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# Emerging Twin Deficits in the Philippines Economy ~Outlook and Risks~

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## 1. Preface

Philippines' current account remained in surplus for a long time since 2003, but in the second quarter of 2016 it fell into deficit. After that, the deficit has continued to widen reflecting an obvious increasing trend of trade deficits, mainly due to an increase in imports of capital goods relating to the government's efforts to promote infrastructure improvement.

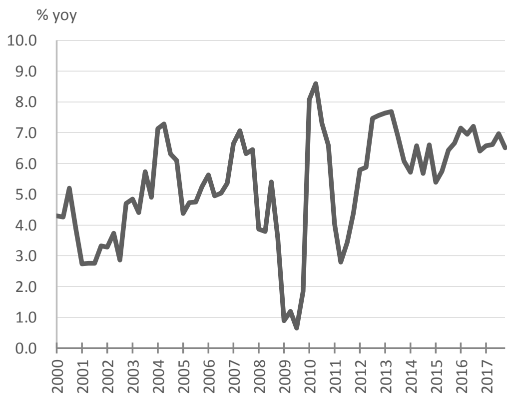
The fiscal balance also went into the red after the Duterte administration started in June 2016. The government implemented a tax reform for the first time in 20 years, initiating a serious effort to secure financial resources and redress the gap between the rich and the poor.

In this paper, the author intends to review the outline of the tax reforms and consider the outlook of the Philippine economy and its risks, while examining the factors behind the twin deficits.

## 2. Recent Economic Developments and Major Actions of the Duterte Administration

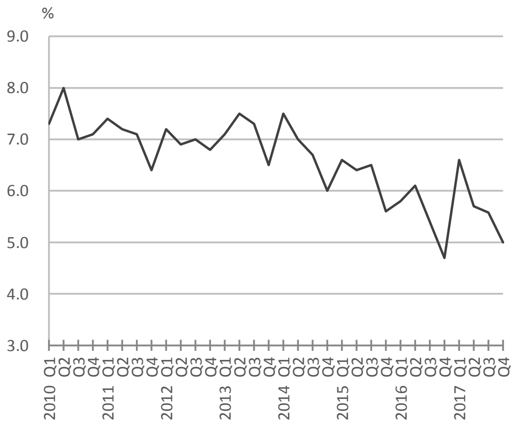
The Philippine economy has continued to perform well. Real GDP has been growing at a high level of 5 to 8% since 2012 (Figure 1), while unemployment rate went down to reach 5.0% in the fourth quarter of 2017, the lowest in the past 10 years (Figure 2). Meanwhile, inflation rate remains within the range of inflation target (2-4%) despite the rise in international commodity and energy prices (Figure 3).

Figure 1: Real GDP growth



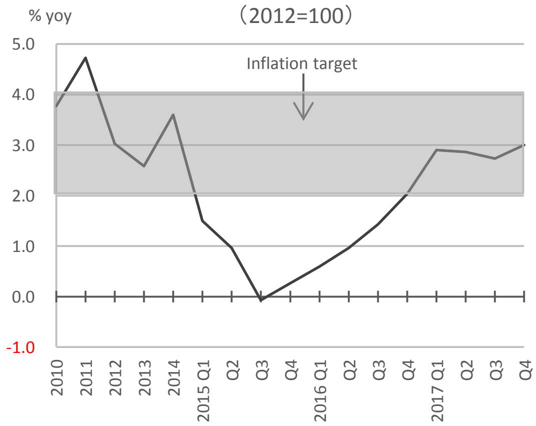

Source: Philippine Statistics Authority

Figure 2: Unemployment Rate



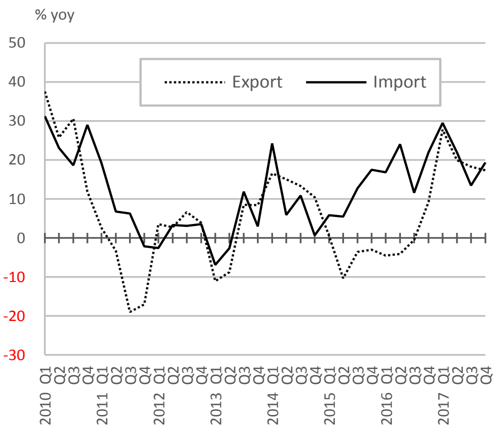

Source: Philippine Statistics Authority

Figure 3: Consumer Price Index (2012=100)




Source: Philippine Statistics Authority

Figure 4: Value of goods



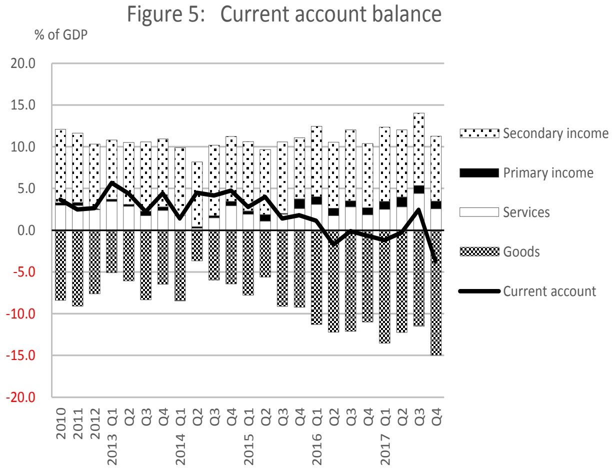

Source: Philippine Statistics Authority

On the other hand, both the current account and fiscal balance went into the red in 2016, with the deficits on an increasing trend (Figures 5 and 6).

During the first year since his inauguration in June 2016, President Duterte focused his efforts domestically on anti-drug campaigns and restoration of public order in Mindanao, and on such political issues as security and closer relationships with China and Russia. Therefore he had few notable policy measures and achievements on the economic front.

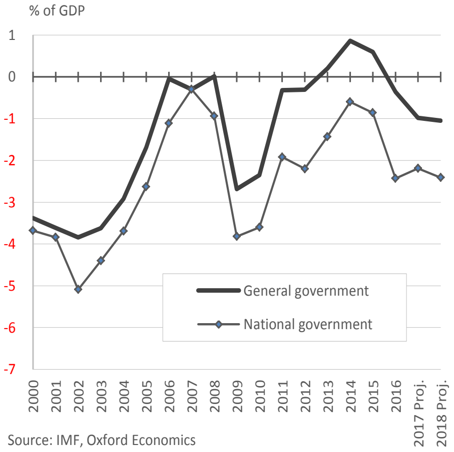
However, he emphasized in his second State of the Nation Address in July 2017 the simplification and fair treatment of taxation as one of his reform priorities, and belatedly started to make serious economic reforms by calling on the congressmen to rapidly approve his first proposal of reform plans.

Figure 5: Current account balance




Source: Bangko Sentral ng Pilipinas

Figure 6: Fiscal Balance




Source: IMF, Oxford Economics

### 3. Factors behind the Current Account Deficits

The ratio of the current account deficit to nominal GDP worsened to -0.7% in 2017 as compared to the forecast of the IMF (-0.1%) (Figure 5 above). The deterioration reflected an expansion of trade deficit (Figure 4 above) mainly due to the increased imports. The breakdown of imports by major type of goods reveals a protruding contribution of capital goods (Table 1). This means the increase of capital goods had been a major factor contributing to the current account deficit.

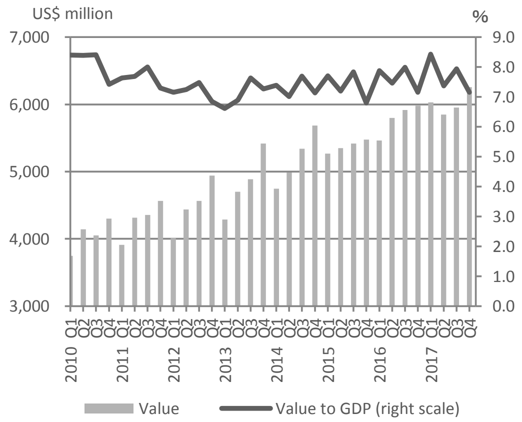
Table 1: Imports (FOB value) by major type of goods

| | 2015<br>US$ billion | 2017<br>US$ billion | 2015-17<br>Growth | 2015-17<br>Contribution |
|---|---|---|---|---|
| **Total** | **711** | **927** | **30.4%** | - |
| Capital goods | 196 | 300 | 52.9% | 14.6%pt |
| Raw materials and Intermediate goods | 305 | 356 | 17.0% | 7.3%pt |
| Mineral fuels, Lubricant and Related Materials | 92 | 106 | 14.5% | 1.9%pt |
| Consumer goods | 114 | 161 | 41.0% | 6.6%pt |
| Special transactions | 4 | 4 | 9.9% | 0.0%pt |

Source: Philippine Statistics Authority

Remittances from Overseas Filipino Workers have been rising, while consumer spending is expected to increase robustly to lead to an increase of imports (Figure 7). The Bangko Sentral ng Pilipinas (BSP, central bank) forecasts the current account balance will remain in the red due to further increase of imports of capital goods prompted by the infrastructure improvement projects the government promotes (to be discussed below).

Figure 7: OFW remittance




Source: Bangko Sentral ng Pilipinas

## 4. Factors behind the Fiscal Deficits

The fiscal deficit of general government in 2016 stood at -0.4% of GDP (Figure 6 above), reflecting an increase of expenditure for infrastructure improvement. Real GDP growth rate by expenditure shares for the two years from 2015 to 2017 indicates that the fixed capital formation (contribution of 9.0 percentage points) contributed almost as much as private consumption (9.1 percentage points) that accounts for about 70% of real GDP (Table 2).

Table 2: GDP by expenditure shares at constant 2000 prices

| | 2015 | 2015-17 |
|---|---|---|
| | Share | Growth/Contribution |
| **GDP** | **100.0%** | **14.1%** |
| Household final consumption expenditure | 69.3% | 9.1%pt |
| Government final consumption expenditure | 10.3% | 1.7%pt |
| Fixed Capital Formation | 23.7% | 9.0%pt |
| Construction | 9.2% | 2.0%pt |
| Durable equipment | 12.4% | 6.3%pt |
| Others | 2.1% | 0.7%pt |
| Changes in inventories | 0.5% | -0.6%pt |
| Net exports of goods and services | -3.8% | -5.1%pt |
| Statistical disrepancy | 0.0% | -0.1%pt |

Source: Philippine Statistics Authority

The 2018 national budget,[1] enacted on December 19, 2017, was 12% higher than last year's

[1] PHP 3.9 trillion (approx. JPY8 trillion)

budget. The biggest portion of the budget was allocated to the Department of Public Works and Highways (DPWH)[2]. It reflected the government's priorities that set the increase in infrastructure investment[3] as one of the supporting measures for economic development. President Duterte also made it his priority to free education in state universities and healthcare, and to increase the base salary of soldiers and police officers. Accordingly the Department of Education (DepEd) and Department of the Interior and Local Government (DILG) received the second and third biggest amounts after the DPWH respectively.

The government anticipates the budget deficit to widen in 2018 due to these expenditures. It has set a target for restraining the deficits of central government under 3% of GDP in the period of 2018 to 2022 to prevent further increase of the fiscal deficits while implementing the tax reforms (to be discussed below) that aim at raising revenues.

The BSP has taken positively the public investment by the government as an attempt that will improve the future productivity over the long-run without regarding the improvement of fiscal balance as an urgent task.

## 5. Outline of Tax Reforms

The government also enacted, at the same time of enactment of the budget bill, the Tax Reform for Acceleration and Inclusion (TRAIN), or the first package of Comprehensive Tax Reform Program (CTRP) consisting of four packages, aimed at securing the fiscal revenues for the 2018 budget and improving the effectiveness and impartiality of tax system. The Department of Finance (DOF) expects the package will increase the revenue by PHP 90 billion[4] (approx. $1.8 billion) or 0.6% of GDP. The BSP forecasts the tax reform will raise the consumer price inflation rate by 1 percentage point in 2018. The package includes the following major contents.

- Reduction of the personal income tax (PIT)[5]
- Abolition of health insurance premium and medical insurance premium for individuals

[2] Corresponds to 16.5% of total budget.
[3] Large scaled infrastructure improvement project called "Build Build Build" aims to increase the amount of infrastructure investment in stages from $17.2 billion (5.4% of GDP) in 2017 to $36.9 billion (7.3% of GDP) by 2022. The BSP forecasts that the project will achieve the economic growth of 7.0-8.0 for 2018 – 2022 on annual average.
[4] The Nikkei, December 19, 2017 https://www.nikkei.com/article/DGXMZO24820720Z11C17A2000000/
[5] 99% of individual tax payers will have a lower tax. In addition, as those with annual taxable income below PHP 250,000 are exempt from paying PIT,, 83% of tax payers will be practically exempt from PIT.

with available income below a certain amount

- Expanding the coverage of value added tax (VAT)
- Simplification to a single rate of donor's tax rate and estate tax rate
- Increase of excise tax on certain goods (oil products, automobiles, tobacco, mineral products, etc.) and introduction of new tax on sugar sweetened beverages and others
- Increase of documentary stamp tax

The IMF and ADB have positively evaluated this reform, but Associated Labor Unions-Trade Union Congress of the Philippines (ALU-TUCP), a labor union league, urges an improved protection of the 15.6 million citizens who are not covered by the social security system.[6] Responding to such calls, the DOF announced on February 23 that the government would pay PHP 200 a month to 7.4 million households of the poor class to mitigate the burden of price increase that would be caused by the reforms.[7]

The proposal for the second package of the CTRP was submitted to the House of Representatives on March 21. It includes the review of preferential treatments of investment such as the exemption of corporate taxes. The Director-General of the Philippine Economic Zone Authority (PEZA) is concerned about the possibility that the foreign firms will withdraw from the Philippines to avoid an increased tax burden.

## 6. Conclusion

The Philippine economy will maintain its high growth due to a solid private consumption reflecting good employment situation and increase in remittances from overseas workers as well as an increase in investment for infrastructure improvement that the current administration promotes. Although the deficits of the current account and fiscal account are expected to continue for the moment, the major factors for the deficits are accounted for by the investment for infrastructure improvement which is also expected to raise the future growth rate through a rise in productivity. Tax reforms may inflict economic pain on certain members of the population, but the government efforts will be easily understood as policies for the future in a favorable employment environment against a backdrop of high economic growth.

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[6] Asian Economic News, December 20, 2017 https://www.nna.jp/news/show/1703326
[7] The Daily Manila Shimbun Web, February 28, 2018
http://www.manila-shimbun.com/series/econo_trend/series236188.html

On the other hand, the economy is expected to face such risks in the future as (i) a decrease in exports to the U.S. reflecting to protectionist trade policies of the U.S., (ii) an outflow of capitals from the Philippines due to a rise of U.S. interest rates, and (iii) delay or cancelation of infrastructure improvement projects due to a labor shortage. Depending on the degree of their damages, there will be a possibility that they will have some influence on the third and fourth packages of tax reforms to be forwarded in the future. It should be carefully watched how President Duterte will exercise his skills on the management of his economic policies.


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