Public Sector Deficits, Fiscal Risks and Policy Options

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Outline of Presentation

- Measures of the fiscal deficit
- Selected fiscal risk indicators
- Fiscal issues
- Policy options
- Risks and challenges

Measures of Fiscal Deficit

- National government budget deficit
- Consolidated public sector deficit (CPSD): combined budget deficits of the national government, government-owned and controlled corporations, and other public sector entities
- Public sector borrowing requirement

Deficit Measures

As percent of GDP

By any measure of fiscal imbalance, the fiscal picture in recent years has turned grim. CPSD has exceeded 5% while PSBR hit its historic high of 6.4 in 2002 and has remained high.

	1998	1999	2000	2001	2002	2003
NG Def	-1.9	-3.8	-4.0	-4.0	-5.2	-4.2
CPSD	-3.0	-3.2	-4.3	-4.4	-5.2	-5.3
PSBR	-4.0	-4.4	-4.9	-4.9	-6.4	-6.0

Fiscal Risk Indicators

Spending for public infrastructure and other capital outlays, has shrunk significantly. By sacrificing public capital formation, the economy could end up on a lower growth path in the long run.

	1999	2000	2001	2002	2003
In billion pesos	96.5	87.3	75.8	93.3	49.7
As percent of GDP	3.2	2.6	2.1	2.3	1.2

Fiscal Risk Indicators

Spending for education and health services, as percent of GDP, has declined. Further cuts in these areas would be ill advised.

	1999	2000	2001	2002	2003
Education as % of GDP	3.4	3.2	3.0	3.0	2.8
Health as % of GDP	0.5	0.4	0.4	0.4	0.3

Fiscal Risk Indicators

Interest payments including net deficit from CB restructuring have crowded out the 'productive' part of the budget. As share of total revenues, interest payments have increased from 26.5% in 1999 to 42.6% in 2003.

	1999	2000	2001	2002	2003
In billion pesos	126.8	160	198.3	201	248.6
As %of total revenues	26.5	31.1	35.2	35.4	42.6

Fiscal Risk Indicators

Discretionary spending, defined as total expenditure less wages and salaries, interest payment, and IRA to local governments, has declined in absolute term, as share of total expenditure, and as percent of GDP.

	1999	2000	2001	2002	2003
As percent of total exp	27.8	24.9	22.1	22.3	15.9
As percent of GDP	5.5	4.8	4.3	4.3	2.9

Fiscal Risk Indicators

Tax effort has declined significantly from 17 % in 1997 to 12.3 % in 2003. The tax system has become highly unresponsive to changes in economic activity. The culprit: tax changes in 1996 and 1997 and lower tariffs.

	1997	1998	1999	2000	2001	2002	2003
Tax effort	17.0	15.6	14.4	13.7	13.3	12.3	12.3
Tax buoyancy	1.03	0.10	0.31	0.55	0.68	0.14	0.97

Fiscal Risk Indicators

The public debt-to-GDP ratio during the post-Asian crisis years had exceeded the benchmark ratio of 30% for developing countries.*

*The IMF has established a new benchmark debt-to-GDP ratio in a recent study: 75% for developed countries, 25 % for emerging market economies, and 30% for other developing countries. See "Public Debt in Emerging Markets: Is It Too High?," in IMF, *World Economic Outlook*, September 2003.

	1998	1999	2000	2001	2002	2003
NG Bln P	1496	1775	2167	2385	2816	3355
% of GDP	56.1	59.6	64.6	64.9	70.0	77.0
Total Publ	2952	3666	4397	4411	5163	5391
% of GDP	110.7	123.2	131.1	120.1	128.3	126

Fiscal Risk Indicators

In recent years, the Government has been unable to generate primary surpluses, defined as total revenues (excluding grants) less non-debt expenditures, sufficiently large to pay for its interest costs. In 1999 and 2002, the primary balance was negative. The difference between the primary budget balance and interest payment represents new additional public debt.

	1999	2000	2001	2002	2003
Primry budget balance	-5.4	10.2	27.8	-24.9	28.8
Interest payment	106.3	140.9	174.8	185.9	230.7
PBB- interest payment	-111.7	-130.7	-147	-210.8	-201.9
As percent of GDP	-3.7	-3.9	-4.0	-5.2	-4.7

Key Fiscal Issues

- Design and implementation of a credible adjustment program to address the high debt-to-GDP ratio
  - It is necessary to generate a high primary surplus. But this requires painful tax and expenditure adjustments. The challenge is how to craft and implement such a program that is politically feasible in an environment characterized by weak institutions
- Low and declining tax-to-GDP ratio.
  - The problem is more structural than administrative.

Key Fiscal Issues

- Ballooning fiscal deficits
  - By any measure of fiscal imbalances, the public sector deficit has become unmanageable in recent years.
- Rising interest cost
  - Interest payments including the net deficit resulting from the 1993 CB restructuring, as percent of total revenue, has doubled in 5 years: from 20.5% in 1999 to 42.6% in 2003.

Key Fiscal Issues

- Shrinking discretionary spending
  - The level of discretionary spending has declined in absolute terms and as share of total expenditures and as percent of GDP. Unless reversed, this could limit the government's flexibility in reallocating resources according to changing priorities.
- Contingent liabilities
  - The practice of past administrations to extend sovereign guarantees to power and transport projects have now translated into large contingent and, in some cases, real debt servicing costs and public subsidy.

Key Fiscal Issues

- Repressed demand for essential public services
  - In the last five years, the budget allocation for education, health and public infrastructure has declined significantly. While stabilization objectives are important, the continuation of the present underspending in human and physical capital could put the economy on a lower growth trajectory.
- Higher foreign exchange risks due to recent deficit financing mix which favor non-concessional, commercial foreign borrowing.

Adjustment Options

- Design and implement a comprehensive public sector reform program. Immediate goal; reverse the present trend of having large public sector deficits. Key features:
  - On the tax side: rationalization of tax incentives; reform in excise taxes on cigarettes, liquor and petroleum products; expanding the base while simultaneously increasing the VAT rate.
  - Moratorium on new locally funded projects for the next three years, partially offset by higher budget for road maintenance.

Adjustment Options

- Cut the IRA to local governments by about 25 % from 2004 to 2007 by invoking pertinent provision of the Local Government Code of 1991 and declaring that an unmanageable public sector deficit exists.
- Adopt a deficit financing mix that would minimize foreign exchange risks by relying more on domestic financing
- Prepare a medium-term expenditure framework (MTEF) for the next six years, 2005-2010 for submission to Congress for its approval through a joint resolution.

Adjustment Options

  - Conduct an inventory and review of all unfunded laws, including the overly generous pension system for the AFP retirees.
- Avoid incurring new, non-concessional foreign debt.
  - This rule should apply not only to the National government but also to all SOEs and other public sector entities.
- Adjust power, water and transport rates
  - The likelihood that contingent liabilities might become real could be reduced if the tariff rates for these sectors are allowed to increase.

Risks and Challenges

- There are growth-limiting risks, such as:
  - **Weak external market**: the weak recovery of the world economy could limit the demand for Philippine exports, such as semiconductor and electrical machinery, and foreign direct investment.
  - **Political uncertainty and peace and order problem:** the uncertainty would depress economic activity, especially private investment.
- Forming a coalition that would support the reform program
  - The absence of real political parties could get in the way of establishing a strong coalition that would push fundamental tax and expenditure reforms in Congress

Risks and Challenges

- Rising rate of interest
  - The government has been lucky that the world interest rate and domestic interest rate has been at rock bottom. But rates have started to inch up.
- Rising foreign exchange risk
  - In recent years, the Philippine government has borrowed heavily abroad to finance its deficits, making it Asia's largest sovereign debt issuer outside of Japan. The spreads on its sovereign dollar bonds remain high.
- Expenditure risk
  - In recent years,there has been significant cut in the budget allocation for social services and public infrastructure, with likely adverse impact on growth.

Final Words

- The fiscal numbers are discouraging. The immediate goal should be to reverse the trend towards large public sector deficits. The immediate task is the design and implementation of a credible adjustment program to address the high and rising level of indebtedness. But to make such program work it is necessary to get the support of a strong coalition. The biggest challenge for the country's leadership is how to form such a coalition in an environment where political institutions are weak and its people politically and socially divided.