2015 BUDGET BRIEFER

CONGRESSIONAL POLICY AND BUDGET RESEARCH DEPARTMENT

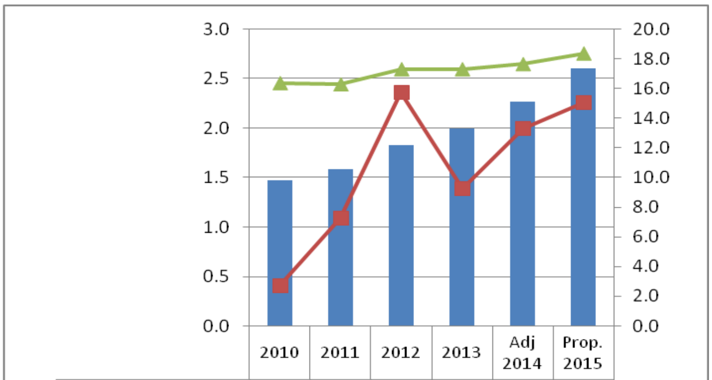
SEPTEMBER 2014 NO. 2014-02

THE MACROECONOMIC PERSPECTIVE:

UNDERSCORING THE ROLE OF THE BUDGET IN PROMOTING AND SUSTAINING INCLUSIVE GROWTH

In line with the Constitution's mandate (Article VI, Sections 24 and 25-1), the President submitted to Congress the proposed obligation budget for 2015 amounting to P2.6 trillion, 15.1% higher than the P2.3 trillion budget in 2014. The proposed budget as a percentage of GDP will increase to 18.4% from 17.7% this year.

CHART 1
NATIONAL BUDGET
IN TRILLION PESOS



	2010	2011	2012	2013	Adj 2014	Prop. 2015
Obligation Budget	1.5	1.6	1.8	2.0	2.3	2.6
Growth Rate (%)	2.7	7.3	15.8	9.3	13.3	15.1
% of GDP	16.4	16.3	17.3	17.3	17.7	18.4

Sources: Budget of Expenditures and Sources of Financing (BESF), various years; and Philippine Statistics Authority for GDP data.

With the goal of seeking to ensure the attainment of inclusive and sustained development, the 2015 Budget Message of President Aquino specifically describes the P2.6 trillion Budget as a ***Budget for Inclusive and Sustained Development***. The thrust of the 2015 budget is very appropriate given that the robust economic growth of the country in recent years has often been criticized as being non-inclusive given the poor state of both unemployment and underemployment in the country and the palpable slow pace of poverty reduction, if not mitigation, vis-à-vis ASEAN member states.

SECTORAL ALLOCATION

The budget prioritizes investments in social protection and basic social services, and the generation of more meaningful employment and livelihood opportunities to spread the benefits of economic growth. In the President's budget message, priority investments programs were identified to promote job generation and economic expansion through transport infrastructure, modernizing the agriculture sector and improving the lives and incomes of farmers and fisherfolk, reviving the manufacturing sector, and maximizing the potential of the tourism sector.

The following imperatives of inclusive development were identified:

(i) Sustain economic expansion and facilitate the creation of more jobs;
(ii) Accelerate poverty reduction by expanding key social protection and social services;
(iii) Manage climate risks and build back better communities ravaged by recent natural and man-made calamities; and
(iv) Establish an enabling environment for inclusive development through lasting peace and the rule of law and, above all, through good governance.

According to the World Bank (2014), low levels of investment in human and physical capital as well as the lack of technological improvement are among the major causes of weak job creation and low quality of available jobs. The growth in output per worker in the Philippines during the period 1961-2000 is only 1% which is way below the 4.4% average in East Asia. Furthermore, a simple growth decomposition analysis showed that the contribution of physical capital to growth is only 0.9 percentage point which is lower than the 2.4 percentage points in East Asia. The contribution of human capital at 0.4 percentage point is comparable to the regional average of 0.5 percentage point but this does not take into consideration the huge variation in the quality of labor force. The contribution of total factor productivity, meanwhile, is -0.3 percentage point.

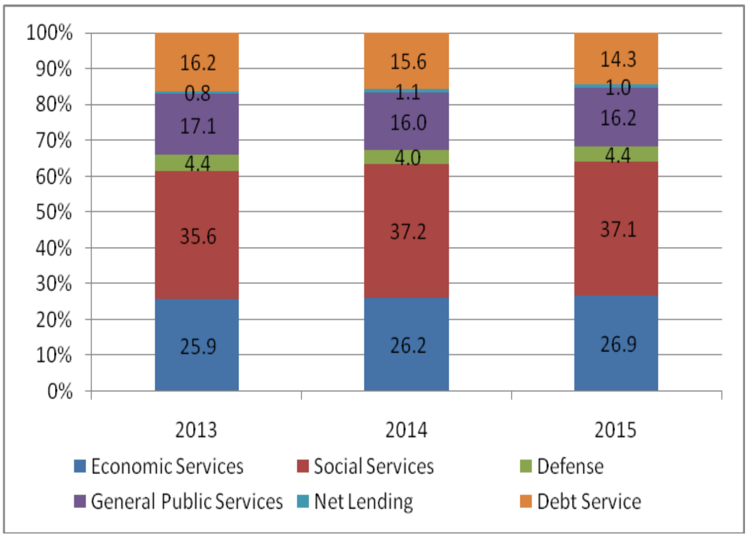
TABLE 1
SOURCES OF GROWTH IN EAST ASIAN COUNTRIES

	Growth in output per worker	Contribution to growth of		
		Physical capital	Human capital	TFP
Philippines	1.0	0.9	0.4	-0.3
East Asia	4.4	2.4	0.5	1.4
China	4.8	1.7	0.4	2.6
Indonesia	3.0	1.8	0.5	0.6
Korea	4.8	2.8	0.7	1.2
Malaysia	3.6	2.2	0.6	0.8
Singapore	5.0	3.0	0.5	1.5
Taiwan	5.8	3.0	0.6	2.1
Thailand	4.1	2.5	0.4	1.2

Source: World Bank staff estimates using data from 1961 to 2000 as cited in Philippine Economic Update (August 2014)

As can be seen in the sectoral allocation of the proposed 2015 national budget, the expenditure priorities support the objective of achieving inclusive growth. Social services with a budget of P967.9 billion will continue to corner the bulk of the budget in 2015 but its share will slightly decline to 37.1% from 37.2% this year. Among the sub-sectors that will continue to get an increasing share of the budget are education, culture, and manpower development, and social security, welfare and employment. Economic services will get the second highest share of 26.9% of the proposed budget with the allocations for communications, roads and other transportation, and water resources development and flood control recording significant increases. *(Please refer to Annex 1 for details of the sectoral allocation of the budget.)*

CHART 2
SECTORAL ALLOCATION OF NATIONAL GOVERNMENT EXPENDITURES
PERCENT SHARE



Source: 2015 BESF

FINANCING

To finance the proposed 2015 budget, total revenues is expected to grow by 15.8% to P2337.3 billion from P2018.1 billion this year. The revenue effort or total revenues as a percentage of GDP will continue to improve to 16.5% from 14.9% in 2013 and 15.7% in 2014. On the other hand, total disbursements is targeted at P2,621.0 billion which is 14.7% higher than the P2,284.3 disbursements this year. It is worth noting that the share of interest payments to total disbursements continues to go down to 14.2% from 17.2% in 2013. In line with the fiscal consolidation goals of the government, the budget deficit is expected to settle at 2.0% of GDP or equivalent to P283.7 billion.

TABLE 2
FISCAL OPERATIONS OF THE NATIONAL GOVERNMENT
IN BILLION PESOS

	In Billion Pesos			Percent of GDP		
Particulars	**2013**	**2014**	**2015**	**2013**	**2014**	**2015**
Revenues	1716.1	2018.1	2337.3	14.9	15.7	16.5
Disbursements	1880.2	2284.3	2621.0	16.3	17.8	18.5
Interest Payments	323.4	352.7	372.9	*17.2**	*15.4**	*14.2**
Surplus/Deficit	(164.1)	(266.2)	(283.7)	(1.4)	(2.1)	(2.0)

Note: Represent percent share to total disbursements.
Source: 2015 BESF

MACROECONOMIC ASSUMPTIONS

Underlying the proposed 2015 budget is a set of macroeconomic assumptions and growth targets which will affect the viability of the budget proposal and the availability of resources that would finance the expenditure program. Among the macroeconomic assumptions are the following: (i) real GDP growth rate; (ii) inflation rate; (iii) 364-day Treasury Bill rate; (iv) foreign exchange rate; and (v) Dubai oil price. These macroeconomic variables and the budget have a dynamic relationship. As pointed out by Miral (2007), the budget underpins both government consumption and investment which are components of economic performance, which, in turn, affects revenue performance and the expenditure program. *(Please see Annex 2 for more discussion on the relationship of budget variables and macroeconomic variables.)*

TABLE 3
MACROECONOMIC PARAMETERS

Particulars	Actual 2013	2014	2015
Real GDP Growth (%)	6.8	6.5-7.5	7.0-8.0
Inflation Rate, CPI (2006=100)	3.0	3.0-5.0	2.0-4.0
364-Day T-bill Rate (%)	0.7	1.5-4.0	2.0-4.0
Foreign Exchange Rate (P:$)	42.45	42-45	42-45
Dubai Oil Price (US$/Barrel)	105.52	90-110	90-110

Source: 2015 BESF

The growth targets and the macroeconomic assumptions must be realistic as these are critical in the realization of the proposed fiscal program. Assumptions that are too optimistic which may be difficult to achieve could constrain the financing of the budget which may either delay some government projects or increase borrowing that puts pressure on the budget deficit. Assumptions that are relatively low, on the other hand, could restrain the planned level of expenditures.

Macroeconomic Performance

<u>GDP Growth.</u> The Philippine economy grew by 6.4% in the second quarter, a deceleration from the 7.9% growth registered in the same period last year. The economic performance was mainly propelled by the performance of both the industry and services sectors on the supply side and the sustained growth in private consumption and recovery in exports on the demand side. Compared to its ASEAN counterparts, the Philippine economic performance in the second quarter matches that of Malaysia and is higher than Vietnam (5.3%), Indonesia (5.1%), Singapore (2.4%) and Thailand (0.3%).

TABLE 4
GROSS DOMESTIC PRODUCT
Growth Rates (%)

	2013				2014	
	Q1	Q2	Q3	Q4	Q1	Q2
SUPPLY SIDE						
Agriculture, Hunting, Forestry and Fishing	3.2	-0.2	0.3	0.9	0.9	3.6
Industry	11.3	10.5	7.7	7.6	5.3	7.8
Manufacturing	9.5	10.3	8.9	12.0	6.9	10.8
Services	6.5	7.8	7.7	6.7	6.8	6.0
DEMAND SIDE						
Household Consumption	5.5	5.1	6.2	5.9	5.9	5.3
Government Consumption	10.0	12.1	7.0	-0.4	1.9	0.0
Capital Formation	49.8	33.6	21.6	22.4	9.5	-2.4
Fixed Capital	17.3	13.6	9.5	8.0	11.0	4.0
Exports	-10.6	-7.7	12.4	3.2	13.5	10.3
Imports	2.8	-4.6	17.3	6.4	10.1	1.4
GDP	7.7	7.9	7.0	6.3	5.6	6.4
GNI	7.3	6.4	9.0	7.2	7.2	7.3

Source: Philippine Statistical Authority

The performance of the industry sector was driven by the 10.8% growth in manufacturing led by food manufactures. The services sector continued to contribute the highest to GDP growth notwithstanding its deceleration to 6.0% in the second quarter from 7.8% in the same period in 2013. All services subsectors recorded a slowdown except for trade and repair of motor vehicles, motorcycles, personal and household goods which managed to accelerate its growth to 6.6% from

6.3%. Meanwhile, the agriculture sector posted a 3.6% growth reversing the 0.2% contraction in 2013. Except for copra and coffee, all major crops recorded improved performance. In the last five years, the agriculture sector has not registered annual growth above 3%.

Remittance inflows continued to shore up the robust growth of private consumption or household spending. Net primary income which is composed primarily of remittances accelerated by 12.7% in the second quarter from a 1.2% contraction in the same period last year. Government spending, on the other hand, was anemic as it registered a flat growth in the second quarter. Total exports grew double-digit at 10.3%, a turnaround from the 7.7% decline last year. After recording robust growth in all four quarters last year, gross domestic investments contracted by 2.4% in the second quarter. There was a substantial decline in public construction investments in the second quarter by 12.9% from 26.5% growth in the same period last year.

Given the first semester growth rate of 6.0%, the economy has to grow by at least 7.0% in the second semester to achieve the low-end of the full year growth target of 6.5% - 7.5% set by the Development Budget Coordination Committee (DBCC). Sustained private consumption spending buoyed by remittances is expected to support growth for the rest of the year until next year. Both the industry and services sectors will support growth on the supply side.

Both domestic and external factors, however, may bring downside risks. Among the domestic risks are: (i) natural disasters such as typhoons, El Niño; (ii) inflation rate increases resulting from spike in food, oil, electricity prices; (iii) interest rate hikes to rein in inflation rate; (iv) volatility in capital flows; (v) infrastructure project delays (public-private partnership projects); and (vi) slow reconstruction spending. On the other hand, external downside risks identified are: (i) sustainability of recovery in advanced economies; (ii) geopolitical tensions in the Middle East and Eastern Europe; and (iii) continued slowdown in Asia's large economies such as China and India.

The World Bank (2014) noted that growth in the medium-term will depend on the country's ability to raise investment and to implement structural reforms to boost potential growth. It was also mentioned that the output gap of the country is also close to zero which indicates that it has a limited capacity to sustain growth of over 6% in the medium term. There is, therefore, a need to increase potential output which requires higher investments in physical and human capital.

The Philippines' investments rate (gross domestic investments as a percentage of GDP) has generally declined in the last 23 years. It also had the lowest investment rate of below 20% in 2013. Based on World Bank data, the investment rate in 2013 of 19.7% is lower than the 22.8% average rate during the period 1990-1994. It can also be noted that more progressive ASEAN countries like Singapore, Malaysia and Thailand also recorded a reduction in their investment during the period. On the other hand, Indonesia managed to increase its investment rate from 30.6% to 33.6% during the period. Vietnam recorded the largest improvement in investment rate from 19.0% to 26.6%.

TABLE 5
GROSS CAPITAL FORMATION (% OF GDP)

ASEAN 6	1990-94	1995-99	2000-04	2005-09	2010	2011	2012	2013
Philippines	22.8	22.7	21.9	18.6	20.5	20.5	18.5	19.7
Malaysia	37.2	35.4	24.4	21.6	23.3	23.3	25.8	26.2
Indonesia	30.6	24.5	23.2	26.8	32.3	32.9	34.7	33.6
Thailand	40.9	31.7	24.5	27.3	25.9	26.6	29.7	29.2
Singapore	35.0	34.3	25.8	25.0	27.9	27.3	30.4	29.1
Vietnam	19.0	28.0	30.5	36.3	35.7	29.8	27.2	26.6

Source: World Bank Economic Indicators

Compared to the growth target of the government, the World Bank is less upbeat with its GDP forecast for the Philippines at 6.4% this year and 6.7% in 2015. Other multilateral institutions such as the Asian Development Bank and the International Monetary Fund are, likewise, subdued in their growth projections with the ADB exactly matching that of World Bank's estimate and the IMF even less optimistic at 6.2% and 6.5% for 2014 and 2015, respectively.

TABLE 6
COMPARATIVE GROSS DOMESTIC PRODUCT FORECASTS
GROWTH RATES (%)

	2014	2015
DBCC	6.5 - 7.5	7.0 - 8.0
ADB	6.4	6.7
IMF	6.2	6.5
World Bank	6.4	6.7

Sources: 2015 BESF, Asian Development Outlook 2014 (April 2014),
IMF Article IV Consultation-Staff Report (August 2014), Philippine Economic Update (August 2014)

Given recent national accounts data, the CPBRD updated its 2014 growth forecast and now reckons 2014 GDP to expand between 6.2% and 6.7% (from the initial 6.0%-7.1% forecast). Private consumption will be sustained with holiday spending providing the added boost. With lacklustre spending in the first half, government expenditures is expected to recover in the second semester. On the supply side, the resurgence of manufacturing and the sustained growth of services will prop up growth. For 2015, the CPBRD expects the economy to slightly improve to 6.5% and 7.3%. The same growth drivers – industry and services, and private consumption along with the strengthening of investments, assuming timely roll out of PPP projects, on the demand side - are expected to sustain growth in 2015.

The impact of GDP on the proposed budget is the most significant among all the macroeconomic parameters identified. Based on the estimates of the Department of Finance and the Bureau of the Treasury on the 2015 Budget Sensitivity to Macroeconomic Parameters, a one percentage point decrease in the real GDP growth would decrease revenues by P23 billion and thus increase the budget deficit by the same amount. *(Please see Annex 3 for more discussion of the 2015 Budget Sensitivity to Macroeconomic Parameters.)*

Inflation Rate. The inflation rate has been on the upward trend since August 2013 from 2.1% in July 2013 which is the lowest rate posted since August 2009. In July 2014, the inflation rate reached 4.9% which was the highest recorded since its peak in July 2012. The average inflation rate for the period January to August 2014 was recorded at 4.3%, substantially higher than the 2.9% average in the same period in 2013 and nearer the high-end of the DBCC target range of 3.0%-5.0% for this year. In 2015, the DBCC is maintaining a lower inflation target range of 2.0%-4.0%.

CHART 3
MONTHLY INFLATION RATES (2006=100)
JANUARY 2010 – JULY 2014

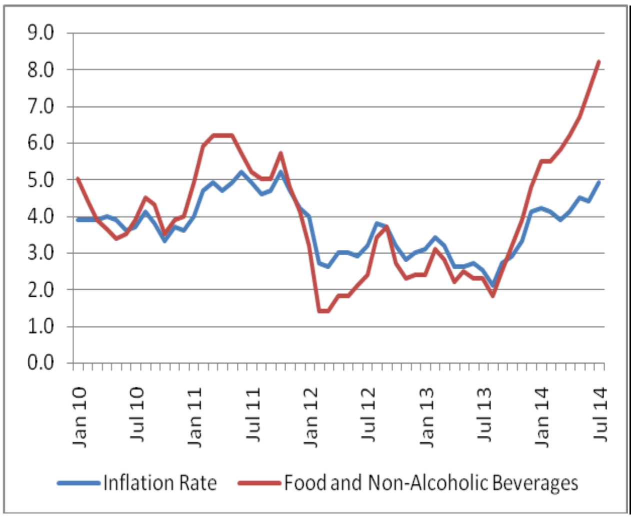


TABLE 7
CONSUMER PRICE INDEX (2006=100)
WEIGHTS BY COMMODITY GROUP

	Philippines
All Items	100.00
Food and Non-Alcoholic Beverages	38.98
Alcoholic Beverages and Tobacco	1.99
Clothing and Footwear	2.96
Housing, Water, Electricity, Gas and other Fuels	22.46
Furnishing, Household Equipment & Routine Maintenance of the House	3.22
Health	2.99
Transport	7.81
Communication	2.26
Recreation and Culture	1.93
Education	3.37
Restaurant and Miscellaneous Goods and Services	12.03

Sources: BSP Key Statistical Indicators, National Statistics Office

There are upside risks to inflation rate for the rest of 2014 and which could spill over to 2015. The direction of the inflation rate is affected by the movement of the components of the consumer price index (CPI). *(Table 7)* Almost 40% of the CPI is accounted for by food and non-alcoholic beverages which grew by 8.4% in August 2014 and which is substantially higher than the 1.8% inflation rate recorded in August 2013. *(Chart 3)* The statement of Economic Planning Secretary Arsenio M. Balisacan on the August 2014 inflation rate mentioned that almost all major food items recorded faster year-on-year growth. Secretary Balisacan underscored the need to ensure the supply sufficiency of key commodities. For instance, timely rice importation is important to augment local production. Supply disruptions in other agricultural crops and even the impact on livestock and poultry of the El Niño phenomenon which is expected to last until the first quarter of next year should also be considered.

Based on National Statistics Office data, the average share of food from the total household expenditures of the country in 2009 is 0.53 (Prtichett and Spivack 2013). For poor households, it could be presumed that their share of food expenditures would most likely be higher. Thus, when the prices of food increases, the impact on poor households is greater compared to non-poor households.

The issue of port congestion and truck ban which have delayed the delivery of certain goods – both food and non-food - is also seen to bring additional upward pressure on the inflation rate. In an ABS-CBN News Channel article, Mr. Steven Cua of the Philippine Amalgamated Supermarkets Association, said that port congestion has increased the costs of bringing in goods and moving them to their destination. The chairman of the Federation of Philippine Industries, Jess Arranza, also said that these problems affect both domestic and foreign market and consumers as costs increases due to the slow delivery of goods. For instance, the reliability of companies as a supplier of goods in the local and foreign market could also be adversely affected if target dates are not met and it will be difficult to regain market share.

Another sizeable/substantial component of the inflation basket, accounting for 22.46%, is the *housing, water, electricity, gas and other fuels.* This subgroup, like the food and non-alcoholic beverages, is also volatile. Geopolitical concerns in Iraq could put upward pressure on international oil price which in turn could contribute to inflation rate in the coming months. Problems in the power and water sectors could also weigh down utility rates next year.

The CPBRD reckons inflation rate in 2014 to be between 4.3% and 4.7% which is closer to the high-end of the government target of 4% - 5%. Upside risks such as volatility in the prices of food as well as oil and other utilities are expected to persist towards year-end. In 2015, the CPBRD expects inflation rate to 4%-5%.

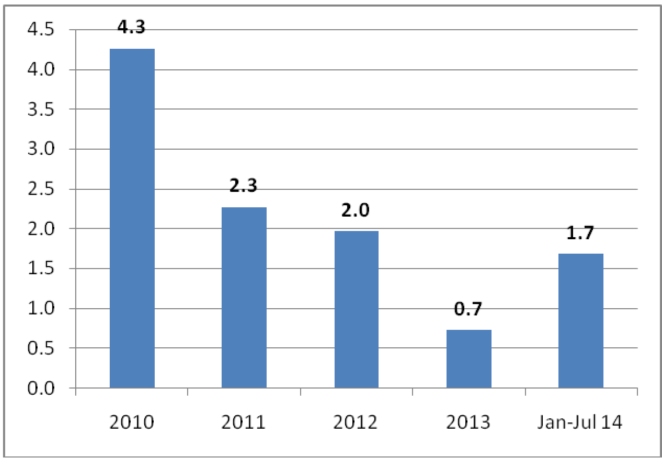
364-day Treasury Bill Rate. The DBCC expects the 364-day[1] T-Bill rate to range between 1.5% and 4% this year and to a narrower band of 2% and 4% in 2014. Movement of the interest rate affects both revenues and expenditures of the government. A higher rate increases the cost of servicing domestic public debt but also boosts revenues due to the higher taxes withheld from the interest income on the sale of government securities.

The 364-day T-Bill rate has been falling starting in 2009, recording an average of below 1% in 2013 to 0.72%. In 2013, several auctions of the Bureau of the Treasury have been oversubscribed which pushed down rates. Starting in January this year, there has been an uptrend in the T-Bill rate starting with 1.079% in January and nearly reached 2.0% in April to settle at 1.972%. For the first seven months of 2014, the T-Bill rate has climbed to 1.7% from 0.8% in the same period last year.

[1] *The DBCC approved the shift from the 91-day to the 364-day Treasury bill rate in its decision dated 11 February 2011 to better capture directions of the market.*

The increase in policy rates by the BSP due to inflation risks may put pressure on the T-bill rates and may adversely impact on the cost of government borrowings (please refer to DoF's sensitivity analysis in Annex 3), as well as that by the private sector.

CHART 4
364-DAY TREASURY BILL RATES

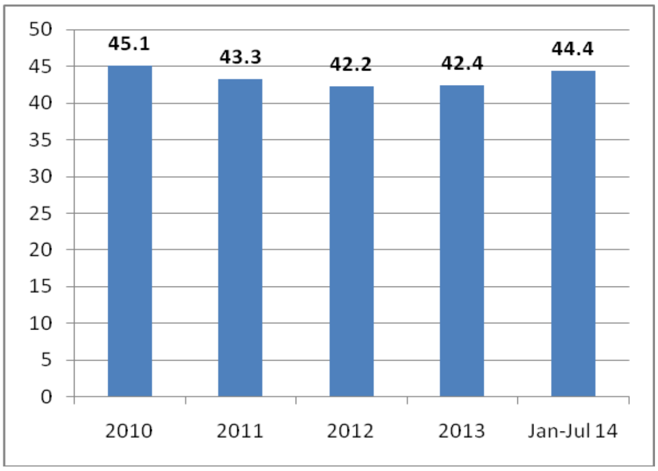


Source: BSP Key Statistical Indicators

<u>Exchange Rate.</u> The peso-US dollar rate started weak this year when it depreciated by 9.3% year-on-year, to record a monthly average rate of P44.9 in January. It was also the weakest rate in 40 months when it recorded P45.2:$ in August 2010. The peso-US dollar rate started to strengthen immediately in February to reach P43.5 in July. However, the average exchange rate for the first seven months of the year of P44.4:$ is still weaker than the P41.5 average in the same period in 2013. It is also near the high-end of the exchange rate assumption of P42-45:$ this year. The peso-US dollar rate is supported by the overseas Filipino workers (OFW) remittances and the business process outsourcing (BPO) revenues.

The DBCC assumption for the peso-US dollar rate of P42-45 this year is maintained in 2015. The peso-US dollar rate is expected to be supported next year by sustained foreign exchange inflows from OFW remittances, BPO revenues and foreign direct and portfolio investments. The appreciation of the peso lowers the peso value of the earnings of exporters and the remittances of OFWs. This, however, is advantageous to importers and those servicing foreign loans like the government and private businesses.

CHART 5
PESO PER US DOLLAR RATE
ANNUAL AVERAGE



Source: BSP Key Statistical Indicators

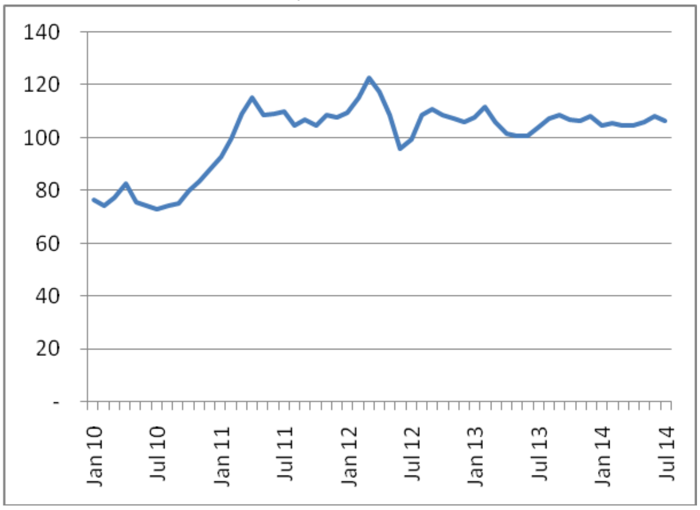
The CPBRD expects the peso-UD dollar rate to settle between P44-45:$. With the incoming holiday season, remittances are expected to increase which will help prop up the peso. In 2015, the exchange rate is reckoned to further strengthen to hover between P43- P44.5:$.

Factors that could weaken the peso include the strengthening of the US economy where it could result to the withdrawal of foreign funds. A depreciation of the peso increases the cost of all dollar-denominated expenditures like imports as well as debt servicing. The higher prices of imported good could add pressure to inflation rate. The higher cost of imports, meanwhile, raises revenues from taxes. A weaker currency could improve country competitiveness and could help boost exports performance.

Dubai Oil Price. The change in the price of Dubai oil during the first five months of 2014 semester was relatively steady ranging from a monthly average price of $104.32 to $105.61 per barrel. In June 2014, it increased to $108.10 then settled back to $106.17 in July. As of the September 3, 2014, Oil Monitor of the Department of Energy, the unresolved conflicts in Ukraine and the Middle East would likely cause crude prices to move higher in the medium term. The movement of the peso-dollar rate also affects the price of oil.

For January-July the average monthly price of Dubai oil was $105.47/barrel which is slightly higher than the $104.4/barrel in the same period in 2013 but within the 2014 BESF assumption of $100-110. The price of Dubai is expected to moderate in 2015 to $90-110. Resolution of the geopolitical tensions affecting oil price remain uncertain. The CPBRD reckons prices of oil to remain within the $100-$110 per barrel in 2015.

CHART 6
MONTHLY DUBAI CRUDE OIL PRICE
US$ PER BARREL



Source: Ministry of Economic Development, New Zealand database

Unemployment Rate. Unemployment rate targets were added back to the set of macroeconomic assumptions in the 2014 proposed budget. The DBCC is targeting a steady improvement in the unemployment rate from 7.1% in 2013 to 6.7% - 6.9% this year and further down to 6.6% - 6.8% in 2015. The inclusion of unemployment target is an indication of the government's recognition of the need to intensify efforts to make growth more inclusive.

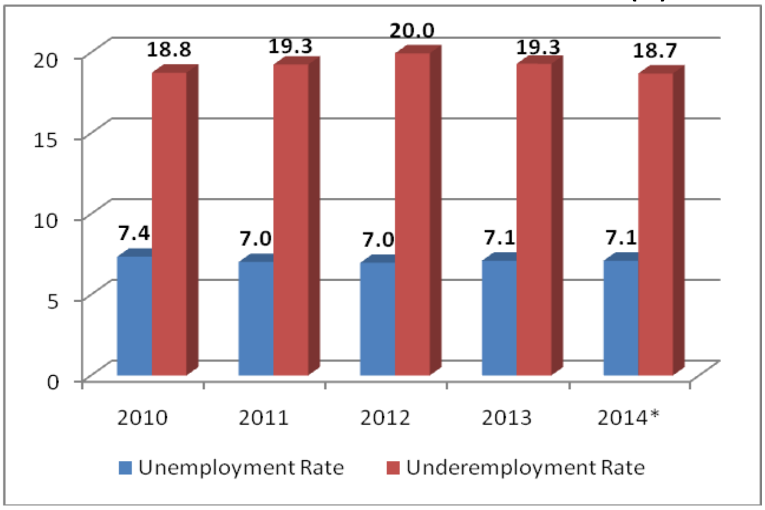
TABLE 8
UNEMPLOYMENT RATE (%)

	2012	2013	2014	2015	2016
Unemployment Rate (%)	7.0	7.1	6.7-6.9	6.6-6.8	6.5-6.7

Source: 2015 BESF

While GDP growth has been generally robust in recent years, there was no commensurate improvement in both unemployment and underemployment rates. The Philippines has one of the highest unemployment rates compared with its ASEAN-5 counterparts. In 2013 when GDP grew by 7.2%, the unemployment rate inched up to 7.1% from 7.0% in 2012. There was, however, an improvement in underemployment rate to 19.3% from 20%. It should also be noted that there is an improvement in the quality of employment as shown in the rising share of wage and salary workers in the total number of employed workers from an average of 54.5% in 2010 to 58.4% in 2013. In the January, April and July 2014 Labor Force Surveys, average unemployment and underemployment rates were recorded at 7.1% and 18.7%, respectively.

CHART 7
UNEMPLOYMENT AND UNDEREMPLOYMENT RATES (%)



**/Average of the January, April and July Labor Force Surveys*
Source: PSA

The marginal success in improving the employment situation in the country points to the need for greater attention to this concern. However, more than just focusing on addressing the unemployment issue, which studies (e.g., De Dios and Dinglasan 2014) have described as essentially a middle class phenomenon in the Philippines, due consideration should likewise be accorded to the underemployment problem, including the quality of employment, as such would have a bearing on efforts to reduce the incidence of poverty. This requires targeting not just the creation of jobs but also targeting the quality of available employment. De Dios and Dinglasan (2014) underscored that policies required to address unemployment greatly vary from those needed to address underemployment and low quality employment.

ECONOMIC GROWTH AND FISCAL SCENARIOS

The country's economic growth has a significant impact on the achievement of the fiscal targets. The sensitivity analysis of the Department of Finance (DOF) and the Bureau of the Treasury (BTr) shows that the growth of GDP has the highest impact on the government's revenues (p*lease see Annex 3*). With higher revenues, the government is able to increase its expenditures which can accelerate GDP growth leading to a virtuous cycle.

The government uses a range for its GDP growth target. It adopts a conservative stance in the preparation of the budget by using the low-end of the growth target in the calculation of projected revenues and planned expenditures. For 2014, the GDP target is between 6.5% and 7.5% which is slightly lower than the PDP target of 7.0% - 8.0%. As pointed out in previous CPBRD budget analysis, the downside in using a conservative GDP growth assumption is the limitation it sets on the government expenditures.

GDP grew by 6.0% in the first semester of 2014. To achieve the low-end of the government target of 6.5%, GDP has to grow by 7.0% in the second semester. The first semester performance was marked with weak government spending and investments that could be attributed mainly to the low absorptive capacity of implementing agencies and judicial cases which could impact on public spending. In the first semester of the year, actual total expenditure of the government amounted to P987.7 billion which represents 43.2% of the 2014 expenditure program of P2,284.3 billion. Meanwhile, total revenue collections grew by 11.2% to reach P933.7 billion. National government deficit stood at P54.0 billion which represents only 20.3% of the 2.1% deficit target for the year. The government has to make up for its lackluster spending in the first semester to at least meet the low-end of the GDP growth target of 6.5% - 7.5%.

For 2015, the government is more upbeat with growth prospects as GDP is targeted to grow within a range of 7.0% - 8.0%. Recent growth projections of the three multilateral institutions point lower forecast averaging only 6.6%. The growth of GDP is affected by rapidly evolving economic conditions. There are also many factors that are beyond the control of the government. However, having a set of realistic macroeconomic assumptions is very important. The target for 2015 is more optimistic at the moment compared to the forecast of the multilateral institutions. *(Please see Table 6.)*

When overoptimistic assumptions are not achieved, financing of the budget which mainly come from tax revenues is constrained. If the government is keen on meeting the deficit target, it may result to the delay, if not cancellation, of certain government programs and projects. On the other hand, the government can allow the budget deficit to go up a bit so as not to sacrifice the implementation of planned expenditures. Improving revenue efficiency can make up for the shortfall in revenues as a result of slower economic activity. At present, the Philippines has low tax efforts compared to its ASEAN counterparts. For instance, the country's tax effort in 2012 is only 12.9% compared to 16.1% in Malaysia and 16.5% in Thailand.

SUMMARY/CONCLUSION

The first semester data show that GDP growth is likely to decelerate from the robust 7.2% growth achieved in 2013. At best, it will attain the lower-end of the government target of 6.5% - 7.5%. The government, with its weak spending in the first half, has to step up to ensure that growth will be achieved. Hence, there is need to enhance the absorptive capacity of all government instrumentalities, as well as seek for the expeditious resolution of judicial cases that may adversely impact on public spending.

The robust economic growth in recent years has been described as not inclusive. Data on both unemployment and underemployment rates have not been very encouraging. The improvement in poverty incidence has not been very significant. Based on data from the PSA, poverty incidence among population in the Philippines has improved from 26.6% in 2009 to 25.2% in 2012 but the magnitude of poor population increased by almost 500,000. In the first semester of 2013, initial estimate of poverty incidence showed that it went down to 24.9% from 27.9% in the same period last year. However, it should be noted that the first semester 2013 estimate is the same figure that was recorded 10 years ago in 2003. The target of the PDP 2011-2016 is to reduce poverty incidence among population to 16.6% in 2015.

TABLE 9
POVERTY INCIDENCE AMONG POPULATION (%)

	2003	2006	2009	2012	2013[a/]
Poverty Incidence Among Population (%)	24.9	26.6	26.3	25.2	24.9

Note: a/ The 2013 poverty estimates are based on the 2013 Annual Poverty Indicator Survey (APIS) conducted in July 2013, which adopted the income module of the FIES (with some modifications in the section containing the list of wage and salary workers in the family), and used one replicate of the 2003 Master Sample or approximately 12,000 sample.
Source: PSA, National Statistical Coordination Board

The government clearly needs to intensify its effort to be able to get near its poverty incidence target. In several studies, the World Bank highlighted the important role of sustaining economic growth to make a significant dent in reducing poverty. A study by the World Bank Philippine Office noted that the economic growth of the country which has been historically weak is one of the main reasons for the below average performance on achieving inclusive growth. The World Bank noted that the average GDP growth of 4.1% in the last three decades is considerably lower than the 6.5% growth of the more dynamic East Asian countries. It was also pointed out that while the country achieved a few growth spurts, it has rarely been able to sustain growth at above 5% for an extended period of time.

The country has gained several international recognitions of its economic achievements. New milestones have been achieved this year including the seven notches jump in the World Economic Forum competitiveness ranking as well as the improvement in the investment grade rating of Standard & Poor’s Financial Services (S&P) from BBB- Stable to BBB Stable which is the highest rating ever recorded in the country’s history.

The government can capitalize on these achievements to further encourage both domestic and foreign investments in the country to supplement available domestic capital to prop up the economy. The investment rate is low and has not improved in the last 23 years *(Table 5)*. Foreign direct investment is likewise low at around $2 billion per year. Apart from providing much-needed capital, foreign direct investment can also bring in improvements in technology and management skills.

Apart from promoting a more conducive environment for investments, the government should also set policies that advance inclusive growth. It is noteworthy to mention that the growth strategies in the PDP 2011-2016 Midterm Update has spatial and sectoral dimension to equalize development opportunities and ensure inclusivity of economic growth. The proposed budget including its regional allocation must therefore support programs and projects on Infrastructure development that promote greater connectivity between regions/provinces and to identify new growth drivers in the regions that can facilitate the reduction of the incidence of poverty.

It should also be considered as pointed out by De Dios and Dinglasan (2014) that solving the poverty problem does not only require creating more employment opportunities but also entails increasing the productivity and incomes of those employed. Government programs and projects must be geared towards improving productivity in the country.

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ANNEX 1
SECTORAL ALLOCATION OF NATIONAL GOVERNMENT EXPENDITURES, OBLIGATION BASIS

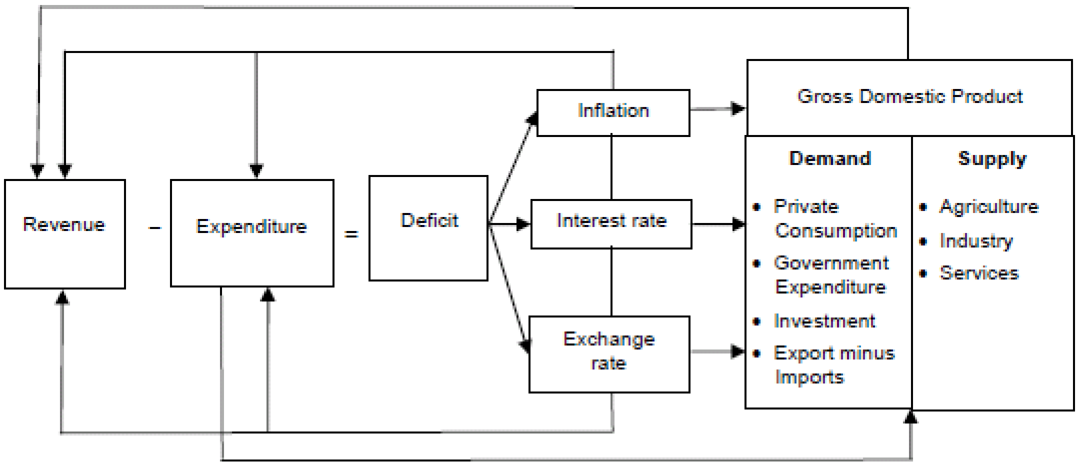
PARTICULAR	Levels (In Billion Pesos)			Percent Share (%)			Growth Rate (%)	
	2012	2013	2014	2012	2013	2014	2013	2014
ECONOMIC SERVICES	**516.7**	**593.1**	**700.2**	**25.9**	**26.2**	**26.9**	**14.8**	**18.1**
Agriculture, Agrarian Reform and Natural Resources and Environment	119.7	137.5	132.9	6.0	6.1	5.1	14.9	(3.3)
Trade and Industry	6.5	7.5	6.1	0.3	0.3	0.2	14.8	(18.4)
Tourism	5.2	3.7	4.3	0.3	0.2	0.2	(28.7)	15.5
Power and Energy	29.8	14.3	9.3	1.5	0.6	0.4	(52.2)	(35.1)
Water Resources Dev't. and Flood Control	27.1	29.4	39.4	1.4	1.3	1.5	8.7	34.0
Communications, Roads and Other Transportation	207.4	260.5	339.4	10.4	11.5	13.0	25.6	30.3
Other Economic Services	15.2	20.6	32.3	0.8	0.9	1.2	35.8	56.4
Subsidy to LGUs	105.8	119.5	136.5	5.3	5.3	5.2	13.0	14.1
SOCIAL SERVICES	**712.1**	**841.8**	**967.9**	**35.6**	**37.2**	**37.1**	**18.2**	**15.0**
Education, Culture, and Manpower Development	327.0	383.1	450.2	16.4	16.9	17.3	17.1	17.5
Health	56.9	90.5	94.6	2.8	4.0	3.6	59.2	4.5
Social Security, Welfare and Employment	177.3	218.0	261.4	8.9	9.6	10.0	22.9	19.9
Land Distribution (ARF)	5.0	5.0	5.0	0.3	0.2	0.2	-	-
Housing and Community Development	32.2	16.9	10.3	1.6	0.7	0.4	(47.4)	(39.2)
Other Social Services	1.8	1.9	2.2	0.1	0.1	0.1	3.1	14.4
Subsidy to LGUs	111.9	126.4	144.2	5.6	5.6	5.5	13.0	14.1
DEFENSE	**87.8**	**89.5**	**115.5**	**4.4**	**4.0**	**4.4**	**1.9**	**29.0**
Domestic-Security	87.8	89.5	115.5	4.4	4.0	4.4	1.9	29.0
GENERAL PUBLIC SERVICES	**341.7**	**362.6**	**423.1**	**17.1**	**16.0**	**16.2**	**6.1**	**16.7**
General Administration	132.5	115.4	150.1	6.6	5.1	5.8	(12.9)	30.1
Public Order and Safety	115.1	134.4	141.9	5.8	5.9	5.4	16.8	5.6
Other General Public Services	9.4	17.1	21.9	0.5	0.8	0.8	81.8	27.8
Subsidy to LGUs	84.6	95.6	109.2	4.2	4.2	4.2	13.0	14.1
NET LENDING	**16.6**	**25.0**	**26.5**	**0.8**	**1.1**	**1.0**	**50.1**	**6.2**
DEBT SERVICE	**323.4**	**352.7**	**372.9**	**16.2**	**15.6**	**14.3**	**9.0**	**5.7**
Interest Payments	323.4	352.7	372.9	16.2	15.6	14.3	9.0	5.7
TOTAL	**1,998.4**	**2,264.6**	**2,606.0**	**100.0**	**100.0**	**100.0**	**13.3**	**15.1**

Source: 2014 BESF

ANNEX 2
BUDGET VARIABLES AND MACROECONOMIC VARIABLES

There is a dynamic relationship between budget variables and macroeconomic variables. The budget variables affect and, at the same time, are affected by the macroeconomic variables. The following diagram by Miral (*2007*) illustrates the relationship between these two sets of variables.

RELATIONSHIP OF BUDGET VARIABLES AND MACROECONOMIC VARIABLES



Source: R. E. Miral Jr., PhD, "Assessment Framework of the National Government Budget", CPBD 2007

A major determinant of revenue collection is the nominal GDP as it serves as the base for tax collection. A higher GDP means a larger tax base and, consequently, higher tax collections. The level of GDP, in turn, is determined by the performance of its components. These include private consumption, government expenditure, investments and trade balance (difference between exports and imports of goods and services) on the demand side, and agriculture, industry (manufacturing) and services on the supply side. Important economic variables that determine the performance of these components are inflation rate, interest rate and exchange rate. Inflation rate or the annual rate of change in the general price level, for instance, is a major factor that affects consumption spending while interest rate mainly affects investment decisions. The exchange rate affects both exports and imports.

The inflation rate, interest rate and the exchange rate also have an impact on government finances. The inflation rate affects both revenues and expenditures. Tax revenues increase with the increase in the price of taxable products. Expenditures also rise due to the higher price level of goods and services which the government avails of. The 364-day Treasury bill rate in recent years has been used as the benchmark for interest rate. A rise in interest rate increases the cost of debt servicing but may also increase government revenues due to the 20% withholding tax on interest income.

Meanwhile, the budget deficit level and its sources of financing have an impact on these three variables. A higher-than-programmed deficit when mainly financed through domestic borrowing could increase interest rates and crowd out private investments. On the other hand, huge inflow of proceeds from borrowing abroad may result in appreciation of the peso and corollary weakens the competitiveness of exports.

It is also important to note that these three variables affect one another. The interest rate is used as a policy tool by the central bank to contain inflation. When the inflation rate is high, the central bank may choose to increase interest rates to reduce the money in circulation. A high interest rate relative to other countries may encourage capital inflows which may lead to currency appreciation.

ANNEX 3
SENSITIVITY ANALYSIS

The movement of the macroeconomic parameters has impact on government revenues and disbursements. The Department of Finance (DOF) and the Bureau of the Treasury (BTr) estimate the impact of six variables on revenues and disbursements, and the net impact on the budget balance. Economic performance as indicated by GDP growth has the highest positive impact on the budget balance. A one percentage point increase in real GDP growth rate increases revenues by P24.3 billion and as a result reduces the budget deficit by the same amount.

The movement of the inflation rate has the second highest impact on government revenues, with a one percentage point increase compared to the assumption resulting to higher revenue collection of P23.5 billion due to the increase in the prices of taxable products. A one percentage point increase in the growth rate of imports is expected to increase revenues by P6.3 billion as a result of higher collections from international trade and income/sales taxes. The resulting increases in revenue collection from the increase in inflation rate and growth rate of imports reduce the deficit by the same amount as there are no accompanying effects on government expenditures.

2015 BUDGET SENSITIVITY TO MACROECONOMIC PARAMETERS
IN BILLION PESOS

	Particulars	Revenues	Disbursements	Budget Balance[1/]
Peso-to-US$ exchange rate	P 1 depreciation	8.7	2.2	6.5
Treasury Bill Rate (All Maturities)[2/]	1 percentage point increase	0.6	3.3	(2.7)
LIBOR (180-Day)	1 percentage point increase		3.1	(3.1)
Inflation Rate	1 percentage point increase	23.5		23.5
Real GDP Growth Rate	1 percentage point increase	24.3		24.3
Growth Rate of Imports	1 percentage point increase	6.3		6.3

Notes: 1/A negative figure in the budget balance means an increase in the deficit.
2/Based on Government Securities flotation for the year. Revenue impact includes 20% withholding tax.
Sources: Department of Finance, Bureau of Treasury as presented in the 2015 BESF

The movements in the exchange rate and interest rate affect both revenues and disbursements of the government. A one peso depreciation in the foreign exchange rate is expected to increase revenues and disbursement by P8.7 billion and P2.2 billion, respectively, resulting in a positive net effect on the budget balance amounting to P6.5 billion. On the other hand, a one percentage point increase in the Treasury bill rate is estimated to increase revenues by P0.6 billion and disbursements by P3.3 billion, adversely affecting the budget balance by P2.7 billion. Meanwhile, a one percentage point increase in the 180-day LIBOR would increase government disbursements by P3.1 billion due to higher debt servicing, resulting to an increase in the budget deficit by the same amount.