Fiscal Space

In its latest World Economic Outlook (WEO) report, the IMF recommends that macroeconomic policies need to remain supportive. However, for the Philippines a more measured fiscal stance is proposed for 2010. At first this may appear inconsistent, but on second look can be understood by noting that fiscal space is limited in the Philippines. But what determines fiscal space, why is it constrained in the Philippines, and how to increase it?

The great recession is ending. Aided by unprecedented global fiscal, financial, and monetary support, the world economy appears to be expanding again. Nevertheless, the current rebound will be sluggish, credit constrained, and, for quite some time, jobless, with downside risks dominating. While systemic risks have declined, the IMF's latest Global Financial Stability Report cautions that credit risks remain elevated and the risk of reversal remains significant.

The rebound in emerging and other developing economies is being led by a resurgence in Asia, most notably in China and India. Indeed, the recent, swift turnaround of economic fortunes in Asia is remarkable and driven by stimulus measures, inventory adjustment following a turn in the global manufacturing cycle, and a rebound in financial markets and capital flows. Growth in the second quarter in the Philippines also rebounded sharply, driven by continued remittances inflows, a stabilizing export sector, and supportive macroeconomic policies.

As financial institutions remain weak, credit intermediation impaired, and households in countries that suffered asset price busts will rebuild savings, a premature exit from supportive macroeconomic policies would be a mistake. At the same time exit strategies need to be formulated for an orderly unwinding of the extraordinary levels of public interventions.

For the Philippines, however, a more measured fiscal stance is called for in 2010 despite the tepid global recovery. The key reason is that the Philippines has limited fiscal space and most of it was used in stimulating growth this year.

In the short-term, fiscal space is determined by the extent the market is able to absorb the additional borrowing by the government without rendering the stimulus ineffective. The latter could occur if interest rates would increase to such an extent that consumption and investment start to weaken, more than offsetting the stimulus impact from the higher deficit.

The Philippines never had much fiscal space for stimulus purposes in the past, until very recently. Years of fiscal reforms saw the consolidated public-sector deficit decline from 5.6 percent of GDP in 2003 to 0.9 percent of GDP in 2008. Correspondingly, non-financial public sector debt declined from over 100 percent of GDP back in 2003 to around 60 percent in 2008. The EVAT law, public sector reforms, and expenditure compression contributed to this remarkable improvement, which led to a significant decline in sovereign bonds spreads, falling below the emerging market average towards the end of 2006 when the fiscal track record was well established.

The limited space afforded by these years of fiscal consolidation allowed fiscal policy to be counter-cyclical this year, a welcome break from the past. Nevertheless, the debt level in the Philippines, and the debt-to-revenue ratio in particular, remain high by regional standards. The slowdown in the economy and the stimulus measures also put a serious dent in the tax effort, to a large extent permanently so. Revenue collection is an important determinant for risk aversion towards Philippine debt, by both domestic and international investors.

As a result, maintaining a high deficit next year could affect investor confidence and backfire in terms of stimulating growth. This is all the more so, as analysis in the October 2008 World Economic Outlook publication showed that fiscal multipliers, the illustrious "bang-for-the-buck", decline if stimulus is not quickly reversed, or is not anticipated to be reversed.

The same research also noted that multipliers on impact are about equal in advanced and emerging economies, but after three years, the growth effects turn negative in emerging markets (in contrast to advanced economies). It also noted that multipliers are lower for a subset of countries with high initial debt levels. This motivated the notion that fiscal stimulus should be TTTT: temporary, targeted, timely, and transparent.

The WEO research also provided clues to make fiscal policy more potent even for countries with limited fiscal space. Increasing expenditure, particularly public investment, appears to have more impact in stimulating growth and investment than measures that reduce revenue. As a result, tax policy changes and new measures that erode the tax base, including the VAT base, should be resisted.

Instead, there should be a concerted effort to raise the tax effort by several percent of GDP. This will entrench investor confidence, create future fiscal space, and allow higher priority spending to stimulate growth and job creation.

To achieve this, it will be critical to clearly demonstrate legislative commitment to medium-term fiscal consolidation, anchored on strengthened revenue efforts. In this regard, it will be essential to reform excises and tax incentives, while accelerating tax administration reforms. For example, total revenue from excises has declined by about 1½ percent of GDP during the last decade, which should be recuperated by raising excise rates and indexing these rates to inflation to prevent gradual revenue erosion.

Public support for these revenue measures will increase with the ongoing public financial management reforms that aim to improve the quality of expenditure. Finally, expenditure reorientation can also create fiscal space. An example would be to limit the role of the National Food Authority to ensuring food security. This would free-up resources to help the poor more efficiently through the conditional cash transfer scheme.