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Philippines: Future Debt Sustainability Hinges on Passage of Key Tax Reforms

Data for January and February suggest the Philippine economy is off to a good start, although a shrinking primary surplus puts the country's debt sustainability in question. Passage of the value-added tax (VAT) reforms now being debated will be vital to recovering the primary balance.

Judging by the first two months of the year, the Philippine budget deficit appears to be under control. Indeed, the fiscal gap for the first two-thirds of the quarter is just PHP 40.1 billion—51.5% of the total deficit target of PHP 77.8 billion set for the quarter. And, total revenue in the January-February period accounted for almost 70% of the first-quarter target, while total expenditures accounted for 63.5% of the quarterly target.

Given these results, the administration appears ahead of the game, as it clearly had planned for some front-loading of expenditures in the first half, given the full-year deficit target of PHP 180 billion (3.3% of GDP) with an expected shortfall in the first quarter accounting for some 43% of the annual total.

But the government also anticipates a boost to revenue in the second half from new tax measures. For the administration to achieve its full-year fiscal deficit target, passage of VAT reforms—including the proposed rate increase from 10% to 12% plus the reduction of tax exemptions—still under consideration in Congress, is crucial.

Furthermore, fiscal data reveals risks to government debt sustainability (stabilizing or reducing the government debt-to-GDP ratio) as the primary surplus narrowed markedly to PHP 16.8 billion, only 14.5% of the annual target of PHP 115 billion, in the two-month period.

A surge in interest payments to a staggering 37% of total expenditure was the chief reason behind the shrinking primary surplus, as it was considerably higher than both the 28.5% share in the fourth quarter and 29.5% for 2004 overall (**Display 1**).

Lowering the Debt Stock Ratio

An adequate primary surplus is vital to debt sustainability. The government must produce a surplus large enough to fill the gap between interest rates on total debt outstanding and the growth rate of nominal GDP.

In retrospect, the Ramos administration already achieved this by running a large primary surplus of some 4.0% to 5.5% of GDP from 1992 till 1996. During this period, a significant reduction of the national government debt-to-GDP ratio from 77% to 54% occurred (**Displays 2 and 3**).

According to the latest long-term budget projection of the Arroyo administration, the national government plans to achieve a primary surplus of about 2.2% of GDP in 2005, which will increase steadily to around 3.5% to 4.0% of GDP by 2008 to 2010. The projections have incorporated extra tax revenues of PHP 25 billion already approved by Congress (i.e., a sin tax on tobacco and alcohol in addition to other minor tax measures) as well as the absorption of PHP 20 billion in interest payments on Napacor's debt following the transfer of the debt to the national government's balance sheet.

The government expects to achieve a balanced budget by 2010 with the assumption that total revenue as a share of GDP will rise from 14.5% in 2004 to 16.5% in 2010. Meanwhile, government spending will continue to be under tight scrutiny, with non-interest payment expenditures' share of GDP expected to fall from 13.0% in 2004 to 11.5% in 2010.

Based on these projections, we estimate that the government debt-to-GDP ratio will stabilize at around the currently high level of 78% over the next three to four years before falling to around 70% in 2010—ratios that would still compare unfavorably with an average government debt-to-GDP ratio of about 50% to 55% among BB credits.

VAT Passage Is Crucial

In our view, the government will need to run a primary surplus of at least 4% to 5% in order to have a more meaningful reduction of its debt stock ratio. We estimate that to achieve this, extra tax revenue of around PHP 80 to 100 billion will be required. The combined VAT bill is expected to generate some PHP 55 billion of new revenue (PHP 30 billion from the increased VAT and PHP 25 billion from a repeal of exemptions) which, if approved, would bridge most of the gap.

We have learned that the government's estimation of potential revenue generation from the combined VAT bill, the sin tax and other tax measures is based on a tax collection efficiency rate of about 50% (roughly the average ratio of the exiting tax regime). As such, any meaningful improvement in tax collection in coming years will be instrumental in raising the primary surplus.

The way we see it, there is a 50/50 chance that the combined VAT bill will be approved by Congress, although the process probably will drag into mid-year.

That President Arroyo has openly and repeatedly talked in favor of the VAT hikes and given a final push for their passage at the bicameral committee makes us optimistic. Recall that the president used her influence similarly to exert pressure on the bicameral committee's debate over the sin tax last December. At that time, it was effective in pushing through the bill at the end, even though the senate opposed the measure all along.

Given the contention surrounding the passage of this bill, resolution of the country's fiscal problems may hinge on whether President Arroyo can engineer a last-minute swing in political sentiment.

If she succeeds, we wouldn't be surprised if the improved revenue prompts an upgrade of Philippine sovereign debt back up to a high-BB level in the coming year and, possibly, to investment grade in the long run.

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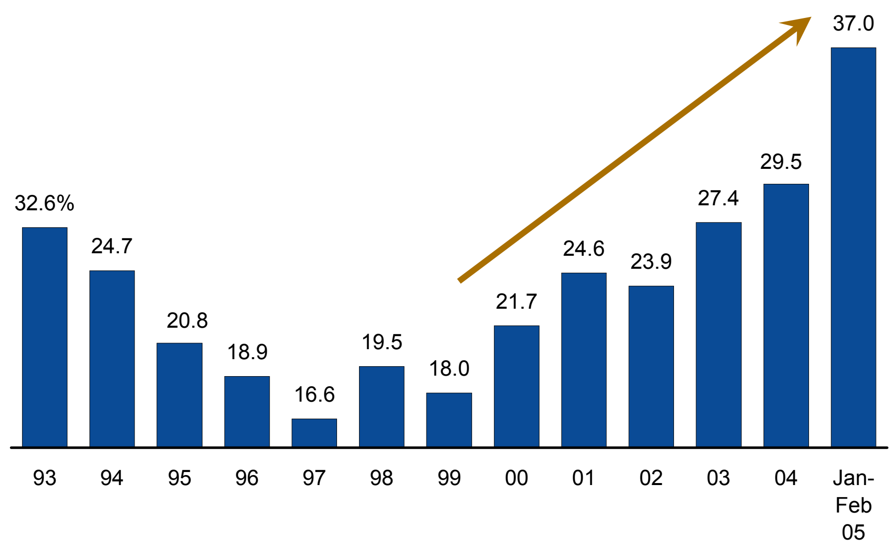
Display 1: The Root of Philippines' Fiscal Problem: Surging Interest Payments

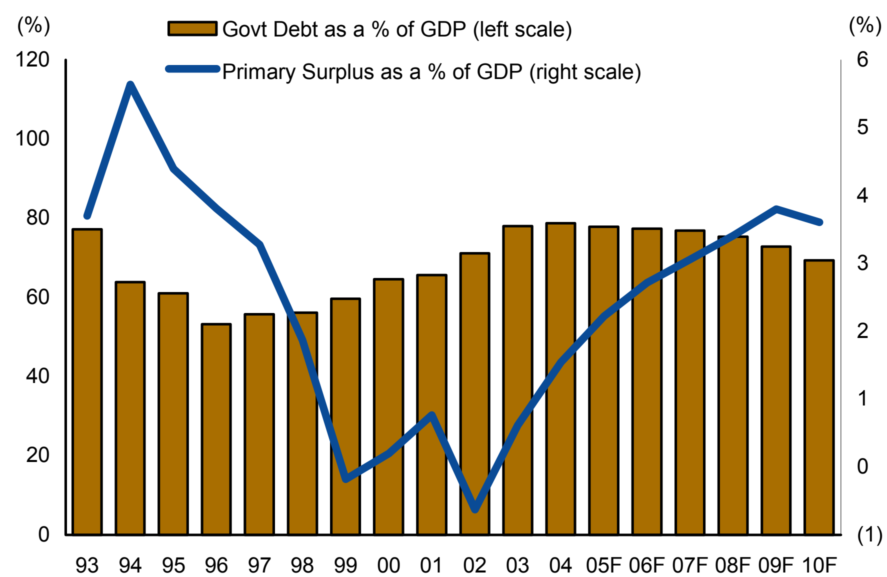
Annual Interest Payments as a Percent of Total Budgetary Expenditure



Source: Philippines' Department of Finance, CEIC Data Inc. and Alliance Capital Fixed Income estimates, April 1, 2005

Display 2: Primary Surplus at 3% to 4% of GDP Not Enough To Meaningfully Reduce Debt Stock Ratio

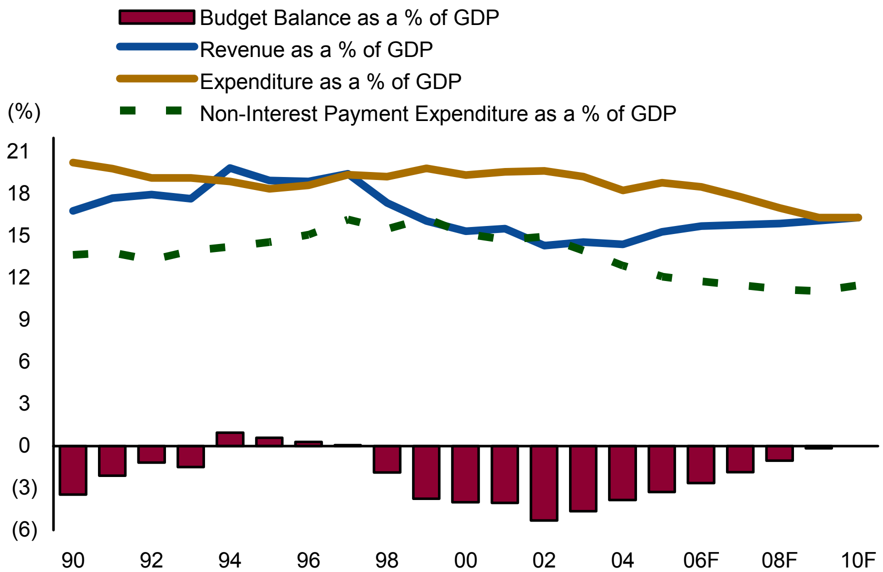
Government Long-Term Budget Projections



Source: Philippines' Department of Finance, CEIC Data Inc. and Alliance Capital Fixed Income estimates, April 1, 2005

Display 3: A Balanced Budget By 2010

Government Budget Projections



Source: Philippines' Department of Finance, CEIC Data Inc. and Alliance Capital Fixed Income estimates, April 1, 2005