

Philippines – On Steady Fiscal Footing But Challenges Remain

***In a nutshell:** The fiscal situation for H1 2021 seems to be on relatively steady footing after the government achieved a deficit of 7.6% of GDP in 2020 versus a target of 9.6% of GDP, i.e. a 2 percentage point undershoot. Following the lock downs in March/April, the government revised its fiscal deficit for the year higher to 9.3% of GDP from 8.5% of GDP initially. Relative to the revised budget, the government has outperformed on its revenue targets and is within striking distance of its capital expenditure targets. To maintain this steadfast fiscal momentum and continue to provide counter-cyclical growth support, the government will need to continue to be nimble with its resource allocations. Furthermore, it will have to balance, with ever more precision, short-term measures to keep afloat important growth multipliers without losing sight of more medium-term growth/reform measures.*

To that end, the authorities have been successful but will have to deal with a number of a challenges in the coming year including the May 2022 Presidential elections and associated political disruptions, changes to legislation mandating a greater share of revenue resources be diverted to Local Government Units and rising national government debt levels putting the sovereign at risk of a credit rating downgrade. To all this, add the unpredictable COVID-19 situation and the need to periodic lock downs (and with it fiscal support) given lags in the vaccination drive.

Steady Fiscal Support in H1 2021

The fiscal position for H1 2021 was surprisingly resilient despite a severe wave of COVID-19 infections, which forced lock downs and tighter social restrictions in many parts of the country. **Revenues collections not only grew 2.5% YoY but also out-performed the government's target for the period.** Tax revenue collections, more specifically, grew 10.6% YoY and outperformed on account of increased digitalisation, better import growth bolstering customs and higher contributions from the Bureau of Treasury.¹

Similarly, **total expenditures grew 9.6% YoY but fell short of the government's target for the period.** Encouragingly, **the emphasis was on capital expenditures which grew 53.4% YoY**, albeit from a low base, **but came within striking distance of the government's target.** This is also well above the pre-pandemic historic disbursement in H1 (2016-2019) of ~40% of the total budgeted amount. Within this, 'infrastructure and other capital outlays' spending actually overshot the government's estimate.

However, current expenditures fell by 2% YoY and were more obviously behind target and at ~44% of the annual budgeted amount. This is modestly lower compared to the pre-pandemic H1 disbursement rate for operational expenditures at ~45%. That said, it allows the government to ramp up these type of spending especially given the unpredictable COVID-19 situation. As such, the **overall fiscal deficit was only 70% of the intended target for the period**². By our estimates, **the fiscal deficit (on a 12-month rolling basis) was at 4.2% of GDP as of end-June versus the government's revised target of 9.3% of GDP for the year.**

¹ On account of higher dividend remittances, income from Bond Sinking Fund investment and government deposits, as well as interest income on advances to GOCCs.

² The fiscal deficit for Q2 was meant to be highest for the year account for 37.5% of the total annual deficit. The lower-than-target deficit in Q2 might imply that some undershoot for the year but the unpredictable COVID situation will likely warrant further reallocations and expediting operational spending; as such, the deficit target will remain relevant.

Summary table of key budget items										
	2019	2020			2021					
	Actual (PHPbn)	Actual (PHPbn)	% YoY	Budget (PHPbn), Original as of Dec '20	%YoY	Budget (PHPbn), Revised as of May '21	%YoY	Jan-Jun 2021 Actual	%YoY	% program*
Govt Revenue	3137	2856	-9.0	2717	-4.9	2882	0.9	1490	2.5	104.8
Tax Revenue	2828	2504	-11.4	2542	1.5	2715	8.4	1346	10.5	101.9
Bureau of Internal Revenue	2176	1951	-10.3	1904	-2.4	2081	6.7	1032	7.9	101.4
Bureau of Customs	630	538	-14.7	620	15.2	617	14.7	302	19.2	103.4
Other Offices	22	16	-28.7	18	11.8	17	7.3	12	50.5	115.7
Non Tax revenues	309	351	13.5	175.4	-50.1	166	-52.7	144	-38.8	142.0
Bureau of Treasury	147	220	49.9	75	-66.0	75	-66.0	82	-55.5	156.5
Fees & Other Charges	55	23	-58.3	40	74.6	31	35.1	22	56.6	111.6
Govt Expenditure	3798	4227	11.3	4467	5.7	4737	12.1	2206	9.6	90.4
Current Operating Expenditures	2741	3353	22.3	3,282	-2.1	3680	9.7	1616	-2.0	87.7
Capital Outlays	1040	879	-15.5	1,157	31.6	1029	17.0	584	53.4	99.7
Infrastructure & Other Capital Outlays	882	682	-22.7		-100.0	761	11.7	427	43.2	101.7
Net Lending	17	-5	-129.1	29	-674.0	29	-674.0	7	0.0	55.4
Fiscal balance	-660	-1371		-1750		-1856		-716		70.3
%GDP	-3.4	-7.6		-8.5		-9.3				

*The government's program for spending and expenditure is made quarterly. We compare spend so far to the programmed spend for H1 2021. Source: DBM; CEIC; Mizuho Bank

Nimbleness: A Key Strength

To the government's credit, it has been nimble with its budget allocations. Following a surge in virus infections in March/April which forced a re-imposition of social restrictions in Manila and other big cities, **the 2021 budget was adjusted to reflect higher expenditures requirements in May**. The **current expenditure budget was adjusted upwards at the expense of the capex budget** – partly allowing for unspent funds in 2020 to be carried over into 2021³. In terms of revenues, **tax revenue estimates were adjusted upwards** with a greater contribution expected from the Bureaus of Customs and Internal Revenue while non-tax revenue collections were modestly adjusted downwards.

Moreover, as underspending remains an issue, a **flexible attitude towards extending the timelines for funds use and re-allocation of funds based on more urgent needs has been adopted**. The unspent funds from Budget 2020 were allowed to be carried over into 2021; for 2021, the government is simultaneously operating under the 2020 and 2021 Appropriations Acts and the Bayanihan II Act (i.e. the second fiscal package effective September 2020). Although the latter expired on 30 June 2020. *That said, despite an extension, some funds under the Bayanihan II Act, which were due to be spent by 30 June, were unspent*⁴.

³ The government undershot its 2020 fiscal deficit by ~2% of GDP. Although the expenditure undershoot was ~0.02% of GDP.

⁴ The DBM has explained that of PH13.9bn unspent funds; PHP6bn was reverted to the general fund when the law expired. See DBM says PHP5.97B expired in Bayanihan 2 budget, *Inquirer.net*, 27 July 2021.

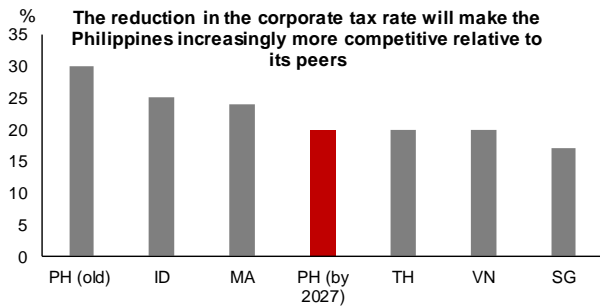
	Obligation Rates	Disbursement Rates
Grand total for Bayanihan I and Upon Expiration of Bayanihan I	94.9%	96.8%
Bayanihan I	95.1%	97.0%
FY 2020 GAA, RA No.11469	94.8%	97.0%
FY 2019 Continuing Appropriations	98.6%	96.7%
Upon Expiration of Bayanihan I	77.5%	88.0%
Bayanihan II	93.5%	89.3%
FY 2020 GAA, RA No.11465	83.6%	84.5%
FY 2019 Continuing Appropriations	96.9%	76.3%
Special Appropriations, RA NO 11494	96.4%	92.0%
<i>Source: DBM; Mizuho Bank</i>		

Avoiding Permanent Pandemic Scars - Striking A Balance Between the Near and Medium-Term

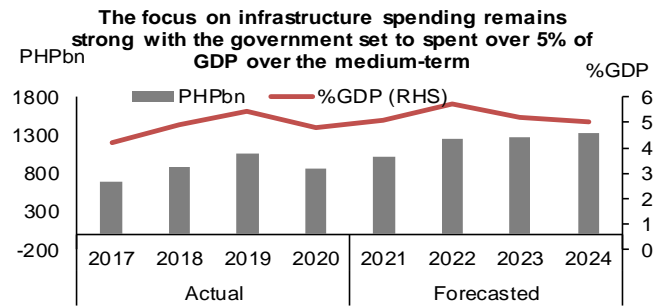
The **challenge** for the authorities **is to prudently strike a balance** in providing counter-cyclical support such that **short-term multipliers are not set back to a point of destruction** and **medium-term growth and reform objectives are not allowed to fall by the wayside**. This is especially because periodic lock downs and social restrictions will need to be introduced, with the country's vaccination drive lagging owing to slow procurement, to stymie the spread of the virus. **The authorities, for the most part, have struck this balance but will need to continue to do so in the face of looming challenges, including the May 2022 Presidential elections and impending legislative changes.**

In terms of short-term measures, **the government has provided cash handouts to lower income households, loan guarantees to businesses, assistance to Local Government Units (LGUs) and bolstered healthcare spending.** Specifically with respect to **cash handouts**, although the government has been conservative in its approach to direct household liquidity support, it **has provided some form of cash or food assistance to lower income household through the strictest lock down periods.** The latest case in point being that eligible Metro Manila residents receive PHP1,000 each (or PHP4,000/family) in cash aid to tide over the two-week lock down in August; this is similar to assistance provided in March 2021 when a lock down was imposed. **While this amount is not enough to entirely offset the impact of the social restrictions, it will to some extent help keep the multipliers on basic/essential spending from further severe impact and completely destroying household balance-sheets.**

At the same time, the **Corporate Recovery and Tax Incentives for Enterprises (CREATE) Act** was passed in March 2021 **lowering the corporate tax rates** and aligning with medium-term objectives to make the Philippines more competitive. **A reduction in corporate taxes to 25% from 30% for non-resident and large corporations (net taxable income >PHP5mn) and to 20% for SMEs** came into effect July 2020. Corporate taxes for non-resident companies will be gradually brought down to 20% by 2027. This will bring the corporate tax rate in the Philippines closer to that of regional peers, enhancing FDI attractiveness.



Source: Tax authorities, KPMG, Deloitte, Pw C



Source: DBM; IMF; Mizuho Bank

Another important aspect of fiscal play is that expenditures have been and will continue to be focussed on boosting infrastructure. The infrastructure budget is set to increase to 5.1% of GDP in 2021 from 4.8% of GDP in 2020. The budget for 2022 is set at a higher 5.7% of GDP before moderating to 5.0% of GDP in 2024. Much of the infrastructure budget is directed towards President Duterte's flagship "Build, Build, Build" initiative which includes road, water and airport expansion projects.

Some Challenges Loom In the Coming Year

There are, however, are some significant challenges ahead in maintaining steadfast fiscal progress. For one, **the low hanging fruit of addressing the issue of underspending**, especially at a time when counter-cyclical policy is imperative to prevent permanent scarring from the pandemic, **may take some time still to be addressed.** Apart from administrative hurdles, which to the governments' credit it is addressing proactively, **the issue is structural and relating to absorptive capacities of implementing agencies predating the pandemic.** **According to the World Bank, the Mandanas Ruling⁵ could exacerbate this problem.**

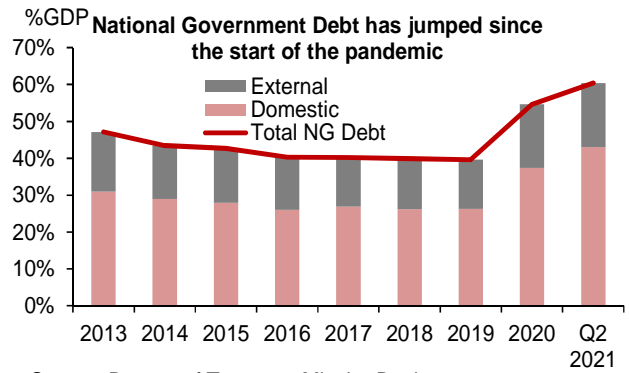
This ruling affects a taxation regime from 2022 mandating that the share of national government revenue transferred to local government increase by over 1% of GDP. The World Bank⁶ has identified that this ruling will **present the government with its own set of challenges; potentially slowing budget execution rate and worsening fiscal imbalances.** Of the World Bank's recommendations is that the central government needs to re-devolve functions clearly and communicate them effectively to both national and LGUs, support LGUs to build capacity and strengthen central and local government agencies coordination.

Second, **as we approach the May 2022 Presidential elections, uncertainties and political distractions will increasingly become the focus.** This will, in the very near-term, detract from the government's spending focus on pandemic support and infrastructure spending. It will in all likelihood lead to a moderation in capital expenditures in H1 2022 and particularly Q2 2022, i.e., during the period of the elections. However, election related spending should provide some offset. Beyond that, **the recent history of power transfer in the Philippines suggests that the process should be fairly smooth**, albeit with the usual rejigging of policy priorities.

⁵ The 2018 ruling in favour of a petition raised by two governors that LGs had not received their fair share of nation tax revenues through the Internal Revenue Allotments was confirmed by the Supreme Court in 2019. IRA allotments are now set to increase 55% in Budget 2022 to 4.8% of GDP from 3.5% in 2021.

⁶ Philippines Economic Update, World Bank, June 2021 Edition, *Navigating a Challenging Recovery*.

Finally, **although the Philippines debt profile is manageable and within prudent international levels, it has risen sharply on account of pandemic related support.** The national government debt has risen to 54.6% of GDP in 2020 from 39.6% of GDP in 2019; NG debt stands at 60.4% of GDP as of end-June 2021. The deterioration in the debt and fiscal position was cited by Fitch as one of the key reasons for changing the country's sovereign credit rating outlook to 'negative' from 'stable'.



Source: Bureau of Treasury; Mizuho Bank

A credit ratings downgrade cannot be ruled out, especially from Fitch. Fitch and Moody's have the sovereign rated one notch above investment grade while S&P ratings is two notches above investment grade. This implies that even with a downgrade, the Philippines credit rating metrics will likely to remain within the 'investment grade' matrix. Given the positive revenue dynamics and the medium-term positive growth trajectory and focus on reforms, we do not expect more than a one notch credit rating downgrade. This should ensure that capital outflows from any negative rating action is backstopped, preventing debilitating macroeconomic instabilities from taking hold⁷.

As of year end, current outlook in brackets	S&P (Outlook: Stable)	Moody's (Outlook: Stable)	Fitch (Outlook: Negative)	Investment Grade versus Junk
2011	BB	Ba2	BB+	Junk
2012	BB+	Ba1	BB+	Junk
2013	BBB-	Baa3	BBB-	Investment Grade
2014	BBB	Baa2	BBB-	One notch above IG according to S&P & Moody's
2015	BBB	Baa2	BBB-	
2016	BBB	Baa2	BBB-	
2017	BBB	Baa2	BBB	IG according to Fitch
2018	BBB	Baa2	BBB	
2019	BBB+	Baa2	BBB	above IG according to S&P
2020	BBB+	Baa2	BBB	
2021	BBB+	Baa2	BBB	outlook to 'negative' from 'stable'

Source: Moody's, S&P, Fitch, PH Gazette, Mizuho Bank

Philippines Credit Ratings Has Incrementally Built Buffer Since being Raised to Investment Grade (IG) in 2013

	2011-12	2013	2014-16	2017-18	2019-21	
Investment Grade (IG)	BBB+				S&P	Investment Grade (IG)
	BBB		S&P Moody's	S&P Fitch Moody's	Fitch* Moody's	
	BBB-	S&P Fitch Moody's	Fitch			
Non-IG	BB+	S&P Fitch Moody's				Non-IG
	BB					

* Fitch has lowered outlook to 'Negative' in 2021

⁷ Unlike in India's case; a downgrade from any one of the three ratings agencies will lead to a loss in the 'investment grade' status of the sovereign.

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