PHILIPPINES

SELECTED ISSUES

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PHILIPPINES

SELECTED ISSUES

Approved By
Asia and Pacific
Department

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POTENTIAL OUTPUT AND SCARRING EFFECTS

The COVID-19 pandemic led to a major economic downturn in the Philippines that could inflict longer-lasting adverse effects on the economy. These scarring effects reflect persistent pandemic effects on tourism and a few other service sectors, lower investment, skill losses from high un- and underemployment, and increases in poverty. Expansionary fiscal policy to stimulate demand and investment, measures to resolve a possible corporate debt overhang after the pandemic, and labor market policies to encourage sectoral reallocation would help to mitigate the extent of economic scarring.

A. Recent Developments

1. The COVID-19 pandemic led to a major economic downturn in the Philippines, although a rebound is now underway. Economic activity was negatively affected by the disruption to supply from the pandemic and containment measures. Real GDP in 2020 decreased by 9.6 percent and unemployment rate rose to 10.4 percent in 2020 from 5.1 percent in 2019. With the easing of containment measures and policy support, economic recovery started in the second half of 2020. However, the COVID-19 impact has not yet been reversed, and a second wave of COVID-19 infections emerging in 2021 has slowed down the recovery. The real GDP level in the first quarter of 2021 was still 4.2 percent lower than it was in the same quarter of last year. The unemployment rate also remained at 8.2 percent in first five months of 2021.

2. The sectoral impacts of the COVID-19 pandemic have not been symmetric. Nonessential and contact-intensive services, including tourism, entertainment, and transportation services, have been most severely and persistently affected. Other sectors, including construction and

![Figure 1. Sectoral Growth and Employment](image-url)

Sources: Philippine Statistics Authority; Haver Analytics; and IMF staff estimates.

Prepared by Bo Hyun Chang.
manufacturing, have also suffered reflecting declining demand and impact from containment measures. In contrast, output in the information, financial services, and public administration has increased during the pandemic, although employments in these sectors have also decreased. Some unemployed workers seem to have moved into employment in agriculture. Since preference changes and social distancing by the pandemic are expected to be maintained in the near term, sectoral reallocation could become crucial to recover the growth momentum.

3. **The financial health of firms may have markedly deteriorated in the pandemic.**
Philippine firms entered the pandemic with generally adequate debt service capacity and moderate balance sheet vulnerabilities. The profitability of firms deteriorated sharply in 2020 due to the pandemic, while the interest coverage ratios (ICRs) of most firms remain relatively stable. Nevertheless, the liquidity shortfall and stress inflicted by the deep recession may have increased insolvency risks in some firms. The adverse impact would be uneven, with the micro, small and medium enterprises particularly vulnerable. According to the assessment in the recent FSAP, distress to the large nonfinancial corporates in terms of increases in the shares of debt-at-risk and firm-at-risk could be widespread even in the baseline and sharply rise in adverse scenarios.\(^2\)

4. **Headline inflation rates rose to an average of 4.4 percent in the first half of 2021, and core inflation rates recorded an average of 3.3 percent in the same period.** Inflation in 2020 was relatively stable (annual average of 2.6 percent), but inflation started to increase in the second half of the year, mainly due to transportation bottlenecks and food supply shocks. In an economic recession, inflation and output typically decrease in tandem because aggregate demand declines below the full capacity of the economy. However, in the COVID-19 pandemic, strict containment measures and social distancing have affected both the supply capacity and demand, which has enabled price increases despite output declines and economic slack. In other words, relatively high inflation could potentially be a sign of declines in potential output, which is the highest level of real GDP sustainable over the longer term with stable inflation.

**B. Economic Outlook and Scarring Effects**

5. **GDP growth is projected at 5.4 percent for 2021 and 7.0 percent for 2022.** The economy has started to recover, but a prolonged virus outbreak could hinder fast recovery in 2021. The government also temporarily tightened containment measures in April and May 2021, given the surge in new daily cases. While the authorities aim to secure 148 million doses of vaccine in 2021 to meet its target of inoculating about 70 percent of the country’s population within the year, the program is still in the early phase. The economy is projected to rebound in 2022, led by the infrastructure push and increased domestic and external demands.

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6. **Potential output is estimated to have declined by 1.2 percent in 2020 due to effects of pandemic and containment measures.** Total factor productivity (TFP) decreased significantly (contributing around −2.8 percentage point to the reduction in potential growth) through the supply constraints from containment measures and social distancing. The economy could not exploit its capital and labor as it usually did before the pandemic. Many business activities have also been halted under enhanced community quarantine. Some workers lost their jobs due to weak health condition or social distancing. The large recession in 2020 also lowered potential output through the sharp decline in investment (−27 percent) and the high unemployment rate (10.4 percent). The decline in effective labor may have contributed as much as 0.5 percentage point to lower potential output growth in 2020. Capital accumulation is expected to have contributed only around 2 percentage points to potential growth, which is significantly lower than usual (average 3.4 percentage points in 2015–2019).

7. **Potential output growth is expected to remain low for several years due to economic scarring before returning to the previous trend rate of 6.5 percent in the medium term.** It may take several years for the structural changes triggered by the pandemic to be absorbed and resources to be redistributed. For instance, contact-intensive services (e.g., tourism) are likely to suffer from low demand and bear the extra cost for the operational changes for some time. Bankruptcies of business could increase due to financial stress leading to some loss of firm-specific capital and knowledge. Sectoral reallocation may incur some losses in productivity since growing sectors may require different types of capital and the technology embodied in new capital. If high unemployment rates persist, discouraged workers may not return fully to the labor market. Worsened inequality and poverty during the pandemic also hinder human capital accumulation over the medium term. Accordingly, the real GDP level in 2025 is projected to be 15 percent below that of the pre-COVID-19 path (January 2020 WEO).

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3 Medium-term projections for the actual and potential GDP growth rates, investments and employments are based on the IMF WEO projections. The capital share is assumed to be 0.6 following the BSP (2015). The projection for human capital is an extension of Barro and Lee (2013) using educational returns in Duval and Maisonneuve (2010). The pandemic impact on the employment is assumed at 30 percent of initial shocks in the crisis, considering experiences in the Asian financial crisis, and a slight delay of educational attainments in 2020 is also assumed.
The early quelling of the virus spread could help the economy to overcome scarring from the pandemic. The second wave of virus infections may have peaked in April 2021, and the government could achieve its target of inoculating to about 70 percent of total population as scheduled. As the advanced economies come out of the pandemic gradually, the external demand may recover fast. The envisaged infrastructure push in 2021 and structural reforms will also support economic recovery. Nevertheless, uncertainty about virus dynamics and vaccine availability is still present. The economic recovery could possibly be bumpy until herd immunity against COVID-19 will be achieved through vaccination.

The projected medium-term output losses for the Philippines are in line with past experiences, both globally and domestically. It is widely believed that large and long recessions could cause GDP to fall much below pre-recession trends for many years, whereas GDP may catch up the trend in small recessions. The long-lasting effects of deep recessions are mainly due to significant declines in the growth of productivity and the capital stock. A persistent increase in unemployed or discouraged workers, along with the sectoral reallocation and loss of human capital, also accounts for such long-lasting effects. A large literature has tried to estimate the effects of large recession on the potential output. For example, Heimberger (2020) argued that the losses in potential and actual output by the global financial crisis are almost perfectly correlated in EU countries, based on the EU Commission’s forecast. Output levels after the Global Financial Crisis (GFC) and other recessions have generally been estimated to be between 4 and 9 percent below the pre-recession trends (e.g., Martin and others 2015, Ball 2014). There is a global concern that the COVID-19 pandemic could have long-lasting negative effects on the economy, as in past deep recessions.

The past experience in the Philippines also support the notion of losses in potential output level after large recessions. Both in 1984 and 1985, the GDP decreased by about 7 percent. By 1990, the output level was about 21 percent below the pre-crisis output trend, which is calculated based on the 5-year average growth rate before the crisis. The Asian financial crisis in 1997 was another event with a fall in potential output. In addition to the GDP decrease in 1998 (~0.5 percent), the economy struggled with a weak growth momentum for several years before growth finally recovered. In contrast, the impact of the GFC on the Philippines was relatively small, with growth decelerating from 4.3 percent in 2008 to 1.4 percent in 2009. Subsequently, actual output caught up with the previous trend level.
C. Policy Recommendations

11. The severity of COVID-19 impact calls for active fiscal action to support the recovery and build productive capacity. With a debt-to-GDP ratio below the EM average, Philippines has the fiscal policy space to support the recovery and avoid a premature consolidation. A premature withdrawal of stimulus could risk unravelling the incipient recovery, leading to a deeper recession that would aggravate scarring. Increased spending in public works and transportation could create more jobs especially by continuing with construction of projects already at advanced stages. A renewed infrastructure push in emerging growth areas such as digitalization, healthcare, and climate change can help with the post-pandemic reorganization of the economy while also boosting medium-term productive capacity.

12. Measures to resolve the possibly large corporate debt overhang after the pandemic, while adapting to structural change, will be crucial. The government should provide targeted support to the viable firms, while facilitating the exit of unviable ones for efficient reallocation of resources. The credit guarantee scheme would encourage banks to lend to corporates by mitigating credit risks to lenders. In the case of systemically important corporates, equity injections by the government could also be considered. The scale of the COVID-19 shock and potential for larger spillovers from bankruptcies than in normal recessions would argue for providing more liquidity and solvency support than usual, except for firms that were already insolvent before the crisis began. The GUIDE Bill, currently under parliament consideration, would provide additional financial resources to government financial institutions to assist firms with temporary solvency issues due to the pandemic.

13. Labor market policies should encourage sectoral reallocation while protecting the vulnerable. Active labor market policies, including retraining programs that help workers acquire new skills, could reduce skill mismatch and support reallocation of workers. To encourage firms to hire new workers, well-designed and targeted subsidies for hiring may be effective. More flexible labor regulation (e.g., dismissal procedure, minimum wage) could also facilitate the relocation of labor. Ensuring adequate safety nets for workers, including more coverage of informal workers, would be essential to protect those most impacted by the economic dislocation.

14. The economic reform momentum should be intensified to boost growth after COVID-19. The planned introduction of the national ID system and implementation of the financial inclusion initiative would complement the ongoing social assistance programs by facilitating the identification of eligible households and delivery of cash aid. Effective implementation of the ease of doing business and CREATE laws would help alleviate the burden of MSMEs hit by COVID-19 and promote new businesses. Further lifting of restrictions on inbound foreign direct investment could help rekindle investment and employment. The planned digitalization of public administration should also be accelerated. In the medium term, more resources and incentives for climate change adaptation and mitigation will be needed to induce more investment and changes in emission patterns.
References


UNDERSTANDING THE TURNAROUND IN THE CURRENT ACCOUNT BALANCE

The Philippines experienced large swings in its current account (CA) balance in the past decade, mainly driven by swings in the merchandise trade balance. A large economic downturn and sharp declines in investments during the COVID-19 pandemic and investment boom before the pandemic played a key role in recent CA fluctuations. With the economic recovery, the projected rebound in investment, and expansionary fiscal policy stance, the surplus is expected to narrow in 2021, and a current account balance is expected to return to the deficit in the medium term.

A. Recent Developments

1. The Philippines experienced large fluctuations in the current account balance in the past decade. The current account balance was in surplus until 2015, averaging 3 percent of GDP in 2011–2015. It moved into deficit in 2016–2019 (average 1.1 percent of GDP), then returned to a large surplus in 2020 (3.6 percent of GDP). These fluctuations are mainly explained by the widening and narrowing deficits for trade in goods. The balances in other accounts (services, primary and secondary income) changed relatively little. In contrast, other ASEAN peers showed either continuous deficits (Indonesia) or surpluses (Malaysia, Thailand), suggesting that recent CA fluctuations in the Philippines mainly reflected country-specific factors.

2. The current account deficit in 2016–2019 was mainly driven by acceleration in goods imports. Goods exports grew slowly, and the corresponding export share in GDP declined during the same period. In contrast, service exports increased faster than the service imports, partially offsetting further deficits. Credits (exports) and debits (imports) in the primary and secondary income, most of which are remittances from overseas workers, remained stable.

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1 Prepared by Bo Hyun Chang.
3. Similarly, the turnaround in the current account in 2020 was mainly driven by a deceleration in goods imports. Service balances (to the GDP) rarely changed since both service exports and imports declined together. Particularly, the tourism and travel sectors have been hit hard by the pandemic. Foreign visitors dropped sharply in 2020, being close to zero from May onward. With fewer visitors, travel exports decreased from US$9.8 billion in 2019 to US$2.0 billion in 2020. However, travel imports also decreased sharply, and the trade deficit in tourism and travel was broadly unchanged in 2020 compared to 2019. While remittances oscillated throughout the year 2020,² total remittances in 2020 were almost similar to the 2019 keeping the primary and secondary income balances.

### Philippines: Current Account Details

<table>
<thead>
<tr>
<th></th>
<th>Goods</th>
<th></th>
<th>Services</th>
<th></th>
<th>Primary Income</th>
<th>Secondary Income</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Exports</td>
<td>Imports</td>
<td>Exports</td>
<td>Imports</td>
<td>Credits</td>
<td>Debits</td>
</tr>
<tr>
<td>2011-2015</td>
<td>16.1</td>
<td>23.2</td>
<td>8.4</td>
<td>6.2</td>
<td>3.1</td>
<td>2.7</td>
</tr>
<tr>
<td>2016-2019</td>
<td>14.6</td>
<td>27.4</td>
<td>10.6</td>
<td>7.7</td>
<td>3.3</td>
<td>2.2</td>
</tr>
<tr>
<td>2020</td>
<td>13.1</td>
<td>21.9</td>
<td>8.7</td>
<td>5.1</td>
<td>3.2</td>
<td>2.0</td>
</tr>
</tbody>
</table>

Source: Haver Analytics; and IMF staff estimates.

B. Drivers of the Current Account Changes

4. The Philippine economy experienced a larger economic downturn with the COVID-19 pandemic than most other countries. Significant local transmission of the virus and stringent

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² Remittances from overseas workers decreased by 9.8 percent (year-on-year) in the second quarter of 2020 and, then, increased by 4.2 percent (year-on-year) in the third quarter.
containment policies led to a sharp drop in domestic demand in the Philippines compared to other emerging markets or ASEAN peers. Real GDP decreased by 9.6 percent in 2020, a noticeable contrast to the average growth of 6.6 percent in 2016–2019. The change in investment was even larger. After an average growth of 12 percent in 2016–19, gross fixed capital formation declined by 27 percent in 2020.

5. The economic downturn and the associated investment decline also contributed to the turnaround in the current account balance. The sharp decline in investment, an import-intensive component of aggregate demand, was particularly relevant. From a saving-investment (S-I) balance perspective, the increasing current account deficit in 2016–2019 mirrored an investment boom during those years—the investment ratio increased from 21 percent of GDP in 2015 to 27 percent of GDP in 2018, while aggregate gross savings barely changed. Public investment, led by flagship projects under the authorities’ signature Build Build Build program, contributed importantly to the boom. In 2020, investment accounted for a larger share in the turnaround in the current account balance than aggregate savings.

6. The terms of trade also contributed to recent CA fluctuations. The terms of trade deteriorated by an average of 2.7 percent per year between 2016 and 2019 widening CA deficits. In 2020, the terms of trade improved because of the decline in the price of oil and commodity prices. Nevertheless, changes in exports and imports were more driven by volumes rather

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3 Due to delays in the parliamentary approval of the 2019 budget, aggregate investment slightly declined to 26 percent of GDP that year.

4 Terms of trade are calculated by export deflator divided by import deflator from the national accounts.
than by prices. Nominal goods exports in the national accounts (in national currency) decreased by 13.2 percent in 2020, with 8.6 percentage points accounted for by the decline in real imports. Real goods imports (in national currency) contributed 20.3 percentage points out of 24.5 percent decrease in nominal imports in 2020.

7. The current account reversal in 2020 also seems to have contributed to upward pressure on the Philippine peso. The external value of the peso declined gradually in 2016–2018 but has appreciated since 2019—movements that are consistent with a stabilizing influence on the external position. The appreciation of the peso in 2020 could thus have been driven in part by the same factors behind the large current account surplus, thereby dampening the actual surplus, and continued capital inflow. Unlike the Philippines, other ASEAN peers experienced currency depreciation due to increased uncertainty during the pandemic.

8. Regression analysis corroborates that shifts in the composition of aggregate demand are associated with substantial changes in the current account balance. To analyze this link, the relation between the current account and its determinants was estimated for the period from 1982

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5 There is a mutual effect between exchange rates and the current accounts. The appreciation of exchange rates can worsen trade balances by reducing exports and increasing imports, while the CA surplus is likely to decrease demand for foreign currency raising the exchange rates (appreciation).
to 2020. Exchange rates, terms of trade and the fiscal balances would be expected to be positively related to the current account balance, while the real GDP growth rate and domestic interest rates would be expected to be negatively related. The table below shows the estimation results. The positive coefficient associated with the lagged variable indicate that changes in the explanatory variables have persistent effects on the current account balance. Improving terms of trade or depreciation of the real effective exchange rate (REER) lead to increases in the current account balance. An expansionary fiscal stance or high real GDP growth have the opposite effect. High interest rates are related with declining current account balance.

When the investment-to-GDP ratio increases, the current account balance decreases with the implied increases in imports.

9. The results are consistent with the hypothesis that recent current account fluctuations were driven mainly by changes in investment and economic shocks. The figure illustrates the decomposition of the recent current account dynamics implied by the estimated model. The turnaround in the current account to a surplus in 2020 was mainly driven by the economic recession and the associated composition in aggregate demand, notably the

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6 We used quarterly data from 1982:Q1 to 2020:Q4 from the Haver Analytics and IMF World Economic Outlook database. The current account, investment shares and fiscal balance are in percent of GDP. The real exchange rates are based on the weights of trade partners and consumer price index. The fiscal balance is central government budget surplus or deficit. The second order of growth rates is included to investigate non-linear effects of economic growth. Interbank call loan rates are used as the interest rates.

7 Lagged exchange rate is used in our specification to avoid an endogeneity issue between the current account and the real effective exchange rates.

8 The effect of interest rates on the current account balance is uncertain, and empirical estimates in the literature are also varied. High interest rates can encourage domestic saving leading to increase in the current account. High interest rate leads to capital inflows and imports can increase. Ariyani and others (2018) reported the negative relation between the interest rates and the current accounts in the ASEAN six countries.

9 All components are calculated by changes in variables (quarterly, year-on-year basis) multiplied by the coefficients in the model.
sharp decline in investment relative to other components. Conversely, the deficit in 2016–2018 was primarily driven by booming investment.

C. Prospects

10. The large turnaround in the current account balance in 2020 is expected to be largely temporary and starting to reverse in 2021 with progress in the economic recovery. Recent health measures and the vaccination program should result in an improving COVID-19 situation and allow for further economic reopening, thereby supporting a recovery in consumption and investments, and in imports. Moreover, the recent rise in oil and other commodity prices should result in higher import values. Nevertheless, in the near term, the current account is expected to remain in surplus, given a relatively gradual economic recovery this year and a relatively stronger economic rebound in advanced economies, which will boost external demand and exports.

11. The current account balance is expected to return to a deficit in the medium term due to rekindling investments. Infrastructure gaps have been an important constraint on economic growth and poverty reduction in the Philippines. To address this constraint, the government has increased public spending on infrastructure significantly, mainly through the Build Build Build

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10 The external balance assessment (EBA) model analyzes the current account surplus in the Philippines from a different angle. The EBA model investigates the effects of economic cycles, including changes in terms of trade and COVID-19 adjustment, and interactions of policy variables across countries, while our regression analysis considers a wider set of domestic variables, but not foreign variables. According to the EBA model, the cyclically adjusted CA in the Philippines in 2020 is larger than the CA norm, and this gap is mainly related to less expansionary fiscal policies in the Philippines than in other countries, especially advanced economies. Our regression analysis illustrates the large effects of the pandemic on investment in the Philippines might be captured by the effect of the difference in the fiscal stance between the Philippines and other countries in the EBA model.

11 The average CA change (quarterly, year-on-year basis) in 2016–2019 was −0.8 percent of GDP. Main drivers implied by the model were persistence (−0.6 percentage points of the change), investment increases (−0.2 percentage points), low interest rate (−0.1 percentage point) and expansionary fiscal stance (−0.1 percentage point).
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program, focusing on transportation, water resources, and energy. Ongoing structural reforms, including reforms at improving the ease of doing business and the tax reductions under the CREATE law, aim to improve the business environment and promote new businesses. Together with the envisaged increase in public investment from 2021, these reforms should rekindle investment going forward, likely contributing to a reversal in the current account from surplus to a deficit.
Reference

PHILIPPINES’ FISCAL SPACE AFTER RESPONDING TO COVID-19 PANDEMIC

Fiscal space in the Philippines has narrowed in the wake of the COVID-19 pandemic. In 2020, the supportive fiscal measures led to an increase in the general government debt-to-GDP ratio by 15 ppts to about 52 percent in end-2020. With a sluggish recovery in revenue and the continued need for fiscal support, the general government debt-to-GDP is expected to peak at about 62 percent in 2024, slightly above the authorities’ indicative cap of 60 percent. As the fiscal space to respond to any future economic downturns is now more limited, rebuilding fiscal space would be desirable in the medium term. This goal could be achieved through higher revenue mobilization, better tax administration, and stronger expenditure efficiency, anchored around a prudent medium-term fiscal framework. Measures to boost real GDP growth would also help to improve the fiscal space.

A. Fiscal Response to the COVID-19 Shock and Its Impact

1. The fiscal deficit nearly doubled in 2020, in part due to the authorities’ fiscal response to support recovery during the COVID-19 pandemic. Prudent fiscal management prior to the pandemic provided the Philippines with substantial fiscal space to respond to the pandemic. The fiscal support included two stimulus packages (Bayanihan Acts I and II) in 2020 and the CREATE tax reform package, which included an accelerated reduction of corporate income tax rates. In total, the direct budgetary support amounted to 4.4 percent of 2020 GDP. The government also introduced below-the-line measures, mainly for credit guarantees, that amounted to about 0.6 percent of 2020 GDP. The measures were well-targeted, focusing on social spending for the most affected sectors (text chart). The fiscal deficit increased by about 4.2 ppts reaching 7.6 percent of GDP in 2020. The deep contraction in output contributed to about 0.6 ppts to the increase in the deficit and to lower revenues.

2. The higher fiscal deficit in 2020 led to a significant increase in the debt-to-GDP ratio, narrowing the fiscal space. The general government gross public debt-to-GDP ratio is estimated to

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1 Prepared by Sarwat Jahan. The analysis is based on data up to May 30, 2021.
2 CREATE refers to the Corporate Recovery and Tax Incentives for Enterprises Act. CREATE lowers corporate income tax from the current 30 percent, the highest in the region, to 20 percent for micro, small, and medium enterprises with net taxable income of PHP 5 million and below, and with total assets of not more than PHP 100 million excluding land. For the rest, including foreign firms, the corporate income tax reduction is 25 percent.
have increased by about 15 ppts in 2020, reaching about 52 percent by the end of the year.\(^3\) The output contraction of about 9.6 percent in 2020 contributed about 4.2 ppts to the increase in the debt-to-GDP ratio in 2020. The higher fiscal deficit led to higher general government gross financing needs, which increased from 5.4 percent in 2019 to 10.1 percent of GDP in 2020. The authorities had continued access to markets and were able to finance the deficit through higher borrowing from both domestic and external sources (which led to cash buffers of about 4 percent of GDP).

### B. Post Pandemic Fiscal Space

3. **The post-pandemic debt trajectory will continue to remain high, as fiscal policy will continue to be expansionary in the near term to support recovery.** The fiscal deficit is projected to increase to about 9.6 percent of staff projected GDP in 2021, reflecting the sluggish recovery in revenue (expected to grow by about 0.9 percent y/y in nominal terms in 2021) and a further expenditure increase, to respond to the pandemic and push for infrastructure projects under the *Build Build Build* program (leading to an increase in the infrastructure program from about 4.8 percent of GDP in 2020 to 5.3 percent of staff projected GDP in 2021).\(^4\) It is assumed that the unwinding of the fiscal stimulus will start in 2022 when tax revenues recover, and support measures elapse. The national government budget deficit is projected to reach 3.5 percent of GDP by 2026, as the revenue-to-GDP ratio converges to historical values, while the expenditure-to-GDP ratio remains slightly higher than the historical average due to the Mandanas ruling on revenue sharing with the local government units (LGUs).\(^5\)

\(^3\) The actual general government gross debt for 2020 is not yet available. However, the national government gross debt increased from about 39.6 percent of GDP in 2019 to 54.6 percent of GDP in 2020 and further increased to 60.4 percent of GDP in 2021:Q1, with about 72 percent denominated in local currency.

\(^4\) The investment program includes national government expenditure on infrastructure investment, infrastructure subsidy/equity to government owned and controlled corporations GOCCs, and transfers to local government units (LGUs) intended for infrastructure spending.

\(^5\) The Mandanas Ruling, confirmed by the Supreme Court in 2019, stipulates that the revenue from all national taxes, with a few exceptions, will be included in the base for determining the total allocation to the LGUs.
4. Staff projects that the general gross government debt-to-GDP ratio will be temporarily higher than the authorities indicative cap of 60 percent during 2023–25. With a sluggish recovery in revenue and the continued need for fiscal support in 2021, temporarily higher budget deficits will add to the debt ratios. Going forward, the relatively small revenue base will continue to weigh on the fiscal space, although it will be partly mitigated by the growth recovery. Under this baseline scenario, the general government gross debt-to-GDP ratio would peak at about 62 percent in 2024 and then gradually start to decline, although negative shocks could lead to higher debt ratios. The fan chart shows the possible evolution of the debt-to-GDP ratio over the medium term by simulating the impact of a large number of shocks (both the upside and downside risks) to relevant macroeconomic variables such as real GDP growth, the effective real interest rate, the real exchange rate, and the primary balance. The chart suggests that while debt may stay above the baseline path under a downside scenario, it will remain bounded below 68 percent of GDP.

C. Rebuilding Fiscal Space

5. The authorities would benefit from a fiscal strategy that balances the need for continued policy support in the short term with the rebuilding of fiscal space in the medium term. In the near term, fiscal policy would need to remain flexible to support recovery, but it would be prudent to build fiscal space in the medium term, to have the flexibility to respond to another major downturn or a large shock (e.g., natural disasters that could lead to bigger damages with climate change). Rebuilding of fiscal space would require a policy mix of revenue generation (¶6 and ¶7), expenditure efficiency (¶8), and boosting GDP growth. Policies to foster stronger growth, including through structural reforms, will be critical in the strategy to increase fiscal space as economic scarring due to COVID-19 will have a persistent impact.

6. Implementing the remaining tax reforms will be essential for sustaining higher spending in support of longer-term growth while creating fiscal space. Fiscal space could be rebuilt by strengthening revenue mobilization as Philippines’ revenue-to-GDP ratio is below the average of ASEAN countries and ranks below many EMs. The authorities implemented the first package of their Comprehensive Tax Reform Program (CTRP) in 2018, which involved excise tax increases for select products and a broadening of the VAT tax base. The envisaged increase in tax collection was to be allocated to infrastructure projects (70 percent) and social service programs (30 percent). More recently, the authorities implemented the second package of the CTRP in March 2021 which accelerated the reduction in corporate income tax compared to the original plan in response to the pandemic through the CREATE Act. Remaining
revenue-raising reform priorities includes broadening the tax base for property-related taxes; and simplify taxes for financial services (table on tax measures).

### Tax Reforms in the Philippines

<table>
<thead>
<tr>
<th>Name of Reform Package</th>
<th>Main Target</th>
<th>Other Issues</th>
<th>Status</th>
<th>Targeted Use of Revenue Generated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Package 1 Tax Reform for Acceleration and Inclusion (TRAIN)</td>
<td>Simplified personal income tax reform; Expanded VAT base</td>
<td>Increase in excise tax (oil, automobile, sweetened beverages, mining, tobacco, cosmetic, documentary stamp tax, stock transaction tax, capital gains etc.)</td>
<td>Passed into law in Dec 2017</td>
<td>70 percent of the incremental revenues of TRAIN will go to infrastructure and the Build, Build, Build program, while the balance will go to social services programs.</td>
</tr>
<tr>
<td>Package 1A Tax Amnesty</td>
<td>Errant taxpayers affordably settle their outstanding tax liabilities</td>
<td>Signals the start of a more aggressive tax enforcement campaign by tax authorities</td>
<td>Passed into law in Feb 2019</td>
<td>Additional revenues for its priority infrastructure and social programs.</td>
</tr>
<tr>
<td>Package 1C Motor Vehicle Users Charge</td>
<td>Impose a unitary rate based on weight for all vehicles.</td>
<td></td>
<td>In progress</td>
<td>Adequate funding for the maintenance of national and provincial roads. Address air pollution from motor vehicles.</td>
</tr>
<tr>
<td>Package 2 Corporate Recovery and Tax Incentives for Enterprises (CREATE)</td>
<td>Reduction in the corporate income tax rate</td>
<td>The FIR will have the authority to recommend to the President appropriate non-financial support, in addition to tax incentives.</td>
<td>Passed into law in March 2021</td>
<td>n.a.</td>
</tr>
<tr>
<td>Package 2A Sin Taxes</td>
<td>Increasing taxes on tobacco, alcohol, and e-cigarette products</td>
<td></td>
<td>Passed into law in July 2019 (increasing excise tax on tobacco), and in January 2020 (increasing excise taxes on alcohol and e-cigarettes).</td>
<td>Fund universal health care and reduce the incidence of risks from the consumption of &quot;sin&quot; products.</td>
</tr>
<tr>
<td>Package 2B Mining</td>
<td>Implement a single fiscal regime applicable to all mineral agreements</td>
<td>Generate additional revenues; make the tax system simpler, fairer, and more efficient</td>
<td>In progress</td>
<td>Fund priority programs on social and environmental protection.</td>
</tr>
<tr>
<td>Package 3 Real Property Valuation Reform</td>
<td>Broaden the tax base used for property-related taxes of the national and local governments.</td>
<td>Increase government revenues without adopting new tax measures. Single valuation base will eliminate wide disparities and achieve consistency in real property valuation</td>
<td>In progress</td>
<td>n.a.</td>
</tr>
<tr>
<td>Package 4 Passive Income and Financial Intermediary Taxation Act</td>
<td>Simplify the taxation of passive income, financial services, and transactions by reducing the number of tax rates from 80 to 36.</td>
<td>Harmonize the tax rates on interest, dividends, and capital gains, and the business taxes imposed on financial intermediaries.</td>
<td>In progress</td>
<td>Attract capital and investments that are urgently needed to finance large-scale infrastructure.</td>
</tr>
</tbody>
</table>

Source: Department of Finance, The Government of the Philippines (https://taxreform.dof.gov.ph/)

7. **Continued efforts to improve revenue administration would reinforce tax reforms.** Revenue administration can be strengthened by maintaining tax compliance of profitable firms, and adopting new digital products and services will help boost revenue mobilization. Additionally, building on the recent CREATE Act, revenue performance can be improved through streamlining and reducing exemptions and loopholes. Under CREATE, the Fiscal Incentives Review Board (FIRB) will
determine the target performance metrics that firms will need to meet to receive tax incentives; and conduct regular monitoring and evaluation of investment and non-investment tax incentives, such as cost-benefit analysis to determine their impact on the economy and whether agreed performance targets are met. If properly implemented, FIRM can improve the oversight and design of current extensive tax incentive regime, making the regime more accountable and effective in encouraging business investment and job creation.

8. **Exploring options to improve expenditure control and efficiency, including by better targeting and improved delivery would complement revenue efforts.** For example, compared to the best-performing countries among emerging market economies, the Philippines has an efficiency gap in translating public investment into infrastructure (IMF Country Report No. 19/137, Philippines: Public Investment Management Assessment, 2019). In other words, although the perceived quality of infrastructure seems good, the Philippines could generate more and better infrastructure services with the same level of the public capital stock per capita if the efficiency gap were closed. Hence, greater infrastructure could be generated with the same level of spending that could help mitigate pressure on fiscal space.

9. **To maintain fiscal discipline, the authorities may benefit from augmenting its medium-term fiscal program (MTFP) with explicit fiscal anchors to ensure fiscal sustainability.** Currently, the Philippines has a three-year medium-term fiscal program (MTFP), which is set by the Development Budget Coordination Committee (DBCC). The MTFP serves as the framework that guides the macroeconomic and fiscal policies of the government. The national government’s fiscal performance is consistently evaluated against the MTFP, and fiscal projections are updated in mid-year to account for actual accomplishments, emerging challenges, and developments and prospects in the macroeconomic and fiscal landscapes. Going forward, there could be benefits to formulating medium-term fiscal plans with explicit anchors which would eliminate any concerns on the authorities’ commitment to ensure fiscal sustainability, especially given the downside risks to the near-term outlook and the heavy reliance on expenditure measures. The parameters could be set by:

- **Medium-term fiscal strategy (MTFS).** The authorities have an indicative debt-to-GDP ratio cap of 60 percent with an implicit deficit rate of around 3 percent. Under the baseline, the general government debt-to-GDP ratio will exceed the indicative cap, and efforts to keep below the cap in the near term will likely be counterproductive as the economy is recovering from a deep

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6 The IMF has developed a methodology for estimating the efficiency of public investment, explained in the 2015 IMF paper, *Making Public Investment More Efficient*. Simply stated, a country’s performance is estimated based on an index of the output of public investment compared to its per capita public capital, or input. A “frontier” that consists of the countries achieving the highest output per unit of input is drawn. Using a consistent set of data, the performance of a total of 128 countries is compared to the frontier.

7 The fiscal projections are regularly updated/revisited by the DBCC in order to adequately guide the country’s annual budget preparation process through the issuance of the Budget Priorities Framework. This is supported by the implementation of the Two-Tier Budgeting Approach through which the forward estimates or the future costs of ongoing policies, and existing programs, activities, and projects (PAPs) for the next three years serve as the baseline budget. This then feeds into the review and/or updating of the MTFP and is used to estimate the available fiscal space to fund new or expanded PAPs.
downturn. Instead, the cap could serve as a medium-term anchor with deficit targets as intermediate objectives. A specific plan to meet the post-pandemic deficit ceiling by detailing the underlying measures could help anchor expectations about the medium-term fiscal position and reduce risks to policy credibility, especially if also backed by revenue measures. If the state of the economy prevents meeting the target, risks to policy credibility could be reduced with a well-articulated escape clause or regular progress reviews.

- **Medium-term revenue strategy (MTRS).** Taking advantage of the current reform momentum in tax policy, the Philippines can adopt a MTRS which would be critical to lay out the plans for financing a higher medium-term growth. The MTRS can draw out measure including to improve tax administration and revenue collection, which could help finance the large infrastructure expenditures as well as potential increase in the allocation to local government units.

- **Medium-term debt management strategy (MTDS).** Elevated public debt has heightened the need to strengthen the capacity in debt management and to accelerate capital market development to ensure stable domestic financing. While Philippines has prudently managed its debt thus far, all debt-related analytical work currently focuses on Annual Borrowing Plans with no clear analytical framework to guide the composition of the public debt portfolio. Adopting an MTDS framework could strengthen debt management by not only providing clarity on the borrowing objectives but also identify the risks of selected financing options.