods are defined as Industrial Supplies and Materials, Manufactured Goods, Machinery and Transport Equipment, Miscellaneous Manufacturing Articles, Commodities and Transactions. Last observation is March 2016.

C. Selected emerging and developing economies are 6 commodity importers (Mexico, Turkey, Philippines, Thailand, India, and China) and 5 commodity exporters (Russia, Brazil, Indonesia, South Africa, and Malaysia). Average of growth for the period of 2013Q1-2015Q4.

D. Global trade measured as the sum of import and export volumes of goods and non-factor services. Excerpt from WB Group report *Global Economic Prospects, June 2016: Divergences and Risks*.

¹⁹ In September the WTO reduced its global trade forecast for 2016 from 2.8 percent to 1.7 percent and cut its 2017 forecast from 3.6 percent to 1.8-3.1 percent. See: WTO (2016).

²⁰ Melitz, 2003; Ahn *et al.*, 2016.

²¹ Srinivasan *et al.*, 2014.

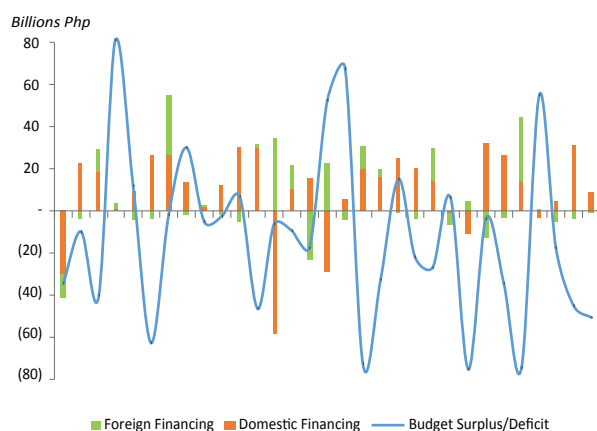
1.4 Fiscal Policy: The New Administration Attempts to Maintain Fiscal Sustainability while Implementing an Ambitious Spending Program

The government's fiscal balance swung into deficit in the first half of the year, as rising expenditures outpaced revenue growth. A surge in election-related spending, combined with efforts to improve budget execution, caused public expenditures to accelerate in the first half of 2016.²² This caused the budget surplus of PHP14 billion (or 0.2 percent of GDP) recorded in June 2015 to plunge to a deficit of PHP120 billion (or 1.7 percent of GDP) by June 2016, though it remained below the statutory deficit ceiling of 2.0 percent of GDP. Domestic borrowing financed 94.4 percent of the budget deficit, and total financing shot to PHP110.3 billion, seven times the level recorded in mid-2015 (Figure 15). Nevertheless, rapid GDP growth caused the public debt burden to decline from 44.8 of GDP percent in June 2015 to 43.0 percent in June 2016 (Table 2).

As public spending increased in the first half of 2016, so did revenue collection. Public spending rose by 14.0 percent in the first half

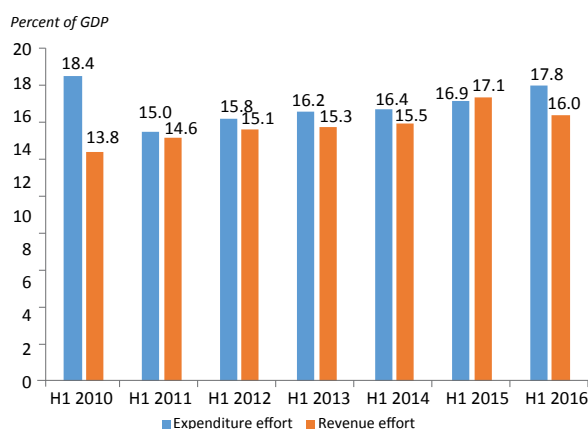
of the year to PHP1.1 trillion, or 17.8 percent of GDP (Figure 16). Infrastructure spending rapidly accelerated as the government frontloaded investment expenditures in order to comply with a ban on public spending immediately before elections.²³ Nevertheless, by mid-2016 the authorities had executed just 11.9 percent of the annual budget. Improvements in revenue collection boosted total public revenue by 0.7 percentage points to 14.3 percent of GDP in the first six months of 2016. Economic growth and enhanced tax administration caused tax revenues to rise by 10.0 percent, year-on-year,²⁴ without any increase in tax rates or other policy changes. Bureau of Internal Revenue (BIR) collections increased by 11.0 percent, while Bureau of Customs (BOC) collections increased by 6.7 percent. In an effort to improve the efficiency of the BOC the government passed Republic Act (RA) 10863, also known as the Customs Modernization and Tariff Act, in May 2016.²⁵

Figure 15: Domestic financing almost totally covered the budget deficit during the first half of the year



Source: BTr

Figure 16: Election-related spending and improvements in budget execution led to a significant increase in public expenditures



Source: BTr, PSA

²² For a more detailed exploration of the government's efforts to address budget procurement and execution bottlenecks, see the October 2015 edition of the *Philippines Economic Update*.

²³ Under the Omnibus Election Code, public officials are not allowed to disburse public funds less than 45 days before the regular election except for: (a) maintenance of existing public works projects, (b) work executed through private contracts, (c) project planning and preparations that do not include actual construction, and (d) emergency response and disaster relief projects.

²⁴ Upgraded IT systems and improved business processes significantly boosted the collection efficiency of the BIR.

²⁵ The new legislation is designed to modernize customs laws, rules and procedures in order to enhance the efficiency and transparency of the BOC.

Table 2: The fiscal accounts, 2013-H1 2016

	2013 (actual)	2014 (actual)	2015 (as programmed)	2015 (actual)	H1 2016 (as programmed)	H1 2016 (actual)	2013 (actual)	2014 (actual)	2015 (as programmed)	2015 (actual)	H1 2016 (as programmed)	H1 2016 (actual)
	(In billions Php)						(In percent of GDP)					
Revenues (in billions Php)	1,716.1	1,908.5	2,275.2	2,109.0	1,065.7	1,101.0	14.9	15.1	16.0	15.8	15.5	16.0
Tax revenues	1,535.7	1,719.0	2,127.6	1,815.5	969.5	982.0	13.3	13.6	15.0	13.6	14.1	14.3
Taxes on net income and profits	718.2	784.9	993.6	846.2	-	-	6.2	6.2	7.0	6.4	-	-
Taxes on property	3.6	5.5	5.0	5.6	-	-	0.0	0.0	0.0	0.0	-	-
Taxes on domestic goods and services	509.0	560.5	692.5	596.1	-	-	4.4	4.4	4.9	4.5	-	-
Taxes on international trade and transactions	304.9	369.3	436.6	367.5	=	=	2.6	2.9	3.1	2.8	=	=
Non-tax revenues	180.7	189.3	145.6	293.4	103.1	118.9	1.6	1.5	1.0	2.2	1.5	1.7
Grants	0.3	0.2	0.0	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Expenditure (in billions Php)	1,880.2	1,981.6	2,558.9	2,230.6	1,385.7	1,221.3	16.3	15.7	18.0	16.8	20.2	17.8
Current operating expenditures	1,519.2	1,616.7	1,985.7	1,784.9	1,048.5	922.5	13.2	12.8	14.0	13.4	15.2	13.4
Interest payments	323.4	321.2	361.8	309.4	194.3	153.7	2.8	2.5	2.6	2.3	2.8	2.2
Capital outlays	344.3	351.5	546.7	436.0	328.5	294.6	3.0	2.8	3.9	3.3	4.8	4.3
Net lending	16.6	13.4	26.5	9.7	8.6	4.1	0.1	0.1	0.2	0.1	0.1	0.1
Deficit (in billions Php)	-164.1	-73.1	283.7	-121.7	-	-120.3	-1.4	-0.6	2.0	-0.9	-	-1.7
National government debt	5,681.2	5,735.2	-	5,954.5	-	5,948.0	49.2	45.4	-	44.8	-	43.0

Source: Bureau of Treasury, Department of Budget and Management, PSA

Note: 1. Revenue targets for H1 2016 based on projected revenue based on the 2017 BEF.

2. H1 2016 expenditure breakdown (as programmed) is based on the 2016 DBCC national government disbursement performance as of June 2016.

The new administration submitted its proposed budget to the legislature on August 15th, shedding new light on the government's policy agenda. The draft budget lays out the government's fiscal policy priorities for 2017 and beyond. It calls for raising the deficit ceiling from 2.0 to 3.0 percent of GDP from 2017 to 2022, in order to allow for increased spending on infrastructure, social services and rural development as part of an effort to promote more inclusive growth (Box 3). Budget

hearings began on August 22nd, and the start of plenary debate in the House of Representatives is scheduled for September 26th. The House of Representatives is expected to complete its third and final debate by the third week of October and then pass the draft budget to the Senate.²⁶ If the approved House and Senate versions differ, a bicameral conference committee will be convened for deliberation, and President Duterte is expected to sign the new budget into law by December.

Box 3 The Duterte administration's inaugural budget

The proposed 2017 budget reflects the new government's 10-point socioeconomic agenda. The proposed PHP3.35 trillion budget would increase spending by 11.6 percent over the 2016 budget in an effort to alleviate binding constraints on the creation of high-quality jobs. The proposed budget would increase infrastructure investment to 5.4 percent of GDP in order to address infrastructure bottlenecks and enhance connectivity between the country's wealthier and poorer areas. Agriculture and rural development are a major expenditure priority, as the government is striving to modernize the agricultural sector and foster inclusive rural development. The budget also calls for boosting education and health spending from a combined 4.7 percent of GDP to 5.3 percent. The increased education budget would finance the construction of 37,500 new classrooms, the hiring of an additional 53,831 teachers and the provision of private-school scholarships to 2.7 million students.

The Duterte administration's emphasis on the rule of law is underscored by a large proposed expansion in the budget for the police, the military and the justice system. The budget proposal includes a 24.6 percent increase in spending on the Philippine National Police and a 15 percent increase in spending on the Armed Forces of the Philippines

In addition to its short-term budgetary priorities, the new government has also outlined its medium-term fiscal plan. The most significant departure from the previous administration is the proposed increase in the deficit ceiling to 3 percent of GDP, which the administration regards as sustainable in the medium term. In a recent budget address President Duterte stated that the higher deficit limit will allow the government to continue to increase spending on infrastructure, rural development and social services. In parallel with its planned expenditure increases the government has launched an initiative to reform the tax system by increasing tax collections, enhancing systemic efficiency and promoting fiscal equity. The government expects these measures to boost tax revenue from a projected 14.5 percent of GDP in 2017 to 16.1 percent in 2018.

²⁶ <http://www.mb.com.ph/p3-3-t-budget-up-for-deliberation/>

1.5 Employment and Poverty: Progress Continues, but Unresolved Constraints Limit Gains in Critical Areas

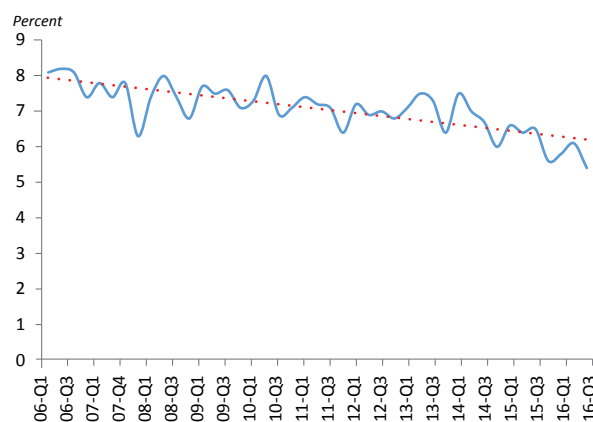
Robust economic growth and an expansionary fiscal policy accelerated job creation in 2016, but persistently high rates of underemployment remain a key challenge. In the second quarter of 2016 the service sector continued to lead net job generation (1.4 million), followed by industry (0.8 million); meanwhile, the agricultural sector continued to post significant job losses (-1.5 million). Strong and sustained economic growth has caused the unemployment rate to decline steadily over the past decade, from about 8 percent in 2012 to just 6 percent in the first half of 2016 (Figure 17). However, the quality of employment remains limited. In the first six months of 2016 the underemployment rate increased by 1.1 percentage points, year-on-year, to 19.0 percent, broadly in line with its decade average (Figure 18). The persistence of high rates of underemployment despite years of robust growth highlights important structural issues in the labor market. In particular, the pervasiveness of irregular employment prevents workers from reaping the full benefits of economic growth (Box 4).

Rising nonagricultural household income and the government's social protection programs continue to improve the welfare of the poor. Recent estimates indicate that the extreme

poverty rate gradually declined between 2012 and 2015, as real household income steadily increased. While a series of natural disasters, including a record number of typhoons, undermined these gains, social protection programs were able to mitigate the damage to household welfare. The extreme poverty rate, measured at the international poverty line of US\$1.90 per day in 2011 purchasing-power parity terms, fell from 10.6 percent in 2012 to 8.4 percent in 2015. The decrease in extreme poverty in recent years was driven in part by the country's conditional cash transfer program, which accelerated income growth among the poorest households.

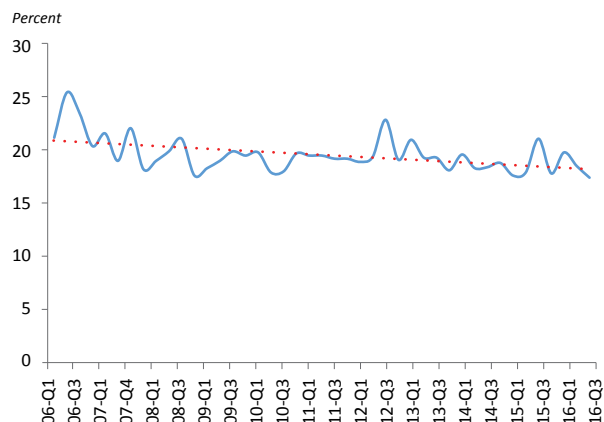
Perception-based survey data indicate that poverty continued to decline during the first half of 2016. Perception-based survey data can provide an early indication of poverty trends that complements official estimates (Box 5). In the first six months of the year, self-rated poverty and self-rated food poverty data from the Social Weather Station revealed continued progress toward more inclusive growth. Self-rated poverty at the household level declined by 5.5 percentage points to 45.5 percent of the population, year-on-year, while 35 percent of the population rated themselves as food poor, the lowest share in over five years.

Figure 17: Rapid GDP growth and expansionary fiscal policies have resulted in a steady decline in the unemployment rate



Source: Philippine Statistics Authority (PSA)

Figure 18: However, underemployment remains persistently high due to structural issues in the labor market



Source: Philippine Statistics Authority (PSA)

Box 4 The challenge of irregular employment

Irregular employment is increasingly common in the Philippines. According to the most recent Labor Force Survey about 25 percent of workers in the formal private sector were employed on an irregular basis in 2014, and there is evidence that this share has increased substantially in recent years.²⁷ While some firms use temporary contracts to hire seasonal or short-term workers, the pervasiveness of these contracts reflects a substantial gap in the employment benefits and protections afforded to temporary and permanent employees. Temporary contracts allow employers to hire workers without providing the benefits that are due to a permanent employee, and to terminate workers without incurring the administrative and monetary costs involved in the formal termination process.

Although temporary contracts, subcontracting and other forms of employment are legal and may serve a legitimate purpose in principle, in practice they are frequently abused. For example, some firms terminate and then rehire the same worker every five months, a practice known as “5-5-5,” in order to circumvent the Labor Code’s provisions on employment security. Similarly, “labor-only subcontracting” allows employers to evade the requirements of regular employment contracts, including employee benefits and employment protections. In particular, the high cost of terminating permanent contracts gives employers a strong incentive to use fixed-term, project-based or seasonal contracts, which are much easier and cheaper to terminate.²⁷

The use of temporary contracts contributes to a bifurcated labor market, in which secure permanent jobs exist alongside precarious temporary jobs. In the Philippine labor market, workers doing similar jobs often receive very different levels of benefits and job security, which is inefficient from both a social and an economic perspective. Temporary workers, whose future employment is highly uncertain, are less likely to invest in job-specific skills. For the same reason, employers are also less likely to invest in the skills of temporary workers. As a result, pervasive irregular employment tends to hinder human capital formation and reduce labor productivity.

Policymakers can limit the abuse of temporary contracts either by strengthening the enforcement of existing regulations or by reforming those regulations to alter employer incentives. While tighter enforcement could marginally reduce the frequency of irregular contracts, this strategy would be costly and difficult to implement effectively. Indeed, the incidence of irregular employment is currently rising in OECD countries despite efforts to curb it.²⁹ Alternatively, policymakers could attempt to narrow the cost gap between permanent and temporary contracts. This could be achieved through regulatory reforms designed to reduce the costs of permanent contracts, increase the costs of temporary contracts, or a combination of both.³⁰

A more radical approach would be to introduce a single employment contract (SEC) in order to eliminate the division between permanent and temporary employment. Under an SEC, all contracts are open-ended, but the administrative procedures governing termination are relatively relaxed; instead, employment protection is provided via severance pay, the amount of which increases with job tenure. Legal recourse is limited to cases of discrimination or violations of worker rights.³¹ In the Philippines an SEC would increase protections for irregular workers, but it would reduce protections for regular workers. From the employer’s perspective, an SEC would be more flexible than a regular permanent contract, but less flexible and costlier than the current range of temporary contracts. For these reasons, introducing an SEC could be an effective means of achieving the government’s goal of “crafting a set of rules and regulations that are more holistic in orientation and at the same time more easily implementable and enforceable.”³²

²⁷ World Bank, 2016.

²⁸ World Bank, 2013 and World Bank, 2016.

²⁹ OECD, 2014.

³⁰ For examples see Rutkowski (2016).

³¹ Several SEC variations are discussed in Rutkowski (2016), including a recent SEC law passed in Italy.

³² Bello, 2016.

Box 5 Perception-based poverty measures

The Philippine Statistics Authority has released official poverty estimates from the Family Income and Expenditure Survey (FIES) every three years since 1988, and it has produced first-semester estimates using the Poverty Indicators Survey each year since 2013. Nevertheless, the timeliness of poverty data has long posed a significant challenge to poverty research. Moreover, the official estimates have undergone multiple methodological revisions, which limit time-series analysis. In this context, alternative estimation measures can help close gaps in the data and provide important complementary information on the evolution of poverty trends.

Surveys that focus on self-rated monetary and food poverty can augment official poverty estimates by providing a qualitative perspective that reflects the experience of poor households. Even the most well-designed poverty line is ultimately an arbitrary number, and households that endure the externalities of economic growth but have limited access to its benefits may experience changes in subjective poverty that cannot be captured by official statistics. In the Philippines, the Social Weather Station, an international survey firm based in the Netherlands, has released self-rated poverty estimates since 1983. Its monetary-poverty estimates have been published quarterly since 1992, and its food-poverty estimates have been published quarterly since 1998. The frequency of the data allows for a detailed qualitative analysis of poverty trends in the Philippines.

However, perception-based, self-rated poverty measures are subject to their own unique caveats. The survey methodology for establishing self-rated poverty is limited and requires additional questions to validate its findings. Moreover, poverty is measured subjectively by the survey respondent (i.e. the head of household) and may not reflect the perceptions of the household as a whole. Nevertheless, the timeliness and frequency of self-rated surveys can provide early indications of emerging poverty dynamics and enable a more accurate analysis of long-term trends.

³³ Pradhan and Ravallion (2000) acknowledge the imbalance between objective-quantitative and subjective-qualitative poverty measures and suggest a hybrid approach.

³⁴ Raquiza, 2008.

PART II:

OUTLOOK AND RISKS

The Philippines' short-term growth prospects remain positive despite a number of medium-term risks and policy challenges. The GDP growth rate is projected at 6.4 percent in 2016, and while the World Bank expects growth to ease slightly to 6.2 percent in 2017 and 2018, this is a conservative forecast with significant upside risks. Meanwhile, the poverty rate is projected to decline further as rapid economic growth boosts real household income. The external environment is expected to gradually improve, but short-term policy uncertainty during the transition to the new political administration and capacity constraints on the execution of public infrastructure projects are expected to slow economy-wide growth. Swift action to address either or both of these risks could accelerate growth over the near term.

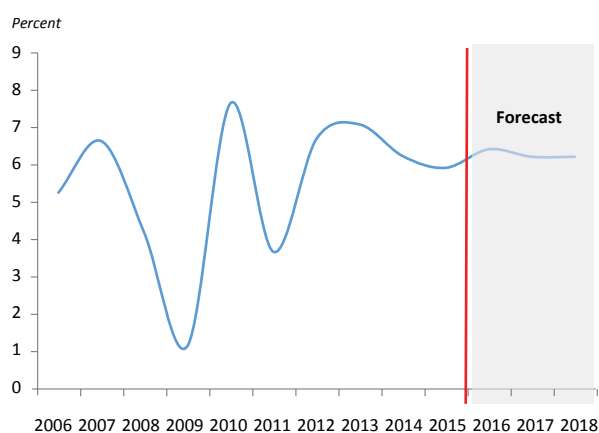


2.1 Growth Outlook: Prospects are Optimistic, with Risks Tilted to the Upside

The Philippines' growth outlook is positive and includes significant upside risks.

The World Bank projects real GDP growth rates of 6.4 percent in 2016 and 6.2 percent in 2017 and 2018 (Figure 19). These growth projections remain unchanged from the April 2016 edition of the Philippines Economic Update, which incorporated the potential impact of the recent election and included the assumption that public expenditures would rise through 2018. However, the current forecast assumes that capacity limitations may slow the implementation of large-scale public infrastructure projects, and that it could take longer to overcome these obstacles. Meanwhile, lingering uncertainty regarding the new administration's reform agenda will lead to caution among investors and consumers. However, if the government is able to successfully address these challenges, growth could exceed the rate of 6.2 percent projected for 2017-2018. These challenges notwithstanding, the Philippine economy continues to benefit from strong macroeconomic fundamentals and is projected to remain among East Asia's top growth performers over the short-to-medium term (Figure 20).

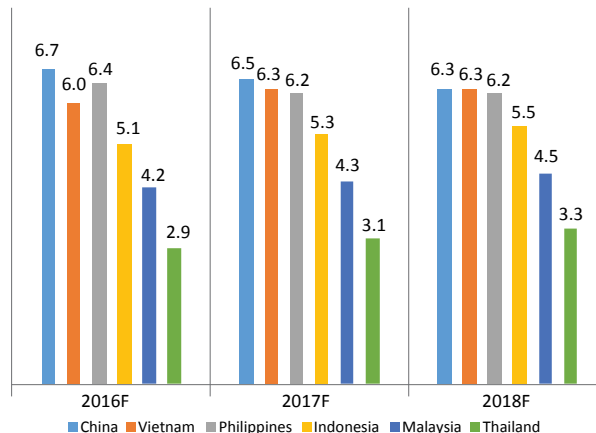
Figure 19: The annual GDP growth rate is projected to exceed 6 percent from 2016 through 2018...



Source: PSA, WB staff calculations

Our growth projection assumes that the government will maintain an expansionary fiscal stance. The government's plan to raise public investment is a good strategy to close the investment gap to other East Asian countries. While infrastructure spending is expected to accelerate in the next two years, it is challenging to reach the PHP860.7 billion allocated in the 2017 budget—which would represent a 13.8 percent increase over 2016—unless the government is able to rapidly expand its implementation capacity. However, if the new administration is able to remove key implementation bottlenecks, the rate of gross capital formation could exceed the current forecasts of 9.0 percent in 2017 and 8.3 percent in 2018, leading to higher overall growth rates. Together with the 2017 budget proposal, the new administration announced PHP7 trillion in new infrastructure spending over 2017-2022. The rollout of infrastructure spending would be partly accelerated through Public-Private Partnership (PPP) projects. In 2017 the government plans to increase the infrastructure budget to PHP860.7 billion, up 14 percent from 2016. While this would push the fiscal deficit to 2.7 percent in 2016 and 3.0 percent in subsequent years, the increase in the

Figure 20: ...and the Philippines is expected to remain among East Asia's fastest-growing economies



Source: WB staff estimates

Table 3: Economic indicators for the baseline projection

	2013	2014	2015	2016f	2017f	2018f
Real GDP growth, at constant market prices	7.1	6.2	5.9	6.4	6.2	6.2
Private consumption	5.6	5.5	6.3	6.8	5.9	5.7
Government consumption	5.0	3.2	7.8	9.7	8.2	7.7
Capital formation	27.9	5.2	15.1	17.4	9.0	8.3
Gross fixed capital investment	11.8	6.2	15.2	17.9	9.1	8.3
Exports, goods and services	-1.0	11.7	9.0	7.6	7.8	9.4
Imports, goods and services	4.4	9.3	14.0	13.7	8.9	9.6
Inflation (period average)	3.0	4.1	1.4	2.0	2.5	3.0
National government balance (% of GDP)	-1.4	-0.6	-0.9	-2.7	-3.0	-3.0
National government debt (% of GDP)	49.2	45.4	44.8	42.6	40.4	38.2
Current account balance	4.2	3.8	2.9	1.8	1.9	2.0

Source: PSA, BSP, BTr, WB staff estimates

projected GDP growth rate would lower the debt-to-GDP ratio from 44.8 percent in 2015 to 42.6 percent in 2016, with further declines in 2017 and 2018.

The growth projection reflects an accommodative monetary policy in a context of slowly rising inflation. The inflation rate is expected to average 2 percent in 2016 before rising to 2.5 percent in 2017 and 3.0 percent in 2018, well within the central bank's target range of 2-4 percent. Rebounding oil prices are expected to boost headline inflation in the second half of 2017. Crude oil prices are projected to level off at US\$39.7 per barrel this year before rising to US\$53.2 per barrel in 2017 and US\$59.9 per barrel in 2018. Meanwhile, a planned increase in the wages of military personnel and teachers, combined with the anticipated acceleration of public investment, is expected to intensify inflationary pressure on the supply side.

The growth forecasts of 6.4 percent for 2016 and 6.2 percent for 2017 assume that economic activity will normalize following the fiscal stimulus caused by the national election. After hitting 6.9 percent during the first half of the year, the GDP growth rate is expected to decline from the second half of 2016 through 2017. As public and

private investment return to equilibrium, the contribution of gross capital formation to growth is expected to diminish. Similar trends were observed during the 2013 and 2010 elections; policy uncertainty prompted firms to accelerate investment in the run-up to the election, while the government frontloaded public expenditures in order to comply with the ban on pre-election spending. As a degree of policy uncertainty is expected to persist during the transition to the new administration, no new major private investments are anticipated over the next 6-12 months.

Over the medium term the government's ability to accelerate infrastructure investment will have a major impact on the economy's growth trajectory. While consumption is likely to remain a mainstay of future growth, a sustained increase in capital formation driven by public infrastructure investment would accelerate growth on the supply side. In 2017 40 percent of the planned infrastructure budget will be allocated to the road network, railways, seaports and airports. While not all of these infrastructure investments are likely to be executed in the proposed timeframe, rising public investment levels could have both a direct impact on growth and important multiplier effects on the productivity of key sectors, including industry, real estate and

construction, and tourism. Gross capital formation is expected to be the single largest contributor to growth over the 2016-18 period. Slowing growth in 2017 and 2018 will result in part from base effects, as growth rates in 2015 and 2016 were already very high. However, if the government is able to fully implement all planned infrastructure projects, rates of gross capital formation could be even higher than anticipated, boosting overall growth in 2017 and 2018.

Domestic consumption is expected to remain the second-largest contributor to growth. Although the share of consumption is diminishing relative to other growth components, it still represents roughly two-thirds of total expenditures. Several factors are expected to support a robust increase in consumption over the projection period. First, the ongoing economic expansion should continue to boost the income of middle-class households, which have a high propensity to

Box 6 The global economic outlook

Global growth prospects have weakened over the past six months. The World Bank recently revised its global economic growth forecast for 2016 downward from 2.9 percent to 2.3 percent. Emerging markets and developing economies are facing stronger headwinds due to anemic growth among advanced economies, persistently low commodity prices, and lackluster global trade and capital flows. Commodity exporters continue to struggle to adjust to the protracted slump in global prices, while commodity importers are showing greater resilience to headwinds. However, low energy prices have delivered a surprisingly modest growth windfall. The global growth rate is projected to gradually accelerate to 2.9 percent by 2018 as commodity prices stabilize (Table 4).

Downside risks to the global outlook have intensified. Key sources of risk include deteriorating economic conditions among major commodity exporters, a weaker-than-expected recovery among advanced economies, rising private-sector debt levels in some large emerging markets, and heightened policy and geopolitical uncertainties. While the available policy space for monetary and fiscal stimulus is narrow globally, structural reforms could boost growth in both the short and long term.

In an environment of weak growth, rising risks and limited policy buffers, growth-sustaining structural reforms are increasingly urgent. Well-targeted structural reforms could boost aggregate demand, reduce macroeconomic vulnerabilities and signal to investors that the authorities are committed to reinforcing strong fundamentals in support of long-term growth. Greater investment in infrastructure, productivity-enhancing technology and human capital could complement and catalyze this process. Structural reform and investment policies should aim to close public infrastructure gaps, encourage foreign direct investment, build human capital, foster economic diversification and lower barriers to trade. While countries with diminishing fiscal space may have a limited ability to finance investments in infrastructure and human capital, international cooperation efforts could support expansionary fiscal policies in the event that large downside risks materialize, channeling global resources into productive infrastructure and strengthening social safety nets in the most fragile economies.

Table 4: Global GDP growth rates, recent and projected

	2014	2015	2016f	2017f	2018f
World	2.6	2.6	2.3	2.7	2.9
High-income countries	1.8	2.1	1.5	1.7	1.8
Developing countries	4.1	3.4	3.5	4.4	4.7
East Asia	6.2	5.9	5.8	5.7	5.7
Philippines	6.2	5.9	6.4	6.2	6.2

Source: East Asia Economic Update

Excerpt from the World Bank Global Economic Prospects, June 2016: Divergences and Risks, Washington, DC.

consume. The combined share of lower middle-, middle-, and upper middle-income households grew from 44.6 percent of the population in 2009 to 45.8 percent in 2012, and in recent years they have consistently accounted for about two-thirds of total household income.²⁵ Second, while remittance inflows are gradually decelerating, they are projected to remain relatively strong over the medium term, and employment prospects for the country's overseas workforce remain generally positive. Third, strong economic growth is expected to expand domestic employment opportunities. As a result, consumption growth is likely to remain strong in 2016 before slowing moderately in 2017 and 2018 as inflation rates rise and remittance inflows level off.

Net exports are unlikely to experience a major rebound in 2016 as global growth remains lackluster, but the external environment is expected to improve gradually in 2017 and 2018. The poor performance of net exports has been the most important drag on growth in recent years, with negative contributions recorded in 2015 and projected for 2016 (Box 6). The World Bank recently lowered its global growth forecast for 2016 from 2.5 percent to 2.3 percent. In 2017, however, global growth is projected to rebound to 2.7 percent before reaching 2.9 percent in 2018. This is expected to boost demand for Philippine exports and to gradually narrow the trade deficit despite strong domestic demand for imported capital and consumer goods. Import growth is projected to remain robust in 2016, then decelerate in 2017-2018 due to base effects and a slowdown in capital-goods imports. By 2018 export growth is expected to outpace import growth, narrowing the trade deficit.

The service sector is expected to remain the key driver of output growth. Prospects for the service sector are highly positive, with sectoral growth rates projected to reach 7.0 percent in 2016 and 6.8 percent over 2017-18. A burgeoning domestic middle class and

remittances from overseas Filipino workers are fueling the growth of real estate and construction, while economy-wide growth is supporting robust demand for financial services. A combination of domestic financing and FDI is facilitating the service sector's growth. Over the past three years, real estate and construction, wholesale and retail trade, utilities, transportation and IT represented a combined average of 55 percent of the banking system's total loan portfolio. Meanwhile, finance and insurance firms were among the top targets of foreign investment, receiving 56 percent of FDI in 2014, 34 percent in 2015 and 70 percent in the first half of 2016. Banks are the largest issuers in the local-currency corporate bond market, accounting for 28 percent of peso-denominated corporate bonds at end-March 2016. The IT-BPO industry enjoys particularly strong growth prospects, with revenues expected to hit US\$35 billion in 2018, surpassing the projected value of remittances. While the IT-BPO industry continues to grow, the Philippines should strive to move into even more sophisticated services such as knowledge-process outsourcing (KPO) (Box 7).

Manufacturing growth is likely to slow unless the sector receives substantial new investments in productive capacity. Since the nadir of the global financial crisis in 2009 the manufacturing sector has steadily expanded, and its contribution to growth has been marginally higher in the post-crisis period (Figure 21). Capacity utilization, however, is estimated at 83-84 percent, broadly unchanged since 2012. Investment in durable equipment is rising, but from 2014 through the first half of 2016 transportation equipment accounted for an average of 46.3 percent of sectoral investment, while specialized and general industrial machinery accounted for 21.9 percent and 16.4 percent, respectively. Going forward, increased investment in new equipment and facilities will be necessary to sustain the sector's growth.

²⁵ Albert et al., 2015.

Box 7 Moving up the value chain: from BPO to KPO

Over the past decade and a half, the Philippines has emerged as one of the leaders in the global IT-BPO industry. Sectoral revenue has risen exponentially over the past decade, growing at an average annual rate of 30 percent between 2000 and 2015 to reach US\$22 billion. The IT-BPO industry is also among the leading contributors to job creation, and total sectoral employment increased from 138,000 in 2005 to about 1.03 million in 2014. Growth forecasts are highly optimistic: the IT-BPO industry is projected to generate US\$25 billion in revenue in 2016, and direct employment is expected to reach 1.3 million. Moreover, IT-BPO has had sizeable positive spillover effects on other economic sectors. The industry's total direct and indirect contribution to the growth of value-addition in services exports, real estate, construction, retail trade and telecommunications is estimated at around 10 percent of GDP. The Philippines currently ranks as the world's top destination for voice support, and it has the potential to compete in a range of high-value-added, knowledge-based services in the future.

However, the country's IT-BPO industry faces long-term sustainability challenges stemming from international competition and technological progress. The Philippines' IT-BPO industry generates 85 percent of its revenue from relatively routine cognitive tasks that are highly susceptible to automation. Low wages could slow the pace of automation, but are unlikely to halt it. As the global market for complex services grows, shifting production toward high-value, non-voice services such as KPO can promote the industry's sustainability.

There are important lessons to be learned from the experience of similar outsourcing destinations. India successfully diversified into high-value-added outsourcing services and is now the global leader in KPO, with a 63 percent global revenue share. With a highly skilled talent pool, relatively low-cost labor, well-developed IT infrastructure, and an enabling business environment, India was in a strong position to take advantage of the rising demand for more sophisticated outsourcing activities. The revenue generated by India's KPO industry shot from just US\$260 million in 2001 to an estimated US\$15.2 billion in 2015 and is projected to reach a staggering US\$55.5 billion in 2019.³⁶ While India is expected to remain the global leader, Latin American and Asian economies have the potential to attract investment in KPO services by leveraging a relatively skilled, low-cost workforce and a generally favorable business climate.

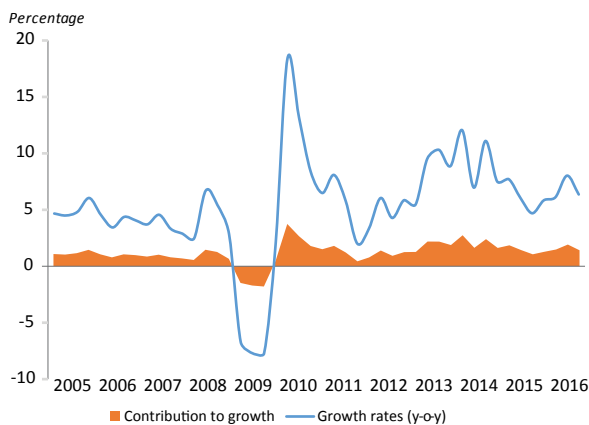
The Philippine government and the private sector recognize the opportunity to expand into KPO and other complex IT-BPO services, but a number of constraints are preventing the country from moving up the IT-BPO value chain. Foremost among these is the need to further develop the skills of the local workforce through improved education and job training.³⁷ In addition, the Philippines must continue to address key infrastructure gaps, especially in IT and telecommunications infrastructure, foster a more favorable business and investment climate, and forge public-private partnerships devoted to providing non-voice service training and skills development. Due to its cross-cutting nature, a successful transition to a more diversified and sophisticated IT-BPO industry will require a concerted effort involving the private sector, academia and the government.

³⁶ Technavio, 2015.

³⁷ DOST-ICTO and IBPAP, 2014

Growth prospects for the agriculture sector remain bleak due to a combination of chronic underinvestment and intense vulnerability to weather-related shocks. Agriculture comprised just 8.5 percent of GDP during the first half of 2016, and the sector's contribution to growth is minimal (Figure 22). However, agriculture employs a disproportionate share of the labor force, and domestic food production has a significant influence on consumer price inflation. Nevertheless, both

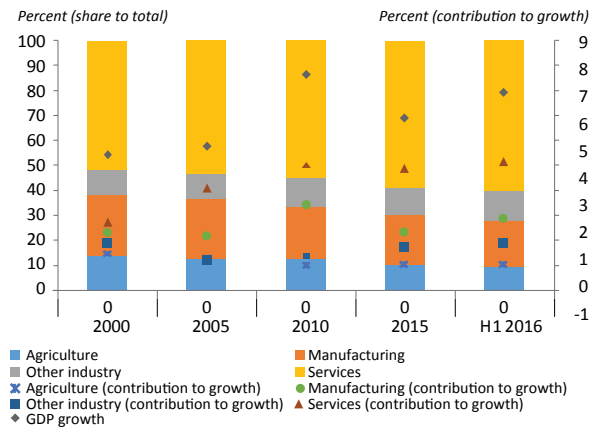
Figure 21: Manufacturing has grown steadily, and since the 2009 financial crisis it has represented an increasingly large share of GDP



Source: PSA

foreign investment and bank lending to the sector have been low, and underinvestment has contributed to the sector's vulnerability to extreme weather conditions. Increasing agricultural productivity will be crucial for boosting growth and also for essential for ensuring more inclusive growth. The structural constraints in agriculture, such as land tenure issue and value chain weaknesses, are a medium-term reform agenda.

Figure 22: However, the outlook for the agricultural sector remains weak due to low investment and minimal productivity gains



Source: Philippine Statistics Authority (PSA)

2.2 Poverty and Shared Prosperity: Progress Continues, Supported by Robust Growth and a Strong Social-Policy Framework

Robust economy-wide growth, combined with the government's stated commitment to an inclusive development agenda, is expected to generate further gains in poverty reduction in the near term (Table 4). The decline in the poverty rate could be accelerated through greater investment in human capital formation, with an emphasis on health, education and social protection services targeting the poor and vulnerable (Figure 23). Poor households are highly concentrated in the agricultural sector, where productivity increases could boost incomes and make growth more inclusive. Accomplishing this would require a comprehensive rural development strategy, and formulating such a strategy is among the

new administration's top policy priorities. The creation of more high-productivity jobs in other sectors would also expand the distribution of the returns to growth.

Improving labor-market conditions and planned investments in human capital are expected to have a positive impact on poverty. The projected economic expansion over 2016-18 is expected to bolster employment, while the country's well-targeted conditional cash transfer program (*Pantawid Pamilyang Pilipino*) should continue to shore-up consumption among poor households. The cash transfer program is currently the third-largest in the world, with 4.2 million beneficiary households

registered in 2015. It has helped reduce short-term poverty by closing the income gap among beneficiaries by up to 7.4 percentage points, enabling poor households to cover their basic needs. Going forward, sustained economic growth combined with increased spending

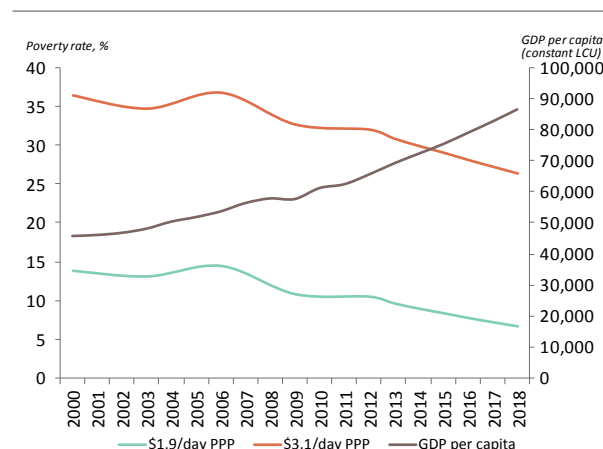
on health, education and social protection programs is projected by the World Bank to reduce the extreme poverty rate from 10.6 percent in 2012 to 7.8 percent in 2016, 7.2 percent in 2017 and 6.7 percent in 2018.

Table 5: Moderate and extreme poverty rates, recent and projected

	Actual & Projected Poverty	
	\$1.9/day PPP	\$3.1/day PPP
2000	13.9	36.5
2003	13.2	34.8
2006	14.5	36.8
2009	10.9	32.7
2012	10.6	32
2013	9.7	30.8
2014	9	29.9
2015	8.4	29
2016	7.8	28.1
2017	7.2	27.2
2018	6.7	26.3

Note: Projections start on 2013
source: World Bank staff estimates

Figure 23: Further gains are anticipated as GDP per capita continues to grow

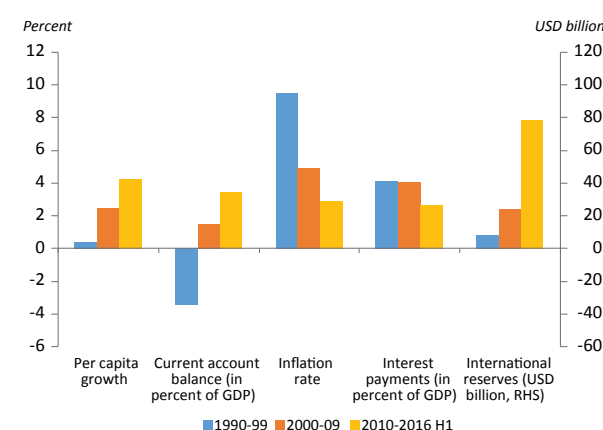


Source: World Bank staff estimates

2.3 Risks and Policy Challenges: The Government Must Maintain Adequate Policy Space to Adapt to Rising Headwinds

The Philippine economy appears well positioned to weather the headwinds generated by a volatile external environment. Robust growth, low and stable inflation, a declining debt-to-GDP ratio, sustained current-account surpluses, and ample international reserves all indicate a strong macroeconomic position (Figure 24). The country's abundant foreign-exchange reserves are adequate to counter global shocks, and the government has enough fiscal space to expand domestic public spending. Meanwhile, the country's monetary position is sufficiently strong to accommodate an increase in global interest rates.

Figure 24: Key macroeconomic indicators have improved significantly in recent decades



Sources: PSA, BSP, World Bank staff estimates

However, the challenging external environment continues to threaten an otherwise positive economic outlook. The most important risks stem from trade and monetary-policy conditions. First, adverse developments among the Philippines' key trading partners could further dampen export growth. Key sources of risk include a difficult recovery in Japan, slower-than-expected growth in the US and further turbulence in the euro zone, as together these markets account for about 60 percent of Philippine exports. Second, the anticipated normalization of US policy rates could increase financial market volatility, prompt a reversal in capital flows and/or increase borrowing costs, all of which could have a negative impact on the Philippine economy. The gap between policy rates in the Philippines and the US is currently narrow at about 2.5 percent. The monetary-policy authorities must carefully account for the real risk of outflows resulting from an increase in the US Federal Funds Rate, which could lead to higher borrowing costs, slower growth in construction and real estate, and increased leverage among both households and firms. The central bank has conveyed its policy commitment to use a mix of monetary policy tools to mitigate external and domestic shocks.

The Philippines has limited direct exposure to the outcome of the "Brexit" referendum, but its exports are vulnerable to Brexit-related disruptions in the euro zone. The UK accounts for about 1 percent of Philippine exports and 0.5 percent of imports. However, the EU represents about 13 percent of Philippine exports and about 11 percent of imports. Moreover, the share of remittances from the UK has averaged 5.3 percent since 2010, though the British labor market employs only 0.3 percent of all overseas Filipino workers. The UK has been the source of about 1.2 percent of total net FDI since 2010, and it represents about 5.1 percent of total external debt, while the EU as a whole accounts for 8.8 percent of external debt. As a result, the depreciation of

either the euro or the British pound would not adversely affect debt repayment.

The new administration will need to take swift and decisive action to confirm its commitment to its stated priorities and dispel any lingering policy uncertainty. The new administration's economic team has laid out a 10-point socioeconomic agenda (Box 8). The new government has taken steps to reassure businesses and investors that the continuity of existing macroeconomic policies will be maintained, including growth-supporting fiscal, monetary and trade policies. Major structural reform initiatives are planned in the areas of tax policy and administration, expenditure tracking, land-tenure security and constitutional restrictions on foreign asset ownership. Nevertheless, as the details of these policies and their implementation strategies are still under discussion, businesses are likely to maintain a cautious approach toward investment and expansion. The government is currently consulting with stakeholders as part of the process for formulating the next Philippine Development Plan, which should be finalized by the end of 2016. This plan is expected to further clarify the government's medium-term policy priorities. If the authorities are able to foster a climate of strong policy credibility over the next 6-12 months, the country's economic prospects could further improve. This represents an important upside risk to the growth forecast.

The new administration has already prioritized a range of revenue and expenditure reforms. The government plans to increase expenditures by 12 percent per year from 2017 to 2019, which would push total public spending from 16.8 percent of GDP in 2015 to 20.2 percent in 2019. To achieve this, the government would need to raise public investment management capacity. Executing its far-reaching public investment agenda will require the establishment of adequate procurement processes and project-implementation safeguards. While public

revenues have been steadily increasing, at their current growth rate they will not be sufficient to finance the government's ambitious expenditure agenda. The authorities have therefore proposed a set of tax reforms designed to boost total revenues from 15.8 percent of GDP in 2015 to 17.2 percent in 2019. In order to accomplish its fiscal-policy goals, the government must avoid delays in the approval and implementation of these reforms. In the most optimistic scenario, in which the tax reform package is approved and implemented on schedule and the medium-term budget is fully executed, growth could exceed the current baseline projection of 6.2 percent in 2017 and 2018.³⁸ This represents a second upside risk to the growth forecast.

The agricultural sector is highly sensitive to weather-related shocks, and this vulnerability poses both direct risks to sectoral output and

indirect risks to consumer-price inflation. Although the effects of El Niño have already waned, the Philippine agricultural sector continues to face the threat of a La Niña pattern toward the end of the year.³⁹ This or other weather-related shocks could further damage agricultural output, which would likely intensify food-price inflation unless the government moved quickly to increase food imports. Anticipating this risk, the government has launched a comprehensive program to help mitigate the effects of La Niña through measures designed to strengthen agricultural production, enhance flood control and reduce disaster risk.⁴⁰ In addition, the government has approved roughly one million metric tons of rice imports to bolster the domestic food supply. The planned removal of quantitative restrictions on rice imports by 2017 should reinforce the resilience of food prices.⁴¹

Box 8 The Duterte administration's 10-point socioeconomic agenda

1. Maintaining the current macroeconomic stance by ensuring the continuity of fiscal, monetary and trade policies;
2. Instituting a progressive tax-reform program, boosting collection efficiency and indexing taxes to inflation as part of a package of tax legislation to be submitted to Congress by September;
3. Increasing economic competitiveness and improving the business environment by drawing on successful local strategies for attracting investment (e.g. the Davao model), and relaxing Constitutional restrictions on foreign ownership of assets other than land;
4. Accelerating infrastructure spending to 5 percent of GDP per year and enhancing the role of public-private partnerships;
5. Promoting rural development by increasing agricultural productivity, facilitating the elaboration of agricultural value chains and encouraging rural tourism;
6. Strengthening land-tenure security to encourage investment and resolve structural constraints in land management and titling;
7. Investing in human-capital development by increasing health and education spending and promoting the expansion of skills training to meet the evolving labor demands of the private sector;
8. Promoting science, technology and the creative arts to accelerate innovation, build creative capacity, and promote sustainable and inclusive development;
9. Improving social protection programs, including conditional cash transfers, in order to protect the poor against economic shocks; and
10. Strengthening the implementation of the Responsible Parenthood and Reproductive Health Law in order to enhance the ability of households—especially poor households—to make informed choices regarding financial and family planning.

³⁸ This would also limit the fiscal deficit to 3 percent of GDP, keeping the debt burden on a sustainable trajectory.

³⁹ La Niña is a weather phenomenon characterized by heavy rainfall, the formation of tropical cyclones and increased monsoon activity. <http://thestandard.com.ph/news/-provinces/207148/govt-drafts-program-to-deal-with-la-ni-a.html>

⁴¹ Quantitative restrictions on rice imports have been in place since 1995 as part of a WTO agreement, which caps the volume of private rice imports at 805,200 metric tons and establishes a rice tariff of 35 percent. <http://www.bworldonline.com/content.php?section=Economy&title=phil-to-lift-restrictions-on-rice-imports-by-2017-&id=133159>

Going forward, the acceleration of structural reforms designed to promote economic inclusiveness and foster high-quality job creation would intensify the impact of growth on poverty reduction and shared prosperity.

At its current growth rate of over 6 percent per year, per capita income could double in a decade. However, maintaining an inclusive growth pattern requires an enduring commitment to implementing structural reforms to encourage investment in industries and sectors that create high-quality jobs. The government's 10-point socioeconomic agenda calls for accelerating public investment in infrastructure and social services, enhancing competition in key economic sectors, securing property rights, and simplifying regulations to improve the ease of doing business in the Philippines.

Its effect on competition will be a key measure of the reform agenda's success. One of the government's most immediate policy challenges will be to ensure the effectiveness

of the Philippine Competition Commission, the country's newly formed antitrust agency. The commission's first case will attract intense scrutiny, as it will likely set important legal and regulatory precedents for mergers and acquisitions. The government will have to balance the commission's mandate to uphold antitrust laws with its goal of promoting the public interest.

The passage of the government's tax-reform agenda will present a second critical policy success. The proposed reforms are designed to make the country's tax system more equitable, efficient and competitive, but their design features, implementation schedule and economic effects are highly complex. As the success or failure of the government's tax reforms may prove pivotal to the country's economic development, the second special focus section included in this edition of the Philippines Economic Update offers an in-depth look at tax policy in the Philippines.

PART III:

INCREASING TAX REVENUES EFFICIENTLY AND EQUITABLY⁴²

The new administration aims to accelerate the creation of high-quality jobs through greater public investment in infrastructure, education and healthcare. To finance this agenda, the authorities are planning a comprehensive tax reform effort designed to make the Philippine tax system the most equitable, efficient and competitive in the region. This special focus section examines critical policy issues related to the government's tax-reform program. It evaluates the design and administration of the value-added tax and the excise tax on petroleum. These taxes have critical implications for fiscal equity, economic efficiency and budgetary sustainability, as well as the achievement of the government's stated development objectives.



⁴² This section was prepared by Birgit Hansl. The analysis presented here is based on tax policy notes by Karl Kendrick Chua (former World Bank Senior Economist), Paul Mariano (Research Analyst), Christine Ablaza (Research Assistant), and Gabriel Roque (Research Assistant).

3.1 Introduction: The New Administration's Tax Policy Agenda

The recently elected government is in the process of launching an ambitious tax-reform initiative designed to enhance fiscal equity and promote shared prosperity. The Philippine economy has expanded rapidly for over a decade, yet the country's impressive growth performance has had only a limited impact on job creation and poverty reduction. The new government is attempting to shift the focus of economic policy from ensuring macroeconomic stability to promoting shared prosperity. A combination of expenditure rationalization, prudent debt management and strong tax administration has reinforced the country's macroeconomic fundamentals, and policymakers can take advantage of this period of stability and growth to build a more equitable, efficient and inclusive revenue framework.

Greater public spending, underpinned by improved revenue mobilization, will be necessary to develop the physical and human capital required for broad-based growth. The authorities have considerable scope to increase revenues through efficiency improvements in tax administration, without the need to raise tax rates or establish new taxes.⁴³ Between 2010 and 2013 tax-revenue collection increased by about 1.2 percentage points of GDP due to a combination of improved tax administration and continuously high growth. However, further improvements in tax administration could continue to yield marginal revenue

gains, but without deeper structural reforms enhanced administration is unlikely to enable the government to reach its revenue target of 16 percent of GDP by 2020.

To generate faster increases in tax revenue and ensure that the government can both achieve and sustain its revenue-to-GDP target, the authorities are considering a comprehensive tax-reform program. This program would proceed in several phases, and it would include both policy changes and administrative reforms. Some elements of the reform agenda would focus on raising tax revenues by strengthening collection efficiency and broadening the tax base, while others would concentrate on enhancing fiscal equity by alleviating the tax burden on lower-income households (Box 9).

Maintaining consistent political support for comprehensive tax reform will hinge on the public's perception that the quality of the tax administration is improving and that tax revenues are being well spent. A successful reform process will require measures to strengthen the transparency and accountability of the budget process and improve the structural efficacy of the nation's revenue institutions.⁴⁴ The authorities have already taken steps to promote public trust in the revenue agencies and reinforce the quality of their services.⁴⁵

⁴³ For instance, in 2013, the BIR announced a campaign to boost tax collection from self-employed professionals such as doctors and lawyers. The government estimates that only about 403,000 out of 1.8 million self-employed professionals pay taxes in a given year, and their average declared income is close to the minimum wage. The government believes that the successful implementation of these reforms could boost tax revenues by as much as 2 percent of GDP.

⁴⁴ Key transparency and accountability reforms include the passage of the Freedom of Information Bill, enhancing budget preparation and reporting, measures to allow the public to track expenditure execution, the timely release of a tax-expenditure statement, limitations on the use of lump-sum funds for large budget items, mandatory posting of procurement bids and awards on government websites, and strengthening the role of the Audit Commission.

⁴⁵ Simplifying tax procedures and processes could help build confidence in the efficiency of the revenue authority. Publishing the net worth of top revenue officials on government websites could send a strong signal to the public that the revenue agencies are committed to good governance. Strengthening the Audit Commission's oversight of BIR and BOC activities and ensuring that they adhere to their own audit rules could improve the accountability of the tax administration. Implementing Executive Order 38 of 1998, publishing BIR and BOC performance indicators on their websites, relaxing bank-secrecy laws in cases involving tax fraud, and requiring all government agencies and selected private sector groups (e.g., utilities and professional associations) to share their data with the BIR and BOC could further enhance public sector transparency.

Box 9 The Government's proposed tax reform package

On September 26th the government submitted the first of six tax reform packages to Congress in support of its inclusive growth strategy. The reform program has two overarching objectives: (i) to make the country's tax system the most equitable, efficient and competitive in the region, and (ii) to generate sufficient revenue to finance the administration's 10-point socioeconomic development agenda. Each reform package will focus on a different area of tax policy and attempt to balance tradeoffs between revenue generation, economic efficiency and fiscal equity. These packages are part of a larger reform agenda that encompasses tax administration, good governance and budgetary reforms, as well as measures to simplify regulations, promote competition and enhance the business environment.

If approved, the first reform package will be implemented in two phases. The first phase would consist of reforms to the personal income tax, the value-added tax (VAT), and oil and vehicle excise taxes. The country's personal income tax brackets would be adjusted to reflect inflation, and its income tax rates, which are among the highest in the region, would be reduced. Reducing the coverage of VAT exemptions would offset the decline in income tax revenue. Meanwhile, the government would restructure the excise tax on personal automobiles and petroleum products, and one-quarter to one-third of the net revenue gain would be allocated to social protection programs such as conditional cash transfers, targeted electricity subsidies, direct discounts, expanded coverage of the national healthcare system (PhilHealth), and targeted subsidies to sectors that are adversely affected by higher petroleum prices. During the second phase a set of new surtaxes would be levied on unhealthy or socially harmful goods. These include taxes on sweetened drinks, which would be indexed to inflation, as well as higher excise taxes on tobacco and alcohol products, which would be introduced after the current "sin tax" matures.

The third tax reform package would reduce corporate income taxes while rationalizing fiscal incentives. The proposed reforms would lower the corporate income tax rate and simplify its provisions to improve compliance. Revenue losses would be offset by the rationalization of fiscal incentives, which would become more transparent, targeted, and performance-based, and "sunset provisions" would be applied to existing incentives. The current 5 percent gross income tax rate would also be replaced by a reduced corporate income tax rate. Finally, VAT zero-rating would be strictly limited to direct exports, tax-credit certificates would be abolished, and all VAT refunds would be paid in cash.

The fourth and fifth reform packages focus on property taxes and capital-gains tax. The proposed reforms would attempt to simplify property taxes to support a more competitive real estate market and improve the efficiency of land use. Key measures would include reducing the estate and donor's tax rates, as well as the tax rate for land transactions. Revenue losses would be offset by the rationalization of property valuation, which would bring property values closer to market prices and require the systematic review and revision of property values every three years. The tax rate on interest earned on peso-denominated deposits and investments would be cut from 20 percent to 10 percent, and all other capital-gains taxes would be harmonized with this rate to improve their progressivity.

A sixth and final reform package would address other tax types, but the specific reforms that would be included are still under discussion. The government is currently in the process of finalizing the sixth proposed tax-reform package. The current draft proposal includes a tax on high-fat foods, a tax on luxury items such as yachts and jewelry, new taxes on gambling, new taxes on mining, and a tax on carbon production.

Successful public finance reforms 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

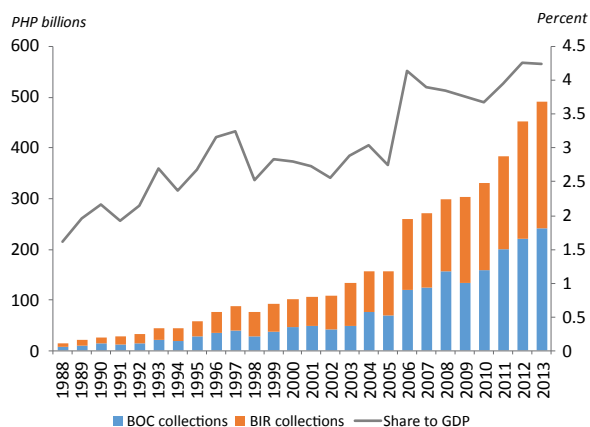
reforms would allow the country to increase public investment and pro-poor spending and take advantage of new opportunities arising from the global economic rebalancing. This note discusses two key taxes, the value-added tax and excise tax on petroleum.

3.2 Value-Added Tax

3.2.1 Performance Challenges

The Philippine VAT system has been repeatedly overhauled in recent decades. These reforms increased VAT revenue from 1.6 percent of GDP in 1988 to 4.2 percent in 2013 (Figure 25). However, billions of pesos in VAT refunds have yet to be disbursed. The establishment of a number of VAT exemptions in 1997 caused a significant decline in VAT receipts in 1998. Conversely, the 2005 Reformed Value-Added Tax (RVAT) Law boosted collections by 1.3 percent of GDP in 2006. However, input-output tables indicate that VAT refunds for 2013 are worth about PHP69 billion (or 0.6 percent of GDP), which would reduce actual VAT revenues to around PHP421 billion (or 3.6 percent of GDP). Between 1998 and 2013 VAT refunds amounted to around 0.7 percent of GDP on average (Box 10).

Figure 25: VAT revenues have increased significantly since the 1980s, both in real terms and as a share of GDP



Source: DOF, NSCB

The BIR collects VAT on domestic commerce, while the BOC collects VAT on imports, and both BIR VAT and BOC VAT revenues have improved over time. BIR VAT receipts grew at an average rate of 17 percent per year from 1988 to 2005, when the RVAT Law caused revenues to jump by 60 percent in a single year. Between 2007 and 2009 revenue growth slowed to an average of 6.5 percent per year, before accelerating again in 2010. Between 2011 and 2012 the annual growth rate of BIR VAT revenue shot from 6 percent to 25 percent. BIR VAT revenue grew by another 9.4 percent in 2013 as a result of improved tax administration. Meanwhile, import VAT revenue has proven much more volatile. BOC VAT receipts grew at an average annual rate of almost 32 percent from 1988 to 1997, then fell by almost 32 percent in 1998 as imports collapsed. BOC VAT revenue briefly recovered during 1999-2001 before falling by 11 percent in 2002. In 2006 the RVAT Law increased BOC VAT revenue by 73 percent, but revenue growth turned negative in 2009 during the global economic slowdown. Since 2010 BOC VAT revenue has significantly improved, growing at an average rate of 16 percent per year, largely as a result of the BOC's intense anti-smuggling campaigns.

The difference between actual and potential VAT revenues—the VAT tax gap—remains substantial despite narrowing significantly in recent years. The VAT tax gap can be broken down into a policy gap, which is the result of legal exemptions and other forms of special tax treatment, and an administrative gap,

Box 10 The Philippine VAT system

The Philippine government introduced the VAT in 1988. In 1994 the VAT base was broadened to include professional service providers, banks, nonbank financial firms and international shipping companies, but the implementation of these reforms was delayed by questions regarding their constitutionality. In 1996 the government approved a number of VAT exemptions, including exemptions on imported oil and coal, educational services, and the importation, production and sale of books and newspapers. In 2005 the authorities expanded the VAT base and increased the VAT rate in an effort to avert a fiscal crisis. Under the RVAT Law the tax base was expanded to include electricity, petroleum, and medical and legal services, inter alia, and the rate was increased from 10 to 12 percent. The law also imposed a 70 percent cap on input VAT credit, extended the input VAT claim on capital goods exceeding PHP1 million over five years, and imposed a uniform 5 percent final withholding VAT on government purchases.

Currently, there are three VAT regimes: exempt, zero-rated and taxed at 12 percent. The 12 percent rate applies to all goods and services except those that are specifically exempted or zero-rated by the tax code. Firms that produce zero-rated products can apply for a VAT refund on their inputs.⁴⁶ In practice, however, these refunds are difficult to obtain, and the government now issues tax credit certificates in lieu of refunds. To protect exporters from cash-flow shortages the government extended the zero-rating to suppliers, but this has become a major source of revenue leakage. One important and unusual feature of the Philippine VAT system is its use of excess input tax credits. These credits cannot be directly redeemed for a VAT refund, but instead enable firms to apply for a tax credit certificate within two years of the quarter in which they were issued.⁴⁷

VAT exemptions are primarily intended to reduce the tax burden on poor households, but the system for granting exemptions is vulnerable to abuse. As of 2014 VAT exemptions were applied to agricultural and marine products, educational services, sales by cooperatives, the sale or lease of small properties, and firms with gross sales of less than PHP1,919,500 per year. Unlike zero-rating, firms that produce exempt goods cannot apply for VAT refunds on their inputs.⁴⁸

which primarily reflects noncompliance. Between 2006 and 2013 the estimated policy gap averaged three percent of GDP, while the estimated administrative gap averaged 3.7 percent of GDP. As actual revenues averaged 4 percent of GDP, the VAT gap represented almost two-thirds (63 percent) of potential VAT revenues. Of this, 28 percent reflects legal exemptions and special treatment, while 35 percent results from noncompliance.

Overall, the Philippine VAT system is slightly progressive due to the exemptions on goods and services consumed by the poor. However, a number of economically unjustifiable

exemptions have also been granted to large corporations and cooperatives. These exemptions reduce the progressivity of the VAT and widen the VAT policy gap.

A large and growing number of exemptions undermines the efficiency of the VAT. Some of these exemptions also create economic distortions. For instance, most cooperatives are exempt from VAT, which creates an incentive for corporations to restructure themselves as cooperatives in order to reduce their tax liability, even if restructuring is not economically efficient. Moreover, the exemption for cooperatives is also largely unnecessary from

⁴⁶ Zero-rating is typically applied to exports. Suppliers selling inputs to exporters are also zero-rated.

⁴⁷ In 2012 the Office of the President issued Executive Order No.68, which enabled all tax VAT-registered taxpayers to redeem their outstanding tax credit certificates for their full cash value. While this did not completely eliminate the use of tax credit certificates, it did make them optional.

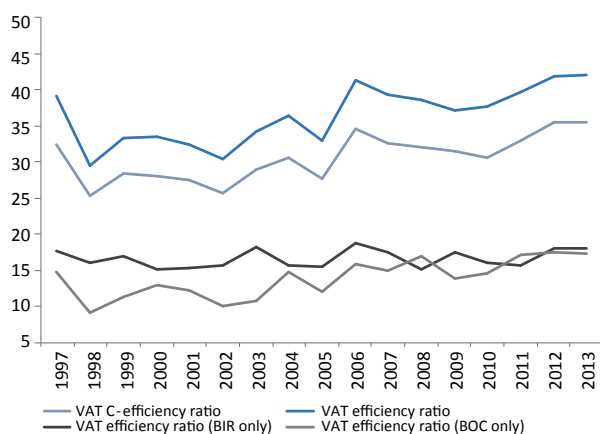
⁴⁸ Firms with revenue below the threshold are not required to register for VAT. If they choose to be exempted from the VAT, they are required to pay income tax equivalent to 3 percent of their annual gross sales and are not allowed to obtain VAT credits for their inputs.

a policy perspective, as small cooperatives are already protected by the VAT threshold. At the individual level, the Expanded Senior Citizens Act of 2010 exempts senior citizens from VAT on specific items such as medical services, food, and transportation, but these exemptions are vulnerable to exploitation.

Moreover, VAT administration is complicated by a number of provisions that are at odds with international good practices. While the introduction of the VAT in 1988 reduced the complexity of the sales tax system, successive policy changes in subsequent decades have made the VAT increasingly complex and difficult to both administer and comply with.⁴⁹

The complexity of the VAT has decreased its efficiency. Following the 2005 VAT reforms a combination of weak tax and customs administration, policy measures that narrowed the tax base, and the proliferation of exemptions and zero-rating reduced the VAT efficiency ratio (Figure 26). However, since 2010 a renewed focus on effective tax administration has improved VAT efficiency.

Figure 26: VAT efficiency has improved in recent years



Sources: WB staff calculations using PSA and DOF data

3.2.2 Reform Options

Broadening the tax base and strengthening administration could greatly increase VAT revenues. The Philippines' experience between 2005 and 2010 shows that raising the VAT rate can boost revenues in the short term, but weak tax administration and the creeping spread of exemptions can erode revenues over time.

More importantly, the VAT's efficiency, equity, and simplicity challenges could be addressed by expanding the VAT base. Eliminating a number of existing exemptions could expand the VAT base and boost revenue. Many exemptions that directly target specific individuals or firms have little economic justification, and even those designed to serve legitimate policy purposes could be replaced by superior alternatives (Box 11). Eliminating exemptions on inputs used to produce final goods that are also exempt would alleviate distortions, reduce administrative complexity and improve compliance rates. Increasing the VAT threshold to around PHP3 million and indexing to inflation would lower compliance costs for small enterprises. Finally, limiting zero-rating to exporters would help curb leakages caused by the current system of zero-rating suppliers of exporters in special economic zones.

VAT administration could be improved by eliminating the use of tax credit certificates and instead providing prompt VAT refunds in cash. The current rule requiring a pre-audit of refunds is not consistent with international good practices and leads to long delays. Relaxing the rule would greatly expedite the refund process. Introducing risk-management techniques would enable low-risk taxpayers to get refunds faster and audits could be completed after the refund was issued. Low-

⁴⁹ For instance, sales by non-agricultural, non-electric, and non-credit cooperatives are considered VAT-exempt only if the capital contribution of each member does not exceed PHP15,000. Sales of residential lots are VAT-exempt only if their value does not exceed PHP1,919,500. For dwellings, the applicable threshold is PHP3,199,200. For leases of residential units to be VAT-exempt, monthly rental must not exceed PHP12,800. These are only a few of the many complicated rules and requirements that characterize the Philippine VAT system.

risk taxpayers caught over-declaring refunds would be reclassified as high-risk and subject to more stringent pre-audit requirements. Finally, policymakers should reject any proposal

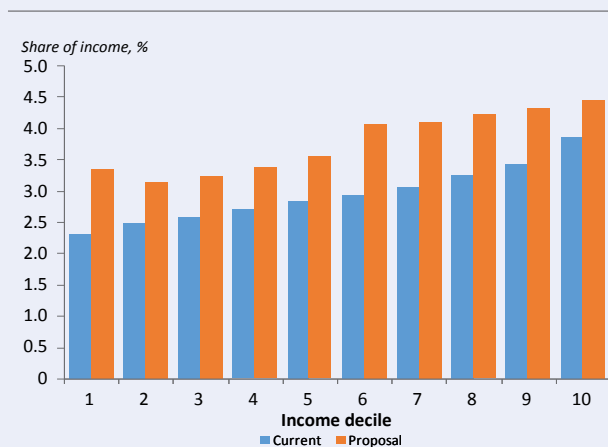
to replace the VAT with either a sales tax or a so-called “simplified VAT,”⁵⁰ as doing so would not reflect international good practices.

Box 11 VAT equity analysis

VAT exemptions on basic consumer goods greatly increase the progressivity of the tax burden.

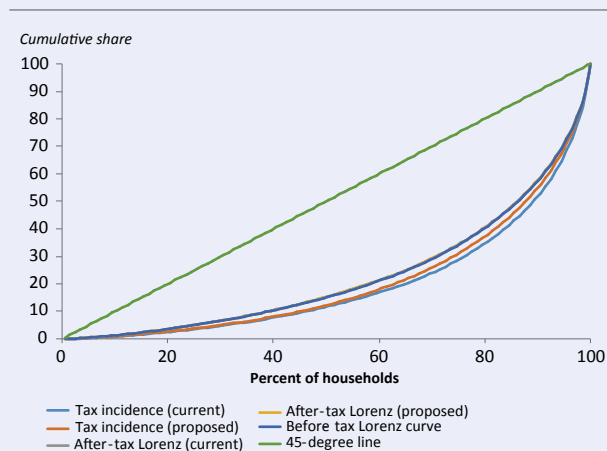
The bottom income decile accounts for 1.8 percent of total adjusted household spending but only 0.9 percent of VAT-eligible spending. Meanwhile, the top income decile accounts for 37.5 percent of total adjusted household spending, but 48 percent of VAT-eligible spending. Because the VAT is a proportional tax, the distribution of VAT liability mirrors the distribution of VAT-eligible spending. (Figure 27). While removing VAT exemptions on electricity, social housing, cooperatives, and spending by senior citizens and persons with disabilities could reduce the progressivity of the VAT system (Figure 28), any resulting increase in the tax burden on the poor could be offset by cash transfers and/or enhanced social services.

Figure 27: The distribution of VAT liability mirrors that of VAT-eligible spending



Source: World Bank staff calculations using FIES 2012

Figure 28: Removing VAT exemptions would reduce the progressivity of the tax burden



Source: World Bank staff calculations using FIES 2012

3.3 The Petroleum Excise Tax

3.3.1 Performance Challenges

The Philippines operates a specific excise tax regime for petroleum products, under which most are either exempt or taxed at very low rates. Since 1997 all excise taxes on petroleum products have either been fixed in nominal terms, reduced or eliminated.⁵¹ The real value of excise tax rates that were fixed in nominal

terms fell by 53 percent between 1997 and 2013, while the real value of rates that were reduced dropped by 83 percent.

Petroleum excise tax rates in the Philippines are low by international standards. Premium unleaded gasoline is currently taxed at 9 percent of the pump price, while diesel is exempt. By contrast, in the majority of OECD countries

⁵⁰ This is similar to a turnover sales tax in that taxes paid on inputs are not refunded.

⁵¹ Excise taxes on a range of industrial chemicals, fuels and building materials remain unchanged since 1997. Liquefied petroleum gas has been exempt from excise tax since 1977. In 2006, excise taxes on oil products consumed by low-income households were reduced or eliminated to offset the impact of the expanded VAT base.

premium unleaded excise taxes account for between 25 and 40 percent of the pump price (Figure 29).⁵² In 2014 the VAT rates on premium unleaded gasoline and diesel were equivalent to just 10 and 11 percent of the pump price, respectively.

Leaving nominal excise rates unchanged has caused excise tax revenues on petroleum products to plummet since the late 1990s.⁵³

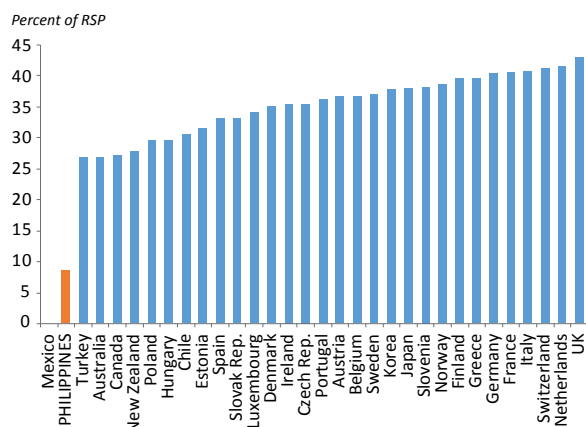
In 1997 the total petroleum excise tax revenue collected by the BIR was equivalent to 1.2 percent of GDP. By 2001 the total petroleum excise tax revenue collected by both the BIR and BOC had fallen to 0.8 percent of GDP, and by 2013 it had dropped to just 0.2 percent of GDP, with BIR revenues amounting to a mere 0.07 percent of GDP (Figure 30). Sharp reductions in BIR petroleum excise revenues were observed in 2001, 2002 and 2004, as refinery production during these years fell by 2, 18 and 21 percent, respectively.⁵⁴ In 2006 petroleum excise revenues again declined when excise exemptions were introduced

and, surprisingly, excise revenues also fell sharply when the economy recovered from the global slowdown and refinery production increased.⁵⁵ As the Philippines' reliance on refined petroleum imports has increased, the share of BOC revenue in total petroleum excise revenue has steadily risen. Between 2006 and 2013 the BOC's excise revenue on petroleum products more than doubled in nominal terms to PHP14.2 billion.

BIR and BOC data would appear to indicate a relatively modest excise tax gap, but these data do not include smuggling.

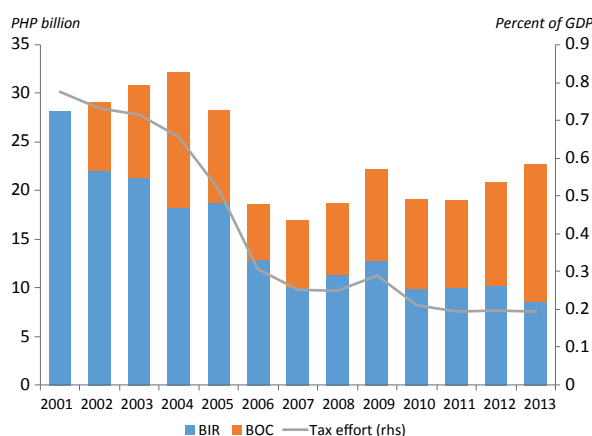
The estimated annual revenue leakage for petroleum excise taxes averaged PHP3.2 billion between 2006 and 2013, or about 13.9 percent of potential revenue. However, in 2011 alone an estimated PHP38 billion in petroleum products was smuggled into the country,⁵⁶ costing the government PHP4.1 billion in foregone VAT revenue and PHP8.5 billion in foregone excise revenue.⁵⁷

Figure 29: Excise tax rates on premium unleaded gasoline in the Philippines are very low by international standards



Source: International Energy Agency (2012), World Bank staff estimate for Philippines

Figure 30: Over the past decade total petroleum excise tax revenues have declined in both nominal terms and as a share of GDP⁵⁸



Source: BIR, BOC, World Bank staff estimates

⁵² International Energy Agency, 2013. Excise taxes are defined as all non-VAT taxes on energy.

⁵³ VAT revenue on petroleum products has also declined as a share of GDP, as the excise tax rate is part of the VAT base.

⁵⁴ The 2004 decline in BIR petroleum excise revenue may be due to the closure of the Caltex refinery in September 2003. Compensatory imports also likely shifted excise revenue from the BIR to the BOC.

⁵⁵ It is possible that following weak demand in 2008 and 2009, local refiners merely drew-down inventories in 2010.

⁵⁶ <http://www.dof.gov.ph/?p=5883>

⁵⁷ Tariff revenue is unaffected, as oil is currently subject to a 0 percent tariff rate.

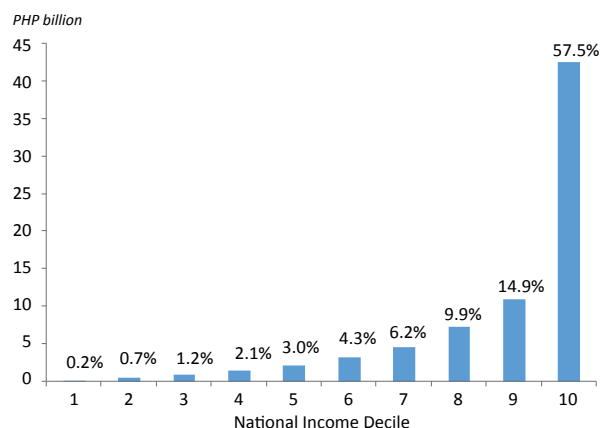
⁵⁸ BOC data prior to 2001 are not available.

The failure to index petroleum excise tax rates to inflation not only reduced revenue but has also diminished the distributional equity of the tax burden, as real tax rates have fallen while real household income levels have rapidly increased. While retail prices for petroleum products have risen significantly since 1997 (Figure 31), petroleum excise rates have fallen sharply in real terms. As petroleum products are overwhelmingly consumed by wealthy households, the declining real value of petroleum excise taxes has greatly diminished their redistributive effect. In addition, the use of different excise tax rates for different petroleum products has generated economic distortions. This is especially true of the exemption for diesel, which has negative equity effects and creates environmental externalities.⁵⁹

Consumption of petroleum products rises with household income. In 2012 households in the top income decile consumed almost 60 percent of all retail petroleum products, and households in the top three deciles consumed

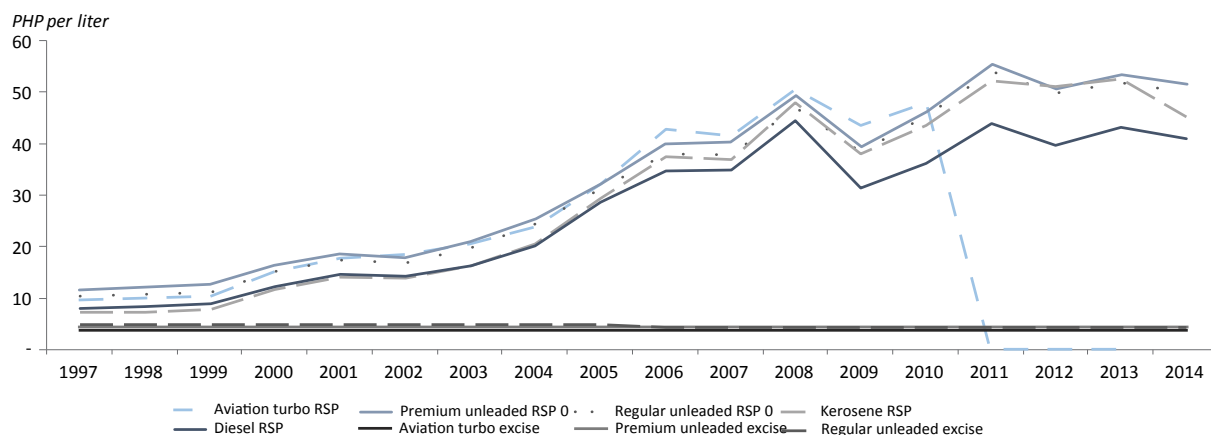
more than 80 percent,⁶⁰ (Figure 32). Even within the top decile, consumption is heavily concentrated in the top two percentiles, which together consume 30 percent of all retail petroleum products. The only exception to the trend is kerosene, the consumption of which is inversely correlated with income (Figure 33).

Figure 32: More than 80 percent of petroleum products are consumed by households in the top 30 percent of the income distribution



Source: Family Income and Expenditure Survey 2012, World Bank staff estimates

Figure 31: Retail prices for petroleum products have risen significantly since the 1990s, while excise tax rates have either remained unchanged or declined in nominal terms

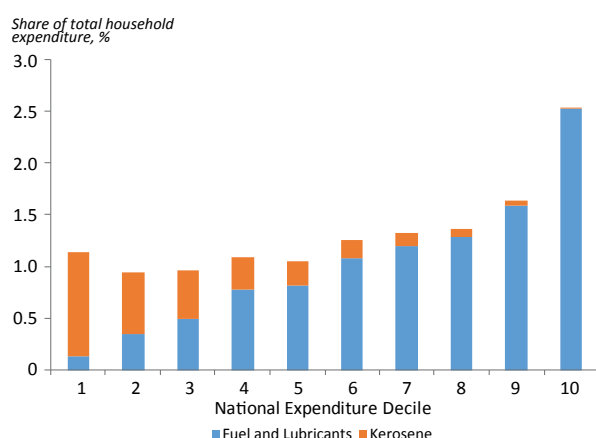


Source: Department of Energy, WB staff estimates

⁵⁹ Diesel's full exemption from excises cannot be fully defended from an equity standpoint as rich people also consume diesel.

⁶⁰ Family Income and Expenditure Survey (FIES).

Figure 33: Wealthier households systematically spend a greater share of their income on all petroleum products except kerosene



Source: Family Income and Expenditure Survey 2012, World Bank staff estimates

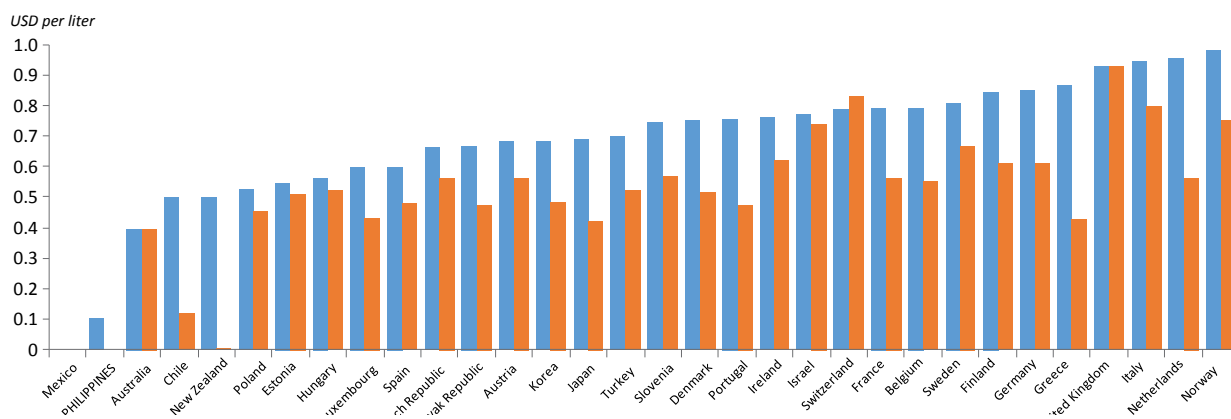
Diesel's exemption from excise taxes not only cannot be justified from an equity standpoint, it also creates economic inefficiencies by distorting relative prices for gasoline and diesel. Fully exempting diesel from excise taxes is not consistent with international good practices.⁶¹ In most countries, the excise tax on diesel is equal to or only slightly lower than the excise tax on premium unleaded

gasoline (Figure 34). However, the Philippine government's complete elimination of the excise tax contributed to the reversal of the diesel consumption trend, from -1.4 percent between 1997 and 2006 to 3.4 percent between 2006 and 2013, despite a general shift toward cleaner energy sources.⁶² As a result, the exemption on diesel likely worked against the government's efforts to reduce air pollution and curb the growth of carbon emissions.

3.3.2 Reform Options

Increasing excise tax rates on petroleum products would improve the efficiency and equity of petroleum taxes, boost tax revenue, and reduce distortions and negative externalities. If rates are not increased, real tax revenues are expected to continue to decline over time, reaching an estimated PHP25.2 billion (or 0.18 percent of GDP) in 2015.⁶³ The most effective option would be to raise excise tax rates to a target share of retail prices, then automatically index tax rates to inflation to maintain a consistent tax-rate-to-retail-price ratio.

Figure 34: In most OECD countries the excise tax rate for diesel is only slightly lower than the excise tax rate for premium unleaded gasoline



Source: International Energy Agency (2012), World Bank staff estimates for Philippines

⁶¹ By contrast, exempting kerosene, which is largely consumed by the poor, is less distortionary and more equitable, as there is no close substitute for kerosene in the same price range.

⁶² Family Income and Expenditure Survey (FIES).

⁶³ These estimates assume that the demand elasticity is -0.3 and that collection efficiency is at 85 percent.

While a one-time increase in excise rates coupled with indexation would be ideal, a second option would be to asymmetrically adjust excise taxes based on petroleum prices. Policymakers can use a formula-based approach to automatically raise excise taxes when petroleum prices fall and keep excise taxes steady when petroleum prices rise. To soften the increase in the excise tax rate as petroleum prices fall, the formula could stipulate that only a portion (e.g., 50 percent) of the decline in petroleum prices be translated

into higher excise taxes. This type of adjustment mechanism can ensure a more gradual, less jarring transition to higher excise rates. For example, when pretax retail prices fall, excise rates could increase by half the amount so that consumers and the government benefit equally until the excise rate reaches its target share of the retail sales price. An equity analysis (Box 12) indicates that in the Philippines the optimal excise-tax-to-retail-price ratio would be 20 percent for gasoline and 10 percent for diesel, kerosene and liquefied petroleum gas (LPG).

Box 12 Excise taxes on petroleum products: an equity analysis

Under the current excise tax regime for petroleum products, households in the top income decile bear 62 percent of the tax burden, while households in the bottom decile bear only 0.18 percent.⁶⁴

However, since the national average petroleum excise tax burden is equivalent to just 0.03 percent of total income, the redistributive effect is extremely modest compared to other taxes.⁶⁵ The progressive distribution of the tax burden is due in part to the fact that gasoline, which is overwhelmingly consumed by the wealthy, is subject to excise taxes, while fuels that are more likely to be consumed by the poor, such as kerosene, diesel and LPG are exempt (Figure 35).

Increasing the excise-tax-to-retail-price ratio to 20 percent for gasoline and 10 percent diesel, kerosene, and LPG would enhance the efficiency of the petroleum excise taxes, but it would reduce the progressivity of the tax burden. Under the revised system the share of petroleum excise taxes paid by households in the poorest income decile would rise from 0.18 to 0.57 percent, while the share paid by households in the richest decile would fall from 62 to 52 percent.⁶⁶ However, the increase in tax rates would intensify the redistributive impact of the tax (Figure 36).⁶⁷ Despite the marginal reduction in progressivity, more than half of the increase in the tax burden would be borne by households in the top income decile, while only 0.63 percent would be borne by households in the bottom decile. Finally, an increase in targeted cash transfers could fully offset the negative impact on poor households.

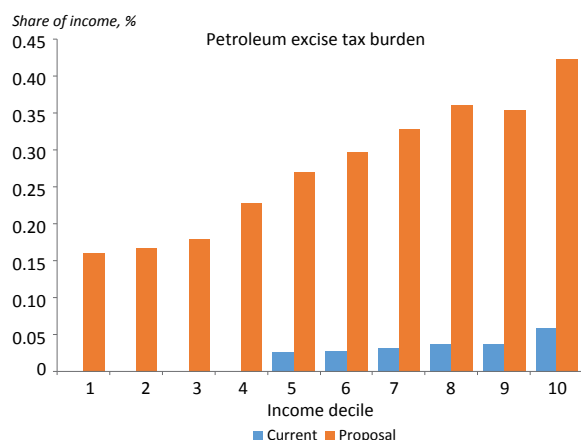
⁶⁴ The petroleum excise tax regime's Kakwani Index score is 18.25, indicating progressivity.

⁶⁵ This is reflected by its very low Reynolds-Smolensky Index score of 0.01.

⁶⁶ It should be noted that the after-tax Gini coefficient would fall to 54.45.

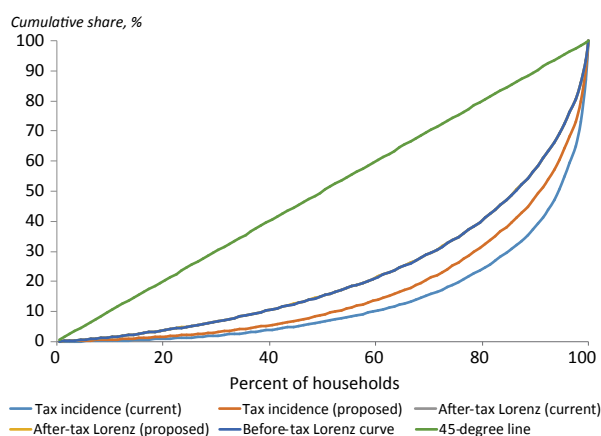
⁶⁷ The very large increase in the magnitude of the tax would boost its Reynolds-Smolensky Index score to 0.04, since the distribution of the tax burden would still be progressive.

Figure 35: Both gasoline consumption and the petroleum excise tax burden are heavily concentrated among wealthier households



Source: World Bank staff calculations using FIES 2012

Figure 36: An increase in cash transfers could offset the negative equity impact of eliminating exemptions on kerosene, diesel and LNG



Source: World Bank staff calculations using FIES 2012

3.4 Conclusion

Targeted reforms to the VAT and petroleum excise taxes could greatly enhance the efficiency, equity and revenue-generating power of the Philippine tax regime. In recent years the growing scope of exemptions and special tax treatment has substantially eroded the VAT base. The VAT policy gap costs the government an estimated 3 percent of GDP in foregone revenue each year, while another 3.7 percent is lost to noncompliance. Many exemptions that focus on specific individuals or firms have little economic justification and should be eliminated. Mandating third-party information sharing to crosscheck VAT declarations could strengthen compliance. Eliminating exemptions and improving compliance can boost VAT revenues without the need to increase rates.

The Philippine government could raise almost 1 percent of GDP in new tax revenue by bringing petroleum excise tax rates closer to global standards. Increasing rates as a share of retail prices and indexing them to inflation would halt the deterioration of real revenue without the political burden of future ad hoc tax increases. Increasing excise tax rates and eliminating exemptions for kerosene, diesel and LNG could also improve the distributional equity of the country's tax system, as higher-income households consume the vast majority of petroleum products. More closely aligning tax rates for gasoline with rates for other fuels would attenuate price distortions, while increasing petroleum excise tax rates would encourage conservation and fuel efficiency, reducing air pollution and carbon emissions.

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APPENDIX

Table A.1: Key economic indicators (2014 to 2018)

	2014	2015	2016	2017	2018
	Actual			Projected	
Growth and inflation	(in percent of GDP, unless otherwise indicated)				
Gross domestic product (percent change)	6.2	5.9	6.4	6.2	6.2
Inflation (period average)	4.1	1.4	2.0	2.5	3.0
Savings and investment					
Gross national savings	24.6	24.3	24.6	24.8	25.0
Gross domestic investment	20.8	21.4	22.8	22.9	23.0
Public sector					
National government balance (GFS basis) ^{1/}	-0.7	-1.0	-2.8	-3.1	-3.1
National government balance (gov't definition)	-0.6	-0.9	-2.7	-3.0	-3.0
Total revenue (government definition)	15.1	15.8	15.5	15.6	17.0
Tax revenue	13.6	13.6	14.1	14.5	16.1
Total spending (government definition)	15.7	16.8	18.2	18.6	20.0
National government debt	45.4	44.8	42.6	40.4	38.2
Balance of payments					
Merchandise exports (percent change)	11.9	-13.1	3.0	6.5	8.5
Merchandise imports (percent change)	6.3	-3.2	7.0	8.0	9.0
Remittances (percent change of USD remittance)	7.2	4.6	4.0	5.0	5.5
Current account balance	3.8	2.9	1.8	1.9	2.0
Foreign direct investment (billions of dollars)	5.7	5.7	5.1	4.0	4.5
Portfolio Investment (billions of dollars)	-0.3	-0.6	2.6	0.5	1.0
International reserves					
Gross official reserves ^{2/} (billions of dollars)	79.5	80.7	87.1	88.4	89.8
Gross official reserves (months of imports) ^{3/}	9.9	10.1	10.7	10.9	11.0
External debt ^{4/}	27.3	26.5	25.2	24.7	24.3

Sources: Government of the Philippines for historical and World Bank for projections.

1/ Excludes privatization receipts and includes CB-BOL restructuring revenues and expenditures (in accordance with GFSM)

2/ Includes gold

3/ Defined as the total of goods and services imports

4/ Central Bank definition

Table A.2: National government cash accounts (GFS basis) (2014 to 2016)

	2014	2015	2016	2017
	Actual	Actual	Estimate	Budget
	(in percent of GDP, unless otherwise indicated)			
Revenue and grant	15.1	<u>15.8</u>	<u>15.5</u>	<u>15.6</u>
Tax revenue	13.6	13.6	14.1	14.5
Net income and profits	6.2	6.4	6.5	6.9
Excise tax	1.1	1.2	1.2	1.2
Sales taxes and licenses	2.7	2.8	3.0	3.0
Others	0.6	0.5	0.5	0.5
Collection from Customs	2.9	2.8	2.8	2.9
Nontax revenue ^{1/}	1.5	2.2	1.5	1.0
Grant	0.0	0.0	0.0	0.0
Total expenditure	15.7	16.8	18.2	18.6
Current expenditures	12.8	13.4	13.6	13.9
Personnel services	4.8	5.0	5.0	5.3
MOOE	2.4	3.0	3.4	3.1
Allotment to LGUs ^{2/}	2.2	2.3	2.4	2.7
Subsidies	0.6	0.6	0.5	0.5
Tax expenditures	0.2	0.1	0.1	0.1
Interest payment	2.5	2.3	2.3	2.1
Capital outlays	2.8	3.3	4.5	4.6
Net lending	0.1	0.1	0.1	0.1
Balance (GFS definition)	-0.7	-1.0	-2.8	-3.1
Balance (GOP definition)	-0.6	-0.9	-2.7	-3.0
Primary Balance (GFS)	1.9	1.4	-0.4	-0.9
<i>Memorandum items</i>				
Privatization receipts (PHP billions)	1.9	62.8	2.0	2.0
Nominal GDP (PHP trillion)	12.6	13.3	14.5	15.9

Sources: Department of Finance, Bureau of Treasury, and Department of Budget and Management, and World Bank 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.

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