REPUBLIC OF THE PHILIPPINES

Fiscal Risks STATEMENT

2012

Development Budget Coordination Committee

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Foreword

The ongoing debt crisis in the United States and Europe, slow growth among developed countries, and fears of regional contagion have proven that no country is truly safe from unforeseen developments either from within or from the increasingly interconnected global economy. To this end, a nation's fiscal stability serves the twofold purpose of safeguarding against adverse shocks and ensuring growth despite challenging circumstances.

This Fiscal Risks Statement (FRS) outlines the country's exposure to fiscal risks stemming from various channels such as the projections used for budgetary purposes, public debt dynamics, operations of local governments and government corporations as well as public-private partnerships, contingent liabilities and the mechanics of the financial sector. Furthermore, it also deals with the risks posed by natural disasters and calamities especially for a country prone to such catastrophes as the Philippines.

Specifically, the FRS highlights the following:

1. Macroeconomic assumptions have been fairly accurate save for periods of crisis (2008-2009), although downside risks of underspending are present;
2. Public debt is projected to be sustainable even under severe interest rate or primary balance shocks although economic growth remains a key concern;
3. Government-owned and/or-controlled corporations (GOCCs) and government financial institutions (GFIs) remain as a fiscal risk, although this has been reduced with the passing of the GOCC Governance Act of 2011;
4. The financial sector proves to be resilient with minimal exposure to "at risk" international financial institutions; and
5. Reforms are currently being pursued to prepare for the eventuality of natural calamities and mitigate the effects of climate change.

Moving forward, the FRS details some of the current and proposed measures by which the various government departments and attached agencies are striving to mitigate these risks along with minimizing their impact should they materialize. 'It gives the end-users an idea as to the country's exposure to various sources of fiscal risks and insight as to what more can be done to ensure fiscal viability in the event of unfavorable fiscal developments. Ultimately, it is the goal of the FRS to present a holistic view of the risks to the government's fiscal position and aid in the formulation of necessary policies and plans of action.

List of Acronyms and Abbreviations

ADB	Asian Development Bank
ASEAN	Association of Southeast Asian Nations
BESF	Budget of Expenditures and Sources of Financing
BIR	Bureau of Internal Revenue
BLGF	Bureau of Local Government Finance
BOC	Bureau of Customs
BOT	Build-Operate-Transfer
BPM5	Balance of Payments Method 5
BSF	Bond Sinking Fund
BSP	Bangko Sentral ng Pilipinas
BTr	Bureau of the Treasury
CAR	Capital Adequacy Ratio
CARP	Comprehensive Agrarian Reform Program
CCC	Climate Change Commission
CFG	Climate Finance Group
CO	Capital Outlays
COA	Commission on Audit
CLM	Contingent Liability Management
DBCC	Development Budget Coordination Committee
DBM	Department of Budget and Management
DBP	Development Bank of the Philippines
DepED	Department of Education
DFA	Department of Foreign Affairs
DIF	Deposit Insurance Fund
DILG	Department of the Interior and Local Government
DND	Department of National Defense
DOF	Department of Finance
DOH	Department of Health
DPWH	Department of Public Works and Highways
DRMD	Debt and Risk Management Division
DSA	Debt Sustainability Analysis
DSWD	Department of Social Welfare and Development
DTI	Department of Trade and Industry
ERC	Energy Regulatory Commission
eTAILS	Electronic Transparency and Accountability Initiative for Lump Sum Funds

FPPO	Fiscal Policy and Planning Office
GAA	General Appropriations Act
GCG	Governance Commission for GOCCs
GDP	Gross Domestic Product
GFIs	Government Financial Institutions
GIFMIS	Government Integrated Financial Management System
GOCCs	Government-Owned and/or -Controlled Corporations
GRT	Gross Receipts Tax
GSIS	Government Service Insurance System
HGC	Home Guaranty Corporation
ICC	Investment Coordination Committee
IMF	International Monetary Fund
IRA	Internal Revenue Allotment
LBP	Land Bank of the Philippines
LGU	Local Government Unit
LIBOR	London Inter-Bank Offered Rate
LRTA	Light Rail Transit Authority
LWUA	Local Water Utilities Administration
MENA	Middle East and North Africa
MFIs	Multilateral Financial Institutions
MIAA	Manila International Airport Authority
MNFGCs	Major Non-Financial Government Corporations
MOOE	Maintenance and Other Operating Expenditures
MWSS	Metropolitan Waterworks and Sewerage System
NCCAP	National Climate Change Action Plan
NDC	National Development Company
NDRRMF	National Disaster Risk Reduction Management Fund
NEA	National Electrification Administration
NEDA	National Economic and Development Authority
NFA	National Food Authority
NG	National Government
NHA	National Housing Authority
NIA	National Irrigation Administration
NPC	National Power Corporation
NPL	Non-Performing Loan
NSCB	National Statistical Coordination Board
ODA	Official Development Assistance
OF	Overseas Filipinos
OSSC	One-Stop Shop Center
PAGASA	Philippine Atmospheric, Geophysical and Astronomical Services Administration
PAGCOR	Philippine Amusement and Gaming Corporation
PCF	Performance Challenge Fund
PCOICOP	Philippine Classification of Individual Consumption Expenditure According to Purpose

PDAF	Philippine Development Assistance Fund
PDIC	Philippine Deposit Insurance Corporation
PDP	Philippine Development Fund
PERA	Personal Equity and Retirement Account
PEZA	Philippine Economic Zone Authority
PFM	Public Financial Management
PHIC	Philippine Health Insurance Corporation
PhilGEPS	Philippine Government Electronic Procurement System
PNOC	Philippine National Oil Company
PNR	Philippine National Railways
PPA	Philippine Ports Authority
PPP	Public-Private Partnership
PS	Personal Services
PSALM	Power Sector Assets and Liabilities Management Corporation
PSCC	Philippine Standard Commodity Classification
PSIC	Philippine Standard Industrial Classification
PTAP	Public Transport Assistance Program (Pantawid Pasada Program)
Quedancor	Quedan and Rural Credit Guarantee Corporation
REIT	Real Estate Investment Trust
SBGFC	Small Business Guarantee and Finance Corporation
SEC	Securities and Exchange Commission
SMV	Schedule of Market Values
SNA	System of National Accounts
SSIs	Social Security Institutions
SSS	Social Security System
SPUG	Small Power Utilities Group
SUCs	State Universities and Colleges
TCC	Tax Credit Certificate
TIDCORP	Trade and Investment Development Corporation
TransCo	National Transmission Corporation
UNESCAP	United Nations Economic and Social Commission for Asia and the Pacific
VAT	Value-Added Tax
ZBB	Zero-Based Budgeting approach

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Fiscal Risks Statement

I. FISCAL POLICY OBJECTIVES

1. **Fiscal strength is one of the key pillars of macroeconomic stability.** The government's fiscal stance shifts towards fiscal consolidation as the global economic recovery slows down. Given the limitation in resources, expenditures are targeted to focus on the five key result areas identified by the President, namely: 1) Anti-Corruption and transparent, accountable, and participatory governance; 2) Poverty reduction and empowerment of the poor and vulnerable; 3) Rapid, inclusive, and sustained economic growth; 4) Just and lasting peace and rule of law; and 5) Integrity of the environment and climate change adaptation and mitigation. The fourth and fifth key result areas create the enabling environment needed for the attainment of the other three objectives identified to be important in the overall improvement of the quality of life of the Filipino people.

2. **To reduce the debt burden, the government will pursue manageable deficit levels over the medium term**. In the fiscal sector, the main task over the medium term is to address the narrow fiscal space through a sustainable revenue and spending path. Furthermore, structural and systemic reforms in the fiscal sector are expected to reduce the country's sources of fiscal risks as policies will center on reforms in tax administration, tax policy, non-tax revenue, expenditure policy, the government corporate sector and debt management.

II. SOURCES OF FINANCIAL RISKS

A. SENSITIVITY OF MACROECONOMIC ASSUMPTIONS

3. **Macroeconomic assumptions play a key role in the formulation of the budget**. Variations in these macroeconomic parameters may create risks to both revenue and expenditure projections that are reflected in the Budget of Expenditures and Sources of Financing (BESF). The degree of the fiscal impact that may be realized from changes in these assumptions depend on the nature of the specific fiscal account. For instance, revenue estimates are more sensitive to changes in the macroeconomic assumptions because of their effect on the tax base. On the other hand, expenditures are not generally and significantly sensitive to macroeconomic variables except for interest payments. Interest payments, a sizeable portion of the budget that is automatically appropriated, is sensitive to the following set of macroeconomic parameters: inflation, interest rates, and exchange rates. Budget expenditure items other than interest payments can only adjust to macroeconomic developments if offset by the provision for other accounts due to the limitations imposed by the overall general appropriations level.

4. The budget is particularly sensitive to the following macroeconomic variables:

- ***Economic growth:*** mostly affecting tax revenues. A decrease in the real Gross Domestic Product (GDP) growth lowers tax collection, especially income taxes and collections from the Value-Added Tax (VAT).

- ***Inflation:*** An increase in inflation leads, *ceteris paribus*, to higher tax revenues through increases in the base for income taxes and VAT[1].

- ***Exchange rate:*** impacts both revenues and expenditures. A depreciation of the peso against the US dollar improves revenue collection, mostly through customs tariff and VAT on imported goods. On the expenditure side, key categories affected include foreign interest rate payments and foreign expenditure-related maintenance and other operating expenditures (MOOE).

- ***Merchandise Imports:*** A growth in merchandise imports, in general, positively impacts revenues given the higher tax base for import duties.

- ***Treasury Bill Rate:*** Treasury bill rates are positively correlated to revenues due to the 20 percent withholding tax on income on all financial instruments and the gross receipts tax (GRT). Similarly, expenditures are affected by changes in T-bill rates through the interest paid by the national government on issuances of T-bills.

Table 1 presents the magnitude of first round impacts of the above macroeconomic variables on fiscal aggregates. Note the net positive impact of a rise in Treasury Bill rates and a peso-to-dollar depreciation.

Table 1. Philippines: Fiscal Sensitivity to Key Macroeconomic Variables, 2012
(in billion pesos per annum)

Parameter	Revenues	Disbursements	Budget Balance[1/]
1 percentage point increase in Real GDP Growth (%)	13.0	-	13.0
1 percentage point increase in Inflation Rate (%)	12.5	-	12.5
1 percentage point increase in Merchandise Imports in US$ Growth (%)	4.3	-	4.3
1 percentage point increase in Treasury Bill Rate, All Maturities (%)	7.4	5.3	2.1
1 Peso appreciation in Foreign Exchange Rate (P/US$)	-7.5	-2.5	-5.0

Sources: DOF, BTr
1/ A positive budget balance implies a corresponding reduction in the budget deficit while a negative balance indicates a corresponding increase in the budget deficit.

[1] Non-tax revenues are also expected to be negatively affected (e.g., lower GOCC dividend payments) but to a lower extent and their impact is difficult to quantify given the lumpy nature of some of these revenues.

5. **Comparison of the macroeconomic assumptions used and actual turnouts in the NG budget showed unbiased trends, with broad improvements reflected in their deviations particularly in 2010** (see Table 2). The accuracy of macroeconomic assumptions is an important factor to consider in evaluating the quality of fiscal performance. As with most countries, errors from the set of assumptions used in the annual budget preparations were relatively large in 2008 and 2009, due mainly to the uncertainties observed during the global economic crisis. Over the period 2008-2010, the average deviation between the assumed and actual real GDP growth rates was 0.9 percentage point. The oil price assumptions have differed significantly from outturns, reflecting the inherent volatility in the global oil market. Meanwhile, the average deviation between the budget assumption and the inflation outturn narrowed considerably as actual inflation rates fell within the government-announced targets in 2009 and 2010. Likewise, actual trade performance was markedly better than assumed in 2010.

Table 2. Philippines: Deviations Between Macroeconomic Assumptions and Actual Data Used in the Budget, 2008-2010 *(in percentage points, unless specified [1/])*

Particulars	2008	2009	2010	Average Difference 2008-2010	Average of Absolute Difference 2008-2010
Real GDP Growth[2/]	2.4	5.0	(4.7)	0.9	4.0
Inflation Rate	(5.8)	3.8	0.7	(0.4)	3.4
91-day Treasury Bill Rate	(0.9)	1.3	2.3	0.9	1.5
Exchange Rate (PHP/USD, period average)	2.5	(4.1)	2.4	0.3	3.0
LIBOR Rate, 6 months	2.3	0.9	2.0	1.7	1.7
Dubai Crude Oil Price (US$/barrel)	(27.6)	58.3	(8.0)	7.6	31.3
Export Growth[3/]	13.5	29.1	(28.8)	4.6	23.8
Import Growth[3/]	5.4	34.0	(19.5)	6.7	19.6

Sources: NEDA, NSO, NSCB, BSP

1/For consistency with the published FRS for 2011, the figures presented in the table refer to differences between budget assumptions (at midpoints when ranges were provided) and actual data for selected macroeconomic variables from 2008-2010.

2/ On 12 May 2011, the NSCB released GDP growth levels using 2000 as the base year. However, for comparative analysis in the table above, the GDP levels including projections considered were still 1985-based as these assumptions were set using the old base year.

3/ Based on the Balance of Payments Method 5 (BPM5) concept

4/In May 12, 2011, the NSCB issued growth levels using 2000 as the base year. However, for the table above, the GDP levels considered were based on 1985 prices.

- Positive values indicate that actual realizations were lower than budgeted.
- For the exchange rate, a positive value implies that the currency was stronger (appreciated) than budgeted.

- The estimates were also based on the macroeconomic assumptions presented in the Budget of Expenditures and Sources of Financing (BESF) for the preparation of the General Appropriations Act (GAA).

Box 1. Revision of National Accounts

On May 12, 2011, the National Statistical Coordination Board (NSCB) released the revised national accounts figures with 2000 as the new base year following the Asian Development Bank/United Nations Economic and Social Commission for Asia and the Pacific (ADB/UNESCAP) recommendation for developing countries. The rebased national accounts are seen as an improvement in the official GDP estimates given the adoption of new standards and classifications[1]. This allows the reclassifying of existing commodities and industries for the system of accounts and facilitates new and updated administrative data techniques thus improving assumptions particularly on the use of more fitting ratios and indices, appropriate deflators, aligned price indices, updated average salary of Overseas Filipinos (OF), and improved estimation methodology while adopting the 1993/2008 System of National Accounts (SNA). The 2000-based and revised national income accounts also addressed some of the issues raised on previous estimates such as the large statistical discrepancy, outdated base year, inappropriate gross value-added ratios, inconsistency of quarter estimates with annual estimates, and the non-inclusion of OF expenses, unorganized activities, and intangible fixed assets

1/ Among the new standards and classifications are the 1994 Philippine Standard Industrial Classification (PSIC), and the 2009 Philippine Classification of Individual Consumption Expenditure According to Purpose (PCOICOP).

6. **No systematic bias in the overall fiscal balance occurred over the past five years, although some patterns seemed to emerge over sub-periods (see Table 3.)** The actual fiscal deficit turned out higher than budgeted from 2008 until 2010. Revenue collection underperformed despite the passage of significant tax legislations, particularly RA 9337 which broadened the VAT base and increased the rate from 10 percent to 12 percent. However, government expenditures increased in order to address external shocks, i.e., the rise of international prices of rice and oil in 2008 and the global financial crisis in 2009, resulting to higher spending compared to programmed amounts.

Table 3. Philippines: Differences Between Targets and Outturn of Expenditures, 2008-2010 *(as percent of GDP)*[1/]

Particulars	2008	2009	2010	Average Difference 2008-2010
Total revenues	0.7	1.4	1.3	1.2
Tax revenues	1.1	1.9	1.0	1.3
Non-tax revenues	(0.3)	(0.5)	0.4	(0.17)
Total expenditures	(0.2)	(2.0)	1.5	(0.22)
Current expenditures	0.1	(1.7)	1.0	(0.20)
Personnel services	0.4	(0.4)	0.4	0.13
MOOE	(0.01)	(0.3)	0.19	0.04
Allotment to LGUs	0.04	(0.3)	0.05	(0.07)
Tax expenditures	(0.6)	(0.4)	(0.08)	(0.37)
Subsidies	(0.09)	(0.1)	(0.06)	(0.08)
Interest payments	0.4	(0.15)	0.47	0.23
Capital and equity expenditures[2/]	(0.26)	(0.4)	(0.49)	(0.06)
Infra and other capital outlays	(0.27)	(0.47)	(0.35)	(0.13)
Equity	0.01	0.06	0.01	0.03
Net lending	(0.03)	0.07	0.07	0.04
Balance (Government definition)	(0.9)	(3.4)	(0.2)	(1.5)
Financing[3/]	(0.9)	(3.4)	0.4	(1.3)
Net Domestic	(2.6)	(0.6)	(0.06)	(1.1)
Net Foreign	0.6	(1.7)	0.0	(0.35)
Memorandum Items:				
Nominal GDP (Billions of Peso)[4/]	7,409.3	7,678.9	8,513.0	

Source: BESF

1/ A positive value indicates that the actual is lower than budgeted

2/ Capital and equity expenditures include Capital Transfers to LGUs and CARP-Land Acquisition and Credit

3/ Less changes in cash and non-budgetary accounts

4/ In May 12, 2011, the NSCB issued growth levels using 2000 as the base year. However, for the table above, the GDP levels considered were based on 1985

More specifically:

Revenues. National government revenues reached P1,207.9 billion for FY 2010. This is P86.5 billion short of the revised program but 7.5 percent higher than the previous year's collection. Tax effort increased minimally from 12.78 percent to 12.85 percent, 1.02 percent lower compared to target[2]. Passage of a number of laws introducing tax exemptions and tax rate deductions significantly lowered tax collections in 2009 and 2010. As is the practice, budget submission does not include the impact of pending bills which potentially impact revenue collections, positively or negatively. Hence, the passage and implementation of these laws negated the impact of higher GDP and higher value of oil imports.

[2] Using the rebased/revised GDP statistics, tax effort went down from 12.85 percent to 12.15 percent in 2010.

Spending. For the period 2008 to 2009, actual total spending or cash disbursements[3] as a percentage of GDP was above programmed amounts due to the government's efforts to cushion the effects of the rice and oil price crisis in 2008 and the global financial crisis in 2009. In 2010, through the efforts of the new Administration to rein in spending, actual spending of P1,522.4 billion was 2.98 percent below the proposed level of P1,569.1 billion. As a percent of GDP, the actual and proposed spending for 2010 amounted to 17.9[4] percent and 18.9 percent, respectively. Interest payments again served as one of the main sources of savings for 2010. For 2010, savings from interest payments amounted to a significant 0.6 percent of GDP, which was also the case for Personal Services (PS). Disbursements for MOOE and capital outlays (CO) still exceeded projections although at smaller margins. Also, the acceleration of expenditures during the first semester of 2010 was reined in during the second semester partly due to the program evaluation activities pursued by the new Administration. These program evaluation activities led to the termination of some programs that were found to be inefficient [e.g., the *Malusog na Simula, Yaman ng Bansa* Nutrition Program of the Department of Education (DepED): P3.3 billion]. On the average, spending for the three-year period were above program by 0.4 percent despite the underperformance in 2010 due to the provisions of subsidies to counteract the effects of the rice crisis in 2008 and pump-priming activities in 2009.

7. **The government's flexibility enables it to quickly react to shocks.** The government is equipped with policy tools to build buffers to mitigate the effects of economic shocks. For instance, early this year, with the rise in the international price of oil due to geo-political tensions in the Middle East and North Africa (MENA) region, the government put in place the Public Transport Assistance Program (PTAP) or the *Pantawid Pasada* program to serve as a contingency program to address the adverse effects of the oil price hikes. For the implementation of the PTAP, the government released P450 million subsidies using revenues from the Malampaya Gas Collection. The said amount will cover subsidies to public utility jeepney drivers and tricycle drivers in the form of discounts for fuel purchases from petroleum retail outlets or gasoline stations.

8. **As the economy comes out from the crisis, the government gradually moves towards more prudent spending.** In 2010, global economic conditions generally improved. The Philippines experienced growth of 7.3 percent in 2010 which is at par with most of its Southeast Asian neighbors (Thailand: 7.8 percent, Malaysia: 7.2 percent, Indonesia: 6.1 percent and Vietnam: 6.8 percent). Equally important to the implementation of economic stimulus is the implementation of a well-thought exit strategy when the economy is recovering. The government should minimize interventions in the conduct of business of the private sector once the economy has recovered, for this might inadvertently lead to crowding out of private investment. For example, the government was able to curb the overspending in the first seven months of 2010 by spending less in the remaining months of the year as the new department and agency heads reevaluated their expenditure priorities. The President is given flexibility by the Constitution to implement contractionary or expansionary measures that allow for rapid adjustments of the budget, if needed. This materially reduces fiscal risks.

9. **However, the slower-than-programmed spending experienced in the first few months of 2011 may pose a risk to the 2012 fiscal program.** In order to prevent this risk from materializing, the government has been pressing its departments to speed up spending for the remaining months of the year. The Department of Budget and

[3] Defined to include current year budget obligations and prior years' account

[4] Actual expenditures as a percent of the rebased GDP is lower at 16.9 percent

Management (DBM) has asked key infrastructure departments to submit their catch-up plans which aim to improve their absorptive capacity. Other measures put in place to propel government spending include the release of 100 percent allotment for regular operating requirements and a new policy on procurement allowing agencies to go through bidding activities even before they receive their comprehensive allotment releases. It is important to note that the government will continue to be strict with compliance to procurement standards. For the 2012 budget preparation, the national government continued the Zero-Based Budgeting (ZBB) approach in the evaluation of several programs/projects to assess their effectiveness and efficiency. The programs/projects include: national government subsidies to State Universities and Colleges (SUCs), teacher deployment and new classroom construction programs of the DepED and the health facilities enhancement programs of the Department of Health (DOH), among others.

B. PUBLIC DEBT

Organizational Responsibilities

10. **To strengthen the government's liability management function, a Debt and Risk Management Division (DRMD) was set up under the Department of Finance (DOF)** to institutionalize policy and debt strategy formulation and ensure prudent debt management given the country's financing needs and debt burden. The DRMD and the Bureau of the Treasury (BTr), performing the tasks of middle and back offices, respectively, are strengthening the coordination between their operations to streamline the country's debt monitoring and strategy implementation efforts.

11. **Under the medium-term debt strategy, the main objectives are the following**: 1) to meet the government's financing requirement at minimal cost consistent with an acceptable level of risk; 2) to reduce National Government (NG) foreign currency denominated debt; and 3) to further support the development of the domestic capital and debt market.

12. **The government's debt management objectives will be pursued through the following measures:**

- Minimize foreign exchange risk exposure by increasing domestic borrowing to reduce foreign currency denominated debt within the portfolio.
- Mitigate refinancing or roll-over risk by lengthening the maturity of NG debt through bond exchange.
- Support the development of domestic capital and securities market.
- Enhance transparency and predictability in debt issuances and debt management.
- Consolidate debt management to include other public sector entities.
- Institutionalize debt management functions and develop capacity within the DRMD.

Quantification of Risks

13. **The latest DRMD debt sustainability analysis (DSA) following the International Monetary Fund (IMF) DSA framework reveals that the Philippines' NG debt remains broadly sustainable.** Based on the government's fiscal targets and projections of the primary fiscal balance and the macroeconomic environment for 2011-2016, NG debt as a percentage of GDP will gradually decline from 2010 to 2016 (see Table 4). Furthermore, the DSA confirms that NG debt is on track towards achieving the government's goal of reducing the portion of foreign-denominated debt.

The DSA also reflects that NG debt is generally resilient even under a severe interest rate or primary balance shock, although it tends to increase slightly over the medium term in the case of the latter (see Annex 1). However, the DSA also shows the vulnerability of the country's debt dynamics given a severe growth shock to the economy.

Table 4. Philippines: Debt Sustainability Analysis of National Government Debt, 2010-2016[1/]

Particulars	2010	2011	2012	2013	2014	2015	2016
National Government Debt							
% of GDP	55.4	55.2	54.0	50.9	48.2	46.3	43.0
% Share							
Domestic	57.6	60.6	62.4	63.2	64.5	65.8	67.1
Foreign	42.4	39.4	37.6	36.8	35.5	34.2	32.9

Compiled by IFG, FPPO – DOF
1/ The DSA utilizes macroeconomic data projections with 1985 as the base year (1985=100).

14. **Stress tests confirm the results of the DSA and demonstrate that key macroeconomic shocks present a fiscal risk through their impact on NG debt.** As presented in Table 5, the stress tests indicate that interest rate and exchange rate shocks have an adverse impact on NG debt. Specifically, the stress tests' details show that:

- A 10 percent depreciation of the peso's nominal effective exchange rate against major currencies such as the US dollar, Japanese yen, and Euro would increase the NG debt ratio by 1.9 percent of GDP. Conversely, a 10 percent appreciation of the peso against the said currencies would result in a reduction of the NG debt ratio by the same magnitude, that is, 1.9 percent of GDP.

- A temporary (one year) 100 basis points (one percent) increase in the average effective interest rate on NG debt rolled over, will increase the budget for NG interest payments by 2.17 percent in the succeeding year equivalent to 0.5 percent of revenue or 0.07 percent of GDP in the succeeding year.

- A combined interest and exchange rate shock of a 1 percent hike and 10 percent depreciation, respectively, would result in an increase in NG interest payments by 1.17 percent of revenue (0.17 percent of GDP) in the succeeding year.

- In contrast, the effects of a 1 percent increase in interest rates can be offset by a 10 percent appreciation of the peso, lowering interest payments by 0.93 percent. The combined scenario would decrease interest payments as a percentage of GDP and as a percentage of NG revenue by 0.03 percent and 0.21 percent, respectively.

Table 5. Philippines: Interest and Exchange Rate Sensitivities of NG Debt

Particulars	1 year impact (in billion PhP)	1 year impact (% increase in interest payment budget)	1 Year impact (1 % shock and peso appreciation, in billion PhP)
Interest Rate Sensitivity (1 percentage point increase)			
Domestic Interest Rate			
Floating interest rate			
Rolled-over fixed rate	2,110.60	0.66	2,110.60
Foreign Interest Rate			
Floating interest rate	3,328.03	1.03	2,995.23
Rolled-over fixed rate	904.26	0.28	814.03
Plus: 10 percent depreciation/appreciation			
Of which against the US$	8,170.12	2.54	-8,170.12
Of which against the JPY	1,053.62	0.33	-1,053.62
Combined interest rate hike and depreciation	16,490.42	5.13	-3,001.78
Foreign Exchange Rate Sensitivity (10 percent depreciation/appreciation)			
Of which against the US$	130,130.20	-	-130,130.20
Of which against the JPY	52,433.87	-	-52,433.87
Of which against the Euro	6,416.89	-	-6,416.89
	(as % of GDP)		**(as % of NG revenue)**
Interest Rate Sensitivity (1 % point increase)	0.07	2.17	0.50
Combined Shock (1 % point increase with 10% depreciation)	0.17	5.13	1.17
Foreign Exchange Rate Sensitivity (10 % depreciation)	1.90		
Combined Shock (1 % point increase with 10% appreciation)	-0.03%	-0.93	-0.21

Based on NG debt outstanding as of December 2010; Assumed roll-over rate/floating rates based on current market rates plus 1 percent shock

15. There is a **moderate refinancing risk**, particularly for domestic debt considering that about 20 percent and 49 percent of the domestic bonds will mature within the next two and five years, respectively. However, this is mitigated by the bond sinking fund (BSF) in which the government sets aside funds sufficient to purchase or redeem maturing bonds. Furthermore, this risk is reduced with domestic bond exchange transactions which lengthen the maturity of affected bonds. On the other hand, about 17.5 percent of the domestic debt (or about 10 percent of total NG debt stock) are in Treasury bills that are exposed to interest rate risk upon roll-over.

C. GOVERNMENT-OWNED AND/OR -CONTROLLED CORPORATIONS (GOCCs)

16. **GOCCs are a possible large source of fiscal risk.** The 158 government-owned and/or -controlled corporations (GOCCs), including government financial institutions (GFIs), social security institutions (SSIs), and their subsidiaries, transferred, and surrendered corporations, remain key players in sectors like banking, transportation, housing, pensions, power, agriculture and water. To a certain degree, some of these GOCCs receive government resource allocations through transfers. Based on Commission on Audit (COA) audited reports, the reported assets of GOCCs excluding those of the Bangko Sentral ng Pilipinas (BSP) reached 60.2 percent of GDP, while liabilities increased to 41.6 percent of GDP as of end 2009.

17. **Of the 158 GOCCs, 14 major non-financial government corporations (MNFGCs), as listed in Table 6, are closely monitored for their fiscal relevance as they account for a substantial portion of the consolidated public sector deficit.** Liabilities of these 14 MNFGCs account for 16.4 percent of GDP as of 2009. Majority of these liabilities are guaranteed by the National Government, made possible through the charters of the GOCCs, or in some cases, through RA 4860, as amended (Foreign Borrowing Act). Some of these 14 MNFGCs depend on the National Government for subsidies and net lending.

Table 6. Philippines: Liabilities of the Government Corporate Sector and 14 Major Non-Financial Government Corporations (MNFGCs), 2008-2009 *(in million pesos)*

Particulars	Total Liabilities		% of GDP[1/]	
	2008	2009	2008	2009
TOTAL GOCCs	**2,734,931**	**3,191,047**	**36.9**	**41.6**
14 MNFGCs to Total GOCCs (%)	48.0	39.6		
TOTAL 14 MNFGCs	**1,312,812**	**1,262,590**	**17.7**	**16.4**
HGC	20,507	24,941	0.3	0.3
LRTA	60,827	64,422	0.8	0.8
LWUA	11,207	11,809	0.2	0.2
MWSS	23,874	21,885	0.3	0.3
NDC	7,754	9,373	0.1	0.1
NEA	18,667	16,627	0.3	0.2
NFA	133,282	155,578	1.8	2.0
NHA	7,456	8,845	0.1	0.1
NIA	39,095	42,583	0.5	0.6
NPC/Transco/PSALM[2/]				
NPC[3/]	3,551	7,743	0.0	0.1
PSALM	914,876	839,091	12.3	10.9
TransCo	16,214	5,741	0.2	0.1
PEZA	1,757	2,107	0.0	0.0
PNOC and Subsidiaries Consolidated	15,499	11,818	0.2	0.2
PNR	23,102	23,940	0.3	0.3
PPA	15,144	16,088	0.2	0.2

Source: 2008, 2009 COA Audited Report

1/ In May 12, 2011, the NSCB issued National Accounts using 2000 as the base year. However, figures under this column were computed using GDP with 1985 as the base year for continuity with previous releases.

2/ NPC, PSALM and Transco are counted as one corporation.

3/ NPC level does not include those classified as temporary registry accounts since these are still for reconciliation.

Table 7. Philippines: Consolidated Public Sector Financial Position, 2008-2010
(as percent of GDP, unless otherwise specified [1/])

Particulars	2008	2009	2010
Consolidated public sector financial position	0.4	-3.1	-4.3
Non-financial public sector financial position	-1.2	-4.3	-4.5
Financing position of 14 major GOCCs	-0.4	-0.3	-0.8
Financing position of 14 major GOCCs (in million pesos)	(27,159)	(19,252)	(71,007)

Source: DOF

18. **GOCCs often act as off-budget mechanisms to achieve social objectives.** Frequently, GOCCs are directed to bear the cost of social programs that should ideally be funded out of the budget. A case in point is the National Food Authority (NFA) which operates on "buy high, store long, sell low policy." Part of NFA's mandate is to protect farm gate prices to provide farmers a reasonable return on their investment (floor price), while keeping retail rice prices at reasonable levels for consumers (price ceiling); multiple objectives which have been shown to be unsustainable. Public utilities, like the Light Rail Transit Authority (LRTA) also face considerable financial risk as user charges are maintained at subsidized levels. The government provides support through subsidy, equity and government advances for debt servicing to these GOCCs who are experiencing losses. From 2008 to 2010, support to GOCCs amounted to P93.5 billion (see Table 8).

19. Collections from GOCCs sustained the fiscal consolidation effort of the government. Inflows in the form of dividends, guarantee fees, other fees and government share on generated revenues by the Philippine Amusement and Gaming Corporation (PAGCOR) and the Manila International Airport Authority (MIAA), as prescribed by law, reached P86.2 billion from 2008 to 2010. Vigorous actions were undertaken in accounting and pursuing the collection of the entire dividend, in arrears, of the GOCCs and GFIs, including their subsidiaries. **For the years 2008-2010, the GOCCs contributed a net negative cash flow to the NG, amounting to P7.3 billion after considering NG advances and other budgetary support provided to the GOCCs** (see Table 8).

Table 8. Philippines: Net Budgetary Flows to GOCCs, 2008-2010
(as percent of GDP, unless otherwise specified)

Particulars	2008	2009	2010
I. NG Flows from GOCCs	**0.3**	**0.5**	**0.3**
Amount (in million pesos)	**23,498**	**35,715**	**26,991**
Dividend	0.1	0.2	0.1
Interest on NG Advances	0.0	0.0	0.0
Guarantee Fees Collected	0.0	0.1	0.0
Forex Risk Cover Fee	0.0	0.0	0.0
NG Share on Net Income	0.2	0.2	0.1
Airport Terminal Fee	0.0	0.0	0.0
II. NG Flows to GOCCs	**0.5**	**0.3**	**0.4**
Amount (in million pesos)	**37,201**	**23,862**	**32,412**
Subsidy	0.3	0.2	0.2
Equity	0.0	0.0	0.0
Net Lending	0.2	0.1	0.1
III. Net NG Flows to GOCCS (I-II)	**-0.2**	**0.2**	**-0.1**
Amount (in million pesos)	**-13,703**	**11,853**	**-5,421**

Source: BTr
Subsidy excludes tax subsidies totaling to P 134.6 billion for 2008 to 2010. Effect of tax subsidy is neutral since it is considered as both revenue and expenditure of the government. Difference in some percentage of total amount of GDP vs. totals of individual percentage is due to rounding.

20. **The power sector has been and remains a key source of fiscal risks.** In the past, the National Power Corporation (NPC) was one of the largest sources of fiscal drain and risk. While the company requires continued fiscal support, the privatization of its generating assets as well as the off-loading of the operations of the National Transmission Corporation (TransCo) to a private company via a concession arrangement has effectively transferred market, financial and operational risks of the power plants and the transmission assets, including future investment responsibility, to the private sector. Energy Regulatory Commission (ERC) approval of universal charges for stranded debt and contract cost will largely contribute to the cash position of the Power Sector Assets and Liabilities Management Corporation (PSALM, created pursuant to the Electric Power Industry Reform Act to privatize NPC assets and liquidate NPC's obligations, among others) and further mitigate fiscal risks. Nonetheless, the operation of the NPC, despite the universal levy for Small Power Utilities Group (SPUG), still requires support from the Government.

21. **GFIs, Guaranty Institutions, and Social Security Institutions are also sources of fiscal risks.** By charter, the government backstops the guarantees issued by the Home Guaranty Corporation (HGC); Quedan and Rural Credit Guarantee Corporation (Quedancor); Trade and Investment Development Corporation (TIDCORP), Small Business Guarantee and Finance Corporation (SBGFC) and the National Development Company (NDC). The charters of SSIs also provide fiduciary guarantees on their obligations to members. In the past, government has bailed out the old Central Bank (1993), the Development Bank of the Philippines (1986) and repeatedly recapitalized

the Philippine National Bank before its complete privatization in 2007. **Current fiscal risks coming from the GFIs and SSIs are however, deemed minimal.**

22. **Major reduction in fiscal risks from GOCCs has happened but risks remain.** A substantial portion of the liabilities of GOCCs and GFIs are foreign-denominated. GFIs and some GOCCs secure foreign exchange risk cover, for a fee, from the NG for their Official Development Assistance (ODA) loans. On the other hand, PSALM, which has the highest share of foreign-denominated loans, is pursuing various financing structures as part of its liability management program. These initiatives aim to, among others, minimize the impact of risk from foreign exchange fluctuation. Policy reforms have also been initiated to minimize government exposure relating to guarantees on GOCC loans, such as conditions and time-bound, trigger-event or falling out provisions on guarantee issuances.

Table 9. Philippines: Outstanding NG Advances to GOCCs, 2008-2010
(in million pesos)

Particulars	2008	2009	2010
Of the 14 MNFGCs			
NPC/PSALM[1/]	12,310.14	9,260.42	11,572.52
NIA[2/]	28,553.41	34,195.16	39,841.16
NDC	1,687.85	1,831.00	2,140.79
LRTA	12,059.57	16,514.37	20,413.73
NEA	19,035.79	19,549.22	19,776.61
PNR	17,879.09	18,967.52	20,091.42
NFA	3,659.98	3,868.83	4,029.83
Other GOCCs	18,735.93	16,355.92	17,459.67
GRAND TOTAL	**113,921.76**	**120,542.44**	**135,325.73**

Source: *BTr.* Includes interest on NG advances.
As of 2010, outstanding NG advances corresponding to interest on NG advances amount to P36.9 billion
1/ Includes Casecnan-related accounts
2/ Represents Casecnan-related accounts

D. PUBLIC-PRIVATE PARTNERSHIPS (PPPs) AND CONTINGENT LIABILITIES

23. **PPP arrangements expose the country to a diverse, complex and often large array of fiscal risks.** Performance undertakings or acknowledgments of Government obligations are issued for projects undertaken by line agencies through PPPs. Fiscal risks stemming from these projects include risks related to right-of-way, political/regulatory risk, change in law, currency convertibility, events of termination, events of force majeure, and take-or-pay arrangements, among others. Some of these eventualities translate to actual liabilities and should be included in the government's budget when they do. The contingent obligations associated with the performance undertakings arise in case of delay or default on the part of Government in executing its deliverables and have varying probabilities of becoming real and having an impact on the budget.

24. **Contingent liabilities expose the government to the possibility of unexpected and substantial obligations over a short period of time and could lead to a severe strain on its fiscal resources.** Given that the impact of guarantees come due only if triggered by a particular event or economic shock, a constrained ability to respond on the part of fiscal authorities could worsen fiscal and macroeconomic vulnerabilities. Provisioning for such contingencies needs to be reflected in the annual budget and clear mechanisms to cover them in case such guarantees are called need to be established (e.g., the government could explore reserve-type, insurance-type, and other mechanisms).

25. **Performance undertakings on BOT/PPP projects also explicitly expose the budget to GOCC credit risk**. ICC clearance is a precondition for projects to secure government guarantees. Nonetheless, in some cases, a project's social desirability takes precedence, despite technical concerns about a project's financial feasibility.

E. FINANCIAL SECTOR

26. **Domestic banks continue to improve its strength and resiliency amid the modest impact of the global financial crisis and the slow recovery in the US**. According to the BSP, direct exposures of domestic banks, including the Development Bank of the Philippines (DBP) and the Land Bank of the Philippines (LBP), to potentially "at risk" international financial institutions stood at 1.7 percent of the total assets of the banking system as of 31 December 2010. The banking sector remains adequately capitalized as capital adequacy ratio (CAR) of the banking system as of end-September 2010 stood at 17.0 percent on a consolidated basis and 16.0 percent on a solo basis. The non-performing loan (NPL) ratio (inclusive of interbank loans) of the banking system dropped to 3.6 percent as of end-December 2010. The NPL ratio of universal and commercial banks fared even better as it improved to 3.0 percent as of end-March 2011.

27. **Fiscal risks in other segments of the financial system have likewise gradually diffused.** The remaining parts of the financial system consists of the two government pension institutions, private insurance companies, investment houses, finance companies, pawnshops, lending investors, securities dealers, etc. A less stable but small segment of the non-bank financial sector is the pre-need industry. In the early 2000s, a crisis in the sector led to the bankruptcy of several pre-need companies with government refraining from extending any financial assistance and instead, strengthening SEC regulation of these institutions, including specifying permissible investments. In 2004, the assets of the sector comprised about 3.7 percent of the assets of the banking system but has probably declined since then owing to decreasing sales. From P2.2 billion in January 2005, the peso amount of their sales dropped significantly to P0.5 billion by end-November 2009.

28. **Notwithstanding this, certain policy gaps in the financial system remain which could potentially pose some risks to fiscal stability.**

- ***The Philippine Deposit Insurance Corporation (PDIC)*** **(see Table 10).** The banking system's deposits are insured through the PDIC, a GOCC attached to the DOF. PDIC charges banks an insurance premium, part of which is set aside in a deposit insurance fund (DIF). At end-2009, DIF assets totaled over P60 billion (6.5 percent of insured deposits). In order to preserve depositor confidence in the banking system at a time of global financial stress, Republic Act No. 9576 or the Amended

Charter of the PDIC was passed. This provided for the doubling of deposit insurance to P500,000 per account resulting in the growth of deposit coverage to 30.0 percent of total deposits in 2009 but reduced the DIF coverage to 4.3 percent. To improve PDIC's financial strength, the law provides for: 1) the NG to directly guarantee deposits between P250,000 and P500,000 in the first three years of implementation (generating an estimated P297 billion or 3.7 percent of GDP in direct NG contingent liabilities); and 2) automatic government guarantees of PDIC bonds (another contingent liability for the budget). As of end-March 2011, the DIF of the PDIC amounted to P64.6 billion. The closure of Banco Filipino, however, has resulted in a potential payout of P9.4 billion, which would lower the DIF by roughly 15 percent.

- ***The BSP's indirect assistance to troubled banks.*** The BSP is not allowed under its charter to extend financial assistance to banks beyond its role as lender of last resort. However, under the PDIC charter, the BSP is authorized to extend loans to

Table 10. Philippines: Selected Financial Accounts of PDIC, 2008-2009[1/]
(in billion pesos, unless otherwise stated)

Particulars	2008	2009
Assets	142.3	150.1
o/w Financial assistance to banks	38.5	24.6
Liabilities	81.9	89.8
o/w BSP	72.5	72.6
Deposit Insurance Fund	60.5	60.3
o/w Permanent insurance fund	3.0	3.0
Net income	0.6	0.4
Return on equity (percent)	0.9%	0.7%
Interest expense (percent of total income)	39.5%	29.4%
Memorandum items:		
Insured deposits	964.8	1,410.0
Insured deposits (percent of total)	23.1%	30.0%
DIF (percent of insured deposits)	6.3%	4.3%

Source: PDIC Audit Reports 2008-2009 (www.coa.gov.ph)

1/ PDIC adopted Philippine Accounting Standards/ Philippine Financial Reporting Standards PASs/ PFRSs in 2006; 2005 accounts were restated to conform with new standards. Prior periods are not comparable, including "financial assistance to banks" account.

2/ Full capitalization reached in 1994 with conversion of P980 million of PDIC obligations to the Central Bank into NG equity.

3/ Deposit insurance was increased in 2004 to P250, 000 from P100, 000 per account.

PDIC for financial assistance to systemically important banks. Outstanding BSP loans to PDIC, which are low-yielding but collateralized, amounted to 0.9 percent of GDP at end-2009 and represented 51 percent of the BSP's total local currency loan portfolio. The positive spread earned by PDIC by investing these loans in Treasury securities is used to extend assistance to banks. These loans may lower potential BSP and PDIC dividends to the NG but are justified to the extent that they forestall broader financial system crisis.

- **GSIS and SSS.** According to Republic Act No. 8291, or the Revised Government Service Insurance Act of 1977, and Republic Act No. 8282, or the Social Security Act of 1997, the National Government guarantees the fulfillment of the obligations of GSIS as well as the benefits of SSS members.

- **Implementation of regulations that reduce transaction taxes on the financial sector.** The Bureau of Internal Revenue (BIR) has released the final implementing revenue rules and regulations for the Personal Equity and Retirement Account (PERA) Act of 2008 on October 28, 2011 and the Real Estate Investment Trust (REIT) Act of 2009 on July 25, 2011.[5] These two laws provide tax incentives on income from specific investment tools and will likely reduce tax revenues over the short to medium term. These laws, however, are considered to be tax-neutral in the long run, with the anticipated increase in capital market activities stemming from such reforms perceived to have net positive effects to the sector and the Philippine economy as a whole.

F. OTHER SOURCES OF RISKS

Local Government Units

29. Built-in checks on local government units' (LGUs) ability to incur debt minimizes fiscal risk from this source. Starting 2002 after the passage of the Local Government Code (LGC), LGUs have consistently earned more (including the 40 percent share of national internal revenue taxes) than they have spent and have thus contributed positively to the consolidated public sector financial position. Fiscal risks from LGUs are also limited by the following legal requirement and institutional setup: 1) the NG is not allowed to guarantee LGUs foreign borrowings, which has prevented such borrowing from occurring (instead the NG may relend borrowed funds to LGUs); 2) LGUs' borrowings are limited by a requirement under the LGC that LGU annual debt servicing may not exceed 20 percent of regular income and that LGUs must provide fully for debt repayments in their budgets or their budgets become inoperative, and that borrowing purposes are specified by the LGC (Title IV. Credit Financing); and 3) the Bureau of Local Government Finance (BLGF) under the DOF vets the maximum borrowings of LGUs.

30. Yet, data for 2006-2008 show that despite the power given to LGUs to raise local taxes and fees, provinces on the average, still relied on the IRA for 79 percent of their annual income, and municipalities, for 76.7 percent of their income. Cities, to some extent, have managed to improve their finances but still rely on IRA for 43 percent of their income.

[5] Given that RA 9505 will only be ready for implementation once the final implementing revenue rules and regulations are issued, this law cannot be said to have contributed to the erosion of tax revenues over the 2007-2009 period.

31. Reforms are needed to improve the efficiency and effectiveness of LGU spending and financial management. Internal revenue allotments and other revenue shares from the national government have grown from P141.5 billion in 2002 to P286.9 billion by 2011, accounting for 17.4 percent of the 2011 budget. Furthermore, outstanding balances on loans of LGUs nearly doubled from 2005 to 2010, and grew by about a third from 2008 to 2011 (see Table 11). This has implications on the fiscal risks from LGUs.

Table 11. Philippines: LGU Outstanding Borrowings, 2008-2010
(in million pesos, unless otherwise stated)

Particulars	2008	2009	2010[1/]
Loans	51,366	57,523	67,768
Bonds	566	631	786
TOTAL	**51,932**	**58,154**	**68,554**
Difference	8,379	6,223	10,400
Growth (%)			
Loans	19.90%	11.99%	17.81%
Bonds	-20.50%	11.53%	24.61%
Total	16.14%	10.70%	15.17%
Bonds w/ BSP Opinion	0	250	333
No. of issuances	0	2	2
Ratio: Loans/Bonds	90.801	91.172	86.197
Loans to Total Debt	0.989	0.989	0.989

Source:DOF – BLGF, based on reports submitted by GFIs (LBP, PVB, PNB, DBP, Municipal Development Fund Office and LGU Guarantee Corporation)

32. As part of the national government's efforts to improve spending at the local level, particularly intergovernmental transfers which includes the Philippine Development Assistance Fund (PDAF), the national government on February 21, 2011 issued National Budget Circular No. 529 which provides the guidelines for the alignment of projects to be funded by the PDAF to the PDAF Project Menu. Furthermore, the government has put in place the Performance Challenge Fund (PCF) which serves as an incentive for local government units that spends in accordance with the priorities of the national government.

33. T**o address the weak revenue performance of LGUs, Joint Memorandum 2010-1 and 2010-2 were issued by the DOF and the Department of the Interior and Local Government (DILG) to enjoin LGUs to regularly revise their Schedule of Market Values (SMV) every three (3) years** to determine the real value of properties and impose additional Ad Valorem Tax on idle lands as provided for under the LGC. To be able to do the revision, the knowledge and capacity of LGU appraisers/assessors shall also be strengthened. Trainings to specifically help the local treasurer in applying all available remedies in the collection of tax dues defined under the LGC shall be undertaken. Under the LGC, LGUs may avail of the administrative remedies such as a levy on real property or sale of real property at public auction and judicial remedy for collecting tax delinquencies.

34. **The DOF likewise pursued the signing of Executive Order 809 which authorizes creditworthy LGUs to directly contract loans with GFIs and other multi-lateral financial institutions (MFIs)** as well, like the Asian Development Bank (ADB) and the World Bank. The DOF and DILG have strengthened and simplified the implementing mechanisms for this "LGU Financing Policy Framework" to assist first-tier creditworthy LGUs secure the necessary domestic and/or foreign funding for their respective projects.

Disaster Risk Mitigation and Management

35. **The Philippines is considered one of the most disaster-prone countries in the world primarily due to its location.** About 20 tropical cyclones enter the Philippine Area of Responsibility every year, 7 to 9 of which make landfall. For the past three years (2008-2010), the average spending for calamity-stricken areas have amounted to P4.0 billion. In practice, the bulk of the costs of disasters have been shouldered by the national government since the mandatory five percent of LGU income set aside for emergency relief, rehabilitation and mitigation purposes can be rapidly depleted in the event of a disaster. Given the frequency and cost of these disasters, the public sector has set up various contingency funds to address the fiscal needs they generate. For 2011, total allocation is equivalent to about 0.2 percent of GDP (P5.0 billion included in the National Disaster Risk Reduction Management Fund (NDRRMF) of the national budget and P17.2 billion at the local level). This is higher in nominal terms than the allocation for 2010 (P5.0 billion for the Calamity Fund and P15.9 billion at the local level).

36. **Due to the risks posted by natural calamities, the National Government has invested in various programs and projects that will improve its capacity to respond to disasters**. Some of these programs/projects are: 1) flood control projects being carried out by the Department of Public Works and Highways (DPWH); and 2) the automation program and upgrading of facilities of the Philippine Atmospheric, Geophysical and Astronomical Services Administration (PAGASA) which will provide timely weather forecasting.

37. **In May 27, 2010 the National Government enacted R.A. 10121 or the Philippine Disaster Risk Reduction and Management Act which provides for the formulation of policies and plans for disaster risk reduction and mitigation.** The thrusts of the Republic Act include: 1) risk assessment and early warning; 2) knowledge building and awareness raising; 3) underlying risk factor/s reduction; and 4) effective early response and recovery preparation. For 2012, the proposed appropriation for the NDRRMF is P7.5 billion with an additional P2.6 billion to be allocated for the Quick Response Fund specifically lodged within the budgets of the Department of National Defense (DND), Department of Social Welfare and Development (DSWD), DepED, and DPWH.

38. **The creation of the Climate Change Commission (CCC) will help better prepare the country for natural disasters in the future.** The CCC approved the National Climate Change Action Plan (NCCAP) on November 22, 2011. The NCCAP outlines the agenda for climate change adaptation and mitigation for the period 2011-2028. Its strategic priorities include: 1) food security; 2) water sufficiency; 3) ecosystem and environmental stability; 4) human security; 5) climate-smart industries and services; 6) sustainable energy; and 7) knowledge and capacity development.

39. **The DOF has successfully secured, from the World Bank, a contingent line of credit worth USD 500 Million** to bridge the fiscal gap in the event that the resources available from the national and local calamity funds are insufficient to cover unexpected or excessive post disaster costs. The Philippines is the first Asian nation to take advantage of this product.

40. At the same time, **the DOF has begun the process of formally drafting a disaster risk financing strategy**. Such a formal strategy will guide the government's decisions on the resources to be dedicated to risk financing, the financial instruments to be used, and the areas to be insured. The overall objective of the strategy is to ensure that the Philippines will be adequately prepared to handle the financial impacts of natural disasters.

41. **To lessen the impact of climate change related disasters on the budget, a Climate Finance Group (CFG) has been created** to provide policy direction on climate change financing including the identification of financing gaps, the development of ecologically related financial instruments, and other funding mechanisms. The CFG is chaired by the DOF with CCC as the co-chair and includes representatives from DBM and the National Economic and Development Authority (NEDA).

III. FURTHER REFORMS TO MITIGATE RISKS

A. GOVERNMENT REFORMS

42. **Poor governance adversely affects economic development.** Executive Order No. 43 entitled *Pursuing Our Social Contract with the Filipino People through the Reorganization of the Cabinet Clusters* strengthens the government's initiatives to further promote transparency, accountability and participatory governance. EO 43 sets forth the creation of the Good Governance and Anti-Corruption cluster. Aside from the promotion of transparency and accountability, the cluster's goals are as follows:

- Strengthening of the capacity of government institutions to link their respective budgets with performance outcomes and enabling citizens and civil society to monitor and evaluate these;

- Creation of a professional, motivated and energized bureaucracy with adequate means to perform their public service missions;

- Improvement of public sector asset and resource management and revenue performance; and

- Establishing an improved policy and regulatory environment that will reduce the cost of doing business in the country and improve competition.

43. **Transparency and accountability standards were included in the 2011 Reform Budget.** Sec. 97 of the 2011 GAA requires agencies to publish in their websites their approved budgets, status of implementation, and program/project evaluation and/or assessment reports. Also, special provisions for some thirty programs and projects have been included in the GAA for agencies to make public information regarding the locations of their projects and details about their target beneficiaries. Non-compliance with the requirements may be a basis for the discontinuation of the program/project concerned. For the 2012 proposed budget, the same provisions on transparency and accountability are being kept. Also included in the 2012 proposed budget are general provision sections 55 and 56 which aim to tighten the use of savings or the realignment of funds and close the avenues for often abused areas. These sections reiterate the need for DBM approval of the realignment of funds a) across allotment classes, b) among objects of expenditures within capital outlays, c) for use in the payment of Magna Carta benefits, and d) savings from mandatory expenditures.

44. **Various information technology programs and projects are being supported by the government to harmonize and integrate the budgeting, accounting, and auditing systems of the government as well as enhance transparency.** These include the development of the Government Integrated Financial Management System (GIFMIS), the continued improvement of the Philippine Government Electronic Procurement System (PhilGEPS) and the launching of the electronic Transparency and Accountability Initiative for Lump Sum Funds or (eTAILS). The GIFMIS' two track approach shall integrate the existing budgeting, cash management and accounting systems within the next eight months while further reengineering/streamlining the processes for integration within five years. The development of the e-payment facility of the PhilGEPS, on the other hand, will enable the electronic transfer of funds that will shorten procurement time. By the end of this year, the e-bidding feature of this project will also be launched. Lastly, eTAILS is a management information system that digitizes the processing of lump sum funds and supports the timely disclosure of lump sum fund release information on the DBM website specifically for Congressional allocation of legislators of their Priority Development Assistance Fund. These systems will make information regarding government expenditures and transactions available to government policy makers and to the public on a timely basis.

45. **The National Government has adopted some budget execution reforms that aim to facilitate the expedient implementation of programs and projects.** These reforms include the release of 100 percent allotment for regular operating requirements and a new policy on procurement allowing agencies to go through bidding activities even before they receive their comprehensive allotment releases. The comprehensive release was intended to facilitate the spending of agencies by shortening the processing time and enabling them to easily plan and implement their programs by granting them

the authority to spend. Similarly, allowing bidding activities ahead of any allotment release will propel spending in the different national government agencies. However, it is important to note that the government will still continue to be strict with compliance to procurement standards.

Local Government Operations

46. The BLGF needs to strengthen its LGU Debt and Creditworthiness Rating System and LGU Financial Reporting System, to record and assess local government obligations/borrowings and local fiscal risks in general. These two systems, in addition to using established financial indicators, can generate a ranking of local governments in terms of fiscal health, and serve as a basis for the government's intervention whether it be tightening expenditures, boosting revenue collection, monitoring of purposes vis-à-vis those specified under the LGC, or limiting future borrowing to prevent deeper financial trouble.

47. Another long term solution being envisioned is the revision of the IRA formula to address the inequalities of the present system. One option is to include a revenue equalization component in the IRA formula which could help in addressing the growing inequality between LGUs such as poverty incidence or the human development index. This revenue equalizing component is intended to capture differences in the revenue generating capacity of localities.

48. Furthermore, given the wide range of issues regarding revenue generation, the BLGF/DOF can advocate revenue enhancement measures like the updating of the LGU Revenue Code. Many local government units have outdated local tax codes. Section 191 of the LGC allows the adjustment of the tax rates once every five years at the rate not exceeding 10 percent, with the *Sanggunian* having the opportunity to adjust accordingly. Very few LGUs are aware of the automatic escalation for the tax or fee rates whose stagnation over time eventually makes internally sourced revenues insignificant. Moreover, revenue enhancement can be stimulated by offering technical assistance, one-on-one mentoring, direct project assistance (like the Real Property Tax Administration Program), providing advisers to local treasurers, monitoring performance and providing incentives. Non-traditional modes of financing can also be explored such as bonds, BOT and various forms of public-private partnerships. Many LGUs have been successful in attaining financial stability by adopting these schemes to finance their development projects.

Tax Credit Certificates

49. The government is committed to shift its system of refunding input VAT claims from the present use of Tax Credit Certificate (TCC) to cash. This shift in the VAT refund system is the country's affirmative response to the business sector's appeal for an enhanced business environment as well as the country's recognition of an internationally accepted practice.

50. As of March 2011, the One-Stop Shop Center (OSSC) and the BIR's outstanding TCCs stood at P2.7 billion and P2.9 billion, respectively, while that of the Bureau of Customs (BOC) stood at P3.7 billion as of December 2010, for a total of P9.3 billion. Due to the substantial amount of accumulated TCCs, the government intends to spread its repayment over a period of five years from 2012 to 2016. DOF has estimated that average yearly claims amount to P8.3 billion. As such, for 2012, the amount of P10 billion will be included in the BIR and BOC budgets to cover part of the outstanding TCCs, current claims and refund for erroneous VAT collections.

B. REFORMS FOR GOVERNMENT-OWNED AND/OR -CONTROLLED CORPORATIONS

51. **Institutions have been established, mainly at the DOF, to address some of the fiscal risks stemming from GOCCs.** As part of its screening process, the DOF ensures a) there is a legal basis for the National Government to extend a guarantee/ performance undertaking on GOCC loans/projects, b) amounts guaranteed are within the legal ceiling, and c) the project shall be utilized for purposes which are in accordance with the policies and thrusts of the Government. Moreover, the DOF checks the credibility of creditors, evaluates the reasonableness of the general terms and conditions including compliance with existing loan covenants, and reviews the financial condition of the GOCC, among others.

52. **The Public-Private Partnership (PPP) Center of the Philippines was established and covers all PPP programs and projects including all the variants or arrangements under the BOT Law and Joint-Venture agreements.** Executive Order 8 of 2010 reorganized and renamed the BOT Center as the PPP Center and transferred its attachment from the Department of Trade and Industry (DTI) to NEDA. With a more proactive role, the main functions of the new PPP Center are: 1) facilitate implementation of PPPs, including provision of advisory and technical assistance to implementing agencies, GOCCs, and LGUs; 2) monitor and evaluate the development, approval, and implementation of PPP programs; and 3) effectively integrate PPPs into government's planning, programming and budgeting processes and policies.

53. **The passing of the GOCC Governance Act (RA 10149) of 2011 aims to strengthen the oversight functions over the government corporate sector for GOCCs and GFIs to be able to reduce their financial vulnerability and improve service delivery.** The GOCC Governance Act provides for the creation of a Governance Commission for GOCCs (GCG) with an authority to, among others,:

    - Evaluate performance and determine the relevance of GOCCs to ascertain whether such should be reorganized, merged, streamlined, abolished or privatized;
    - Adopt government corporate governance standards; and
    - Review the compensation granted to board members, officers and employees to control costs of personal services in GOCCs and achieve a rationalized pay package while maintaining competitiveness in attracting talents to the government corporate sector.

54. **To better manage the Government's exposure to risks associated with GOCCs and PPPs, several initiatives can be undertaken to mitigate fiscal risks.** In addition to other NG reforms, the following are some strategic measures the Philippine Development Plan (PDP) 2011-2016 spells out to address fiscal risks arising from

contingent liabilities as well as some needed improvements in the government corporate sector:

- **Strengthen Contingent Liability Management (CLM) through a joint ICC-DBCC resolution** that provides for the preparation of the CLM Plan by implementing agencies, training for value analysis/value engineering and contingent liability (CL) assessment, CL evaluation of every financing/ procurement option by DOF, and full disclosure of the required budget for CL that will become real liabilities and will thereby need funding.

- **Debt management reforms (see section on Public Debt and the newly established DRMD under DOF)** to pursue more aggressive options such as debt exchanges and swaps at the most opportune times to optimize savings. There is also a need for greater diversification of modes, instruments used, and currency mix, as well as more innovative terms and features. All types of projects funded from borrowing, whether these are government-to-government arrangements, automatically guaranteed under GOCC charters, and under BOT or PPP arrangements, should be subject to the rigid test of project viability and procurement processes and conducted with the highest standards of transparency.

55. **A stronger legal and institutional framework for project selection, approvals and contract negotiations is needed to comprehend fiscal risks involved in PPPs.** In this regard, the NEDA Board Committee on Infrastructure (Infracom) Technical Board has drafted proposed amendments to the Implementing Rules and Regulations of the BOT Law to improve the investment climate for private sector participation in public sector projects/programs through streamlined and simplified procedures/policies that are consistent and transparent. The proposed amendments are available at the NEDA website. Furthermore, a risk allocation policy for PPPs between the national government and the private sector is being formulated. The risk allocation policy will facilitate the transparent and efficient valuation as well as monitoring of associated contingent liabilities and the timely provision in the budget in the event these liabilities are triggered.

Annex 1. Philippine Debt Sustainability Analysis Stress Test

The Debt Sustainability Analysis utilizes historical and medium-term projections of several key macroeconomic variables to predict the evolution of a country's debt as a proportion of its GDP over a given period. The table below shows the computed 10-year average for the real GDP growth rate, real interest rate and the primary balance which was used to come up with baseline and historical forecasts shown in Figure 1. As part of the DSA, a stress test was conducted wherein two scenarios were applied to the aforementioned variables. The size of the shock was based on the computed standard deviation over the 10-year period 2001-2010 wherein a mild shock corresponded to 1 standard deviation while a severe shock was 2 standard deviations. The applicable mild and the severe shocks were determined by observing the historical behavior of each particular variable.

Particulars	Historical Average	Shock	
		Mild	Severe
Real GDP growth	4.7	-2.1	-4.2
Real interest rate	3.1	1.4	2.8
Primary balance	-1.2	1.4	2.8

Fig 1. Baseline and historical path of NG debt

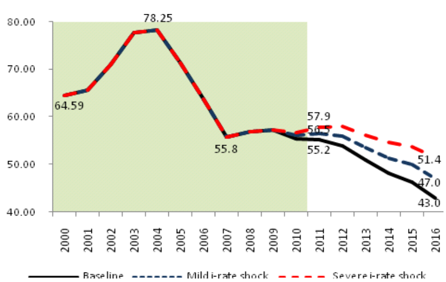

Fig 2. DSA NG debt projection with interest rate shocks

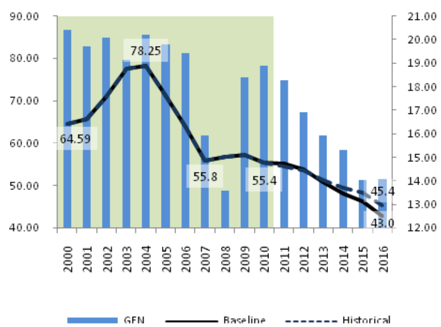

Fig 3. DSA NG debt projection with growth shocks

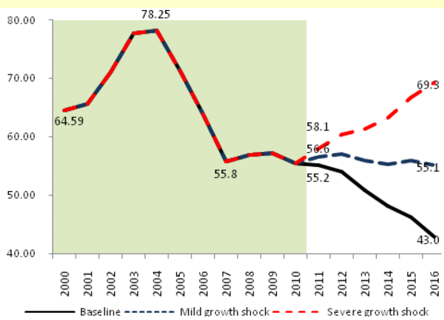

Fig 4. DSA NG debt projection with primary shocks