Special Report

Philippines: Fiscal Prospects Revisited

Ratings

Foreign Currency
Long-Term .... BB
Short-Term .... B
Outlook .... Stable

Local Currency
Long-Term .... BB+
Outlook .... Stable

Country Ceiling .... BB

Ratings History

Date	LTFC	LTLC
12 June 2003	BB	BB+
15 March 2001	BB+	BBB-
8 July 1999	BB+	BBB

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Summary

Fitch Ratings revised its Outlook on the Philippines' Long-term foreign and local currency sovereign credit ratings to Stable from Negative on 26 May 2005, reflecting enhanced prospects for fiscal adjustment following the passage of landmark tax legislation. This brief comment sets out Fitch's revised projections for the Philippines' public finances, incorporating the expected impact of the government's package and other recent developments in fiscal policy and performance. These forecasts show significantly improved public debt dynamics compared with those made previously thanks to the likelihood of primary fiscal surpluses of over 3% of GDP in the near term. With a strong likelihood that the tax package will be implemented and with a firm commitment to most of the additional revenue being devoted to deficit reduction, public finances are set to improve sufficiently rapidly over the short and medium term to avoid a downgrade of the ratings.

The VAT Package

President Arroyo signed the VAT package into law on 24th May 2005 following several months of intense debate over its contents in the House of Representatives and the Senate. The package represents the core component of the government's tax policy response to the fiscal problems that have beset the Philippines in the last few years, as reflected in its sovereign rating downgrades in 2001 and 2003 and the downward revision of its Outlook late last year.

The package contains three components:

a. It grants authority to the President to increase the VAT rate from 10% to 12% on 1st January 2006, provided that *either* the national government deficit in 2005 is greater than 1.5% of GDP *or* that VAT receipts in 2005 exceed 2.8% of GDP.

b. A significant reduction in VAT exemptions, including for the power sector and the legal and medical professionals, to be implemented 1 July 2005.

c. An increase in the corporate income tax rate from 32% to 35% until 2009, after which it will be reduced to 30%.

The conditionality attached to the VAT increase results from the outcome of the political bargaining that was required to get the package through Congress, with opposition congressmen keen that "ownership" of the package is associated as closely as possible with the President. Nevertheless, both conditions are currently being met and are highly likely to be met in 2005. Moreover, it would be wrong to characterise the package as having been watered down as a result of political discussions – the final version actually involved a broader set of tax measures than was envisaged in the President's initial plan.

There is some residual risk that the package will not be implemented on 1st January, even if the conditions are being met, but this seems small. It is true that legal challenges to legislation are not uncommon in the Philippines and some minority Senate members have indeed been questioning whether the authority awarded to the President to raise taxes is constitutional. However, the authority that has been given to the President to raise VAT takes the form of a directive from the Finance Minister. Having been fully discussed and approved by both houses it is hard to see how the tax increase could be seen as a unilateral action on the President's part. In addition, while it is conceivable that the President may choose not to sign the package in the face of popular protest, this seems very unlikely in view of the personal store she and her team have put into the VAT bill. Not to sign would entail a large loss of credibility and make her "fiscal crisis" gambit – whereby she emphasised the threat of financial ruin if politicians failed to agree to tax increases – look very odd indeed.

The Department of Finance (DOF) estimates that the package will raise just under PHP30bn in additional revenue this year and around PHP100bn next year, based on an assumed 70% collection rate. Fitch takes a more conservative view, but nevertheless expects a revenue haul of around PHP80bn or 1.3% of GDP in 2006.

The Overall Fiscal Policy Effort

The passage of the VAT package more or less draws to a close the tax policy response that commenced with the President's "PHP80bn" tax increase plan unveiled 12 months ago. A bill rationalising tax incentives (which consolidates disparate tax incentives into a single and more transparent law and repeals a number of the smaller incentives) has been passed by the Lower House, but is still being discussed in the Senate. However, this is not expected to be particularly significant in revenue terms. Along with the other tax policy measures that have already been passed as part of the PHP80bn package – including the re-indexation of cigarette and alcohol duties and a lateral attrition law that creates stronger incentives for tax collector's to deliver increased revenue – the overall tax policy effort looks set to raise around PHP110bn or 2% of projected 2006 GDP.

But this does not reflect the fiscal policy response in its entirety. Petroleum import duties were also increased to 5% from 3% in January 2005. In addition, the government is sustaining an impressive austerity drive, as demonstrated by a decline in national government primary spending (excluding interest payments) to less than 13% of GDP in 2004,

Table 1: Fiscal Measures

	2005 PHPbn	2005 % GDP	2006 PHPbn	2006 % GDP
Indexation of Sin Tax	15	0.3	15	0.3
Rationalisation of Incentives	5	0.1	5	0.1
Lateral Attrition	10	0.2	10	0.2
VAT Package	20	0.4	80	1.3
Total	**50**	**0.9**	**110**	**1.9**

Source: DOF, CPBO, Fitch

the lowest ratio since data were first readily available in 1990. In the first four months of this year, primary expenditure grew by only 0.7% from the same period a year earlier. While this very slow pace of growth may partly reflect one-off factors, this, nevertheless, points to the likelihood that primary spending could fall further as a share of GDP this year. Finally, outside the sphere of the national government (NG) budget, last September's hike in electricity tariffs is estimated to improve the deficit of government-owned and controlled companies (GOCCs), particularly NAPOCOR, by 0.7% of GDP from 2005.

In the future, the government's focus is likely to switch towards implementing measures to improve tax efficiency. There has been a lot of noise in this area of late, including several high profile tax cases against celebrities, and anecdotal reports are emerging of greater anxiety among the private sector over tax affairs. Until Q105, however, the Bureau of Internal Revenue (BIR) had only succeeded in stabilising its revenues as a share of nominal GDP and not increasing them. However, April 2005 saw the government record its first monthly fiscal surplus since 2001, driven by a 19% year-on-year increase in BIR receipts. Obviously, it would be foolhardy to make too much of one month's data, but it is noteworthy that April is the key month for BIR collections and has been a good indicator of annual deficit trends in the past, while early indications point to another strong month for BIR collections in May. For the time being the jury remains out on whether the tax crackdown is working to raise the elasticity of the Philippine tax system, but it is also quite feasible that the BIR is benefiting from the delayed impact of strong corporate income growth last year. For example, the large telecommunications companies have recently been making very healthy profits and time-limited tax holidays, granted previously to this sector, expired this year. Meanwhile corporate net income growth has been strong across the board.

Revised Public Finances Outlook

Table 2 below presents a revised forecast for national government finances, incorporating the package and a more sanguine view on the outlook for primary spending in 2005 than that taken in Fitch's December 2004 Sovereign Report (assumptions for nominal GDP growth are little changed from the December 2004 report). The table shows the NG primary balance rising to 2.7% of GDP this year (around PHP170bn) thanks to a 0.8% of GDP increase in revenue and a 0.4% of GDP decline in primary spending. Next year revenue is expected to rise to 16.4% of GDP – its highest level since 1998 – which helps push the primary balance to 3.5% of GDP despite a 0.4% of GDP increase in primary expenditure. This would be the largest primary surplus since 1996. The overall deficit, including interest payments, is forecast to fall to 2.7% of GDP in 2006, which would be the lowest since 1998 despite the national government having absorbed additional interest payments from the assumption of NAPOCOR debts from this year.

Table 2: Revised Fiscal Outlook

% of GDP	2004	2005 Budget	2005 Fitch: 12/04	2005 Fitch: 6/05	2006 Fitch: 12/04	2006 Fitch: 6/05
Revenue	14.4	14.8	14.7	15.2	15.4	16.4
Expenditure	18.3	18.4	18.6	18.4	19.0	19.1
"Exc. Interest	12.9	12.5	12.7	12.5	12.8	12.9
Balance	-3.9	-3.6	-3.8	-3.2	-3.6	-2.7
Primary Balance	1.5	2.3	2.1	2.7	2.6	3.5

Source: DOF, Fitch projections

Table 3 shows the outlook for public debt. A key point to note here is the recent downward revisions to government debt data following the completion of a consolidation exercise in January 2005. The DOF, with help from the IMF, have reworked the government debt figures to exclude intra-government holdings, which is standard international practice. This makes a significant difference in the Philippines because of sizeable holdings of government paper by the national government's own "Bond Sinking Fund" and, at the level of the non-financial public sector (NFPS), large cross holdings of debt between the NG and the GOCCs. Fitch's sovereign database is now working with consolidated general government debt data (reworked from 1998), as opposed to the unconsolidated national government series, which was available in the past. At end-2003 general government debt was 73% of GDP compared with a previous national government (unconsolidated) estimate of 78%, while non-financial public sector debt was 101% compared with a previous (unconsolidated) estimate of over 110%. For end-2004 Fitch estimates that general government debt declined to 71.4% and NFPS debt to 95.6%, based partly on consolidated public debt data recently published for Q304.

In terms of the projected debt ratios NG debt declines only modestly this year to 70%. However, this is rather misleading as a guide to underlying government debt dynamics, as the government absorbed PHP200bn of debts from the state-owned power company NAPOCOR in February 2005. Excluding this 3.7% of GDP transfer, government debt would have been projected to decline by five percentage points of GDP by end-2005 to 66.4% reflecting the increased primary NG surplus and healthy nominal GDP growth. By end-2006, government debt is forecast to drop to 67.5% of GDP, which would be its lowest level since 2002. The ratio of government debt to revenue – which has been a focus of concern from the viewpoint of fiscal flexibility – is projected to decline to 412% by end-2006 from 494% at end-2004. While still high in comparison with the median of 'BB' rated sovereigns, this would be the lowest debt to revenue ratio since 2001. It would also be some 75 percentage points lower than Fitch's previous projections for end-2006. The government's debt service burden, as measured by the ratio of interest payments to revenue, is still expected to remain high at around 38% throughout the forecast period, but is now projected to decline after 2005 in contrast with earlier forecasts, where it was expected to intensify over time.

One final point to consider is that these debt and interest to revenue ratios may be slightly overstated to the extent that they ignore the own tax revenue of local governments. In the absence of historical data for consolidated general government revenue Fitch has used central government revenue as the denominator in these calculations. However, according to the Department of Budget Management, local government units had own revenues (i.e. excluding transfers from central government) of around 1.2% of GDP in 2004. Adding these to central government revenue would reduce the 2004 ratios of general government debt to revenue and interest to revenue to 454% and 34% respectively.

Table 4 shows projections for the finances of the broader non-financial public sector, including the

Table 3: Revised Government Debt Projections

(%)	2004e	2005f	2006f
Government Debt/GDP*	71.4	70.1	67.5
"from Fitch Dec 2004 Report**	81.0	77.7	75.2
Government Debt/Revenue*	494.2	459.7	412.3
"from Fitch Dec 2004 Report**	561.5	527.0	488.2
Interest/Revenue	37.3	38.6	37.7
"from Fitch Dec 2004 Report	38.2	40.1	40.3

* Consolidated general government debt
** Unconsolidated national government debt figures
Source: DOF, Fitch estimates and projections

recently-troubled state-owned power company NAPOCOR. The public sector borrowing requirement – which on Fitch's definition includes the surpluses of social security funds and local government units – is projected to decline to 3.7% of GDP in 2005 from 5% last year. The pace of improvement is actually somewhat faster than for the NG deficit, reflecting the impact of the recent hike in electricity prices on the finances of NAPOCOR. By 2006 the PSBR is forecast to narrow to 3.2%, which would be its lowest level since 1999. NFPS debt is forecast to decline by 10 percentage points over the course of 2006 to 85% of GDP from 96% at end 2004. This would take the NFPS debt stock to roughly the same level as in 1999 when Fitch first assigned the Philippines' sovereign ratings.

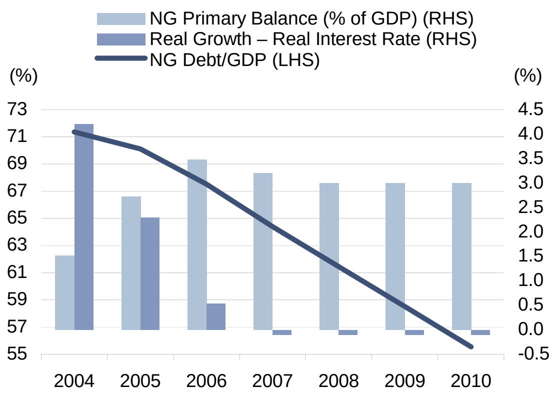
Table 4: Broader Measures of the Public Finances

% GDP	2003	2004	2005f	2006f
PSBR*	-5.5	-5.0	-3.7	-3.2
PSBR (Authorities' Definition)**	-6.4	-5.9	-4.5	-3.9
NFPS Debt	101.2	95.6	88.1	85.1

* Includes national government, local government, social security funds and public corporations
** Excludes local government and social security funds
Source: DOF, Fitch projections

Fitch's last report emphasised the need for fiscal adjustment to put public debt ratios on a firm downward path over the medium term, back towards 'BB' norms. The consolidation that is now taking shape – assuming that it is implemented as planned – looks set to deliver this. With the tax increases in place, sustained primary NG surpluses of 3% should be achievable even allowing for some rise in non-interest spending from current levels. The longer term projections shown in the chart below – which also allow for less favourable macroeconomic dynamics over the medium term as the real interest rate on public debt is assumed to rise by over 2 percentage points from current levels, while real GDP growth is held constant at 4.5% per annum – show NG debt declining to around 58% by end 2009 and NG debt to revenue to around 350% (see Chart 1).

Chart 1: Public Debt Dynamics



Source: Fitch