Report No. 1095a-PH

# The Philippines
# Priorities and Prospects for Development
# Basic Economic Report

(In Three Volumes)

## Volume III: Investments & Resource Management

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East Asia and Pacific Region
East Asia and Pacific Programs Department

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**Document of the World Bank**

## CURRENCY AND OTHER EQUIVALENTS

| | | |
|---|---|---|
| Currency Unit | = | Peso (₱) |
| US$1.00 | = | ₱ 7.5 |
| ₱ 1.00 | = | US$0.1333 |
| US$1 million | = | ₱ 7,500,000 |

## Fiscal Year

| | | |
|---|---|---|
| Through 1976 | : | July 1 to June 30 |
| Beginning 1977 | : | January 1 to December 31 |

## Tables

| | | |
|---|---|---|
| ... | = | zero or negligible |
| -- | = | not applicable |
| n.a. | = | not available |

This report is based primarily on the findings of an economic mission which visited the Philippines in April/May 1975. The preliminary findings of the mission were further updated after discussions with the Government in December 1975 and January 1976.

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Chapter 8

# THE LEVEL AND ALLOCATION OF INVESTMENT

# Chapter 8

## THE LEVEL AND ALLOCATION OF INVESTMENT

8.01 The unequal distribution of benefits among the population and the unbalanced pattern of sectoral development that characterized Philippine growth for much of the past three decades was closely linked to resource management policies and to the pattern of resource allocation in that period. Although the aggregate level of resources available for investment were relatively high, outcomes in terms of output and employment growth were disappointing. The reasons for this situation included the limited access to the investable resources and the concentration of investment in large-scale enterprises, which reinforced rather than changed the concentrated pattern of asset ownership and income distribution that existed at the time of independence.

8.02 The strategies for rural and urban development and the programs for agricultural, industrial, and human resource development that are outlined in the preceding chapters should help to broaden the distribution of benefits in the Philippines. If these programs are moderately successful, they should, over a period of years, provide for more rapid growth in employment opportunities and for an improved level of services in both urban and rural areas. But successful implementation of these programs will call for a substantial increase in the level of investment in the Philippines and for important changes in the sectoral allocation of that investment. Aggregate investment would probably have to grow by about 12 percent a year in real terms during the second half of the 1970s. The ratio of investment to GDP would have to rise from about 20 percent (the average of recent years) to no less than 25 percent by the early 1980s and thereafter remain at about that level. Within this total, the share of public investment would need to double to at least 5 percent of GDP. An investment program of this magnitude raises a number of important issues in resource management which can be conveniently divided into three main groups:

(i) How can the required sectoral allocation of investable resources be accomplished?

(ii) Can sufficient domestic resources be mobilized to carry out the program without excessive dependence on foreign financing?

(iii) If the needed domestic and foreign resources are not forthcoming, what are the main elements of flexibility in the investment program; that is, to what extent should the investment program be reduced, and to what extent can dependence on external foreign financing be increased?

8 .03 The issues dealing with resource mobilization are discussed in Chapters 9, 10, and 11, while those related to the size and allocation of investments are dealt with below.

## A. Overview of Investment Needs

### Past Trends in Investment

8.04 In aggregate terms, the level of fixed investment in the Philippines rose from about 13 percent of GDP in the early 1950s to an average of about 16 percent during the late 1950s and early 1960s (Table 8.1). In the latter half of the 1960s, a period in which there were heavy investments in steel, chemicals, cement, and other intermediate goods industries, the investment rate rose to about 20 percent of GDP. Since 1970 the rate has dropped back to an average of about 18 percent as a result of the sluggish growth in domestic demand, the excess capacity in industry that stemmed from the heavy investment in the late 1960s, and the sharp increase in the cost of imported capital goods after the 1970 devaluation. Following the boom in incomes in 1973, the investment rate recovered to about 20 percent of GDP in 1974. The yearly increase in stocks has climbed steadily from a little more than 1 percent of GDP in the early 1950s to about 2.5 percent in the 1970s.

8.05 A striking feature of past development has been the high levels of investment relative to output, the average incremental capital-output ratio 1/ in the 1960s was 3.9. Unfortunately, there are no data available on the sectoral allocation of investment during this period, so it is not possible to pinpoint the reasons for what appears to be a relatively inefficient use of investable resources. However, it is generally agreed that a large share of fixed investment was concentrated in manufacturing and, in particular, in projects whose impact on output and employment was relatively small.

8.06 The Mission has attempted to put together a rough picture of the sectoral allocation of investment for the first half of the 1970s in Table 8.2. Although the data in the table are only estimates, they highlight several characteristics of investment in the Philippines: (i) industry (manufacturing and mining) has probably accounted for about 40 percent of total fixed investments in recent years; (ii) the transport sector has had a rather significant share of investment, most of which is private investment, primarily in transport equipment (including private automobiles), rather than public investment in transport infrastructure; (iii) the agricultural sector has had a relatively small share of investment, no more than 10 percent of total investment according to Mission estimates; and (iv) only a small amount of investment has been undertaken by the public sector, about 2 percent of

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1/ The incremental capital-output ratio is defined as the ratio of fixed capital formation in the current period to the increase in gross domestic product over the previous period.

Table 8.1. Share of Gross Domestic Capital Formation in GDP and Incremental Capital-Output Ratios
(At 1967 constant prices)

| Year | Fixed Capital Formation | | | Increase in Stocks | Gross Domestic Capital Formation | Incremental Capital-Output Ratio a/ |
|---|---|---|---|---|---|---|
| | Private | Public | Total | | | |
| 1950 | n.a. | n.a. | 14.7 | 1.4 | 16.1 | 2.01 |
| 1951 | " | " | 13.1 | 1.0 | 14.1 | 1.66 |
| 1952 | " | " | 11.9 | 0.9 | 12.8 | 1.57 |
| 1953 | " | " | 13.8 | 1.3 | 15.1 | 1.73 |
| 1954 | " | " | 13.6 | 1.8 | 15.4 | 1.88 |
| 1955 | " | " | 13.8 | 1.9 | 15.7 | 2.12 |
| 1956 | " | " | 15.6 | 1.3 | 16.7 | 2.70 |
| 1957 | " | " | 17.6 | 1.5 | 19.1 | 3.55 |
| 1958 | " | " | 16.7 | 1.7 | 18.4 | 3.72 |
| 1959 | " | " | 18.1 | 1.8 | 19.9 | 5.33 |
| 1960 | " | " | 15.7 | 1.6 | 17.3 | 4.85 |
| 1961 | " | " | 16.5 | 2.0 | 18.5 | 4.98 |
| 1962 | " | " | 15.5 | 2.2 | 17.7 | 3.06 |
| 1963 | " | " | 16.8 | 2.4 | 19.2 | 4.15 |
| 1964 | " | " | 19.1 | 2.2 | 21.3 | 4.32 |
| 1965 | " | " | 19.0 | 2.2 | 21.2 | 4.73 |
| 1966 | " | " | 18.3 | 2.2 | 20.5 | 3.77 |
| 1967 | 18.9 | 2.2 | 21.1 | 1.9 | 23.0 | 3.79 |
| 1968 | 18.4 | 2.2 | 20.6 | 1.9 | 22.5 | 3.80 |
| 1969 | 17.4 | 2.2 | 19.6 | 1.8 | 21.4 | 3.61 |
| 1970 | 15.6 | 1.9 | 17.5 | 2.4 | 19.9 | 3.49 |
| 1971 | 15.9 | 1.6 | 17.5 | 2.1 | 19.6 | 3.55 |
| 1972 | 15.1 | 2.0 | 17.1 | 2.2 | 19.3 | 3.21 |
| 1973 | 15.1 | 2.2 | 17.3 | 2.6 | 19.9 | 3.43 |
| 1974 | 17.9 | 2.4 | 20.3 | 3.1 | 23.4 | |

a/ Three-year moving average. The incremental capital-output ratio is defined as the ratio of fixed capital formation in the current period to the current increase in gross domestic product over the previous period.

Source: Based on data supplied by the National Accounts Staff, Statistical Office, National Economic and Development Authority (NEDA), and Auditor General's reports

Table 8.2. Sectoral Allocation of Fixed Investment Estimated for 1970-74 and Projected for 1980
(Amounts in millions of pesos at 1974 prices)

| Sector | Average Annual, 1970-74 | | | | | | Projected, 1980 | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Amount | | | Percentage of GDP | | | Amount | | | Percentage of GDP | | |
| | Public | Private | Total | Public | Private | Total | Public | Private | Total | Public | Private | Total |
| Agriculture | 170 | 1,400 | 1,570 | 0.2 | 1.6 | 1.8 | 600 | 3,100 | 3,700 | 0.4 | 2.1 | 2.5 |
| Mining and manufacturing | ... | 6,570 | 6,570 | ... | 7.5 | 7.5 | ... | 13,400 | 13,400 | ... | 9.1 | 9.1 |
| Transport | 880 | 2,620 | 3,500 | 1.0 | 3.0 | 4.0 | 1,800 | 4,400 | 6,200 | 1.2 | 3.0 | 4.2 |
| Power | 180 | 700 | 880 | 0.2 | 0.8 | 1.0 | 3,350 | 150 | 3,500 | 2.3 | 0.1 | 2.4 |
| Other utilities | 180 | 80 | 260 | 0.2 | 0.1 | 0.3 | 450 | 150 | 600 | 0.3 | 0.1 | 0.4 |
| Housing | ... a/ | 2,100 | 2,100 | | 2.4 | 2.4 | 300 | 3,800 | 4,100 | 0.2 | 2.6 | 2.8 |
| Other | 350 | 530 | 880 | 0.4 | 0.6 | 1.0 | 1,150 | 1,150 | 2,300 | 0.8 | 0.8 | 1.6 |
| **Total** | 1,760 | 14,000 | 15,760 | 2.0 | 16.0 | 18.0 | 7,650 | 26,150 | 33,800 | 5.2 | 17.8 | 23.0 |

a/ Refers to housing construction by the public sector and excludes Government financing through the Government Service Insurance System (GSIS) and the Social Security System (SSS) of houses built by the private sector.

Source: Data for 1970-74 are Mission estimates; data for 1980 are Mission projections.

GDP according to Mission estimates. 1/ Only in recent years has the share of investment undertaken in the public sector increased; in 1975, it had risen to about 3 percent of GDP. It should be noted, however, that until recently it was the private sector in the Philippines that undertook a large share of the investment in areas that, in many other countries, are the responsibility of the public sector. Thus, there has been substantial private investment in power generation and transmission and in roads, ports, and communications facilities, although not all of the facilities have been for use by the public.

Future Level and Allocation of Investment

8.07 There is no up-to-date Government statement of the planned level and sectoral allocation of future investment. 2/ The Mission has therefore attempted to formulate a statement of investment priorities that would be needed to support the sectoral development strategies outlined earlier in this report.

8.08 Because of the need for relatively larger investments in utilities, especially in power generation and transmission, and the initiation of a number of large, capital-intensive projects in the industrial sector, a sharp rise in the investment rate will be necessary. The rate of fixed investment to GDP, which has been about 18 percent in recent years, would have to rise by about 12 percent a year and reach 23 percent of GDP in 1980; it will need to be maintained at least at that level in the first half of the 1980s. As Table 8.2 indicates, this would mean fixed public and private investment of about ₱ 34 billion by 1980 (at 1974 constant prices). As a result of the probable composition of investment, the incremental capital-output ratio is not expected to change significantly from the current level of about 3.4 during the next five years. This ratio conceals opposing trends, however; better capacity utilization in industries like steel, wood products, pulp and paper, and cement will tend to bring down the ratio, while capital-intensive projects with long gestation periods, like nuclear power plants, will tend to raise it.

1/ For the purposes of this report, public investment is defined as capital expenditures by the national government, by local governments, and by public corporations in such areas as transport, power, and public irrigation works. Specifically excluded are equity investments and loans from the public sector in industrial activities and the banking system. Also excluded, but discussed separately, are public investments in housing projects. Unfortunately, there is no one series of data that adequately measures these public investments in infrastructure. The data used in this report are a composite of infrastructure expenditures of the national government as reported by the National Economic and Development Authority (NEDA) and capital expenditures by local governments as reported in Auditor General Reports.

2/ The most recent statement, for FY74-77, was contained in the Four Year Development Plan, FY74-77, which is now out of date in many respects.

8.09 Successful implementation of the development strategy would result in significant increases in the rate of investment in agriculture, industry, transportation, and power. Because of their current large share of investment, industry and mining would account for about one-third of the total increase in investment. Nevertheless, the share of investment going to industry would decline somewhat and successful implementation of the development strategy would cause the share of investment in power, agriculture, and "other services" 1/ to rise. At the same time, there would be a sharp increase in the relative importance of public investment. Whereas the public sector accounted for about 11 percent of total fixed investment in the first half of the 1970s, its share would rise to about 23 percent by 1980 if the proposed programs were implemented. In terms of its share in GDP, public investment would rise from an average of 2 percent in the first half of the 1970s to about 5 percent by 1980. After taking into account increases in stocks, gross capital formation in the Philippines would probably have to rise from an average of 20 percent of GDP in the first half of the 1970s to about 25 percent by 1980, and then remain there during the first half of the 1980s.

8.10 Raising aggregate investment to this level will require vigorous efforts to mobilize more domestic resources. It should be possible to raise domestic savings to about 22 percent of GDP by 1980; 2/ the remainder of the program would have to be financed with foreign savings. Even so, this would mean a decline in the ratio of foreign savings to GDP from the present high level of about 4.5 percent to about 3 percent by 1980. The decline would continue in the 1980s, and by 1985 foreign savings probably would only be about 1 percent of GDP. Provided these external resources are available on suitable terms 3/, the task of maintaining internal and external financial stability should be manageable.

8.11 The present relatively strong dependence on foreign savings is primarily the result of the recent large increases in the price of petroleum crude and products. It will be a number of years before the Philippine economy can complete a reasonably smooth transition to the point where these higher energy costs have been fully absorbed. Increased investments in the export sector, in import-replacing industries, and in alternate sources of energy will be required to reach that point. Some of these investments are necessarily capital-intensive with large foreign exchange requirements. The Mission believes that a smooth transition is preferable to the alternate strategy of trying to sharply reduce dependence on foreign savings in the next couple of years, which would have unduly disruptive effects on income

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1/ This category includes educational facilities, flood control and drainage canals, medical facilities, and commercial buildings.

2/ See Chapters 9 and 10.

3/ See Chapter 11.

and employment growth. Since finished consumer goods are now only a small proportion of total imports and cutbacks in raw materials would have an immediate and unacceptable impact on production and employment, rapid cutbacks would have to be concentrated on capital goods. However, a decrease in imports of capital goods would not only hamper the Philippines' adjustment to higher energy prices, but it would also have adverse effects on programs aimed at expanding productive employment opportunities.

8.12 The projected rise in the share of investment in GDP and the decline in the relative importance of foreign savings will undoubtedly not progress quite as smoothly as the foregoing discussion implies. The actual outcome in any one year will be influenced by the world prices of capital goods, short-term changes in domestic incomes and savings, and the timing of major investment projects. The issues related to foreign and domestic resource mobilization are discussed in the subsequent chapters, but it may be helpful at this stage to give some indication of the extent to which outcomes on the investment side may deviate from the projected trends.

8.13 There are several reasons for which investment expenditures in any one year could be somewhat different from those projected. One reason is, of course, that physical investment programs may turn out somewhat differently than expected. Final decisions on a number of major investment projects for the industrial sector have not yet been taken, 1/ so it is difficult to be very precise about the timing of these projects, and hence about investment requirements. In addition, although the Mission has argued for a major increase in investments in so-called nontraditional industrial exports by 1980, it is by no means certain that, even with the promotional policies of the Government, individual Filipino entrepreneurs will feel that the potential profits outweigh the risks inherent in greater exposure in export markets. A more cautious approach among private investors may, therefore, result in a smaller investments in industry.

8.14 For the agricultural sector, gross investment is projected to grow at about 12 percent a year, compared with an almost negligible rate of increase in the past few years. Whether this will materialize will depend on incentives for private investment in agriculture and on the availability of credit. With the relaxation of credit restrictions (e.g., collateral requirements) under programs of the Masagana type, effective private demand in agriculture for capital from institutional sources is probably far in excess of supply. Private incentives will also depend, in part, on the rate of progress in the public agricultural program. Hence, shortfalls in public agricultural programs may not be entirely offset by private agricultural investment demand that is greater than planned. As a result of these and other uncertainties in the agricultural program, 2/ circumstances may preclude an agricultural investment program as large as planned.

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1/ See Chapter 6.

2/ See Chapter 5.

8.15 The total investment program of the public sector could fall short of projected levels if difficulties are experienced in project preparation and implementation. This is perhaps most likely in the power sector where a very large build up in projects is required. Such a situation could, however, be offset by larger-than-projected programs in other sectors, especially in transportation and public housing.

8.16 Any reduction in investment expenditures caused by delays in project preparation and implementation could possibly be partially offset by substantial cost overruns, particularly for equipment purchases in the steel, chemicals,and mining industries, and in the power sector. There are several large capital-intensive projects in these sectors that have long gestation periods; because the details for a number of these projects have not yet been fully developed, an accurate estimate of their cost is not yet established. In the field of transportation, cost overruns may also prove to be an important factor that may tend to raise investment needs.

8.17 These various possibilities suggest that investment costs could vary from the projected level in any one year by about 10 percent. Such a variation is not, of course, substantially different from the projected investment figures. If, however, investment expenditures exceeded the projected level by 10 percent and if that difference had to be met through a corresponding increase in the dependence on external financing, the increase in estimates of foreign borrowing requirements would be very large indeed. The alternative to heavy reliance on foreign capital is some combination of a reduced investment program and a higher level of domestic savings in the event of contingencies adversely affecting the resource outlook. Fortunately, the Philippines would appear to have scope for adjustment without seriously affecting the economic growth targets or sacrificing employment objectives.

8.18 The kinds of adjustments that could be made in the face of excessive investment demand will depend to some extent on the form in which the demand is manifested. The effects of excess demand for investment in construction may have largely internal inflationary effects, whereas excess demand for machinery and equipment is apt to have much more important balance of payments consequences. In the former case, adjustments in the level of domestic construction activity could be made by delaying some construction starts or using other means, while in the latter case imports could be reduced by resorting to tax measures and other controls.

## B. Expanding Public Sector Infrastructure Expenditures

8.19 In the Philippines, public investment has historically been very low and sector accomplishments very uneven. Even though the Government has, in recent years, been making vigorous efforts to improve the public infrastructure, facilities are still grossly inadequate. If the sectoral strategies outlined earlier in the report are to succeed, it will be necessary to continue giving a high priority to public investment in the future.

8.20 It is estimated that public investment will have to rise from the present level of about 3 percent of GDP to at least 5 percent by the end of the decade. Such a rise is required in part because relatively larger amounts must be spent in areas like irrigation and transportation to directly support efforts to expand production. The increase is also the result of recent policy changes that have given the public sector sole responsibility for developing power generation facilities and the national power grid. As a result of this policy change and the Government's efforts to reduce dependence on imported petroleum by developing alternative sources of electric energy, the share of expenditures on power would rise from about 10 percent in recent years to about 35 percent in the future. The share allocated to transportation would decline from 50 percent to 33 percent. Despite these changes in the composition of the public investment program, there would still be substantial growth in real terms in public investment in all sectors.

8.21 The other major change in the pattern of public investment relates to the regional distribution of expenditures. Greater efforts would be needed to use the public investment program as a means of improving the regional distribution of the benefits of development. The Government is already making noteworthy progress in this area and there is likely to be a very substantial change in the geographical concentration of public investment away from Metropolitan Manila and Central Luzon to other regions such as Mindanao, Bicol, the Visayas, and the Cagayan Valley.

8.22 The Mission estimates that during the next ten years public investment outlays will need to be about ₱ 76 billion (at 1974 constant prices), 45 percent of which would be foreign exchange outlays for imported goods and services. In the past, public investment was constrained both by insufficient funds and by the Government's inadequate planning and implementation capacities. In recent years, there has been substantial progress in overcoming the problems created by the lack of funds, but even so, a program of the above magnitude will require additional fiscal reforms in the latter part of the 1970s. 1/ Moreover, there will need to be continued efforts to improve the capacity of Government agencies to plan, prepare, and implement projects, especially in such sectors as power and irrigation.

The Past Record

8.23 Public investment in the Philippines during the 1960s and early 1970s has averaged about 2 percent of GNP. About 75 percent of the public investment in the Philippines has been undertaken by the national government, 15 percent by public corporations, and 10 percent by local governments. Compared to many other developing countries, public investment in the Philippines is relatively low. Intercountry comparisons, however, are complicated by variations in the extent of Government responsibility for providing infrastructure and services. As was noted above, for example,

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1/ See Chapter 10.

Table 8.3 Public Capital Formation in Selected Countries

| Country | Per Capita GNP 1972 (In US dollars) | Public Capital Formation[a/] as Percentage of GDP | Period |
|---|---|---|---|
| Philippines | 220 | 2.2 | 1969 |
| Jamaica | 810 | 4.1 | 1968-70 |
| Kenya | 170 | 4.0 | 1969-71 |
| Korea | 310 | 7.0 | 1969-71 |
| Malaysia | 430 | 5.1 | 1963, 1966 and 1967 |
| Mexico | 750 | 3.8 | 1963, 1966 and 1967 |
| Zambia | 380 | 6.9 | 1968-70 |

a/ Public capital formation is defined for Jamaica, Kenya, and Mexico as gross fixed capital formation by producers of government services; for Malaysia, Zambia, Korea and the Philippines as gross capital formation by general government. These countries were selected on the basis of availability of data and level of economic development.

Source: Data on public capital formation is from United Nations, Yearbook of National Income Statistics, 1972, ST/STAT/Sec. 012, Add. 1 (1974), vols. 1 and 2. Data on GNP per capita is from the World Bank Atlas, 1974.

much of the past investment in power and telecommunications in the Philippines has been undertaken by the private sector. Even so, it would appear that there has been a relative neglect of infrastructure facilities that serve the needs of the public at large. As Table 8.3 indicates, public investment outlays of 4 to 7 percent of GDP are not uncommon among countries at roughly the same per capita income level.

8.24 The main reasons for the relatively low levels of investment by the national and local governments and by public corporations during the 1960s were a shortage of public funds from domestic sources, a relatively weak capability within the public sector to adequately prepare and implement projects, and a concomitant lack of external financial support. During the past three or four years, however, a very considerable effort has been made to overcome these bottlenecks. Government revenues have increased substantially, external assistance has burgeoned since the Consultative Group for the Philippines was formed in 1971, and the project pipeline has increased substantially. These factors have resulted in a considerable rise in public investment during the past few years, and the ratio of public investment to GDP is now about 3 percent. (Table 8.4.) There has also been a dramatic increase in the official external assistance available for investment projects, which rose from US$125 million in 1970 to over US$700 million at the end of 1974.

8.25 Only since 1967 has reliable information been available on the allocation of public investment among sectors. More than half of total outlays went to the transport sector during FY67-75, 11 percent to irrigation, 9 percent to power and rural electrification, and 5 percent to water and sewerage. The remaining 18 percent was allocated for flood control, school construction, and other programs. The dominance of transportation reflects both the Government's priorities during that period and the transportation sector's relative superiority in implementing projects. While the allocation may at first glance appear to be unbalanced, it must be remembered that there was insufficient spending in all sectors.

8.26 There has also been a very uneven distribution of outlays among the various geographic regions in the Philippines. Infrastructure investments in the past have been very heavily concentrated in Manila and Central Luzon. The International Labor Office (ILO) reported that "between 1965 and 1972 almost half (47.5 percent) of the total infrastructural investment took place in only two regions: Rizal (which includes Manila) and Central Luzon." 1/ Perhaps even more revealing is a recent analysis done by the National Economic and Development Authority (NEDA). 2/ In terms of ongoing projects in December 1974, the per capita investment in Metropolitan Manila was three times higher than the national average. Central Luzon was second with a per capita investment about 50 percent higher than the national average. (Table 8.5)

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1/ ILO, Sharing in Development, p. 196.

2/ NEDA, "Regional Distribution of Public Investment," NEDA Development Digest, Vol. 2 to 22 (April 1975).

Table 8.4. Public Investment Expenditures in the Philippines

| Item | 1960 | 1965 | 1970 | 1975 | Average Annual Increase (In percent) 1960-70 | 1970-75 | 1960-75 |
|---|---|---|---|---|---|---|---|
| Total Public Investment (in millions of pesos at 1974 prices) | 1,000 | 1,186 | 1,579 | 2,936 | 4.5 | 13.2 | 7.3 |
| National government | n.a. | n.a. | 1,164 | 2,449 | n.a. | 16.0 | n.a. |
| Local governments | n.a. | n.a. | 183 | 125 | n.a. | -7.2 | n.a. |
| Public corporations | n.a. | n.a. | 232 | 362 | n.a. | 9.4 | n.a. |
| Share of Public Investment in GNP (in percent) | 2.2 | 2.0 | 2.1 | 2.9 | -- | -- | -- |
| National government | n.a. | n.a. | 1.6 | 2.4 | -- | -- | -- |
| Local governments | n.a. | n.a. | 0.2 | 0.1 | -- | -- | -- |
| Public corporations | n.a. | n.a. | 0.3 | 0.4 | -- | -- | -- |

Source: Mission estimates based on Government construction figures in the national accounts, infrastructure expenditures reported by NEDA, and capital expenditures of local governments listed in Auditor General's reports.

8.27 There is evidence that the Government is attempting to redress this imbalance in its current infrastructure program. In its analysis of the FY74-77 infrastructure program, NEDA indicated a very substantial shift away from Metropolitan Manila and Central Luzon to Mindanao and the Cagayan Valley. While the Visayas continue to receive less than the national average, there has been a substantial improvement in their position from less than a third of the national average on a per capita basis to over two-thirds. The short-term horizon of the analysis, together with the lumpy nature of public investment projects, caution against attaching too much significance to the particular numbers presented in Table 8.5. However, the overall thrust of the analysis indicates that the Government is moving in the direction of a more balanced regional allocation of funds than in the past.

Public Investment Needs for the Next Decade

8.28 If the Philippines is to expand output and employment opportunities, a relatively larger share of investable resources will have to be channeled into public investment programs in order to upgrade and expand existing facilities. Particularly large programs will be needed in the power and irrigation sectors in direct support of production programs. The Mission believes that the level of public investment in infrastructure will need to rise from the current level of 3 percent of GDP to 5 percent by the end of the decade and to remain at about that level during the 1980s. This would require more than a fourfold increase in the average level of public investment in real terms compared to the level of FY67-75. The average rate of increase would be about 13 percent a year in real terms during 1975-85 compared to an average of 7 percent a year during 1967-75. In 1974 prices, the program would require outlays of over US$10 billion for the next ten years.

8.29 Sectoral Allocation: The problem is more complicated than just increasing the overall level of public investment, however. The particular circumstances of the Philippines warrant a major change in the sectoral distribution of public investment during the next ten years. (Table 8.6) If output in the Philippines economy is to grow at about 7 percent, there must be a major increase in investment in power generation and distribution facilities. This large increase in public investment in power is due in part to the Government's decision to have the National Power Corporation (NPC) responsible for all new generation facilities in the Philippines. Previously, a large amount of power had been provided by the major private power company--Meralco. It is also due to the Government's decision to substantially increase the availability of power in Mindanao and the Visayas, areas which have been largely neglected by private utilities.

8.30 A detailed review of the proposed program is given in Appendix III to this report. Briefly, however, the demand for power is expected to grow at about 11 percent a year during the next decade, so that additional generating capacity of about 5,000 megawatts (MW) will be needed during 1975-85. The Government is actively engaged in a program aimed at reducing dependence on oil-fired power plants, which presently account for almost 80 percent of

Table 8.5. Regional Allocations of Public Investment Expenditures Per Capita on Projects During FY74-77

(In pesos per capita at current prices)

| Region | On-Going Projects (December, 1974) | Projects to be Implemented in FY74 | Projects to be Implemented After FY74 |
|---|---|---|---|
| Metropolitan Manila | 754 | 24 | 167 |
| Ilocos | 174 | 85 | 145 |
| Cagayan Valley | 138 | 85 | 972 |
| Central Luzon | 375 | 93 | 107 |
| Southern Luzon a/ | 83 | 58 | 367 |
| Bicol | 146 | 27 | 282 |
| Western Visayas | 74 | 27 | 196 |
| Central Visayas | 54 | 31 | 162 |
| Eastern Visayas | 131 | 30 | 173 |
| Western Mindanao | 69 | 55 | 179 |
| Northern Mindanao | 215 | 99 | 442 |
| Southern Mindanao | 225 | 62 | 227 |
| Philippines | 243 | 55 | 255 |

a/ Excluding Metropolitan Manila.

Source: NEDA, "Regional Distribution of Public Investment" (n.p., 1975, processed)

Table 8.6. Investment Outlays by the Public Sector

| Sector | Average Annual Expenditure (In millions of pesos at 1974 prices) | | Composition (In percent) | | Share in GNP (In percent) | |
|---|---|---|---|---|---|---|
| | FY67-75 a/ | FY76-85 b/ | FY67-75 a/ | FY76-85 b/ | FY67-75 a/ | FY76-85 b/ |
| Transportation | 977 | 2,410 | 56.9 | 31.7 | 1.2 | 1.6 |
| Power c/ | 117 | 2,680 | 6.8 | 35.3 | 0.1 | 1.8 |
| Rural electrification | 38 | 330 | 2.2 | 4.3 | - | 0.2 |
| Irrigation | 186 | 590 | 10.8 | 7.8 | 0.2 | 0.4 |
| Water and sewerage | 88 | 400 | 5.2 | 5.3 | 0.1 | 0.3 |
| Flood control | 64 | 460 | 3.7 | 6.1 | 0.1 | 0.3 |
| Other | 248 | 730 | 14.4 | 9.6 | 0.4 | 0.4 |
| Total | 1,718 | 7,600 | 100.0 | 100.0 | 2.1 | 5.0 |

a/ Actual expenditures.
b/ Mission projections.
c/ Excluding rural electrification.

Source: For actual data, the infrastructure expenditures of the national government and public corporations reported by NEDA and capital expenditures of local governments listed in the Auditor General's reports were used. The projections are Mission estimates based on the analysis of individual sector programs that are reviewed in this report.

generating capacity. The program includes development of additional hydroelectric projects, exploitation of geothermal resources, and construction of two nuclear power plants with a combined capacity of 1,200 MW. After allowing for additional transmission and distribution facilities, the Mission estimates that investment outlays in the power sector will have to amount to about ₱ 29 billion during 1976-85 at 1974 prices (equivalent to US$3.9 billion at the present exchange rate). The program would absorb about a third of public investment during the period, compared to the 7 percent allocated to the power sector during the past decade. The Government recognizes that it is confronted with a major challenge in implementing a program of this magnitude. It has, therefore, begun to upgrade the capacity of NPC, which has the main responsibility for implementing the program 1/. These expenditures do not include the requirements of the Government's ambitious rural electrification program that was discussed in Chapter 4.

8.31 The other major component of the proposed investment program is transportation. Investment expenditures on transport infrastructure will have to be expanded significantly during the next decade if there is to be a continued improvement in the amount and quality of transport services in the economy. The emphasis will have to be put on improving the coverage of public transportation in Metropolitan Manila and on improving interisland shipping and farm-to-market roads to support rural development in other parts of the country. However, because a substantial part of the current Government transportation program is essentially only a project list with little supporting data and justification, a meaningful review of this program could not be carried out. 2/ Until such a review is undertaken, a reasonable target would be to increase capital expenditures on transportation by about 10-12 percent a year. This would result in transport expenditures of about ₱24 billion (at 1974 prices) during FY76-85. This would be equivalent to about 1.6 percent of GNP during the period and about one-third of the public investment program.

8.32 For the reasons given in Chapters 4 and 5, this report places a high priority on continued expansion of irrigation facilities. At this stage, it seems likely that about 300,000 additional harvested hectares could be brought under irrigation with new gravity schemes (including communal ones) constructed by the National Irrigation Administration (NIA) and another 300,000 hectares could be rehabilitated. In addition, some public investment expenditures would be required in the companion program to expand pump irrigation, adding about 200,000 hectares during the next 10 years. Total public investment in new irrigation facilities probably would amount to

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1/ The steps being taken are discussed in more detail in Appendix III.

2/ In this regard, the World Bank is considering providing technical assitance to the Government to review the immediate four year infrastructure program (FY76-79) and to assist in an updating of the "Philippine Transport Survey" prepared in 1970 by Metra International and Sauti Consulting Engineers.

about ₱5.9 billion at 1974 prices during FY76-85. Although the share of public investment in irrigation would decline to about 6 percent, there would still be a threefold increase in the level of outlays compared to the period FY67-75. While this program would still not meet the need for additional irrigation facilities, the present constraints on constructing and operating irrigation systems make achieving even this target optimistic.

8.33 Other sectors would continue to account for about one-quarter of the overall program. They would, nevertheless, require a more than threefold increase in the average levels of investment. Because of its past neglect, the flood control sector warrants a larger share of the total. The Government has recently increased investment in this sector considerably; maintaining this momentum would result in flood control accounting for about 7 percent of investment during the next ten years. Similarily, compared to past levels of investment, the Government has embarked on a large water supply and sewerage program in Metropolitan Manila, as well as improved water supply in a number of provincial cities. This program would result in an increase in that sector's share from less than 1 percent in FY75 to 6 percent by FY80. No substantial changes are proposed in other sectors; telecommunication will probably continue to account for less than 1 percent of public investment, schools for 3-4 percent, and miscellaneous public works and projects for 4-6 percent.

8.34 Financial Implications: The financial implications of the proposed public investment program are considerable. In 1974 prices, the program will require ₱ 76 billion during FY76-85, more than four times the actual outlays during the previous ten years. Along with this substantially larger overall requirement, there would also be a significant change in the pattern of expenditure. (Table 8.7) Primarily because of the increase in expenditures on power, the public corporate sector would account for almost half the program compared to its current share of about 12 percent. Local governments would maintain their share of about 4-5 percent of public investment, and the national government's share would decline to about 48 percent. The foreign exchange component of this program is roughly estimated to be ₱ 34 billion (at 1974 prices) or US$4.5 billion.

## Planning and Implementing the Program

8.35 The proposed public investment program is ambitious and, in view of the past record, there is a question as to whether the program can be fully implemented. The Mission believes that it can if there continues to be close attention to project formulation and planning among the various agencies of the Government and if there are concerted efforts to build up the capabilities of these agencies and of the domestic construction industry to execute the programs.

Table 8.7 Projected Public Investment Expenditures by Source, 1976-85
(In billions of pesos at 1974 prices)

| Public Sector | Amount | Percent |
|---|---|---|
| National Government | 36.5 | 48.0 |
| Public corporation a/ | 36.5 | 48.0 |
| Local governments | 3.0 | 4.0 |
| Total | 76.0 | 100.0 |
| Foreign exchange component | 34.2 | 45.0 |

a/ Includes the Philippine National Railways, National Power Corporation, National Electrification Administration, Metropolitan Manila Waterworks and Sewerage System .

Source: Mission estimates.

8.36 Sector and Project Planning: Public sector investment planning in the Philippines has, in the past, suffered from both a weak link between the macro planning and project planning units within the central planning agency, and from the lack of adequate planning units in the various operating agencies. As a result, projects have not been grouped into sound sector programs and the central planning authority has not had a significant influence on the programs of the various sectors or the intersectoral investment mix. The Government has recognized this shortcoming and NEDA has begun sectoral planning exercises in the areas of education, industry, tourism, infrastructure/utilities, agriculture, housing, health, social welfare, and foreign trade.

8.37 As this is the first effort of its type to be undertaken in the Philippines, there is obviously considerable room to improve the sector plans. The treatment of the individual subsectors is sketchy and overall financial planning is largely neglected, but NEDA is aware of these deficiencies and intends to remedy them in the future. Despite particular weaknesses in some of the sector plans, however, the basic approach that NEDA has taken is commendable in that an effort has been made to include the implementing agencies in the exercise so that the plans that are eventually approved will have the backing of both agencies. The involvement of various planning agencies has varied considerably because of substantial differences among them. The first drafts of the sector plans were also reviewed in workshops that included representatives from the Budget Commission and the Central Bank in order to translate the sector plans into budget allocations. In the future, it is NEDA's intention to emphasize longer term planning in the various sectors as well as to add a regional dimension to the sector plans. The goal is to eventually have the operating agencies define the sector plans and to limit NEDA's role to one of general guidance, coordination, and determination of intersectoral priorities.

8.38 One particular planning problem relates specifically to the public infrastructure projects. In the past, the approved infrastructure program has usually been significantly larger than could possibly be undertaken either from the point of view of financial availability or implementation capacity. This has left the final determination of actual priorities to another agency or to the capabilities of the agencies to implement their respective programs. This situation has usually resulted in actual expenditures not matching planned priorities and in the highway sector receiving the major portion of the funds available for public investment. More emphasis needs to be given to evaluating the implementation capacities of the various agencies to determine whether they can carry out the proposed programs and, if not, what action should be taken to build up the agencies' capacities.

8.39 Project Selection: Many considerations must enter into the choice of specific projects that are to be undertaken in any one year. In the past, political influence probably played an unduly large role and, as a result,

projects were concentrated in a few regions and, on occasion, were not economically justified.

8.40 Efforts are now being made to improve the methods used to select individual investment projects. With the assistance of the United States Agency for International Development (USAID), an inter-agency team (including NEDA, the Development Academy of the Philippines, the Project and Planning Development Office, and the Presidential Economic Staff) has been developing a methodology for project ranking. 1/ The approach of the team is to estimate the performance of a proposed project on a large number of specific indicators which are related to particular development objectives, and then to rank projects according to their potential for achieving the various goals set out in the Philippines' development strategy. These performance indicators are weighted to give an overall performance rating. These overall performance ratings can then be used to select projects. It is significant that the goals or objectives against which projects are rated are much broader than economic efficiency as measured by traditional cost-benefit analysis; they include such objectives as job creation and a more equitable distribution of income. In order to attach weights to the various goals, opinion surveys were used to determine the Philippine society's relative valuation of the goals. 2/ The approach is still being developed and application has been only on an experimental basis; however, the model could result in an improvement in the process of project selection and a better alignment between the investment program and the nation's overall development goals.

8.41 In a separate exercise, Deepak Lal has developed accounting ratios for a large number of tradeable goods and the major non-traded goods for the Philippine economy. 3/ Those ratios, when divided into the market price of a good, yield the accounting price, which is an estimate of the social value as distinct from the market value placed on the commodity or service. The

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1/ The following discussion is based on a summary of the preliminary report on the "Methodology for Project Ranking," prepared by the Project Economic Staff of NEDA.

2/ The weights worked out from these surveys are as follows: promotion of social development, 28 percent; more equitable distribution of income and wealth, 26 percent; maximum feasible economic growth, 19 percent; maximum use of labor force, 19 percent; preservation of environmental stability, 8 percent. Of course, the problem with this approach is that the ranking of goals is arbitrary since the notion an individual has about attaining a social welfare goal may well differ from the value society at large attaches to it.

3/ Deepak Lal, Men or Machines - A Philippine Case Study of Labor/Capital Substitution in Road Construction, (Geneva: International Labor Office, forthcoming).

two prices often diverge due to market distortions. 1/ Although Lal's study made use of these shadow prices to evaluate alternative production techniques for a road project, they could be used to evaluate other investment projects in the Philippines.

8.42 Project Implementation and Monitoring: Project implementation capacity was frequently poor in the past. There were often long delays in initiating projects and construction schedules were frequently extended substantially. These delays in turn led to cost overruns. There are a number of reasons for the rather poor record of implementation, including a shortage of financial resources, delays in release of budgeted funds, the release of funds for non-approved projects, poor maintenance and organization of government-owned equipment, and weak project management and implementation capacity.

8.43 The problem created by the poor fiscal position of the national government has been largely overcome but difficulties caused by the delay in releasing funds when needed to carry out the approved program have persisted. This has been due to administrative delays, and to the fact that the link between approved programs and the budget was weak, therefore, planned priorities were not always those that were funded. In the most recent report of the Project Monitoring Service of NEDA, however, the funding problem, including inadequate and delayed releases, was estimated to account for only 7 percent of the delays encountered in on-going projects and thus seems to have dwindled as a serious source of project delay. Nevertheless, some implementing agencies continue to identify budget releases as a problem.

8.44 In an effort to further steamline the budgetary process, the Government has recently implemented a system of automatic cash releases. This empowers the Budget Commission to make releases based on the approved program without necessitating approval from the Office of the President for quarterly releases as was the previous practice. It is too early to see what effect this modification might have, but obtaining releases for the approved annual program and the budget should now be easier. In general, it should strengthen the relationship between the approved program and the budget.

8.45 The Government is attempting to strengthen other areas of project implementation as well. It has established a system of sector and regional specialists to monitor and identify problems in on-going projects. This

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1/ The accounting prices were derived along the lines of the OECD manual on Social Cost Benefit Analysis, except that a somewhat different numeraire was used. See I.M.D. Little and J.A. Mirrlees, Manual of Industrial Project Analysis in Developing Countries, Vol. II, Social Cost Benefit Analysis (Paris: Development Center of the OECD 1969).

involves a system of Presidential Regional Officers for Development (PRODs) and Coordinating Officers for Program Execution (COPEs) under the Office of the President. There is a PROD in every region who is responsible for seeing that projects are operating on time, within the budget, and according to standard. The line agency project officers call problems to the PROD's attention, and the PROD attempts to resolve the problem himself, if possible, or report it to the Office of the President. The PRODs operate without any official budget as they do not receive any additional remuneration for carrying out this responsibility. The COPEs perform the project and program monitoring function at the national level. A senior official is appointed to see that programs or projects are implemented on schedule and that interdepartmental programs escape the normal bureaucratic hazards.

8.46 The more structured and formalized monitoring is undertaken by the line agencies providing data to the National Computer Center (NCC). The NCC maintains a standard and efficient project monitoring format. Actual target and variance data are recorded for the key projects and programs on a monthly basis. In addition, however, the NEDA recently created the Project Monitoring Service (PMS) to monitor the implementation of on-going projects. It functions similarly to the defunct Infrastructure Operations Center in that it relies on reports from the line agencies on the status of its projects. The PMS issues quarterly reports summarizing the status of national development programs and identifies major problem areas of implementation. It also makes recommendations for improving the process of implementation to the NEDA Board. Finally, the Department of Public Works, Transportation, and Communication (DPWTC) is in the process of starting a data bank in support of its Planning and Project Development Office. In general, it appears that the DPWTC intends to build a system to provide the basis for both planning and implementing the infrastructure projects under its jurisdiction.

8.47 These monitoring systems usually operate independently of each other, and for that reason there is both a duplication of effort and the failure to take advantage of each others efforts. It is not clear at present what the Government's intentions are regarding the long-term role of the agencies involved in monitoring, but there is a strong prima facie case for improving communication and coordination among these agencies. The PMS, for instance, could make use of the data generated by the NCC monitoring service as well as at the reports of PRODs on the problems they encounter in the field.

8.48 The administrative capacity of the line agencies responsible for implementing major parts of the public investment program is crucial for the proposed development program. In areas like power and irrigation, the very large increases in investment that are proposed will undoubtedly strain the capacities of the responsible agencies. To ensure that these programs move forward as planned, the Government will have to give close attention to the needs of the technical and managerial staff and to the planning and administrative procedures being followed within these agencies.

## C. Influencing the Pattern of Private Investment

8.49 Even though the relative importance of public investment should rise in the future, the major portion of total investment will continue to be provided by the private sector. The creation of new public infrastructure and the improvement of existing facilities will have an important indirect effect on the pattern of private investment. Nonetheless, the Government will have to depend primarily on indirect methods of influencing investment decisions. The credit and interest rate policies of the monetary authorities will, of course, have a considerable bearing on the outcome, and these, as well as the level and allocation of private investment, are discussed in the next chapter. The fiscal incentives and administrative controls over domestic and foreign private investment that are operated by the Board of Investments (BOI) will also have an important influence.

### Investment Incentives

8.50 Investment incentives have been used in the Philippines since the early 1950s as a major tool for mobilizing domestic and foreign resources and channeling them into socially desirable directions. The incentives system that operated through the early and mid-1960s was regulated by the Basic Industries Act (Republic Act 3127); a number of specialized incentive laws concerning individual sectors such as mining, textiles, and cottage industries were also an important part of the incentives system. 1/ A comprehensive Investment Incentives Act (R.A. 5186) promulgated in 1967 and the 1970 Export Incentives Act (R.A. 6135) were both amended by Presidential Decrees 92 and 485. The incentives established by these laws are now administered by the Board of Investment, which also has the task of preparing annual investment and export priority plans.

8.51 Apart from non-measurable rights and guarantees, investment incentives consist of a number of tax exemptions and deductions. They are summarized in the Technical Note attached to this Chapter. These incentives are used to encourage investment in manufacturing, mining, some agricultural activities, fisheries, exports, tourism, and public utilities.

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1/ The most important among these laws covered mining activity (C.A. 187, R.A. 3823, P.D. 34, 69, 237, and 238); oil exploration and development (R.A. 387, P.D. 8, 87, and 234); cottage industries (R.A. 3470), R.A. 5326, P.D. 34 and 62); iron and steel industry (P.D. 272); fertilizers (R.A. 3050, P.D. 135); textiles (R.A. 4086); tobacco industry (R.A. 4155); Export Processing Zone Authority (R.A. 5490, P.D. 66 and 69); private development banks (R.A. 4093, 4887, 5431 and 6110, P.D. 34 and 69); rural banks (R.A. 720, 3128, 4106 and 5938, P.D. 34 and 69); and nonagricultural cooperatives (R.A. 2023, 4363 and 5431, P.D. 34, 69, 175 and 299-A).

8.52 In all these areas, incentives are applied to "preferred" activities, which are all those included in the current Investment Priorities Plan (IPP) and the Export Priorities Plan (EPP). In the field of industry proper, all activities that are not included in the list of "overcrowded industries" are potentially preferred. 1/ However, they must be included in the IPP or EPP in order to be registered with BOI and thus eligible for incentives. Since about one-fourth of the industrial sector (in terms of value of output) falls in the category of overcrowded industries, it is clear that by far the greater part of it is either explicitly (through priorities plans) or potentially eligible for incentives. At present there are about 130 subsectors under the IPP and 280 under the EPP 2/ listed as investment priority areas, compared to 40 overcrowded industries.

8.53 Size and Cost of Investment Incentives: It would be difficult to assess with any degree of accuracy the real cost of tax reliefs granted by the Government, since the kind of data needed for such an assessment is simply nonexistent. According to an estimate compiled by an earlier World Bank mission, the total tax forgiveness associated with industrial investments as a result of general investment incentives (R.A. 3127) and sectoral incentives in textiles, mining, fertilizer and cottage industries amounted in 1965-68 to ₱ 430 million, or ₱ 108 million per year, which was about 20 percent of gross investments in those years. The same ratio for BOI-registered projects under R.A. 5186 in 1969-72 has been estimated at 15 percent. 3/ This decline in the relative incidence of tax relief is to be attributed partly to the fact that the greatest beneficiary of incentives during 1965-68 - the textile industry - enjoyed no benefits during 1970-72, since it was classified as overcrowded.

8.54 The relative incidence of fiscal incentives has probably risen again since 1972 due to their broadened scope and to increased investments

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1/ Overcrowded industries are those in which the existing capacity is deemed sufficient to cover domestic and external demand. These are: meat processing, coffee and cocoa, flour milling, sugar centrals, soft drinks, beer brewing, alcoholic drinks, cordage, leather tanning, rubber tires, matches, paints and varnishes, ammonium sulphate (excluding urea), complex and mixed fertilizers, super-phosphate (with qualifications), non-integrated paper plants, cement, soap and detergents, cold rolling, iron sheets, pipes, steel wires, tin plating, bar mills, copper wires, nails, LPG cyclinders, room air conditioners, automotive assembly, truck assembly, wheeled tractor assembly, electric and gas stoves, refrigerators, sewing machines, fluorescent ballasts, light bulbs, pencils, soybean oil meal, radios, phonographs and storage batteries.

2/ The number of actual projects under the Sixth EPP is 61.

3/ See World Bank Report No. 280-PH, "Industrial Development Problems and Prospects in the Philippines" (March 19, 1974), pp. 23-24 and Tables II-8 and II-9. It should be noted, however, that this may be an underestimate since it is derived from preinvestment studies, which tend to minimize the size of fiscal savings for the investor. Besides, the ratio would certainly be higher if more projects were covered.

in capital-intensive and exporting sectors where the cumulative value of tax relief has been the greatest. In a large copper smelting and refining project now under consideration with BOI, for instance, the total investment cost has been estimated at US$239 million with incentives, and US$284 million without incentives; US$45 million worth of taxes forgiven represent a savings of 16 percent of the total project cost for the investor. For the Government, this represents a clear-cut revenue loss unless the project would not have been applied for in the absence of incentives. This loss will presumably be partly offset by the revenue increase after the expiration of incentives and by the secondary growth effects of the project. For the national economy, the question of whether there will be a net loss depends on whether the amount saved (or foregone) will be invested in a preferred area.

8.55 These considerations suggest that the initial net revenue loss for the Government amounts to 12-15 percent of the total cost of investments effected through Government channels. In most Philippine large-scale investments, some 60-70 percent of total project cost relates to imported equipment and other imported inputs. Since the minimum import duty is 10 percent and the compensating sales tax 7 percent of the c.i.f. value augmented by import duty, the tax relief on this account alone will amount to at least 10.5-12.5 percent of total project cost. Other tax exemptions make up the remainder. Due to the long duration of post-operative incentives, an additional revenue loss builds up after a project has started to function.

8.56 Economic effects of investment incentives: There is no doubt that the share of favored investments (that is, of BOI-registered projects) in total investments in the large-scale sector is preponderant and rising, although it would be difficult to document this for the years since 1972. 1/ The implied investment requirements for all BOI-projects (approved, registered, applied for or planned, and as such included in the Eighth IPP or Sixth EPP) for 1976, for instance, would total ₱ 6.6 billion at 1974 prices, which might be four-fifths of total investment needs in organized industry in that year. Based on past experience, it can be safely assumed that actual BOI-sponsored investments will amount to much less than ₱ 6.6 billion in 1976, though much more than the ₱ 1.5 billion which was their estimated annual level in the early 1970s (in 1974 prices).

8.57 This, of course, does not tell what proportion of actual increment in investments was or will be induced by the benefits associated with tax and other concessions. The cursory evidence based on personal interviews with businessmen and on knowledge of prevailing profit rates in major investment areas seems to suggest that much of the investment would have been effected even without incentives. Equally important in influencing investment decisions seem to be factors that are not actually fiscal benefits but are

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1/ Most of BOI investment statistics relate to planned rather than actual investment. Moreover, the project coverage in the reporting system has usually been less than 50 percent.

associated with them, such as a preferred access to institutional finance and foreign exchange.

8.58 It would also be very important to see in which way the incentives system influences the use of productive factors, employment creation, and industrial exports. Most of the incentives are input, import, and capital-oriented. The system is understandably geared to making investments more attractive through enhancing their profitability, but this is being done primarily through a cheapening effect of incentives on the inputs used. Of all the incentives listed, only general tax exemptions, the deduction of pre-operational expenses, the additional deduction of incremental export sales, and the carry-over of net operating losses, have a bearing on profitability via output or sales levels. Since most inputs other than labor are imported and the bulk of material inputs consists of capital equipment that is again imported, the mere existence of input-oriented incentives produces a bias toward the use of capital and of imported components. The relative net gain accruing to the investor enjoying tax forgiveness is directly proportional to the size and capital intensity of a project.

8.59 These following benefits are directly or indirectly related to the use of capital and, in fact, encourage it: an exemption from customs duties and compensating taxes on imported machinery, equipment and spare parts; a tax credit for locally purchased machinery; accelerated depreciation; a re-investment allowance; the reimbursement of infrastructure cost; a double deduction of shipping costs; and a tax credit for interest withheld on foreign loans. The share of these capital-biased benefits in all benefits provided by the incentives system is overwhelming, as can be seen from Table 8.8.

Table 8.8: Estimate of Incentives Availed of by BOI-registered projects, 1970-72 (In millions of pesos)

| Category | 1970 | 1971 | 1972 | Total |
|---|---|---|---|---|
| Capital-related incentives | 63.0 | 108.0 | 57.9 | 228.9 |
| Transport duties on machinery | 11.1 | 37.0 | 32.7 | 80.8 |
| Compensating tax on imported machinery | 7.3 | 23.2 | 10.8 | 41.3 |
| Tax credit for locally produced machinery | 1.0 | 0.3 | ... | 1.3 |
| Accelerated depreciation | 1.4 | 11.5 | 3.7 | 16.6 |
| Double deduction of shipping cost | 3.8 | 6.2 | 4.0 | 14.0 |
| Reinvestment allowance | 38.3 | 29.8 | 6.6 | 74.7 |
| Tax credit for tax on foreign loans interest | 0.1 | 0.0 | 0.1 | 0.2 |
| Other Incentives | 20.6 | 22.4 | 12.7 | 55.7 |
| Pre-operating expenses | 3.0 | 0.5 | 0.1 | 3.6 |
| Double deduction of promotional expenses | 0.2 | 0.2 | 0.2 | 0.6 |
| Net loss carry-over | 2.6 | 2.4 | 0.2 | 5.2 |
| Compensating tax on imported raw materials | 1.6 | 13.1 | 7.6 | 22.3 |
| Sales tax | 12.3 | 2.1 | 4.5 | 18.9 |
| Tax credit for exported finished products | 0.9 | 4.1 | 0.1 | 5.1 |
| Total value of tax relief | 83.6 | 130.4 | 70.6 | 284.6 |
| Capital-related incentives as percent of total | 75 | 83 | 82 | 80 |

Source: BOI, Statistical Appendices to the Fourth, Fifth, and Sixth IPP. The number of reporting firms was 75 in 1970, 105 in 1971 and 70 in 1972.

8.60 In 1970-72, capital-favoring incentives accounted for ₱ 229 million out of ₱ 285 million, or 80 percent of the total estimated amount of tax relief enjoyed by BOI projects. In order to contain this capital bias, the policy makers have included certain labor-favoring devices in the system. Registered enterprises are entitled to deduct one half of labor-training expenses incurred from their taxable income, up to 10 percent of the direct

labor wage. In addition, they may deduct from taxable income the cost of direct labor and local raw materials used in the manufacture of export products as long as it does not exceed 25 percent of total export revenues for producers, 10 percent for traders, and 50 percent for service exporters. The first provision has been made very little use of so far, and the second, introduced in 1973, will probably not have much impact on the use of labor for two reasons: (1) in many cases, the share of the value of domestic raw materials alone in total export value is apt to approach the 25 percent ceiling, with no room left for the subsidy for the use of labor; and (2) the real weight of this measure is limited to a maximum of 8.75 percent of gross export sales (equivalent to the 25 percent income deduction), to which a tax rate of 35 percent is applied, and this maximum can be achieved only by firms with export profit margins of at least 25 percent of gross sales. The relative importance of this measure is even smaller for enterprises engaged in production for both domestic and export markets.

8.61 The BOI has attempted to reduce the capital-favoring effect of incentives in another way. It has imposed conditions on a relatively large number of industries which require that a new project should generate at least one job for every US$4,000 worth of imported equipment, failing which it must earn through exports within five years the foreign exchange it uses in excess of US$4,000 per job created. The purpose of this condition is to make new projects in capital-intensive industries such as petrochemicals, pulp and paper, nickel and copper somewhat less advantageous, while at the same time giving more weight to employment and export criteria in project selection. This provision is applied to selected industries only, and is therefore unlikely to divert many resources from capital-intensive to labor-intensive sectors. Moreover, it is difficult to understand the rationale for setting a uniform limit of US$4,000 worth of imported equipment per job in a variety of industries, with each one of them having a different economic and technological profile. In addition, an industry should not have to undersell for export in order to receive other benefits, and then have to seek to recover the profit loss through higher prices in the domestic market.

8.62 The need for revising the incentives system: The above analysis, together with the discussion of export incentives in Chapter 6, suggests that a thorough overhaul of the incentives system is needed. It will not be an easy undertaking, considering the complex interests involved. While any concrete proposals for a change in the system will have to be based on a comprehensive study, the Mission would like to offer a few comments on the principles of such a change.

8.63 It is easy to agree that investment incentives should be made less costly, more effective, and administratively more manageable. But it must also be recognized that what the system needs is to focus on achieving very specific goals. In the Mission's opinion, employment creation and export expansion deserve the highest priority; a rapid expansion in labor-intensive exports is probably the single most important part of a future

industrial strategy since the Philippines' comparative advantage lies here. The incentive system should be instrumental in pursuing these priorities.

8.64 Such an approach would imply a major restructuring of the present system. There are two methods for doing this: to change the selection of industries eligible for incentives, or to change the incentives-mix itself. A combination of both methods is possible and perhaps preferable, particularly during the transitional period.

8.65 Under the first method, incentives would ultimately be confined to the industries complying with certain labor-intensity criteria, and to exporting industries (other than extractive). Some improvements along this line could be undertaken within the present system without much delay: a) the distinction between "pioneer" and "non-pioneer" project categories could be removed, since it is by no means clear why a certain product should enjoy additional benefits merely because it has not previously been manufactured in the Philippines, while another product, perhaps more essential in other respects, should not; b) the list of overcrowded industries could be revised on the basis of recent findings on the changes in the rate of capacity utilization in individual manufacturing industries; and c) more industries could lose the status of preferred investment areas on the basis of certain adopted criteria (e.g., industries constantly attaining profit margins above a certain level or above the average).

8.66 Restructuring the existing incentives through changing their composition and relative importance could also be effected on a step-by-step basis. In general, the duration of tax holidays should be reduced. The National Internal Revenue Code currently grants a 100 percent exemption from all taxes except the income tax for the first five years and a diminishing rate for another ten years. Some of the incentives favoring the use of capital could be reduced or abolished and new powerful incentives favoring the use of labor could be introduced. One example of a direct employment incentive would be an income tax deduction equivalent to perhaps 200 percent of the annual wage bill of production workers earning less than a certain amount per month; 1/ another would be a direct employment subsidy. The revised system should also provide for a much more pronounced differential between export and other incentives in favor of the former. Under certain conditions, a transfer of incentives should be allowed; e.g., the main contractor should be entitled (or perhaps compelled) to pass on to his subcontractors a part of the benefits accorded him. Finally, the whole process of restructuring incentives could be made less painful by transforming some of the tax exemptions into tax deferrals.

## The Role of Direct Foreign Investment

8.67 In recent years the Government has been attempting to attract a larger amount of direct foreign investment to the Philippines. This drive

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1/ This is an idea proposed by G. Sicat in Economic Policy and Philippine Development (Manila: University of the Philippines, 1972), pp. 46-51.

appears to be succeeding; since 1972 there has been a sharp increase in new commitments and in actual net inflows, reversing the pattern of net outflows that had prevailed for the previous 15 years. Foreign companies are being attracted to investments in such export ventures as component parts for automobiles, textiles, and other manufactured products. The sheer volume of investment required for the proposed projects in mineral ore processing, fertilizer production, and other major import-replacing projects will necessitate much larger inflows of direct foreign investment in the next decade.

8.68 Past Pattern of Direct Foreign Investment: According to the Inter-agency Study on Foreign Investments, gross direct investment inflows totaled US$1.40 billion during 1955-70, and related outflows were US$1.78 billion, leaving a net outflow of about US$380 million. 1/ Nearly half of the surveyed firms had foreign equity participation, and the share of foreign equity was over 60 percent in about one-quarter of them. Overall, foreign equity investment accounted for 40 percent of the total equity capital of all firms. 2/ About four-fifths of the foreign investments were owned by United States nationals as a result of a special post-colonial relationship where investors from the United States were granted a privileged status compared to other foreign investors. Nearly three-fourths of the total foreign investments were in the mining sector and in the import-substituting manufacturing sector. There appears to have been little attempt by foreign firms to take advantage of the relatively cheap labor and to produce manufactured goods for export, which is a development strategy widely followed by neighboring countries such as Korea and Taiwan.

8.69 Incentives for Foreign Investors: The Government has recently liberalized foreign investment rules to broaden the scope of incentives for foreigners in desirable business activities. The Board of Investment implements the general incentive system for foreign investments under three laws: the Investment Incentive Act, the Export Incentive Act, and the Foreign Business Regulation Law. Full foreign ownership is allowed for companies with a pioneer status, companies which export 70 percent of their output, companies in the Export Processing Zone, and companies active in areas which are not "overcrowded" and which do not conflict with the nationality requirements of the Philippine Constitution and nationalization laws. In the nonpioneer areas, foreign ownership is limited to 40 percent. Foreign investors are entitled to certain basic rights and guarantees which include: the rights to repatriation of investment, remittance of profits, interest payments, and repayments of loans; guarantees against expropriation and requisition; assurances regarding the continuation of protection and action

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1/ See Government of the Philippines, Inter-agency Study on Foreign Investments, June 1972.

2/ A similar study based on a survey of the nonfinancial corporate sector for the years 1964 and 1965 indicates the proportion of foreign equity of about 32 percent of the total equity capital of the reporting firms. See Niceto S. Poblador, "Foreign Investment in the Major Nonfinancial Corporate Sector of the Philippines, 1964 and 1965," (Quezon City: University of the Philippines School of Economics, 1971, processed).

against foreign dumping; and provisions for preferential treatment of registered enterprises by the Government's financial institutions in extending loans, and for employment of foreign nationals for a period of five years.

8.70 Apart from these general incentives, there are various fiscal incentives given to foreign investors which depend on the nature of the activities of the firm. Pioneer firms are entitled to exemption from all taxes under the Internal Revenue Code except income tax and post-operative tariff protection. Exporting firms enjoy additional privileges, including: tax credits on taxes and duties paid on supplies, raw materials and semi-manufactured products; additional deductions from taxable income of the sum of direct labor costs and local raw materials used (which cannot exceed 25 percent of total export earnings); and exemption from export taxes, imposts, or fees. Other fiscal incentives which are applicable to non-pioneer enterprises are summarized in Technical Note I.

8.71 Overall, the general as well as fiscal incentives for foreign investments in the Philippines appear competitive with incentives in other Southeast Asian countries. 1/ Nevertheless, the chief determinant of foreign investment flows, particularly direct investment, is apparently not the fiscal inducements offered by the host countries, but the general political and economic climate prevailing in each country. According to a study of foreign investment in Singapore, investment decisions are generally made on the basis of the long-term outlook for political and economic stability in the host country rather than on the basis of tax incentives. 2/

8.72 In the last few years, foreign investments registered with the Board of Investments have increased sharply; commitments jumped from a level of US$30 million in 1972 to US$63 million in 1973 and almost quadrupled to US$234 million in 1974. More than one-half of these investments were in mining, mineral processing, and chemical-based industries. There was also an increasing trend of investments in agro-based enterprises. Data on foreign investments by country of origin reveal the increasing importance of Japanese and European investors in the Philippines. In 1974, 35 percent of the total direct investments were from Japan and about 18 percent each from the United States and Europe. The prospects for a continued increase in direct foreign investments appear promising in view of the current level of interest in the Philippines among potential investors and the opportunities for participation in the proposed major projects in industry and mining. These projects might involve a total investment of about US$4.6 billion

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1/ See the report of the Government of the Philippines, "Comparison of Laws and Regulations on Foreign Investment of Asian Countries" in the Study of Private Foreign Investments in the Philippines, 1972. The countries used for comparison are Hong Kong, Indonesia, Republic of Korea, Malaysia, Singapore, Taiwan, and Thailand.

2/ Helen Hughes and You Poh Seng (eds.), Foreign Investment and Industrialization in Singapore (Canberra: Australian National University Press, 1969), p. 183. See also, Thomas W. Allen, Direct Investment of U.S. Enterprises in Southeast Asia (New York: Scott, 1973).

at 1974 prices in the next decade, requiring a considerable amount of foreign equity participation. If these projects materialize, the total of private foreign investments would provide a net inflow of about US$150 million a year during the decade.

## D. The Role of the Construction Industry

8.73 The construction industry has a particularly important role to play in Philippine development over the next decade. If the proposed investment program is to be successfully implemented, the construction industry will have to expand by about 12 percent a year during 1975-85. The prospect of rapid growth in construction offers important opportunities for expanding productive employment in the economy. It is estimated that the sector could be creating close to 100,000 jobs a year in the 1980s, which would be a major contribution to employment in both rural and urban areas. However, if this potential is to be realized, and if construction is not to become a bottleneck to implementing the investment program, Government policies will need to encourage the orderly expansion of the sector.

### General Characteristics of the Industry

8.74 The potential future contribution of the construction sector contrasts sharply with its actual contribution in the past. One of the most striking features of the industry was its relatively small contribution to value added and employment during the 1960s, especially when compared with other countries in Southeast Asia. This was not always the case. In the early 1950s during the postwar reconstruction period, for example, the construction sector accounted for about 6 percent of GNP, and the share of construction in gross fixed capital formation was about 80 percent. But the industry stagnated during the 1950s with most of the new investment in the form of equipment. Its decline in relative importance continued in the 1960s, and by 1970 it accounted for little more than 2 percent of GNP, employed only about 3 percent of the labor force, and construction expenditures accounted for less than 30 percent of fixed investment. Since 1970 there has been an encouraging reversal of these trends. Value added by construction has grown by an average of about 8 percent a year in real terms, so that its share in GNP has begun to rise, and the share of fixed investment in the form of construction has increased to 40 percent. However, there has not yet been a significant increase in employment in the sector; the labor force has remained at about the 1970 level of 400,000 workers.

8.75 An important characteristic of construction employment is the relatively low skill level required. The proportion of manual workers and craftsmen to the total employed in construction has been 90 percent or more, at least since the mid-1960s. Moreover, there is a high percentage of wage and salary employment in construction--consistently above 90 percent. By providing substantial employment for unskilled workers, the sector has probably contributed to a more equal size distribution of income. But as we

have already seen, there has been a concentration of investment activity in Manila and Central Luzon so the contribution of construction to a more equal regional distribution of income has probably been rather limited. Another important characteristic of the industry is that it is comprised of a large number of small contractors. Among a group of 1,109 contractors licensed in the Philippines in 1972, some 870 of them (almost 80 percent) had a net worth of less than ₱ 500,000 and 450 had a net worth of less than ₱ 50,000. Only one contractor had a net worth of more than ₱ 100 million.

The Potential Contribution of Construction to Employment

8.76 With an acceleration in the investment program along the lines proposed in this report, the construction sector could play a major role in employment creation in the decade ahead. Its precise impact will depend on the extent to which the productivity of construction labor rises, which, in turn, depends largely on the techniques used in construction. The Mission believes that the proposed investment program could result in an increase in employment in construction of about 10 percent a year during 1975-85.

8.77 As Table 8.9 indicates, a substantial part of the increase could be expected to come from the proposed public infrastructure program and from an expansion of investment in housing. It is estimated that ₱ 1,000 (at 1967 prices) spent on Government infrastructure created between 40 and 50 man-days of work during 1967-72, although there was a downward trend over this period. 1/ Because of the increasing relative importance of investments in power equipment, this decline may continue to about 20 man-days by 1985, but even so the proposed public investment program would account for an average of 25,000 new jobs a year during 1975-85. Employment on public works projects would rise to an estimated 350,000 by 1985. In the case of housing, the Mission estimates that employment in residential construction could rise from the present level of 100,000 to about 250,000 by 1985. Assuming a somewhat slower growth in employment on other kinds of construction activity in the private sector, the Mission estimates that total employment in construction could rise to about 1 million workers by 1985, compared to about 400,000 at present. By 1985 the sector could be absorbing 15 percent of new entrants into the labor force, which would be a major contribution to employment creation. Employment could be somewhat higher with the use of labor-intensive techniques, particularly in the sectors with significant earth-moving components, such as highways, irrigation, and flood control.

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1/ ILO, Sharing in Development. See especially Chapter 6.

Table 8.8. Projected Employment in the Construction Sector
(In thousands of persons)

| Sector | 1975 | 1980 | 1985 |
|---|---|---|---|
| Public infrastructure | 100 | 180 | 350 |
| Housing | 100 | 150 | 250 |
| Other private construction | 200 | 300 | 400 |
| Total | 400 | 630 | 1,000 |

Note: For public infrastructure and housing, the projection is based on the estimate in the ILO report, Sharing in Development, pp. 198-202, that, at 1967 prices, ₱ 1,000 expended on public infrastructure created approximately 25 man-days of employment. Dividing this ratio into actual expenditures of public infrastructure and housing in 1975 gave the base 1975 employment estimates of 100,000 in public infrastructure and 100,000 in housing. Because of the increase in the relative importance of power expenditures in future public investment, and hence a larger equipment as opposed to construction component on average, this man-day ratio was projected to drop to 20 by 1985 for public infrastructure. For housing, it was assumed to remain at about 25 man-days per ₱ 1,000 expended.

Source: Mission estimate.

8.78 Scope for Labor-intensive Techniques: The Government has demonstrated considerable interest in the possibility of using labor-intensive techniques and in 1972 established a committee in the Department of Public Works, Transportation, and Communication to undertake studies in the use of labor in public works to help solve the problem of unemployment. The Government supported extensive use of labor-intensive techniques on some projects and has issued guidelines on the construction of feeder roads requiring that, as far as possible, preference be given to such techniques. Further, a draft presidential decree on the use of labor-intensive methods is being considered. It would propose that labor-intensive methods be used whenever the structural integrity of the project is not impaired, its financial cost does not increase by more than 10 percent over capital-intensive methods, and employment of workers for labor-intensive operations will not significantly detract from the labor required for agricultural production.

8.79 Aside from this formal support, two significant pilot projects on labor-intensive techniques have been undertaken. In 1972, the Bureau of Public Works, with the assistance of the ILO, undertook a pilot project on the construction of levees by labor-intensive methods. This was a relatively small project based on the reconstruction of about 750 meters of flood control levees which were washed out during the floods of 1972. The study concluded that labor-intensive techniques could compete on favorable terms with traditional capital-intensive methods, and, as a result, the Committee studying labor-intensive projects endorsed a manual for the construction of levees by labor-intensive methods.

8.80 More recently, a pilot project on the construction of a road using labor-intensive techniques was undertaken, this project involved field experiments on the Capas-Botolan pilot road project. The project was carried out in collaboration with the ILO and involved comparing capital-intensive techniques to both traditional and modified labor-intensive techniques. 1/ This was done at both market prices and shadow prices. A basic conclusion of the study was that the modified labor-intensive methods had an overall lower cost (using market prices) and yet it generated substantially more employment than did construction by capital-intensive methods commonly used in the Philippines. 2/ The results of the Capas-Botolan road project were adjusted to give a similar conclusion for an average gravel road in the Philippines. In applying shadow prices to labor and equipment, it was also found that the modified labor-intensive method was cheaper than the capital-intensive one both for the Capas-Botolan road and for the average gravel road. This was true for the two alternatives employed - high shadow wage/low equipment rental and low shadow wage/high equipment rental--although the superiority of the modified labor-intensive technique is greater in the low wage alternative. The results of these two studies are summarized in Table 8.10.

8.81 Based on these results, the study concluded that it is possible to devise technically efficient labor-intensive techniques (at least for certain tasks) for gravel road construction in the Philippines. The findings are encouraging, and the Mission believes that the Government should proceed in making use of them in order to ensure that labor is employed effectively. However, there are some special problems that Government should keep in mind in this regard. Results of experimental work often make labor-intensive techniques appear more promising than they actually are when applied in actual production conditions for an extended period of time. 3/

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1/ The project and its results are discussed in detail in Deepak Lal, Men or Machines: Philippine Case Study of Labour/Capital Substitution in Road Construction.

2/ Based on an extrapolation of experimental productivity rates gathered during actual field observations of the project over a six month period.

3/ This has been an observation made by the World Bank in its study on the substitution of labor and equipment in civil construction.

An important reason is that the management and supervision of large labor forces require special skills, experience, and organization quite different from those needed in equipment-intensive operations. In a country where these methods have not been commonly practiced, large-scale implementation of civil works by labor-intensive methods without careful advance planning, organization, and training could render these techniques quite inefficient. 1/

8.82 Another possible problem is that in the large-scale implementation of such techniques, there are frequently shortages of labor at different times and places, even in labor-abundant countries, and that the social cost of labor fluctuates widely with season and location. Unless construction authorities are prepared to pay higher wages during peak periods (e.g., the harvest season), projects may suffer costly interruptions. 2/ In addition, although it has not been possible to quantify the costs, there are indications that with larger labor-intensive projects the cost of management may increase more than proportionately with project size. 3/ Thus, while the results of the pilot studies undertaken in the Philippines have been encouraging, there remain important questions as to their efficiency when applied on a large scale. Perhaps the most appropriate next step would be an attempt to apply these results to a large project in actual production conditions with careful attention to developing suitable project organization, including the supervision and management structure, for the construction units. 4/

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1/ The World Bank found in studies in India and Indonesia, for instance, that good supervision was associated with productivities from 33 to 125 percent higher than those with fair supervision. See "Study of the Substitution of Labor and Equipment in Civil Construction: Phase II, Final Report," World Bank Staff Working Paper No. 172 (January 1974).

2/ In particular, the World Bank study found that the supply price of labor increases where large labor forces are required. Large projects call for supplies of labor from points beyond the local market. Even in abundant labor economies, this labor can only be obtained by paying prices high enough to cover the additional costs of transportation and, in some cases, to cover the cost of on-site housing.

3/ Thus, one conclusion of the World Bank study is that labor-intensive methods suffer from diseconomies of scale as project size increases.

4/ A possible model for such a project is the Kenyan Rural Access Roads Program, in which the ILO and World Bank are helping to implement labor-intensive techniques.

Table 8.10 Comparison of Employment Effect and Costs Between Labor and Capital-Intensive Road Building Techniques

| Item | Evaluated at Market Prices | | Evaluated at Shadow Prices | |
|---|---|---|---|---|
| | Labor-Intensive | Capital-Intensive | Labor-Intensive | Capital-Intensive |
| **Capas-Botolan Road** | | | | |
| Man-days per km. | 10,224 | 1,491 | 10,224 | 1,491 |
| Total cost per km. (in thousands of pesos) | 176 | 209 | -- | -- |
| With low wage/high rental | -- | -- | 633 | 1,377 |
| With high wage/low rental | -- | -- | 813 | 1,082 |
| **Average Philippine Gravel Roads** | | | | |
| Man-days per km. | 5,639 | 674 | 5,639 | 674 |
| Total cost per km. (in thousands of pesos) | 101 | 119 | -- | -- |
| With low wage/high rental | -- | -- | 62 | 131 |
| With high wage/low rental | -- | -- | 78 | 102 |

Source: Deepak Lal, Men or Machines: Philippine Case Study of Labour Capital Substitution in Road Construction, (Geneva: International Labor Office, 1974, forthcoming).

8.83 While there are difficulties and unresolved problems in any attempt to employ more labor in construction, these difficulties should not be allowed to weaken efforts in this area. The potential benefits of greater use of labor-intensive techniques require, if anything, an intensification of efforts to determine effective ways of employing more labor in public construction. 1/

1/ The ILO estimated that use of labor-intensive techniques could add some 49 million man-days or 200,000 jobs during 1974-77, an amount equal to present employment in public construction. While this estimate appears somewhat exaggerated, it does show that even if employment creation is much less it could still be significant. See ILO, Sharing in Development, p. 210.

Measures to Promote the Construction Industry

8.84 If the proposed investment program were to be carried out, value added in the construction sector would grow by an average of about 12 percent a year during 1975-85. Such rapid growth may impose considerable strains on the sector, and in order that it does not become a bottleneck in implementing the programs, measures may be needed from time to time to ensure that the capacity of the domestic construction industry does expand adequately.

8.85 It is clear that there will be a growing number of individually large construction projects in both the public and private sectors in the future. These will call for a growing number of contractors capable of undertaking such large projects. At the present time, there are very few large domestic construction firms in the Philippines, and, in the past, large projects like the Upper Pampanga Dam and the Nonoc Island Nickel Project have been built by consortia of relatively small local contractors. With a growing number of large projects, this formula may not work so well in the future, and if the domestic construction industry is to compete successfully against large overseas firms, measures may be needed to ensure adequate growth of the local industry.

## Technical Note I

### Summary of Incentives under the Investment Incentives Act and Export Incentives Act as Amended by Presidential Decrees 92 and 485

| | Export Incentives Act | | | Investment Incentives Act | | |
|---|---|---|---|---|---|---|
| | | | | Filipino-owned | | Foreign-owned |
| | Export Producer | Export Trader | Service Exporter | Pioneer | Non-Pioneer | Pioneer |
| A. Rights & Guarantees to Registered Enterprises | | | | | | |
| 1. Basic rights and guarantees under the Constitution | X | X | X | X | X | X |
| 2. Right to repatriate investments and remit earnings* | X | X | X | X | X | X |
| 3. Right to remit foreign exchange to service foreign loans and obligations arising from technological assistance contracts* | X | X | X | X | X | X |
| 4. Freedom from expropriation of investment | X | X | X | X | X | X |
| 5. Freedom from requisition of investment, except in event of war or national emergency and only for the duration thereof | X | X | X | X | X | X |

| | Export Incentives Act | | | Investment Incentives Act | | |
|---|---|---|---|---|---|---|
| | | | | Filipino-owned | | Foreign-owned |
| | Export Producer | Export Trader | Service Exporter | Pioneer | Non-Pioneer | Pioneer |
| B. Incentives to Registered Enterprises | | | | | | |
| 1. Deduction of organizational and pre-operational expenses from taxable income over a period of not more than 10 years from start of operation | | | | X | X | X |
| 2. Deduction of labor training expenses from taxable income equivalent to 1/2% of expenses but not more than 10% of direct labor wage | X(5) | | | X | X | X |
| 3. Accelerated depreciation | | | | X | X | X |
| 4. Carry-over as deduction from taxable income of net operating losses incurred in any of the first 10 years immediately following the year of such loss | X(3) | X(3) | | X | X | X |
| 5. Exemption from tariff duties and compensating tax on importations of machinery, equipment and spare parts | X(5)(10)(11) | | X(6) | X(11) | X(10) | X(11) |
| 6. Tax credit equivalent to 100% of the value of compensating tax & customs duties that would have been paid on machinery, equipment and spare parts (purchased from a domestic manufacturer), had these items been imported | X(5) | | X(6) | X | X | X |
| 7. Tax credit for tax withheld on interest payments on foreign loans provided such credit is not enjoyed by lender-remittee in his country and registered enterprise has assumed liability for tax payment | | | | X | X | X |
| 8. Right to employ foreign nationals in supervisory technical or advisory positions within five years from registration | X | | | X | X | X |
| 9. Deduction from taxable income in the year reinvestment was made of a certain percentage of the amount of undistributed profits or surplus transferred to capital stock for procurement of machinery and equipment and other expansion | X(5) | | | X | X | X |
| 10. Anti-dumping protection | X(5) | | | X | X | X |
| 11. Protection from government competition | X(5) | | | X | X | X |

| | Export Incentives Act | | | Investment Incentives Act | | |
|---|---|---|---|---|---|---|
| | | | | Filipino-owned | | Foreign-owned |
| | Export Producer | Export Trader | Service Exporter | Pioneer | Non Pioneer | Pioneer |
| 12. Exemption from all taxes under the National Internal Revenue Code, except income tax on a gradually diminishing percentage | X(2) | | | X | | X |
| 13. Post-operative tariff protection | X(2) | | | X | | X |
| 14. Tax credits equivalent to sales, compensating and specific taxes and duties on supplies, raw materials and semi-manufactured products used in the manufacture, processing or production of export products | X | X | X(1) | X | X | X |
| 15. Additional deduction from taxable income of direct labor cost and local raw materials utilized in the manufacture of export products but not exceeding 25% of total export revenues for producers, 10% for traders and 50% for service exporters | X(7) | X | X | X(9) | X(9) | X(9) |
| 16. Preference in grant of government loans | X(5)(12) | X(12) | X(12) | X | X | |
| 17. Employment of foreign nationals within five years from operation or even after said period in exceptional cases | X(2) | | | X | | X |
| 18. Exemption from export and stabilization taxes | X | X | | | | |
| 19. Additional deduction from taxable income of 10% of incremental export sales | X(3)(4) | X(3)(4) | | | | |
| 20. Additional incentives whenever processing or manufacturing plant is located in an area designated by BOI as necessary for proper dispersal of industry or which is deficient in infrastructures, public utilities and other facilities. | X(8) | | | | | |

| | Export Incentives Act | | | | | | Investment Incentives Act | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Filipino | | | Foreign | | | Filipino | | Foreign | |
| | Export Producer | Export Trader | Service Exp. | Export Prod. | Export Trader | Service Exp. | Pioneer | Non-Pioneer | Pioneer | Non-Pioneer |
| C. Incentives to Investors | | | | | | | | | | |
| 1. Basic rights and guarantees | X | X | X | X | X | X | X | X | X | X |

| | Export Incentives Act | | | | | | Investment Incentives Act | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Filipino | | | Foreign | | | Filipino | | Foreign | |
| | Export Producer | Export Trader | Service Exp. | Export Producer | Export Trader | Service Exporter | Pioneer | Non-Pioneer | Pioneer | Non-Pioneer |
| 2. Right to repatriate investments and remit earnings* | X | X | X | X | X | X | X | X | X | X |
| 3. Freedom from expropriation of investments | X | X | X | X | X | X | X | X | X | X |
| 4. Freedom from requisition of investments | X | X | X | X | X | X | X | X | X | X |
| 5. Protection of patents and other proprietary rights | X | X | X | X | X | X | X | X | X | X |
| 6. Exemption from capital gains tax on disposition of capital assets provided proceeds of sales are invested in new issues of capital stock of a registered enterprise within six months from the date gains were realized | X(13) | X | X | X | X | X | X | X | X(13) | X |
| 7. Tax allowance to the extent of actual investment but not to exceed 10% of taxable income | X(2) | | | | | | X | | | |
| 8. Tax exemption on sale of stock dividends provided sale occurs within 7 years from date of registration | X(2) | | | | | | X | | | |
| 9. Preference in grant of GSIS and SSS loans for purchase of shares (for members only) | X(5) | | | | | | X | X | | |

*Subject to Central Bank regulations.

(1) Applicable to service exporters producing and exporting television and motion pictures or musical recordings.
(2) Provided registered export producer is engaged in a pioneer area.
(3) Applicable whenever a registered export producer or export trader shall use a brand name for an export product that distinguishes it from products produced outside the Philippines.
(4) Applicable whenever financial assistance is extended by export trader to export producers in an amount equivalent to not less than 20% of export trader's export sales during the year.
(5) Applicable only to all projects for expansion under List A of the EPP and to both pioneer and non-pioneer projects under List B.
(6) Same as No. (1) but limited to expansion projects only and to service exporters catering primarily to foreign tourists.
(7) Applicable to all registered export producers, except foreign firms exporting 70% of their productions.
(8) Additional incentives consist of using an amount equivalent to double the export producer's direct labor cost in applying the reduced income tax formula and/or tax credit on infrastructure.
(9) In the case of traditional export, local raw material component is not included in the computation of said deduction.
(10) Applicable to new and expanding non-pioneer projects with total assets not exceeding ₱500,000 for the first two years of commercial operation. Non-pioneer projects with assets exceeding said amount and expanding non-pioneer projects with less than 20% return on equity are entitled only to reduced tariff and compensating tax, on a deferred payment basis for a period not exceeding 10 years. Expanding non-pioneer projects with 20% or greater return on equity shall be entitled to mere deferment of taxes and duties without any reduction thereof.
(11) Applicable to new or expanding pioneer projects with less than 20% return on equity. Expanding pioneer projects with 20% or greater return on equity and existing pioneer projects desiring to replace and modernize their facilities are entitled to mere deferment of taxes and duties without any reduction thereof.
(12) Applicable to enterprises at least 60 per cent Filipino-owned.
(13) Exemption under Sec. 6(b) of R.A. 5186 is applicable only to Filipino investors in pioneer projects.

Source: Board of Investments, Philippine Progress, Volume VIII, Second Quarter, 1974

Chapter 9

# DOMESTIC RESOURCE MANAGEMENT

# CHAPTER 9

# DOMESTIC RESOURCE MANAGEMENT

9.01 Raising the aggregate level of investment from about 20 percent of GNP in the first half of the 1970s to about 25 percent by 1980 will require vigorous efforts to mobilize more domestic resources. The domestic savings rate will need to be about 20-23 percent, which will imply a marginal savings rate of 25-30 percent. As important as the level of savings, however, is the form of savings. Authorities should encourage savings to take place in the form of financial savings with long-term maturities in order to meet the requirements of the next decade's planned investment program, one which includes many new large projects with long gestation periods. Even after taking into account foreign financing, it is unlikely that the savings of either Government or the corporate sector will be sufficient for this program, which means that the household sector will have to generate larger surpluses. 1/ The ratio of household savings to GDP, which has hovered around 5 percent in recent years, will probably have to increase to about the 10 percent level of the mid-1960s.

9.02 As more savings flow from households to Government and the corporate sector through financial intermediaries, interest rate and credit policies will become increasingly important. The Government's role will be a critical one in ensuring that the interest rate level and structure are in line with the opportunity cost of capital in the economy and satisfy both savers and investors with rates that reflect different maturities and risks. In addition, efforts will be needed to strengthen the institutional framework of the financial system in order to enable it to undertake its increasing responsibilities. The Government, through the Central Bank, has started this process with a program to increase commercial bank capitalization. More needs to be done, however, to clarify the allocational role of each type of institution and to improve the quality and broaden the coverage of financial services. This would involve stimulating the growth of thrift banks, insurance institutions, and the rural banking system, as well as encouraging the emergence and development of stronger securities markets.

## A. Mobilization and Allocation of Savings

9.03 Aggregate domestic savings in the Philippines have generally been adequate for investment; the real constraint has been the availability of foreign exchange. Most of the domestic savings have been generated and used by the private sector for investment purposes. In the future, there will be important changes in the flow of funds among the household, corporate, Government and financial sectors. To obtain a better perspective of the major

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1/ This situation contrasts with the economic expansion of the 1960s, which was financed primarily by the internal savings of the corporate sector.

issues involved and the measures that need to be taken jointly by the Government and the private sector, it may be useful to review past trends of savings mobilization and allocation and the development of financial institutions.

Performance of Domestic Savings

9.04 Savings performance in the Philippines during the 1960s improved moderately over that of the previous decade, with a ratio of gross domestic savings to GDP averaging about 20 percent, compared to the 15 percent ratio of the 1950s. Although savings rates have been comparable to those of other countries at a similar stage of economic development, 1/ the increase in the marginal savings ratio has not been exceptional (Table 9.1). In the early 1970s, the marginal gross domestic savings ratio was 22 percent, close to the long-run marginal propensity to save of about 24 percent.

9.05 The primary determinant of domestic savings during 1951-74 was the growth of incomes (Table 9.1). Other factors, such as changes in the price of foreign exchange, have also influenced the savings rate, but statistical analysis suggests that their impact was small relative to that of income growth. The unavailability of data on incomes from wages and capital prevents an analysis of the effects of income distribution on savings performance, or the identification and the relative importance of savings units in the country. The patterns of acquisition of financial assets, however, suggest that large savers dominate the market, although the extent to which they do so is unclear.

9.06 One dimension of domestic savings behavior that is not apparent from an analysis of average savings rates is the cyclical movement of marginal saving rates (Table 9.1). Instead of a secular upward trend in the postwar

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1/ In 1972, the savings rate in the Philippines was 19.4 percent, in Colombia 19.5 percent, and in Korea 15.3 percent. Taiwan, with a long history of financial reforms, exhibited a 30.9 percent domestic savings rate.

Table 9.1. Philippines: Savings Performance, 1951-74

| Year | Gross Domestic Savings[a/] (In millions of pesos) | Rate of Growth of Real GDP (In percent) | As Share of GDP (In percent) | Annual Marginal Savings Rate (In percent) | Marginal Savings Rate[b/] (In percent) |
|---|---|---|---|---|---|
| 1951 | 962 | 10.4 | 13.4 | -3.4 | 38.6 |
| 1955 | 1,172 | 7.1 | 13.2 | -13.4 | -4.6 |
| 1960 | 2,130 | 1.9 | 16.3 | -10.2 | 20.6 |
| 1961 | 2,367 | 5.4 | 16.6 | 20.7 | 9.0 |
| 1962 | 2,665 | 4,9 | 16.6 | 16.5 | 29.4 |
| 1963 | 3,971 | 6.8 | 21.4 | 51.2 | 27.5 |
| 1964 | 4,186 | 3.0 | 20.9 | 14.9 | 32.7 |
| 1965 | 4,789 | 5.3 | 21.9 | 32.0 | 24.6 |
| 1966 | 5,437 | 5.0 | 22.4 | 27.1 | 22.6 |
| 1967 | 5,697 | 6.1 | 20.9 | 8.8 | 9.8 |
| 1968 | 5,496 | 5.6 | 18.1 | -6.6 | 2.2 |
| 1969 | 5,655 | 5.3 | 16.7 | 4.5 | 11.6 |
| 1970 | 8,408 | 6.0 | 20.4 | 37.0 | 19.8 |
| 1971 | 9.940 | 5.2 | 20.0 | 18.0 | 23.4 |
| 1972 | 10,994 | 4.5 | 19.4 | 14.9 | 14.8 |
| 1973 | 12,560 | 9.2 | 17.8 | 11.4 | 18.3 |
| 1974 | 20,487 | 5.1 | 20.9 | 28.4 | -- |

a/ Adjusted for statistical discrepancy and excluding net factor income from abroad.

b/ Three year centered moving average.

Source: National Economic and Development Authority (NEDA), National Accounts Series, April 23, 1975.

period, there has been a wide fluctuation of marginal savings rates primarily due to changes in real incomes. 1/

Characteristics of Savings and Financial Asset Holdings

9.07 In addition to the general improvement in the aggregate savings performance during the last decade, there were also significant changes in the composition of savings and financial asset holdings, especially in the early 1970s. There was an increase in gross government savings from 1 percent of GDP during the 1960s to about 4 percent in 1973, 2/ a rise in the gross acquisition of financial assets by the private sector from about 7 percent of GDP in the 1960s to 12 percent in the early 1970s, and an increase in the share of short-term financial asets to total financial assets acquired by the private sector from an average of 17 percent in the 1960s to over 40 percent by 1973-74. Most of these changes took place only during the last few years, and it is too early to determine whether these trends will continue for a longer period.

9.08 Recent increases in public sector savings, which had been quite low for a long time, illustrate the success of the recent fiscal measures discussed in Chapter 10. The growth of financial asset holdings by the private sector also reflects a higher degree of financial intermediation and improvement in the financial mechanism.

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1/ The troughs that occurred in 1955, 1961, and 1968 indicate that savings performance deteriorated almost in anticipation of foreign exchange crises. Although Government spending was the immediate cause of the foreign exchange crises, their root cause was the slow growth of the export sector and the very limited progress towards import substitution. One explanation that has been advanced is that the administration in power imported large amounts of rice before and during election years, depleting foreign reserves and precipating foreign exchange crises in the process. See John H. Power and Gerardo P. Sicat, The Philippines: Industralization and Trade Policies (London: Oxford University Press for the Organization for Economic Cooperation and Development, 1971), pp. 50-53, and, especially, H.A. Averch, et al., Matrix of Policy in the Philippines, Rand Corporation Research Study (Princeton: Princeton University Press, 1972), chap 5.

2/ These figures refer to gross public savings. Gross general government savings were calculated as the sum of general government savings (net general government savings) estimated from budget sources (see Chapter 10) and imputed general government capital consumption allowances. The latter were derived by applying the share of general government in total fixed capital formation in a particular year to the total capital consumption allowances in that year.

9.09 The first reason for these important changes was the improvement in Government savings that resulted in large part from the major tax reforms undertaken after 1972. Government savings averaged over 12 percent of gross domestic savings in the 1950s. As real income growth slowed down in the 1960s, the ratio of Government tax receipts to GDP levelled off and the savings performance of the public sector deteriorated, with savings of the Government accounting for less than 10 percent of total savings. This situation persisted into the early 1970s. However, after the enactment of the tax reforms, Government savings increased to about 25 percent of the (largely unchanged) total and the share of private savings declined correspondingly, particularly in 1973, when the large tax collections resulting from the tax amnesty program apparently caused a substantial transfer of savings to the Government from households and from unincorporated enterprises. Private sector savings averaged around 19 percent of GDP in the 1960-72 period, but only about 15 percent in 1973 and 1974 (Table 9.2).

9.10 Second, holdings of financial assets (unadjusted for liabilities) by the private sector increased significantly in the 1970s, especially after 1972. They rose from about 7 percent of GDP in the 1960s to 12 percent in 1973-74 (Table 9.3). The immediate reason for this rapid growth was a substantial generation of incomes in the booming export sector, which created a large supply of liquid resources seeking quick investment with good returns. The preference for direct holdings of tangible assets 1/ by the private sector in the 1960s was due both to declining real yields on financial assets (Table 9.5), and to increasing opportunities for direct investments. For example, corporate incomes were absorbed into fixed capital and transportation equipment as a result of very liberal fiscal incentives; household incomes were used for residential construction, automotive equipment, and purchases of consumer durables. These interrelated developments - attractive real investment opportunities within the household and corporate sectors and unattractive yields on financial assets - meant that surpluses generated by each sector were generally used in that sector rather than channeled to financial markets either for investment opportunities or for financing requirements.

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1/ Tangible assets consist of earnings and depreciation reserves reinvested in fixed capital and inventories by corporations and unincorporated enterprises, residential construction, purchase of consumer durables, and nonmonetized agricultural improvements by households. Because disaggregated flow of funds accounts do not exist, the analysis is based on the Mission's preliminary findings and may be considered indicative rather than definitive.

Table 9.2. Sectoral Composition of Gross Domestic Savings as a Percentage of GDP

| Year | Gross Domestic Savings (Millions of pesos) | Gross Domestic Savings[a/] (Percentage) | Gross General Government Savings | General Government Capital Consumption[b/] | Net General Government Savings[c/] | Gross Private Savings | Private Capital Consumption | Corporate Savings[d/] | Household Savings |
|---|---|---|---|---|---|---|---|---|---|
| 1960 | 2,130 | 16.4 | 2.0 | 0.8 | 1.2 | 14.1 | 5.1 | 3.6 | 5.4 |
| 1961 | 2,367 | 16.6 | 3.1 | 0.9 | 2.2 | 13.5 | 5.4 | 2.4 | 5.7 |
| 1962 | 2,665 | 16.7 | 2.1 | 1.0 | 1.1 | 14.6 | 5.8 | 3.3 | 5.5 |
| 1963 | 3,971 | 21.4 | 1.8 | 1.0 | 0.8 | 19.6 | 6.3 | 3.3 | 10.0 |
| 1964 | 4,186 | 20.8 | 0.3 | 0.7 | -0.4 | 20.5 | 7.0 | 3.3 | 10.2 |
| 1965 | 4,789 | 21.8 | 0.3 | 0.9 | -0.6 | 21.5 | 7.3 | 2.4 | 11.8 |
| 1966 | 5,467 | 22.3 | -0.9 | 1.0 | -1.9 | 23.2 | 7.3 | 3.6 | 12.3 |
| 1967 | 5,697 | 21.0 | 0.9 | 1.0 | -0.1 | 20.1 | 7.3 | 4.0 | 8.8 |
| 1968 | 5,496 | 18/1 | 0.5 | 1.0 | -0.5 | 17.6 | 7.6 | 4.7 | 5.3 |
| 1969 | 5,655 | 16.7 | 0.1 | 1.5 | -1.4 | 16.6 | 7.6 | 3.5 | 5.5 |
| 1970 | 8,408 | 20.4 | -0.4 | 0.8 | -1.2 | 20.8 | 9.3 | 5.3 | 6.2 |
| 1971 | 9.940 | 20.1 | 1.5 | 1.1 | 0.4 | 18.6 | 9.8 | 3.6 | 5.2 |
| 1972 | 10,994 | 19.4 | 1.2 | 1.4 | -0.2 | 18.2 | 9.8 | 3.1 | 5.3 |
| 1973 | 12,560 | 17.8 | 3.7 | 1.4 | 2.3 | 14.1 | 9.3 | 1.8 | 3.0 |
| 1974 | 20,487 | 20.9 | 5.3 | 1.9 | 3.4 | 15.6 | 8.9 | 0.8 | 5.9 |

a/ Adjusted for statistical discrepancy and excluding net factor income payments from abroad
b/ Assumed proportional to the share of Government in gross fixed capital formation during the current year.
c/ Table 10.1, Chapter 10.
d/ Excluding net factor income payments from abroad.
e/ Residual representing savings of households and unincorporated enterprises.

Source: NEDA, National Accounts Series, April 23, 1975

Table 9.3 Changes in Gross Financial Assets

| Year | Financial Assets (In million of pesos) | Percentage of Gross Domestic Product |
|---|---|---|
| 1955 | 305 | 3.4 |
| 1961 | 1,078 | 7.5 |
| 1962 | 1,113 | 7.0 |
| 1963 | 1,559 | 8.3 |
| 1964 | 736 | 3.7 |
| 1965 | 1,404 | 6.5 |
| 1966 | 2,069 | 8.5 |
| 1967 | 2,584 | 9.4 |
| 1968 | 1,984 | 6.6 |
| 1969 | 2,936 | 8.7 |
| 1970 | 2,965 | 7.2 |
| 1971 | 3,811 | 7.7 |
| 1972 | 4,688 | 8.3 |
| 1973 | 8,653 | 12.3 |
| 1974 | 12,100 | 12.3 |

Source: Tables 9.1 and 9.4.

9.11 This pattern apparently changed in the 1970s as attractive opportunities for direct intrasector tangible investments declined and as attractive yields on short-term financial instruments outside the traditional banking system 1/ became more readily available. These instruments were able to absorb the excess liquidity generated in the economy as a result of windfall incomes in the external sector, in large part, because the instruments were free of the deposit rate ceilings that governed the banking system The rapid growth of these financial assets in this period was encouraged and facilitated by the emergence and growth of nonbank financial institutions such as investment houses, finance companies, and securities dealers and brokers, which very rapidly began to offer a wider variety of instruments and savings features than was previously available. These innovations appear to have effectively conterbalanced the substantially negative real yields on bank deposits in the 1970s. Consequently, more intersector flows occurred than previously, with more corporate investments being financed from sources external to the sector.

1/ These instruments, generally referred to as "deposit substitutes," comprise the unregulated money market in the Philippines and include promissory notes, repurchase agreements, participation certificates, interbank loans, and commercial paper.

9.12 Third, the shift in financial assets from longer to shorter maturities that occurred in the 1970s is a particularly noteworthy aspect of the increase in gross financial assets of the private sector. It represents an important policy issue for the second half of the 1970s in view of the long-term finance needs of the projects planned. From a 17 percent share of gross financial assets acquired in the 1960-70 period, the share of short-term financial assets (currency, demand deposits, and deposit substitutes issued by banks and quasi-banks) consistently rose and accounted for over half of all financial assets acquired in 1973-74 (Table 9.4). In fact, at the end of 1974, gains in lengthening maturities of private financial asset holdings that had begun in the 1960s were somewhat reversed. Although long-term financial assets also grew during the 1970s, their growth was at a much slower rate, and, as a result, their share in total financial assets actually fell.

9.13 The preponderance of short-term financial flows resulted in weaker corporate financial positions because the roll-over of short-term debt could not be assured. Thus, corporations financing projects with long gestation periods with short-term debt tended to be pressed for funds in periods of tight credit. More important, the general shift in preferences of the private sector for shorter-maturing assets in recent years impeded the further development of savings intermediaries and markets. With the supply and cost of short-term funds becoming volatile, the financial institutions - especially commercial banks - found it difficult to extend longer term credits, a practice already constrained by certain regulatory and administrative factors.

9.14 The lack of sufficiently attractive long-term investment opportunities in the economy resulted from the excess capacity that developed in several key import-substituting and export industries (particularly textiles, cement, sugar refining, and milling) in the 1960s and a levelling off of the investment demand. Furthermore, the substantial peso devaluation in 1970 made imported capital goods more expensive in peso terms and reduced investment demand in the early 1970s. In the last two years, the combination of rapid inflation, fixed low rates on savings and time deposits, tax and institutional impediments to the placement and acquisition of longer-term securities, and the traditionally low rates of return on life insurance, diminished demand for long-term instruments relative to short-term assets.

9.15 The interest in short-term assets grew with the emergence of the money market as a significant mobilizer and allocator of short-term funds. Money market rates were not subject to the controls applied to the banking system. As a result, funds were retained in the Philippines and within the formal financial system. Alternatives to the money market included the unorganized credit markets, overseas deposits, or increased consumption, which, in any case, would have meant sub-optimal utilization of funds. Even though the money market may have created distortions in savings patterns and institutional development, it has played a vital role in the last few years in mobilizing a larger share of incomes in the form of financial assets.

Table 9.4 Changes in Gross Financial Assets of the Private Sector
(In millions of pesos and percentages)

| Year | Currency[a/] (1) | Demand Deposits[b/] (2) | Deposit Substitutes[c/] (3) | Total Short-term Assets (4)=(1)+(2)+(3) | Savings, Time, and Other Deposits[d/] (5) | Life Insurance[e/] (6) | Government Securities[f/] (7) | Corporate Bonds[g/] (8) | Corporate Stocks[h/] (9) | Investments in Unincorporated Enterprises (10) | Subtotal (11)=(5+6+7+8+9+10) | Total Financial Savings (12)=(4+11) | GNP Deflator (13) | Real Short-Term Savings (14) | Real Long-Term Savings (15) | Real Total Financial Savings (16) |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | Millions of pesos | | | | | | | | |
| 1951 | -30 | -93 | ... | -123 | -1 | 12 | 4 | ... | 34 | 146 | 195 | 72 | 64.3 | -191 | 303 | 112 |
| 1955 | - 9 | 35 | ... | 26 | 123 | 18 | 24 | ... | 28 | 86 | 279 | 305 | 59.9 | 43 | 466 | 509 |
| 1961 | 97 | 95 | ... | 192 | 336 | 175 | 27 | ... | 241 | 107 | 886 | 1,078 | 70.7 | 272 | 1,253 | 1,525 |
| 1962 | 123 | 90 | ... | 213 | 331 | 175 | 43 | 6 | 172 | 173 | 900 | 1,113 | 75.8 | 281 | 1,187 | 1,468 |
| 1963 | 190 | 207 | ... | 397 | 457 | 214 | 49 | 6 | 239 | 197 | 1,162 | 1,559 | 82.3 | 482 | 1,412 | 1,894 |
| 1964 | -38 | -63 | ... | -101 | 221 | 120 | 40 | 6 | 243 | 207 | 837 | 736 | 86.1 | -117 | 972 | 855 |
| 1965 | 158 | 84 | 123 | 365 | 119 | 279 | 77 | 74 | 286 | 204 | 1,039 | 1,404 | 89.5 | 408 | 1,161 | 1,569 |
| 1966 | 60 | 203 | 12 | 275 | 835 | 283 | 37 | 52 | 353 | 234 | 1,794 | 2,069 | 94.5 | 291 | 1,898 | 2,189 |
| 1967 | 213 | 179 | 39 | 431 | 843 | 321 | 94 | 267 | 404 | 224 | 2,153 | 2,584 | 100.0 | 431 | 2,153 | 2,584 |
| 1968 | 22 | 80 | 154 | 256 | 342 | 379 | 104 | 151 | 498 | 254 | 1,728 | 1,984 | 105.3 | 243 | 1,641 | 1,884 |
| 1969 | 341 | 439 | -14 | 766 | 584 | 393 | 236 | 226 | 504 | 227 | 2,170 | 2,936 | 111.5 | 687 | 1,946 | 2,633 |
| 1970 | 291 | 76 | 255 | 622 | 777 | 442 | 322 | -42 | 616 | 228 | 2,343 | 2,965 | 127.7 | 487 | 1,835 | 2,322 |
| 1971 | 240 | 365 | 423 | 1,028 | 913 | 507 | 145 | 87 | 660 | 471 | 2,783 | 3,811 | 146.6 | 701 | 1,899 | 2,600 |
| 1972 | 785 | 457 | 308 | 1,550 | 302 | 573 | 1,117 | 38 | 779 | 329 | 3,138 | 4,688 | 159.9 | 969 | 1,963 | 2,932 |
| 1973 | 17 | 1,117 | 2,946 | 4,080 | 1,986 | 698 | -129 | 444 | 938 | 636 | 4,573 | 8,653 | 182.3 | 2,238 | 2,846 | 4,747 |
| 1974 | 859 | 912 | 3,224 | 4,995 | 1,901 | 749 | 1,476 | -138 | 2,321 | 796 | 7,105 | 12,100 | 243.3 | 2,952 | 2,921 | 4,973 |
| | | | | | | | | Percentage Composition | | | | | | | | |
| 1951 | -41.7 | -129.2 | ... | -170.9 | -1.4 | 16.7 | 5.6 | ... | 47.2 | 202.8 | 270.9 | 100.0 | | | | |
| 1955 | -3.0 | 11.5 | ... | 8.5 | 40.3 | 5.9 | 7.9 | ... | 9.2 | 28.2 | 91.5 | 100.0 | | | | |
| 1961 | 9.0 | 8.8 | ... | 17.8 | 31.2 | 16.2 | 2.5 | ... | 22.4 | 9.9 | 82.2 | 100.0 | | | | |
| 1962 | 11.1 | 8.1 | ... | 19.7 | 29.7 | 15.7 | 3.9 | 0.5 | 15.5 | 15.5 | 80.3 | 100.0 | | | | |
| 1963 | 12.2 | 13.3 | ... | 25.5 | 29.3 | 13.7 | 3.1 | 0.4 | 15.3 | 12.6 | 74.5 | 100.0 | | | | |
| 1964 | -5.2 | -8.6 | ... | -13.8 | 30.0 | 16.3 | 5.4 | 0.8 | 33.0 | 28.1 | 113.8 | 100.0 | | | | |
| 1965 | 11.3 | 6.0 | 8.8 | 26.1 | 8.5 | 19.9 | 5.5 | 5.3 | 20.4 | 14.5 | 73.9 | 100.0 | | | | |
| 1966 | 2.9 | 9.8 | 0.6 | 13.3 | 40.4 | 13.7 | 1.8 | 2.5 | 17.1 | 11.3 | 86.7 | 100.0 | | | | |
| 1967 | 8.2 | 6.9 | 1.5 | 16.6 | 32.6 | 12.4 | 3.6 | 10.3 | 15.6 | 8.7 | 83.4 | 100.0 | | | | |
| 1968 | 1.1 | 4.0 | 7.8 | 12.9 | 17.2 | 19.1 | 5.2 | 7.6 | 25.1 | 12.8 | 87.1 | 100.0 | | | | |
| 1969 | 11.6 | 15.0 | -0.5 | 26.1 | 19.9 | 13.4 | 8.0 | 7.7 | 17.2 | 7.7 | 73.9 | 100.0 | | | | |
| 1970 | 9.8 | 2.6 | 8.6 | 21.0 | 26.2 | 14.9 | 10.9 | -1.4 | 20.8 | 7.7 | 79.0 | 100.0 | | | | |
| 1971 | 6.3 | 9.6 | 11.1 | 27.0 | 24.0 | 13.3 | 3.8 | 2.3 | 17.3 | 12.4 | 73.0 | 100.0 | | | | |
| 1972 | 16.7 | 9.7 | 6.6 | 33.0 | 6.4 | 12.2 | 23.8 | 0.8 | 16.6 | 7.0 | 67.0 | 100.0 | | | | |
| 1973 | 0.2 | 12.9 | 34.0 | 47.1 | 23.0 | 8.1 | -1.5 | 5.1 | 10.8 | 7.4 | 52.9 | 100.0 | | | | |
| 1974 | 7.1 | 7.5 | 26.6 | 41.2 | 15.7 | 6.2 | 12.2 | -1.1 | 19.2 | 6.6 | 58.8 | 100.0 | | | | |

a/ Defined as currency in circulation, i.e., currency issue minus inactive cash. Source: Table 2, Central Bank Statistical Bulletin (CBSB), various issues.

b/ Demand deposits of private businesses and individuals. Source: Table 2, CBSB.

c/ Figures prior to 1971 were estimated by assuming that the importance of deposit substitutes increased gradually from 1965 - the year when bills of the Bureau of Agricultural Economics were first issued - to 1971 when they accounted for 33.1 percent of total other net liabilities of the banking system. The step functions applied were 1965-67, 10 percent; 1968-69, 15 percent; 1970, 20 percent.

d/ Consists of time and savings deposits in commercial banks which are viewed as elements of quasi-money; time and savings deposits in rural banks, savings banks, postal savings banks and savings and loan associations and capital accounts in mutual building and loan associations. Source: Tables 5, 51-53, CBSB, and CB.

e/ Consists of legal reserves of private life insurance companies operating in the Philippines (domestic and foreign) and technical reserves of the Social Security System (SSS) and the Government Service Insurance System (GSIS) Source: Office of the Insurance Commissioner.

f/ Holdings of trust operations and the nonfinancial private sector. For years prior to 1957, it was assumed that the share of these two groups in the total was the same as in 1957. Source: Table 85, CBSG; for years prior to 1957, Table 86, CBSB, but excluding issues of local governments and CB and PNB.

g/ Peso-denominated bonds only. Source: Securities and Exchange Commission.

h/ Net holdings. Source: Central Bank and NEDA

9.16 In 1974, in response to tight market conditions and in recognition of the high rates in the nonregulated money market, interest rates on savings and time deposits, which ranged from 5 to 9.5 percent, were increased by one to two percentage points to 6 and 11.5 percent; administrative ceilings were lifted on time deposits with maturities of over two years, and savings banks paid 14.5 percent on these deposits. Nevertheless, high rates of inflation rendered real deposit yields more negative than they had ever been in the 1956-1974 period (Table 9.5), unregulated money market rates, in some cases had risen to levels of well over 30 percent on an annual basis in 1973 and 1974, and the growth of these latter instruments exceeded that of traditional deposits. Total short-term deposit substitutes outstanding were equal to 82 percent of total medium and long-term time and savings deposits in commercial banks and thrift institutions at the end of 1974, compared to 24 percent at the end of 1972.

Patterns of Past Credit Allocation

9.17 The historical trends of institutional credit allocation since the 1950s reveal two important characteristics: (i) credit to the private sector averaged about 82 percent of the total during the last two decades, and (ii) the share of credit to agriculture declined steadily from 40 percent in the early 1950s to 18 percent in the early 1960s and 7 percent in 1973, while the shares of credit to the manufacturing and trade sectors rose. The growth of credit to the manufacturing and trade sectors has been partly due to the increased importance of industry in the economy. In agriculture, the sugar growers had been the main recipients of credit in the early 1950s, but they did not expand their investments further after their production reached the limits of the sugar import quota of the United States.

9.18 Most of the credit extended by all financial institutions, except the Central Bank, has gone to the private sector (Table 9.6). The patterns of allocation between the public and private sectors in the 1970s have been similar to those that prevailed in the 1950s and early 1960s. The private sector received an average of 82 percent of total institutional credit outstanding in the early 1970s, with the public sector (general government, including public enterprises) obtaining the rest. Commercial and development banks and Government nonbank financial institutions - principally the Government Service Insurance System (GSIS) and the Social Security System (SSS) - were the most important sources of credit to the private sector in the early 1970s. Total institutional credit outstanding grew at an annual rate of 6 percent; the rates of growth of credit to the private and public sectors were 5 percent and 12 percent, respectively. The faster growth of credit to the public sector was the result of substantial purchases of Government securities by financial institutions in recent years to meet reserve and portfolio composition requirements.

Table 9.5. Annual Average Nominal and Real Interest Rates for Selected Assets, 1956-74
(In percent)

| Year | Savings Deposits | | Time Deposits | | Government Securities[a] | | Deposit Substitutes[c] | |
|---|---|---|---|---|---|---|---|---|
| | Nominal | Real[b] | Nominal | Real[b] | Nominal | Real[b] | Nominal | Real[b] |
| 1956 | 2.00 | 0.60 | 2.25 | 0.80 | 4.69 | 3.25 | n.a. | n.a. |
| 1957 | 2.25 | -1.70 | 2.75 | -1.20 | 5.65 | 1.59 | n.a. | n.a. |
| 1958 | 2.25 | 0.10 | 3.25 | 1.00 | 4.83 | 2.57 | n.a. | n.a. |
| 1959 | 2.25 | -0.20 | 3.25 | 0.80 | 6.06 | 3.58 | n.a. | n.a. |
| 1960 | 3.00 | -2.10 | 3.50 | -1.60 | 7.38 | 2.07 | n.a. | n.a. |
| 1961 | 3.00 | -0.10 | 3.75 | 0.60 | 3.06 | -0.40 | n.a. | n.a. |
| 1962 | 3.00 | -3.90 | 2.75 | -3.20 | 3.40 | -3.54 | n.a. | n.a. |
| 1963 | 3.50 | -4.70 | 4.25 | -4.00 | 5.54 | -2.82 | n.a. | n.a. |
| 1964 | 3.50 | -1.10 | 4.50 | -0.10 | 5.45 | 0.81 | n.a. | n.a. |
| 1965 | 4.50 | 0.60 | 6.25 | 2.30 | 8.89 | 4.80 | n.a. | n.a. |
| 1966 | 5.75 | 0.10 | 6.25 | 0.50 | 6.69 | 0.94 | n.a. | n.a. |
| 1967 | 5.75 | 0.10 | 6.25 | 0.50 | 8.25 | 2.41 | n.a. | n.a. |
| 1968 | 5.75 | 0.40 | 6.25 | 0.90 | 9.63 | 4.11 | n.a. | n.a. |
| 1969 | 5.85 | -0.10 | 6.50 | 0.60 | 6.32 | 0.40 | n.a. | n.a. |
| 1970 | 6.00 | -7.40 | 7.00 | -6.60 | 12.17 | -2.03 | n.a. | n.a. |
| 1971 | 6.00 | -7.70 | 7.00 | -6.80 | 12.03 | -2.51 | 13.30 | -1.31 |
| 1972 | 6.00 | -2.80 | 7.00 | -1.90 | 13.49 | 4.02 | 13.90 | 4.40 |
| 1973 | 6.00 | -7.00 | 7.25 | -5.90 | 15.05 | 0.92 | 9.40 | 4.03 |
| 1974 | 6.25 | -20.40 | 10.00 | 17.60 | 16.54 | -12.72 | 31.80 | -1.27 |

a/ Yields on Government securities (which are tax free) have been recalculated on a before tax basis (at a 35 percent tax rate) to be comparable with the rest, which are fully taxable.

b/ Deflated by the rate of increase of the GNP deflator (1967 = 100.0). Interest rates shown are the average rates on new issues.

c/ Weighted average of all maturities.

Source: Central Bank Statistical Bulletins, and Report of the Inter-Agency Committee on the Study of Interest Rates, March 12, 1971.

Table 9.6. Composition of Institutional Credit Outstanding by Sector, 1965-74
(In billions of pesos)

| | 1965 | 1966 | 1967 | 1968 | 1969 | 1970 | 1971 | 1972 | 1973 | 1974 | Averages 1965-69 | Averages 1970-74 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Central Bank | | | | | | | | | | | | |
| Private | 6.0 | 6.5 | 9.4 | 9.7 | 9.0 | 6.6 | 5.7 | 5.8 | 3.7 | 7.3 | 8.1 | 5.7 |
| Public | 6.9 | 6.2 | 5.6 | 5.0 | 4.4 | 4.2 | 3.2 | 3.1 | 1.1 | 0.9 | 5.6 | 5.5 |
| Subtotal | 12.9 | 12.7 | 15.0 | 14.7 | 13.4 | 10.8 | 8.9 | 8.9 | 4.8 | 8.2 | 13.7 | 8.2 |
| Commercial Banks | | | | | | | | | | | | |
| Private | 50.9 | 47.6 | 45.0 | 41.2 | 39.6 | 42.0 | 42.8 | 43.7 | 49.0 | 48.8 | 44.9 | 45.3 |
| Public | 6.9 | 7.9 | 8.6 | 12.3 | 13.8 | 12.1 | 11.8 | 11.2 | 14.9 | 12.1 | 9.9 | 12.4 |
| Subtotal | 57.8 | 55.5 | 53.6 | 53.5 | 53.4 | 54.1 | 54.6 | 54.9 | 63.9 | 60.9 | 54.8 | 57.7 |
| Savings Banks | | | | | | | | | | | | |
| Private | 1.3 | 1.7 | 1.7 | 1.9 | 1.7 | 2.3 | 2.5 | 2.0 | 1.4 | 1.3 | 1.7 | 1.9 |
| Public | 0.2 | 0.3 | 0.4 | 0.2 | 0.7 | 0.7 | 0.6 | 0.5 | 1.0 | 0.9 | 0.4 | 0.7 |
| Subtotal | 1.5 | 2.0 | 2.1 | 2.1 | 2.4 | 3.0 | 3.1 | 2.5 | 2.4 | 2.2 | 2.1 | 2.6 |
| Rural Banks | | | | | | | | | | | | |
| Private | 2.4 | 2.6 | 2.7 | 2.7 | 2.7 | 2.8 | 3.0 | 3.0 | 3.1 | 4.1 | 2.6 | 3.2 |
| Public | 0.1 | 0.1 | 0.1 | ... | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 |
| Subtotal | 2.5 | 2.7 | 2.8 | 2.7 | 2.8 | 2.9 | 3.1 | 3.1 | 3.2 | 4.2 | 2.7 | 3.3 |
| Development Banks | | | | | | | | | | | | |
| Private | 12.6 | 12.0 | 12.4 | 12.9 | 13.8 | 15.0 | 15.3 | 14.4 | 13.1 | 11.0 | 12.7 | 13.8 |
| Public | 1.3 | 1.2 | 0.1 | 0.8 | 0.7 | 0.6 | 1.0 | 2.3 | 1.2 | 1.8 | 0.8 | 1.4 |
| Subtotal | 13.9 | 13.2 | 12.5 | 13.7 | 14.5 | 15.6 | 16.3 | 16.7 | 14.3 | 12.8 | 13.5 | 15.2 |
| Nonbank Financial Institutions | | | | | | | | | | | | |
| Private | 0.2 | 1.2 | 1.2 | 1.2 | 1.2 | 1.2 | 1.5 | 1.6 | 0.5 | 1.5 | 1.0 | 1.3 |
| Public | ... | ... | ... | ... | ... | ... | ... | ... | 0.2 | 0.4 | ... | 0.1 |
| Subtotal | 0.2 | 1.2 | 1.2 | 1.2 | 1.2 | 1.2 | 1.5 | 1.6 | 0.7 | 1.9 | 1.0 | 1.4 |
| Government Nonbank Financial Institutions | | | | | | | | | | | | |
| Private | 11.1 | 12.8 | 12.8 | 12.0 | 12.4 | 11.9 | 11.5 | 11.3 | 8.9 | 7.8 | 12.1 | 10.3 |
| Public | ... | ... | ... | 0.1 | 0.1 | 0.6 | 1.1 | 1.2 | 1.7 | 2.1 | 0.1 | 1.3 |
| Subtotal | 11.1 | 12.9 | 12.8 | 12.1 | 12.5 | 12.5 | 12.6 | 12.5 | 10.6 | 9.9 | 12.2 | 11.6 |
| Subtotal | | | | | | | | | | | | |
| Private | 84.5 | 84.4 | 85.2 | 81.6 | 80.4 | 81.8 | 82.3 | 81.8 | 79.7 | 81.8 | 83.1 | 81.5 |
| Public | 15.5 | 15.6 | 14.8 | 18.4 | 19.6 | 18.2 | 17.7 | 18.2 | 20.3 | 18.2 | 16.9 | 18.5 |
| Total | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

Source: Central Bank

9.17 Credit Allocation by Industry: 1/ The composition of credit flows (loans and credits extended but unadjusted for repayments) among the four major sectors (agriculture, manufacturing, trade, and financial institutions) has undergone fundamental changes during the past two decades, reflecting both the Government's industrial policy and the evolving structure of the financial system (Table 9.7). Clearly, the most striking feature of credit flows in the 1951-73 period was the consistent and substantial erosion of the share of agricultural credit, which declined from 40 percent in 1951 to 7 percent in 1973. Although part of the explanation lies within the agricultural sector itself, 2/ the most important reason for this decline was the Government's policy of encouraging the growth of import-substituting industries through various policy instruments, including low long-term rates of interest and preferential access to substantial amounts of financial resources. As large-scale capital and import-intensive manufacturing industries became the focal point of the industrialization strategy, the flow of domestic institutional credit to the manufacturing sector increased. 3/

9.18 Credit to the manufacturing sector rose from ₱ 91 million in 1951 to ₱ 5.7 billion in 1973 (in real terms), but the period of rapid growth was from 1955 to 1962, when real credit increased from ₱ 209 million to ₱ 2.5 billion at an annual growth rate of over 40 percent. As a share of the total, manufacturing's share in this period rose from 15 to 37 percent. Following the devaluation of the peso in 1962, the flow of domestic credit to manufacturing declined, and was only 20 percent by the end of the 1960s. It picked up

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1/ Lack of comparable and consistent data on the direction of credit granted and credit outstanding of all the institutions included in Table 9.6 prevents a comprehensive discussion of credit flows during the 1951-74 period. The analysis that follows, therefore, is based on gross flows of credit (unadjusted for repayments) from commercial, savings, and development banks to the private sector. The term "institutional credit" will refer to credit from these three classes of institutions, which together account for about three-fourths of the total credit supply. The GSIS and SSS are also important sources of finance, but a large part of their industrial financing is channelled through the Development Bank of the Philippines (DBP); consequently, omitting them from the discussion would not materially affect the conclusions and would preclude double counting.

2/ See Chapter 5.

3/ The figures, however, understate to some extent the true level of credit flows to manufacturing, since, beginning in the mid-1960s, part of the fixed capital formation in this sector has been financed by suppliers' credits from abroad guaranteed by DPB. The Mission estimates that DBP guarantees in calendar year 1973 would have amounted to ₱ 1,517 million at prevailing exchange rates. Adding this to credits granted to manufacturing raises its share in the (adjusted) total from 23 to 25 percent.

Table 9.7. Amount and Composition of Loans and Credits by Commercial Banks, Savings Banks, and Development Banks to the Private Sector by Industry[a/]

| Sector | 1951 | 1955 | 1960[b/] | 1961[b/] | 1962 | 1963 | 1964 | 1965 | 1966 | 1967 | 1968 | 1969 | 1970 | 1971 | 1972 | 1973 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | Amount (In millions of pesos) | | | | | | | | | |
| Agriculture, fisheries and forestry | 168.7 | 200.4 | 502.7 | 660.4 | 844.2 | 1,115.9 | 1,200.1 | 1,210.3 | 1,356.7 | 1,699.7 | 1,813.2 | 1,888.8 | 2,260.9 | 2,575.4 | 2,653.0 | 2,988.6 |
| Mining and quarrying ) | 58.5 | 123.2 | 36.7 | 51.2 | 59.9 | 60.3 | 85.6 | 51.4 | 70.8 | 62.7 | 96.7 | 93.4 | 96.7 | 322.4 | 563.7 | 836.0 |
| Manufacturing ) | | | 886.2 | 1,437.6 | 1,900.8 | 2,258.7 | 2,362.2 | 2,322.2 | 2,721.0 | 3,122.3 | 3,767.8 | 4,039.7 | 4,102.2 | 5,985.4 | 7,431.2 | 10,447.5 |
| Construction | n.a. | n.a. | 45.9 | 62.2 | 77.5 | 124.9 | 115.2 | 143.5 | 133.2 | 151.9 | 192.3 | 223.8 | 187.3 | 227.6 | 364.6 | 368.8 |
| Public utility[b/] | 3.5 | 11.7 | 65.1 | 112.8 | 158.8 | 195.9 | 164.3 | 157.1 | 256.0 | 226.3 | 281.1 | 211.8 | 314.9 | 470.7 | 821.8 | 871.3 |
| Services | 24.4 | 73.8 | 41.2 | 48.9 | 63.9 | 88.7 | 96.5 | 88.1 | 167.4 | 170.9 | 251.8 | 265.5 | 368.5 | 496.5 | 552.0 | 595.1 |
| Trade | 98.9 | 307.7 | 1,077.5 | 1,478.5 | 1,708.9 | 2,546.4 | 2,275.7 | 3,019.0 | 2,622.5 | 3,413.5 | 6,782.9 | 7,130.1 | 9,796.2 | 12,001.4 | 13,873.0 | 22,380.2 |
| Banks and other financial institutions | n.a. | n.a. | 71.9 | 127.4 | 170.5 | 372.7 | 572.1 | 651.2 | 805.1 | 830.7 | 1,516.3 | 1,738.9 | 2,774.9 | 4,922.0 | 4,720.5 | 5,777.2 |
| Real estate | 57.8 | 80.0 | 43.4 | 57.6 | 87.8 | 122.4 | 156.1 | 145.0 | 227.0 | 325.5 | 383.8 | 364.8 | 497.6 | 683.2 | 717.2 | 977.1 |
| Consumption | 14.5 | 35.2 | 98.0 | 109.3 | 105.3 | 150.2 | 157.4 | 147.0 | 208.9 | 242.5 | 228.7 | 331.9 | 869.8 | 1,169.5 | 880.3 | 937.0 |
| Total | 426.3 | 832.0 | 2,868.6 | 4,145.9 | 5,177.6 | 7,036.6 | 7,185.2 | 7,934.8 | 8,568.6 | 10,246.0 | 15,314.6 | 16,288.7 | 21,269.0 | 28,854.1 | 32,577.3 | 46,178.8 |
| | | | | | | | Percentage Composition | | | | | | | | | |
| Agriculture, fisheries and forestry | 39.6 | 24.1 | 17.5 | 15.9 | 16.3 | 15.9 | 16.6 | 15.3 | 15.8 | 16.6 | 11.8 | 11.6 | 10.5 | 8.9 | 8.2 | 6.5 |
| Mining and quarrying) | 13.7 | 14.8 | 1.3 | 1.2 | 1.2 | 0.9 | 1.2 | 0.7 | 0.8 | 0.6 | 0.6 | 0.6 | 0.5 | 1.1 | 1.7 | 1.8 |
| Manufacturing ) | | | 30.9 | 34.7 | 36.7 | 32.1 | 32.9 | 29.3 | 31.8 | 30.4 | 24.6 | 24.7 | 19.3 | 20.8 | 22.8 | 22.6 |
| Construction | n.a. | n.a. | 1.6 | 1.5 | 1.5 | 1.8 | 1.6 | 1.7 | 1.6 | 1.5 | 1.3 | 1.4 | 0.9 | 0.8 | 1.1 | 0.8 |
| Public utility | 0.8 | 1.4 | 2.3 | 2.7 | 3.1 | 2.8 | 2.3 | 2.0 | 3.0 | 2.2 | 1.8 | 1.3 | 1.5 | 1.6 | 2.5 | 1.9 |
| Services | 5.7 | 8.9 | 1.4 | 1.2 | 1.2 | 1.3 | 1.4 | 1.1 | 2.0 | 1.7 | 1.7 | 1.6 | 1.7 | 1.7 | 1.7 | 1.7 |
| Trade | 23.2 | 37.0 | 37.6 | 35.7 | 33.0 | 36.2 | 31.6 | 38.0 | 30.6 | 33.3 | 44.3 | 43.8 | 46.1 | 41.6 | 42.6 | 48.5 |
| Banks and other financial institutions | n.a. | n.a. | 2.5 | 3.1 | 3.3 | 5.3 | 8.0 | 8.2 | 9.3 | 8.1 | 9.9 | 10.7 | 13.2 | 17.0 | 14.5 | 12.5 |
| Real estate | 13.6 | 9.6 | 1.5 | 1.4 | 1.7 | 1.7 | 2.2 | 1.8 | 2.7 | 3.2 | 2.5 | 2.2 | 2.3 | 2.4 | 2.2 | 2.1 |
| Consumption | 3.4 | 4.2 | 3.4 | 2.6 | 2.0 | 2.2 | 2.2 | 1.9 | 2.4 | 2.4 | 1.5 | 2.0 | 4.1 | 4.1 | 2.7 | 2.0 |
| Total | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

a/ Information on loans granted by development banks not available for 1960 and 1961
b/ Included in real estate for 1951 and 1955

Source: Department of Economic Research, Central Bank of the Philippines, Twenty-Five Years of Economic and Financial Statistics in the Philippines, Vol. 1, 1974. Tables 21, 32 and 41

again in 1970, contrary to what may have been expected, with another substantial devaluation of the peso in that year, as intermediate goods industries benefitted from substantial imports of raw materials during the late 1960s and therefore required higher levels of working capital.

9.19 Another important change in institutional credit allocations has been the sharp increase in credit to the domestic and external trade sector, whose share more than doubled in the last two decades, reaching the exceptionally high level of about one half of total credit outstanding in 1973. This growth reflects the importance of external trade for the Philippines economy, the country's dependence on imports of capital goods, and the rapid expansion of domestic commercial activities in the 1951-73 period.

9.20 There has also been a significant rise in inter-firm credits. Large urban-based firms have become net extenders of credit to smaller firms and households. 1/ Yet another important change in the pattern of credit allocation has been the sharp rise of credit to banks and other financial institutions, averaging about 15 percent of the total in the early 1970s compared to a negligible proportion in the early 1950s. Credit to this sector has stood just behind that of the trade and manufacturing sectors in recent years. These developments reflect intrafinance sector transactions and an increasing layering of the financial intermediation process in the early 1970s. 2/

9.21 Credit Allocation by Maturity: The maturity structure of credits granted by the banking system shows that demand and short-term loans (i.e., those of less than one year) accounted for around 95 percent of total credit during the past two decades. Although credit maturities, as most other financial flows, have become shorter in recent years, short-term credits generally revolve several times, and, therefore, are *de facto* long-term credits. Statistics about the change in amounts outstanding classified according to maturity would be useful in this discussion, but are not available. Similarly, although the practice of rolling over short-term credit is quite common in the Philippines, data on the actual extent of roll-overs are not available. These would have been useful in assessing the extent to which corporations face the risk of a lack of liquidity and default in the event of a credit squeeze and the attendant inability to roll over short-term obligations.

## Structure of Financial Institutions

9.22 In the 1950s, intermediation and the provision of financial services were performed primarily by the commercial and thrift banks and by the Development Bank of the Philippines (then known as the Rehabilitation Finance Corporation). The institutional base has since evolved into a widely diversified

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1/ Richard W. Hooley and Honorata A. Moreno, *A Study of Financial Flows in the Philippines*, Institute of Economic Development Research Discussion Paper No. 74-16 (Quezon City: University of the Philippines School of Economics, 1974) pp. 134-135.

2/ See discussion in Chapters 5, 6, and 10.

structure which includes regional units (rural banks); insurance companies (both Government and private); and nonbank investment institutions, such as investment houses, finance and leasing companies, trust operations, and security dealers and brokers.

9.23 The importance of financial assets in the economy has also increased considerably. During 1960-74, total assets of financial institutions increased at an annual rate of over 20 percent. Since this growth was consistently higher than GNP growth during the period, assets of financial institutions as a percentage of GNP at current prices rose from 56 percent in 1960 to 96 percent in 1974 (Table 9.8). This achievement is comparable to rates that of Colombia and Venezuela, but was exceeded by Taiwan and Korea, which allowed higher interest rates and introduced special reforms to encourage the growth of financial institutions and markets.

9.24 The commercial banks are the most important class of financial institutions and their growth reflects the patterns of financial asset acquisition of the private sector discussed above (Table 9.9). The growth was fastest in the 1960-65 period because of the changes in interest rates and the improvement in financial services that were introduced in the late 1950s and early 1960s; acquisitions picked up again in the early 1970s as the money market became important. The experience of the commercial banking system was essentially similar to that of other classes of banking institutions (except for thrift banks, which suffered declines in growth rates in the 1970s due to their inability to attract deposits). Real yields on their deposit liabilities had become highly negative, and savers wanted to retain their flexibility by holding quick-maturing financial assets provided by other institutions.

9.25 Among nonbank intermediaries, insurance companies grew slowly, while other investment institutions (such as investment houses) and securities dealers and brokers grew rapidly. The sluggish performance of insurance companies resulted from the stagnation of insurance coverage at about 4 percent of the population, largely because the insurance policies were not adjusted for rapid inflation and other changing situations, and because the cost of insurance was relatively high due to the widespread use of policy loans at low interest rates. The growth of investment houses and securities dealers is, of course, related to the importance of the money market in recent years, as well as to the expansion of stock brokerage facilities to handle increasing transaction volumes on the three exchanges located in the Greater Manila area.

9.26 In the early 1970s, Government-owned institutions controlled about half of the total assets of the financial institutions. This was less than their 65-70 percent share in the 1960s, but it represents a higher proportion of total resources, since a much larger share of gross private savings was held in financial assets in the early 1970s compared to the 1960s. The Mission estimates that Government-owned institutions directly controlled over one-third of total investable resources in the 1970-74 period. In reality,

Table 9.8. Assets of Financial Institutions[a/] as Percentage of GNP

| Year | Total Assets of Financial Institutions (In millions of pesos) | Assets of Government Institutions (In millions of pesos) | Share of Government Institutions (In percent) | Assets of Financial Institutions/GNP at current prices (In percent) |
|---|---|---|---|---|
| 1960 | 7,227 | 4,859 | 67 | 56 |
| 1961 | 9,311 | 6,305 | 68 | 66 |
| 1962 | 9,827 | 6,095 | 62 | 62 |
| 1963 | 11,671 | 6,742 | 58 | 63 |
| 1964 | 14,275 | 8,689 | 61 | 71 |
| 1965 | 15,598 | 10,957 | 70 | 73 |
| 1966 | 18,096 | 12,553 | 69 | 75 |
| 1967 | 22,315 | 12,465 | 56 | 83 |
| 1968 | 25,200 | 13,594 | 54 | 84 |
| 1969 | 28,855 | 15,508 | 54 | 86 |
| 1970 | 33,868 | 17,825 | 53 | 84 |
| 1971 | 38,537 | 19,392 | 50 | 78 |
| 1972 | 47,502 | 24,003 | 51 | 85 |
| 1973 | 66,549 | 33,344 | 50 | 95 |
| 1974 | 94,804 | 48,410 | 51 | 96 |

a/ Include the Central Bank, the Philippine National Bank, Philippine Commercial and Industrial Bank, DBP, Land Bank, GSIS, SSS, and Acricultural Credit Administration (ACA)

Source: Central Bank.

Table 9.9. Philippines: Structure of the Financial System, 1974
(In millions of pesos and percentages)

| | Asset Size | | Real Rates of Growth[a/] | | |
|---|---|---|---|---|---|
| | Amount | Composition | 1960-65 | 1965-70 | 1970-74 |
| Central Bank | 21,273.6 | 22.5 | 4.0 | 6.3 | 16.8 |
| Banking System | 54,457.9 | 57.4 | 16.4 | 8.8 | 10.9 |
| Commercial Banks | 42,663.2 | 45.1 | 17.2 | 7.9 | 12.3 |
| Private Banks | 30,114.3 | 31.8 | 17.0 | 8.8 | 14.0 |
| Government Banks | 12,548.9 | 13.3 | 17.5 | 6.3 | 8.6 |
| Thrift Banks | 1,743.6 | 1.8 | 28.2 | 15.0 | -2.9 |
| Savings Banks | 1,236.6 | 1.3 | 25.3 | 14.7 | -5.5 |
| Private Development Banks | 296.3 | 0.3 | 46.5 | 9.2 | -0.8 |
| Stock, Savings and Loan Associations | 210.7 | 0.2 | ... | ... | 17.3 |
| Regional Unit Banks (rural banks) | 2,110.7 | 2.2 | 23.0 | 10.5 | 14.0 |
| Other Banks | 7,940.4 | 8.3 | 10.0 | 10.7 | 7.4 |
| Development Bank of the Philippines | 6,758.0 | 7.1 | 10.0 | 10.7 | 3.4 |
| Land Bank | 1,182.4 | 1.2 | ... | ... | 128.0 |
| Nonbank Financial Intermediaries | 19,072.2 | 20.1 | 11.5 | 8.5 | 2.7 |
| Insurance Companies | 9,094.8 | 9.6 | 7.0 | 4.7 | -4.5 |
| Government [b/] | 6,537.4 | 6.9 | 4.8 | 4.1 | -3.0 |
| Private | 2,557.4 | 2.7 | 13.3 | 6.2 | -8.0 |
| Investment Institutions | 6,835.0 | 7.2 | ... | 16.6 | 11.2 |
| Finance Companies | 2,306.1 | 2.4 | ... | 9.3 | -3.5 |
| Investment Companies (Mutual funds) | n.a. | n.a. | ... | ... | ... |
| Others | 4,528.9 | 4.8 | ... | 37.1 | 25.8 |
| Trust Operations | 1,951.5 | 2.1 | ... | 23.7 | 18.8 |
| Other Financial Intermediaries | 1,190.9 | 1.2 | -8.4 | 22.3 | 13.9 |
| Mutual Building and Loan Associations | 24.7 | ... | 0.0 | -2.0 | -14.8 |
| Credit Unions | n.a. | n.a. | ... | -1.9 | ... |
| Securities Dealers and Brokers | 882.1 | 0.9 | ... | 111.8 | 29.7 |
| Nonstock Savings and Loan Associations | 71.2 | ... | ... | ... | -5.3 |
| Agricultural Credit Administration | 112.1 | 0.2 | -23.3 | 12.0 | -9.0 |
| Pawnbrokers | 100.8 | 0.1 | ... | ... | ... |
| Total | 94,803.7 | 100.0 | 12.0 | 8.3 | 10.1 |

a/ Deflated by GNP deflator (1967 = 100)
b/ Includes GSIS and SSS

Source: Central Bank, Securities and Exchange Commission.

Government's control over financial resources is even greater than that implied by these figures, since its influence extends to the rural and private development banking systems, which were established and funded by the Central Bank and the DBP, respectively. Moreover, the Government-owned financial institutions enjoy economies of scale and privileges not normally open to private sector institutions, such as the ready marketability of their securities (which have relatively high tax-exempt yields), repurchase facilities, the acceptability of their bonds as collateral for borrowing transactions, the eligibility of their bonds as banking reserves, and even their acceptaability as payment for the purchase of public lands (in the form of Land Bank bonds).

9.27 Nevertheless, the private financial institutions have thrived under these conditions, in large part because of the Government's essentially pro-private enterprise outlook. In savings mobilization, private institutions appear to have catered to urban savers 1/ who have invested in deposits, life insurance policies, deposit substitutes, high-yielding Government securities, and corporate securities. Government institutions, on the other hand, have been more widely dispersed, with branches of the PNB and DBP in most urban centers outside of Manila, and the rural banking system operating in almost all rural provinces.

Future Allocation of Finance

9.28 Resource allocation has traditionally been very much influenced by direct import controls, overvalued exchange rates, heavy protective tariffs, sugar quotas, and liberal fiscal incentives, but there are likely to be important changes in the future. One such change will probably be the increasing influence of financial policies in resource allocations. Increasing the level and improving the composition of domestic savings are of little value unless there is also an appropriate allocation of resources into desired directions. The allocation of resources for a suitable investment program will be a key determinant of the degree of success the Government will have in accelerating the real growth of the economy in the future and in promoting the sectoral development outlined earlier in this report.

9.29 The Government's involvement in the allocation process will be critical. Capital will have to be correctly priced in terms of an interest rate level and structure that appropriately matches returns with risks and reflects the scarcity value of capital in the economy. Such an interest rate structure will assign to interest rates a more active role in the allocational function than they have had previously. Interest rates may have influenced the choice of technology and the build-up of productive capacity in the past, but their influence was circumscribed by the capitalintensive nature of the industries that were being encouraged and financed.2/

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1/ The principal operations of private commercial banks, savings banks, investment houses, and finance companies are concentrated in or around Manila.

2/ See Chapter 6.

9.30 The pattern of allocation of domestic resources in the future will be considerably influenced by the priority given to the proposed public investment program, which includes a domestically financed outlay of about ₱ 40 billion (in 1974 prices) during FY76-85, over four times the actual outlays in the previous ten years. Resources, including institutional credit, will have to be directed in large part to agriculture, agro-industries, small-scale industries, and the power sector, since growth in those areas is crucial to the Government's development strategy. The Government's direct control over investable resources in the second half of the 1970s should be reasonably adequate, because public sector-owned financial institutions like the Central Bank, PNB, GSIS, SSS, DPB, and the Land Bank are likely to continue to control almost half the total assets of all financial institutions.

9.31 This situation is likely to change in the future. Credit allocations by financial institutions will become more critical, since they will involve larger shares of the total resources. Not only will the flow of funds be on a much larger scale in the next decade compared to the previous once, but there will probably also be a considerable change in the pattern of financing. First, large amounts of savings in financial forms will need to be transferred from the household sector to the Government and the corporate sector. Second, an increasing proportion of these funds will be flowing to the public sector to finance the Government's enlarged public investment program. Third, larger proportions of these funds will need to have longer maturities than in the past. Finally, the industry-wide allocation of credit will need to reflect the objectives of industrial policy, that is, encouraging the domestic processing of primary products and developing export markets. Table 9.10 presents the likely allocation and financing of investable resources by 1980 (at constant 1974 prices); this allocation would be consistent with the Government's development strategy. 1/

9.32 The public investment program in 1980 would amount to over ₱ 7 billion at constant 1974 prices, with 55 percent, or ₱ 4 billion, financed from general government savings and the remainder by borrowings. As noted in Chapter 10, Government borrowings from official and commercial sources abroad would be close to ₱ 2 billion, leaving about ₱ 1.5 billion to be borrowed from domestic sources. The Mission estimates that more than half of these domestic borrowing requirements, or about ₱ 800 million, would be met from the monetary system, i.e., from the Central Bank and commercial banks. This would be about 15 percent of the estimated liquidity expansion of ₱ 6 billion in 1980, 2/ an

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1/ The discussion here of the rationale behind such an allocation and its implications is necessarily limited because the matter is treated more comprehensively in the appropriate sections of Chapters 6, 8, and 10. In this chapter, we are concerned only with analyzing the financial requirements of the various investment programs in order to demonstrate their implications for savings performance and for the efficient use of capital to achieve stated national objectives.

2/ See Chapter 8.

Table 9.10. Allocation and Financing of Investable Resources in 1980
(In millions of pesos at 1974 constant prices)

| Category | Public Sector | Private Sector | Total |
|---|---|---|---|
| Fixed Capital Formation | | | |
| Agriculture | 1,030 | 4,140 | 5,170 |
| Mining and manufacturing | ... | 13,300 | 13,300 |
| Power and other utilities | 2,960 | 450 | 3,410 |
| Transportation | 2,510 | 4,430 | 6,940 |
| Other | 890 | 4,280 | 5,170 |
| Subtotal | 7,390 | 26,600 | 33,990 |
| Increase in Stocks | ... | 4,430 | 4,430 |
| Total Capital Formation | 7,390 | 31,030 | 38,420 |
| Financing | | | |
| Direct investment of sector savings | 4,070 | 12,000 | 16,070 |
| Intrasector borrowings | ... | 13,190 | 13,190 |
| Intersector borrowings | 3,320 | 790 | 4,110 |
| Foreign | 1,840 | 2,270 | 4,110 |
| Domestic | 1,480 | -1,480 | ... |
| Equities | ... | 5,050 | 5,050 |
| Foreign | ... | 670 | 670 |
| Domestic | ... | 4,380 | 4,380 |

Source: Mission estimates

amount consistent with price stability, since it means that liquidity would expand at the same nominal rate as GNP and remain at a level equal to 30 percent of GNP in the 1976-80 period. 1/ The rest of the Government's domestic needs of about ₱ 700 million would have to come from nonmonetary financial institutions and the capital markets. The former might provide a much larger share of these funds than the latter, since capital markets in the Philippines are still at an early stage of development.

9.33 Apart from these intersector transfers, private sector savings would have to allow for a large amount of intrasector transfers to finance large investment projects in mining, manufacturing, agriculture, and transportation. A substantial amount of private sector savings will, therefore, have to be held in the form of financial assets. The financial requirements of the private sector, about ₱ 19 billion at 1974 current prices, could be met primarily by domestic borrowings (about ₱ 13 billion from financial intermediaries) and from direct sales of corporate debt instruments on the bond markets. About ₱ 2 billion could be provided from foreign sources in the form of commercial credits and from foreign funds onlent by domestic financial institutions such as the DBP and the Private Development Corporation of the Philippines (PDCP).

9.34 About ₱ 4 billion could probably be met by equity funds, about ₱ 500 million of which are expected to be provided by foreign investors 2/ and the rest by domestic savers (through the securities markets and private placements) and by corporate retained earnings and other reserves. The estimated equity needs would account for about 25 percent of total external finance requirements of the corporate sector 3/. While a major part of these equity needs would be met by private placements, a considerable amount perhaps ₱ 2 billion - would have to be mobilized through the primary market for equities. Since the organized equity markets have not been major sources of new funds to date, providing the above-mentioned amounts would represent a significant development in the capability of the securities markets to act as primary channels of funds.

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1/ The Government's share in liquidity expansion, which is equivalent to the growth of domestic credit from monetary authorities, does not appear to be excessive and is equal to its historical share (Table 9.6); this would mean that the private sector would not be lacking domestic credits from the banking system.

2/ Direct portfolio investments of about US$100 million at current prices as discussed in Chapter 11.

3/ While the Board of Investments (BOI) recommends a 3:1 ratio for projects it endorses, a figure consistent with the historical aggregate ratio, the effect of the intra- and intersector financing patterns cited above would be to lower this ratio. This is because most of the direct investment of sector savings would be construed as equity. The Mission welcomes this development since it would strengthen the financial position of Philippine enterprises by lowering the relatively high debt-equity rations now prevailing.

9.35 As for domestic borrowings, the Mission estimates that the monetary system would provide about ₱ 5 billion of domestic credits to the private sector, or 85 percent of the estimated liquidity expansion of about ₱ 6 billion. The balance of ₱ 6-7 billion from financial intermediaries would be provided by nonmonetary financial institutions and by the bond market. Since the primary market for corporate bonds is at an even earlier stage of development than the primary market for equities, raising approximately ₱ 3 billion from this source would be a considerable achievement.

## B. Issues of Financial Policy

9.36 Future growth in aggregate savings will continue to depend primarily on income growth. If the economy were to grow at about 7 percent a year in real terms, given observed historical relationships and no radical changes in savings behavior, the ratio of gross domestic savings to GDP would rise from its present level of 20 percent to about 22-23 percent by the early 1980s. The performance of public savings would depend primarily on the success with which the Government mobilizes resources through the fiscal measures discussed in Chapter 10. According to the Mission's estimates of possible increases in Government revenues, Government savings net of depreciation would not rise much beyond 3.5 percent of GDP by 1980. This would fall short of the total requirements of the public sector development program, which means that the balance would have to be financed by private savings.

9.37 With a higher rate of income growth, the expected pattern of private savings is likely to reflect more savings in the business sector and a recovery in households' savings. This recovery, however, would be adversely affected by increasing mobilization of resources by the public sector. Given the continuing pressure for increasing Government savings for financing the Government's development expenditures, the greater tax effort required might continue to result in a shift from private to public savings as occurred in the last couple of years. Similarly, if inflationary pressures are not checked in the future, the level of private savings as well as the form in which these are held could be adversely affected.

9.38 The key issues for the Government in this area are how to increase the share of financial savings and how to lengthen their maturities. The former is important for facilitating intersectoral transfers of resources, especially for major investment projects, while the latter is necessary to avoid short-term fluctuations in the credit markets and to strengthen financial institutions. There are three aspects of financial policy that will need particular attention if the levels and composition of savings and investments are to be improved during the next decade. First, both the levels and structure of interest rates, which influence the mobilization and

allocation of domestic resources, should become increasingly important. Second, the role of various instruments of credit policy which have been utilized by the Government so far will have to be reexamined in the context of the proposed changes in interest rate policies and the development of financial institutions. Third, financial institutions and instruments will have to be developed if the financial system grows in the near future as envisaged.

Measures to Increase Domestic Savings

9.39 Promoting Financial Savings: An increasing amount of savings will have to be available in financial forms to facilitate the flow of funds necessary to meet the large requirements of the Government and the corporate sectors and also to sustain the investment pattern outlined in Chapter 8. In view of the characteristics of savings and financial asset holdings that seem to have emerged in the early 1970s, the success of the savings efforts required in the second half of the 1970s will depend very much on the Government's financial policies. The Mission would expect that intrasectoral channelling of savings would grow at the same rate as investment requirements, and would account for 40-45 percent of the ₱ 35 billion (at 1974 prices) requirements of the investment programs in the public and private sectors. Consequently, whether the balance of about ₱ 20 billion would be reached or not would depend on the amounts of financial savings that the private sector could accumulate. This, in turn, would depend on the incentives to own financial assets.

9.40 Nonyield considerations are equally important in stimulating and sustaining the flow of private savings into financial assets, as shown by the response of savers to such innovations as repurchase features, convenient withdrawals terms, and potential participation in capital gains, which were introduced in the early 1960s and 1970s. In the second half of the 1970s, financial institutions should be able to attract a greater volume of savings by offering differing risk, maturity, and marketability or liquidity characteristics that suit a broad range of savers' preferences, while simultaneously improving the overall quality of financial services. The latter aspect would include improved access to high-yielding assets by savers in various income brackets, broader deposit insurance coverage, full disclosure of all pertinent information, and other forms of investor protection to sustain confidence in financial assets. It would also include convenience in terms of more branch offices of banks and nonbank institutions.

9.41 The existing financial institutions have adapted rapidly in the recent past to widen the array of their financial instruments and to mobilize a much larger proportion of savings through these new instruments. For example, commercial banks confronted with disintermediation adapted their operations to capture substantial savings in recent years not through deposit growth, but through their money market operations. In fact, despite a slow, and even negative (at the end of 1974 and early 1975) growth of deposits, commercial bank assets have increased because of the large share

of bills payable. 1/ At the end of 1974, twelve of the thirty-six banks had bills payable representing at least 30 percent of their resources, with the mode being 40 percent and the range from 3 to 46 percent.

9.42 There is sufficient scope for other financial institutions to mobilize more savings by offering differentiated financial instruments or improved service facilities. For example, saving banks have frequently adapted more attractive interest computation and payment procedures as well as wider branch networks to compete more aggressively for savings. As for the life insurance institutions, the promulgation of a new and stronger insurance code in 1974 (Presidential Decree 612) goes a long way towards increasing the professionalism of life insurance companies, especially the private ones, and improving their ability to market policies and, thereby, to mobilize more resources. The potentially strong future role of the life insurance institutions in mobilizing funds is further indicated by the fact that new industrial insurance policies 2/ written in 1974 amounted to ₱ 102 million, and a substantial part of these were sold in the rural areas. Moreover, as insurance coverage expands, which has not been the case in recent years, the contribution of life insurance to private savings mobilization in long-term maturities should increase correspondingly.

9.43 Lengthening Maturities: To sustain the investment pattern outlined in Chapter 8 and to strengthen corporate financial positions, a substantial proportion of the private savings that will have to be mobilized in the second half of the 1970s should be in the form of longer term assets. This would ensure a reasonable blend of maturities in the total obligations of corporations and financial institutions and facilitate a sound intermediation process. Therefore, any measures to mobilize more domestic resources through an increase in financial assets of households should also seek to lengthen the maturities of these assets and widen the array of financial instruments.

9.44 These measures would include steps in three major areas: interest rates, fiscal treatment of financial assets, and encouragement of investment house placements in longer term instruments. In the interest rate area, low administrative interest rate ceilings on longer term deposit assets had in the past discouraged the use of these assets in relation to short-term money market instruments. The impact of higher yields on portfolio composition is evidenced by the rapid growth of time deposits following the July 1974 interest rate reform. These have grown at an annual rate of approximately 57

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1/ The bills payable consisted of deposit substitutes and interbank borrowings, which averaged 29 percent of commercial bank resources at the end of 1974, which is unusual by international standards.

2/ Where premiums for individual life insurance policies with savings features are collected weekly.

percent compared to 13 percent in the 12 months preceding the policy change. Although specific data is lacking, most of this incremental growth appears to be represented by deposits with maturities over two years, with significant but slower rates of growth being shown by lesser yielding savings deposits.

9.45 In the fiscal area, interest paid on a deposit or coupon basis is reportable for income tax purposes, whereas discounted interest earned on money market instruments may easily escape reporting, creating a strong tax bias in favor of the latter instruments. The market for longer term financial instruments could benefit from tax policies that are more favorable to longer term maturities, such as a graduated withholding tax system. However, there are arguments favoring neutrality of the tax system in order to avoid an interference with the market mechanism.

9.46 Finally, underwriting regulations and profit incentives greatly encourage the Philippine investment houses to deal in short-term instruments. Whereas a three or four point spread may be realized on very short-term money market transactions, the Securities Act establishes an effective 5 percent ceiling on underwriting commissions. Thus, for example, the underwriting and placement of a three or five year bond, for which turnover may be small, would compete directly with the more profitable money market operations of the investment houses.

9.47 Measures taken regarding the interest rate, taxes, and investment houses should be directed at creating the appropriate environment for the issuance and purchase of longer term instruments. The sophistication and capability of the Philippine financial institutions indicate that this environment would bring a rapid response from savers. In this context, Government securities, high grade corporate bonds, and mortgage-backed bonds issued by savings and mortgage banks should pave the way for greater saver confidence and demand for long-term financial assets. Given attractive risk/reward features on these securities and the establishment of secondary market liquidity at the outset, the large financial needs outlined in this report suggest that the longer term debt securities market in the Philippines could be the major growth area in the country's financial system in the next ten years.

Interest Rate Policy

9.48 In the past, the Anti-Usury Law, enacted in 1916, imposed statutory limits of 12 and 14 percent on secured and unsecured bank loans, respectively, which may have set an upper limit on deposit rates. This did not create a problem in terms of savings mobilization and intermediation during the 1950s and 1960s when inflation rates were low and real deposit rates were still positive. But the situation changed dramatically in the early 1970s, and resulted in negative real rates on bank deposits, which were at a nominal level of 6-8 percent at the maximum. Money market interest rates, however, were not subject to the limits set by the Anti-Usury Law, nor were the money market institutions required to allocate certain portions of their

9.52 The recent reforms also raised the minimum denomination of deposit substitutes from the previous level of ₱ 50,000. When the increase takes full effect on July 1, 1976, the minimum denomination of deposit substitutes of up to two years maturity will be ₱ 200,000 and of over two years maturity will be ₱ 100,000. As for reserve requirements, all banks will have to maintain a 20 percent reserve against deposit substitutes with maturities of up to two years, while the nonbank financial intermediaries will have to maintain a 20 percent reserve against all deposit substitutes.

9.53 These reforms represent a continuation of earlier measures undertaken and the authorities have stated their intention to follow up with further corrective measures. In the meantime, the inflation rate has declined sharply from the annual average of 35 percent in 1974 to less than 10 percent in 1975 and, consequently, real deposit rates have again become positive. Moreover, the revised term structure of deposit rates, with no ceiling on deposits for over two years, would encourage mobilization of long-term resources. With the ceilings on yields for short-term deposit substitutes, savers would be encouraged to return to bank deposits.

9.54 As these measures have only just been introduced it would be premature to attempt a full assessment of the situation. However, it is important to note the extent to which these reforms do represent a departure from past policies: (a) there is a broad thrust toward increasing the mobilization and allocation of long-term resources as against short-term funds; consequently, efforts are made to control short-term money market operations and to strengthen the organized banking institutions; (b) for the first time there is a distinction between short-term and long-term lending rates; (c) the Monetary Board has been empowered to adjust interest rate ceilings and to differentiate interest rates within these ceilings; and (d) deposit rates have been raised for the second time in about eighteen months. The reforms, therefore, represent a positive attempt to rationalize the level and structure of deposit and lending rates.

Credit Policy

9.55 Since the past role of interest rates as an allocational tool was limited, the Government relied on a variety of instruments to ensure that credit was channelled into priority activities. These included an investment priority plan administered by the Board of Investments, special programs to aid small and medium-scale industry, the establishment of specialized institutions, preferential rediscounting by the Central Bank, tax exemption, subsidies, and other administrative regulations. 1/

9.56 The most prevalent instrument affecting the rationing of funds among investments has been the reliance on collateral, which has made possible substantial flows of credit to large enterprises and has strengthened the

1/ These have been discussed in Chapters 5, 6, and 10.

bias for large, capital-intensive undertakings. However, this particular credit policy merely confirmed the directional bias of industrial policy. The pattern of investments and credit flows has been most influenced by foreign exchange availability, import licenses (which allowed exemptions from customs duties for imported capital equipment), accelerated depreciation, and exemptions from income taxes. In addition, heavy domestic market protection implied that even uneconomical enterprises could survive and generate adequate financial returns. These factors need to be kept in mind while formulating a credit and interest rate policy.

9.57 The fundamental issues involved in allocating institutional credit in the future will probably be: (i) to ensure that labor-intensive manufacturing in sectors such as food, textiles, wood processing, engineering, and other light industries obtain adequate financial resources; and (ii) to improve the credit delivery systems in general, and those in agriculture and industry in particular, to allow small and medium-scale industries, as well as small agricultural borrowers, greater access to institutional credit. 1/ Some steps have already been taken in this direction. The operations of the Industrial Guarantee and Loan Fund, which assist the development of small and medium industries, have expanded considerably in the past couple of years. There has also been an increasing flow of institutional credit into agriculture through the Masagana 99 program and through strengthening and expanding the rural banking system. The Development Bank of the Philippines is assuming a more active role in lending for rice production, fisheries, livestock development, and food processing. The Government is also strengthening the Philippine National Bank by further expanding its network of branches to increase the availability of funds for agricultural and small and medium-scale industrial development.

## Development of Financial Institutions

9.58 The future issues for resource management that were discussed earlier in this chapter are closely related to the institutional structure of the financial system. In addition to interest rate and credit policies, the development of financial institutions and instruments is important in improving the quality and coverage of financial services. Because of its extensive influence over the financial system, the Government will need to take the initiative in improving the financial structure by encouraging financial institutions to lengthen the maturities of their instruments, and, as discussed in Chapters 5 and 6, by improving credit delivery systems, especially in agriculture and to small and medium-scale industries. There should also be improvements in the operating efficiency of financial institutions, which should lead to reduced spreads and lower costs. The growth of financial intermediaries in the Philippines has been quite extensive but uneven. Consequently, although there is no need to establish whole new classes of institutions, it is important that the relatively undeveloped ones, such as savings and mortgage banks and the securities markets, should be given sufficient incentives to grow.

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1/ See Chapters 5 and 6.

Issues in Developing the Financial System: The overwhelming need in the next few years will be to make the existing system work more effectively by encouraging certain new activities in both the mobilization and allocation of resources among the present institutions, fostering competition, and lowering the cost of intermediation. In the long run, the Government should aim at developing a strong securities market which can provide liquidity to holders of stocks and bonds, and thus be an effective mechanism for mobilizing and allocating funds directly from savers to Government and corporate users. The following discussion, therefore, deals in broad terms with various ways to strengthen the existing institutions and with the future role of the money and securities markets. 1/

9.59 Before the Central Bank's recent program to improve its equity position, many commercial banks had weak financial structures as a result of lending beyond normal levels of their loanable funds by depleting excess and required reserves. The insolvency of the Continental Bank in June 1974 was only symptomatic of more widespread difficulties. There were several reasons for these financial difficulties. In constrast to the 1950s, the banks had to operate with significantly reduced reserves when they expanded their lending volume sizably in the 1960s and the early 1970s. Entrepreneurs preferred financing through borrowing rather than through raising equity, since by borrowing loan capital they could maintain control over their enterprises. The authorities recognized the need to expand the equity base of banks. The Central Bank's program to double the capital base of the whole commercial banking system to ₱ 3 billion in 1975 was a step in the right direction. This was achieved through increased capitalization, the merger or consolidation of commercial banks, and foreign equity participation.

9.60 The most suitable financial institutions for dealing in long-term funds are development banks, thrift banks, insurance companies, and pension funds. The role of these institutions should grow in the next decade because of the substantial increase in the demand for long-term funds to finance large investment programs. The development banks, especially the DBP, which have been the main suppliers of long-term finance, would continue to play a dominant role in this field. The DBP will play an important role by continuing to finance both capital-intensive industries, which require substantial amounts of foreign and domestic currency, and small and medium scale industries which entail greater financial risks. Private development banks would perform a useful supporting function by focusing on local needs and absorbing the risks inherent in small-scale loans that do not receive the DBP's support. In the long run, efforts of these institutions would be aided by an organized bond market and an invigorated stock market.

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1/ The role of the rural banking system has been discussed specifically in Chapter 5.

9.61 Thrift banks (e.g., savings banks, and mortgage banks) should be considered a main vehicle for issuing long maturity obligations. Mortgage and savings banks could be major issuers of consolidated mortgage bonds, and could expand their operations in financing construction activity and housing. In order to provide that service, however, it would be necessary for the mortgage and savings banks to expand to areas other than Greater Manila and Southern Tagalog.

9.62 Another important type of institution having considerable potential for supplying long-term funds are life insurance companies. These institutions, both private and Government-owned, could provide long-term finance to agriculture and industry either directly, through purchases of corporate securities, or indirectly, through purchases of DBP, Government, and other intermediary bonds. These institutions also finance construction and residential mortgages. Insurance companies in general, and GSIS and SSS in particular, can act as catalysts in rationalizing and developing the mortgage market by moving away from direct mortgage lending and concentrating on acting as financial intermediaries through purchasing consolidated mortgage bonds issues of savings and mortgage banks. Pension funds are similar to insurance companies in terms of their ability to mobilize long-term funds and could be major factors in the development of securities markets.

The Short-Term Money Market: The money market will continue to perform a major intermediation function in the future. From the point of view of liquidity management, it serves a useful purpose as the interbank market by allowing banks and quasi-banks to balance their day-end portfolios. But in the last few years, commercial banks have availed themselves of other segments of the money market to cover reserve deficiencies by direct borrowing from the nonfinancial private sector, thus circumventing reserve requirements and interest rate limitations 1/ as savers moved out of currency and deposits and acquired higher yielding deposit substitutes. However, it is equally important to recognize that savings have been channelled to this market in part because of tax advantages obtainable from these instruments and because there have been few long-term instruments offered.

9.63 In the future, the money market should emphasize its function of placing large amounts of temporarily idle corporate funds and savings of large investors, since large amounts are normally required to permit economical and efficient money market transactions; for this reason it is not a place for the small saver. However, it is important that the dualism which now characterizes the market for savings, where large savers obtain higher yields for shorter maturities than do small savers for longer maturities, be reduced and that opportunities for obtaining better yields from longer term assets be open to all classes of savers.

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1/ Prior to December 1974, promissory notes and other dealer-issued paper were not required to be backed by liquid reserves. However, Central Bank authorities, recognizing that these instruments were essentially banking liabilities and must be backed by reserves, then imposed a 5 percent reserve requirement on these instruments, which were issued by both banks and quasi-banks.

9.64 In addition, it is important to segregate the interbank market from the rest of the money market. Measures are needed to prevent the circumvention of reserve requirements which current money market practices permit. One way of dealing with this would be to preclude commercial banks from originating issues in the form of promissory notes and repurchase agreements, and instead, to encourage them to issue only longer term certificates of deposit subject to the same reserve requirement as time deposits. However, since a market for overnight money is needed by all financial institutions, the Central Bank should perhaps consider expanding the interbank market to allow quasi-banks to participate. But the Central Bank must ensure that these transactions are processed through its central clearing system to prevent institutions from raising reserves by direct borrowing from the nonfinancial private sector.

The Securities Market: The Philippine financial system does not have an active and quantitatively important stocks and bonds market. In recent years, only a small proportion of the capital expansion of Philippine corporations has been financed through issues sold in the three stock exchanges, which are located in Manila, Makati, and Quezon City. Only corporations such as San Miguel, Meralco, and the PDCP have been able to tap private savings directly to some extent. New firms - except for highly speculative mining ventures - have been unable or unwilling to sell equities. The same applies to corporate bonds. No corporate bond offerings have been made to the public in recent years other than those issued by one finance company, and those have already been redeemed. The peso-dominated corporate bonds included in the definition of gross private financial assets have been sold through private or direct placements rather than through the exchanges.

9.65 There are several reasons for the underdeveloped state of the securities market. The first one is a supply constraint. Private owners are not disposed to sharing their control over the enterprises and have, therefore, avoided raising new equity through public issues. Moreover, there are no incentives for enterprises to go public, since the corporate income tax rate is the same for an open as well as for a closed or privately-held corporation. 1/ Second, high interest rates and tax advantages on short-term money market instruments compared to those on long-term securities biased savers' preferences toward the former type of investments and constrained the demand for securities. Third, except for mining, the largest commercial and industrial issues, and a few speculative shares, shares are not very liquid investments, since the market is limited. Fourth, the substantial swings in market activity reflect speculation which is not adequately controlled by the regulatory framework. Finally, there are deficiencies in the dissemination of information to the market and especially to smaller investors.

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1/ Twenty-five percent on taxable income of up to ₱ 100,000 and 35 percent on income above ₱ 100,000.

9.66 These structural problems can be resolved by a determined effort of the Government authorities in cooperation with the private sector. The primary securities markets should mobilize more private savings by offering a greater variety of investment opportunities, and it should channel more of the mobilized funds into long-term assets. Direct financing through stock and bond markets would also represent the creation of an investment medium which is distinct from a money medium. It might be desirable to gradually introduce long-term bonds through the organized exchanges by starting with 3 to 5-year corporate debentures, followed by 5 to 10-year mortgage bonds, stretching to 20 to 25-year maturities for Government bonds. Under prevailing market conditions, issues could be sold to yield from 16 to 25 percent depending on quality and maturity. These bonds should lead the way in creating a bond market and increasing the share of long-term assets in private financial savings.

9.67 Apart from their involvement in the money market, investment houses can play a very important institutional role in expanding the ownership base of private industry and broadening its sources of finance. They were established to create a core of underwriters who could assist firms in raising capital in the securities market. However, investment houses have yet to fulfill this role. Thus, in taking steps to create a bond market and to strengthen the stock market, Government authorities would not only be paving the way for the issue of new long-term instruments, but would also be enabling investment houses to function as they were originally intended.

9.68 Measures to stimulate the supply of and demand for securities could also include fiscal incentives to induce privately-held corporations above a certain size to go public. For example, a 10 percentage point differential in the tax rates between open and closed corporations may be sufficient to promote the formation of open corporations. Better tax enforcement would make effective tax rates even more important than changes in the legal tax rate. As is shown in Chapter 10, some of the corporations pay less than 5 percent corporate income tax. In addition, investor confidence in securities could be strengthened by improving the stock exchange regulations. The Securities and Exchange Commission needs to be revitalized and to act more as a regulatory agency than just a registry of corporations. The dissemination of information to the public, especially to the small investor, also needs to be improved considerably.

9.69 Finally, the liquidity of the securities markets can be increased substantially by institutionalizing securities credit, i.e., credit to purchase or hold stocks and bonds collateralized by the securities purchased. This is perhaps the most important element in furthering the growth of Philippine securities markets, as investors can purchase a larger amount of securities with available funds through appropriately structured margin accounts, with the Central Bank specifying margin requirements to maintain

its control over liquidity expansion 1/ and with sufficient regulation to prevent speculative excesses. Brokers and underwriters could likewise broaden their operations by making available increased working capital. Experience in some countries where commercial banks have been reluctant to lend to the securities markets or do not have the inclination or the expertise for doing so, as seems to be the case in the Philippines, has shown that a specialized institution acting as a central source of securities finance could provide the required services. 2/

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1/ In a margin loan, an investor wishing to purchase an eligible security needs to put up a deposit representing only a fraction of the purchase price and to pledge the security to the broker. Thus, with a 60 percent margin requirement, an investor purchasing ₱ 1,000 worth of stocks or bonds must put up only ₱ 600; the broker will extend him a loan of ₱ 400 collateralized by the pledge of security purchased. Should the security value decline to ₱ 900, the investor must put up an additional ₱ 40 as deposit, because the loan value of the securities has declined to ₱ 360. Conversely, should prices rise and the security value increase to ₱ 1,100, the investor will have a credit balance of ₱ 40 in his account.

2/ For instance, the Japan Securities Corporation and the Korea Securities Finance Corporation perform these functions for the Japanese and Korean markets, respectively.

Chapter 10

# THE ROLE OF THE PUBLIC SECTOR

# Chapter 10

## THE ROLE OF THE PUBLIC SECTOR

10.01 Until the early 1970s, the Philippine economy was controlled and dominated by the private sector. The public sector was small and played only a relatively minor role in economic development. By international standards, the Philippines had low levels of government revenues and expenditures. General government 1/ revenues hovered around 11-12 percent of GNP during the 1960s; general government expenditures were only marginally higher (Table 10.1). In per capita terms, general government current and capital expenditures combined (at current prices) increased by only 4.5 percent a year between 1950 and 1970. 2/

10.02 The country also suffered from inefficient fiscal administration and uncoordinated financial planning. The tax system had strong regressive features and tax enforcement was inadequate. The low level of effective tax rates which resulted from this situation necessarily reduced the potential of fiscal policies and incentives and discouraged the efficient use of the available economic and financial resources. The scarcity of available financial resources and insufficient administrative capacity resulted in inadequate levels of Government investment in social and economic infrastructure, and became a major constraint on economic development. Moreover, the accomplishments of the infrastructure programs were very uneven and, in general, unduly favored the major urban centers, especially the Greater Manila area.

10.03 In addition, the potential of local governments as generators of grass-roots support for economic development and as vehicles for balanced regional development was neglected. Their administrative powers were not strengthened and their tax base was gradually eroded. Public authorities and corporations provided only a few basic services (e.g., power and railroads), and, as indicated in Chapter 8, their investments were small and were concentrated in urban areas. Finally, the public sector's lack of attention to management training resulted in an overall deterioration of administrative capabilities at all levels.

10.04 The situation began to change in the early 1970s, when the Philippine Government began to play a more active role in development. The Government formulated a long-term strategy which called for substantial growth in public sector investments, an expansion and improvement of government services at all levels, a restructuring and revitalization of the local governments to

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1/ General government refers to all government, both national and local.

2/ General government current and capital expenditures rose from ₱ 30 per capita in 1951 to ₱ 60 and ₱ 83 in 1970. See Agustin Kintanar, "Financing the Public Sector," in The Philippine Economy in the 1970s (Manila: Institute of Economic Development and Research, University of the Philippines, and the Private Development Corporation of the Philippines, 1972), p. 164.

Table 10.1. Government Finances by Fiscal Year

| Category | Millions of pesos | | | | | Percentage of GNP | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | FY59 | FY64 | FY69 | FY72 | FY74 | FY59 | FY64 | FY69 | FY72 | FY74 |
| General Government | | | | | | | | | | |
| Revenue | n.a. | 2,434 | 3,603 | 6,388 | 12,800 | n.a. | 12.7 | 11.4 | 12.2 | 14.8 |
| Expenditures | 1,284 | 2,577 | 4,428 | 6,851 | 13,076 | 11.1 | 13.4 | 14.0 | 13.0 | 15.1 |
| GNP (at current prices) | 11,542 | 19,231 | 31,704 | 53,956 | 86,548 | -- | -- | -- | -- | -- |
| Public Investment | | | | | | | | | | |
| Total (including public corporations) a/ | 280 b/ | 405 | 681 | 877 | 1,760 | 2.4 | 2.1 | 2.1 | 1.6 | 2.0 |
| Tax Revenues | | | | | | | | | | |
| National tax revenues | 844 | 1,819 | 3,041 | 5,213 | 10,847 | 7.3 | 9.4 | 9.6 | 9.7 | 12.5 |
| Local government tax revenues | 150 | 210 | 334 | 424 | 560 | 1.3 | 1.1 | 1.0 | 0.8 | 0.7 |
| Social security contributions | 126 | 262 | 480 | 432 | 766 | 1.1 | 1.4 | 1.5 | 0.8 | 0.9 |
| Total tax revenues | 1,120 | 2,291 | 3,855 | 6,069 | 12,173 | 9.7 | 11.9 | 12.1 | 11.3 | 14.1 |

a/ Includes National Power Corporation, National Electrification Administration, Metropolitan Manila Waterworks and Sewerage System, Export Processing Zone Authority, Laguna Lake Development Authority and the Philippine National Railways.

b/ Mission estimate

Source: World Bank Economic Reports, 1968 through 1972. R.M. Bird, O. Shimoni and R.S. Smith,"Taxes and Tax Reform in the Philippines"(Washington: International Monetary Fund, 1974, processed draft), Tables 2, 3 and 4; National Economic and Development Authority (NEDA), Statistical Yearbook of the Philippines, 1975. National accounts as prepared by National Accounts Staff, Statistics Office (NEDA), revised as of December 1975

actively involve them in development efforts, and the assumption of a greater role of publicly-owned corporations, agencies, enterprises, and banks in the economy. The Government began to expand public resources through a sharp increase in tax revenues. Although the Philippine Government can claim considerable achievements in all of these areas, more difficult issues are expected to arise and present new challenges. Among these issues will be major changes in the public sector's administrative structure, the setting of new priorities for current and capital outlays, the implementation of tax reforms, the future organization of the public corporate sector, and sound debt management in the face of rapidly rising public corporate borrowings.

10.05 The role of the public sector in the economy will have to expand significantly in the future if the Government's development programs are to be implemented. Large public investments in the economic and social sectors and substantially higher current outlays as public services improve will claim considerably more resources - both domestic and external - than in the past and will require concerted efforts to mobilize the required resources. An adequate mobilization of financial resources will depend largely on the results of the various tax reform measures currently in progress or contemplated. The enlarged role of the public sector will also place added burdens on administrative capability and will require the Government to put more emphasis on training and on administrative and organizational improvements. The increasing importance of the public sector will mean that the division of responsibilities among the various levels of government will have to be reassessed.

## A. The Role of the National Government

10.06 Historically, the Philippines has had a centralized governmental structure. The delegation of authority by the national government to the provinces and other local governments has been more the exception than the rule. Philippine constitutional law has always viewed local governments as entities formed by the national government, which reflects the centralized system of the Spanish colonizers. Consequently, the national government and its agencies have been the most important components within the public administrative system and have been dominant both politically and financially. However, the public sector has represented only a relatively small share of the economy as a whole, which has meant that the national government's economic and financial impact was, until a few years ago, smaller than that in other countries with a similarly centralized structure.

10.07 The Government's administration was rather ineffective until the early 1970s. Functional responsibilities were ill-defined, with a plethora of parallel departments and bureaus; budget preparation and implementation procedures were influenced by the United States budgetary system and were unusually complex; and, on the whole, fiscal policy lacked focus. The status of the Department of Finance, which, in other countries, is the locus of policy formulation and decision-making in the fiscal field, was weak. As a result of all these factors, the Government's capacity to identify, prepare, and implement development projects was inadequate. In addition, widespread corruption

in public administration impaired the reputation of the civil service and contributed to the widespread belief that the Government's role in development should be kept as small as possible. In view of this feeling, little effort was made to increase the level of domestic resources for the public sector by higher and more effective taxation. Capital outlays by the Government were small, between 1 and 2 percent of GNP. The Government's current expenditures - at around 7-8 percent of GNP - were also low by international standards. The level of Government services was inadequate, except for relatively large expenditures for public primary education. Because of a conservative budget policy and the low level of development expenditures, national government borrowing was, until a few years ago, insignificant.

10.08 In recent years, the Government's intensified development efforts and its change in attitude in favor of an active role for the public sector have caused a different picture to emerge. The Government's project preparation and implementation capability has improved, and overall measures have been undertaken to modernize budget procedures and to streamline the governmental structure. Government services have been expanded, especially for agriculture and rural development. Above all, infrastructure expenditures by the Government have increased significantly, and large capital transfers have taken place from the Government to its corporate sector. Local governments have been encouraged to take an active role in development by a more efficient and equitable system of financial assistance to them by the national government. In part, at least, these developments have been made possible by the significant progress that has been made in raising revenues through tax reform measures, which were aided by the recent export boom. At the same time, however, the Government's desire to expand its role in the economy necessitates a larger resource base, which will require continued efforts to expand revenues relative to GNP.

National Government Revenues

10.09 National government tax revenues as a whole increased faster than GNP in the early 1960s; however, they remained fairly stagnant as a percentage of GNP from FY64 until FY72. The national government tax ratio (excluding contributions to the Social Security System) was between 9-10 percent of GNP during that time (Table 10.2). This was low if compared with countries at similar stages of economic development. 1/

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1/ See Roy W. Bahl, "A Representative Tax System Approach to Measuring Tax Effort in Developing Countries," IMF Staff Papers, Vol, XIX, No. 1 (March 1972), pp. 87-124. The author examined the taxable capacity and tax effort of 49 developing countries during 1966-68. The study concluded that the Philippines' actual tax ratio in this period was about 36 percent below the expected tax ratio. It also shows that the tax effort in the Philippines was generally low and was not attributable (as in other countries) to a very low intensity of use of one particular tax base. Of the 36 percent shortfall, 15.6 percent was due to below average intensity of use of the corporate income/export tax base, about 9.5 percent each to below average use of the import base and the personal income/internal indirect tax base, and 1.3 percent to below average use of property and personal taxes.

10.10 Since the late 1960s, the Government has initiated various tax policies aimed at raising the level of tax revenues and reforming the tax system. Legislation has been enacted in the area of indirect taxes, especially those related to external trade. Partly as a result of the tax reform measures, the Philippines' tax revenue performance has improved significantly over the last few years. National tax revenues increased by 35 percent in FY73 and by 55 percent in FY74, when the tax ratio reached 12.5 percent of GNP, compared to 9-10 percent a few years earlier. About one quarter to one-third of the revenue increments can be related to the new tax measures. Tax revenues were also boosted, of course, by the overall increase in economic activity and especially by the dramatic temporary improvement in export earnings. Despite the recent recession and falling export prices, the tax ratio in FY75 remained at the FY74 level.

10.12 The structure of national government taxes underwent some changes during the 1960s and the early 1970s. Although taxes on income and wealth increased in relative importance, the Government continued to depend heavily on indirect taxation, which accounted for 70 to 75 percent of total tax revenues. Direct tax revenues increased, in large part because of the rise in the top corporate income tax rate from 30 to 35 percent in 1969. Personal income tax revenues, on the other hand, showed little responsiveness to GNP growth and were equivalent to less than 1 percent of GNP on the average. Taxes on domestic goods and services declined as a share of total tax revenues since revenues from selective excise taxes, which had been the major revenue source in the 1950s, decreased sharply throughout the 1960s. Only sales tax revenues collected on imported goods showed significant gains during the period.

10.13 Apart from higher corporate income tax revenues, the entire increment in the national tax ratio in the early 1970s was the result of the increased role of taxes on external trade. This was attributable to the growing importance of taxes on imports (particularly since the floating of the peso in 1970) and the introduction of export taxes in 1970. With around 40 percent of total national tax revenue in FY72 derived from international trade, the Philippine's internal revenue system became highly sensitive to the fluctuations of the country's international terms of trade.

10.14 A study for the International Monetary Fund on taxation and tax reforms in the Philippines 1/ calculated for the FY60-73 period an elasticity of 1.1 for the national government tax system; that is, tax revenues rose by 1.1 percent for each 1.0 percent growth in GNP. By analyzing the varying actual elasticities of the individual tax categories, the report concluded that the built-in elasticities of the Philippine Government's tax system as a whole (excluding the export tax) was 0.9 in FY73. Even with the export tax (which varies with the value of exports and not with GNP), the elasticity of the system was still only close to unity. 2/

1/ R.M. Bird, D. Shimoni and R.S. Smith,"Taxes and Tax Reform in the Philippines"(Washington: International Monetary Fund, 1974, processed draft).

2/ The report used the methodology developed by Sheetal K. Chand and Bertram A. Wolfe in The Elasticity and Buoyance of the Tax System of Peru, 1960-71: An Empirical Analysis (Washington: International Monetary Fund, July 1973).

Table 10.2. National Tax Revenue by Fiscal Year

| Category | Millions of pesos | | | | | | | Percentage Composition b/ | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | FY59 | FY64 | FY69 | FY72 | FY73 | FY74 | FY75 a/ | FY59 | FY64 | FY69 | FY73 | FY73 | FY74 | FY75 |
| **Taxes on Income and Wealth** | 200 | 428 | 860 | 1,465 | 2,617 | 3,057 | 3,466 | 23.7 | 29.1 | 28.6 | 28.1 | 37.2 | 28.2 | 25.9 |
| Corporate income tax | 116 | 263 | 597 | 908 | 1,396 | 2,080 | 2,310 | 13.8 | 14.4 | 19.6 | 17.4 | 19.8 | 19.2 | 17.3 |
| Personal income tax | 66 | 158 | 204 | 443 | 562 | 641 | 858 | 7.8 | 8.7 | 8.0 | 8.5 | 8.0 | 5.9 | 6.4 |
| Others | 18 | 7 | 59 | 114 | 84 | 77 | 77 | 2.1 | 1.0 | 1.0 | 2.2 | 1.2 | 0.7 | 0.6 |
| Tax amnesty | ... | ... | ... | ... | 575 | 259 | 221 | ... | ... | ... | ... | 8.2 | 2.4 | 1.6 |
| Taxes on International Trade | 226 | 658 | 1,006 | 2,139 | 2,537 | 4,840 | 6,505 | 26.7 | 36.1 | 33.1 | 41.0 | 36.1 | 44.6 | 48.7 |
| Import duties | 226 | 419 | 607 | 1,084 | 1,435 | 2,772 | 3,729) | 26.7 | 23.0 | 20.0 | 20.8 | 20.4 | 25.6 | 27.9 |
| Sales tax on imports | ... | 239 | 399 | 580 | 645 | 1,003 | 1,126) | | 13.1 | 13.1 | 11.1 | 9.2 | 9.2 | 8.4 |
| Export duties | ... | ... | ... | 475 | 457 | 1,065 | 1,650 | ... | ... | ... | 9.1 | 6.5 | 9.8 | 12.4 |
| Taxes on Domestic Goods and Services | 364 | 604 | 951 | 1,261 | 1,390 | 2,273 | 2,850 | 43.1 | 33.2 | 31.3 | 24.2 | 19.7 | 21.0 | 21.3 |
| Excise tax c/ | 259 | 373 | 553 | 664 | 735 | 1,203 | 1,678 | 30.7 | 20.5 | 18.2 | 12.7 | 10.4 | 11.1 | 12.5 |
| General sales tax | 28 | 98 | 153 | 240 | 217 | 402) | 1,172 | 3.3 | 5.4 | 5.0 | 4.6 | 3.1 | 3.7) | 8.8 |
| Other indirect taxes | 77 | 133 | 245 | 357 | 438 | 668) | | 9.1 | 7.3 | 8.1 | 6.8 | 6.2 | 6.2) | |
| Other Taxes | 55 | 129 | 228 | 348 | 493 | 677 | 544 | 6.5 | 7.1 | 7.5 | 6.7 | 7.0 | 6.2 | 4.1 |
| Motor vehicle fees | 30 | 49 | 85 | 118 | 137 | 156 | 164 | 3.6 | 2.7 | 2.8 | 2.3 | 1.9 | 1.4 | 2.2 |
| Other | 25 | 80 | 143 | 230 | 356 | 521 | 380 | 2.9 | 4.4 | 4.7 | 4.4 | 5.1 | 4.8 | 1.9 |
| Total national tax revenues | 844 | 1,819 | 3,045 | 5,213 | 7,037 | 10,847 | 13,365 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |
| National Tax Revenues as a percentage of GNP | 7.3 | 9.1 | 9.6 | 9.7 | 11.5 | 12.5 | 12.6 | | | | | | | |

a/ Estimated in part
b/ Percentage totals do not always equal 100 because of rounding
c/ "Specific taxes" on tobacco products, petroleum products and other.

Sources: Data for FY59, FY64, and FY69 are from Bird, et al., "Taxes and Tax Reform in the Philippines;" data for FY72, FY73 and FY74 are from National Tax Research Center, Assessment of Tax Reforms in the Philippines, November 1975; data for FY75 are from the Budget Division of the Department of Finance.

10.15 Need for Additional Tax Reforms and Future Revenue Growth: The tax reforms of recent years have raised the level of revenues significantly, from around 9 percent of GNP in FY69 to an average of over 12 percent in FY73-75. Yet the share of revenues in GNP will have to rise even higher if the Government's development goals are to be achieved. While more improvements in tax enforcement and collection on the basis of the present tax laws would certainly produce some additional growth in revenue accruals, this increase would probably not suffice to provide all the required funds. The Mission, therefore, believes that major tax reform legislation will be needed in the latter half of the 1970s. Moreover, apart from the more medium-term need to generate sufficient revenues for financing the budget, the Government may, in the longer-term, want to correct the tax system's current social inequities.

10.16 The main elements of reform that appear to be necessary are set out in Technical Note I at the end of this chapter. In brief, the Mission believes that the main thrust of tax reform measures would need to be: (i) to widen the domestic base of tax revenues and reduce the heavy dependence of those revenues on international trade, and (ii) to improve the tax system's social equity by a sharp rise in direct taxation and higher indirect taxation of domestic goods and services consumed by the upper income groups of the population. In addition, the introduction of a national tax on land and on rural property warrants careful consideration. If a series of reforms along these lines were implemented, it should be possible to raise the ratio of national government taxes to GNP from around 12.6 percent in FY75 to at least 14.5 percent by FY80 1/ and 17 percent by FY85 (Table 10.3). Local tax revenues are likely to rise to 0.9 and 1.4 percent, respectively, in FY80 and FY85. As the coverage of social security benefits is being expanded, one could expect that social security contributions could reach 1.8 percent of GNP by FY85. Total aggregate tax effort would be over 16.5 percent of GNP by FY80 and almost 20 percent by FY85. Such revenues increases would require determined efforts on the part of the Government to formulate concrete legislation and to take immediate action in fully enforcing existing tax laws.

10.17 The Mission realizes that, in the short run, the national government is confronted with recessionary conditions which make immediate tax rate increases difficult. Further increases in local government revenues will depend on the effective delegation of financial authority to the local governments and the progress in their administrative capabilities to take over additional functions. However, policy decisions on tax measures will have to be made rather soon in order to produce results in the next few years, since more comprehensive reforms (for instance, those regarding income taxes) normally take a long time to be both legislated and implemented.

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1/ It should be noted that the fiscal year will be identical with the calendar year beginning in 1977.

Table 10.3: Revenue Projections of National and Local Government Taxes and Social Security Contributions

| Category | Year FY76 | FY80 | FY85 | Annual Growth Rate FY76-85 |
|---|---|---|---|---|
| Tax revenues | Millions of pesos at current prices | | | |
| National government | 16,530 | 33,360 | 78,000 | 18.8 |
| Local governments | 1,050 | 2,300 | 6,620 | 22.6 |
| Social security contributions | 1,050 | 2,530 | 8,510 | 26.2 |
| Total | 18,080 | 8,190 | 93,130 | 19.6 |
| | Percentage of GNP | | | |
| National government | 12.6 | 14.5 | 16.5 | |
| Local governments | 0.8 | 1.0 | 1.4 | |
| Social security contributions | 0.8 | 1.1 | 1.8 | |
| Total | 14.2 | 16.6 | 19.7 | |
| GNP | 131,080 | 230,055 | 472,765 | 15.3 |

Note: Revenue figures for FY76 are budget estimates.

Source: Mission estimates.

The Mission's projections of national government tax revenues until FY85 are based on the information contained in Technical Note I. The base year data are the Government's cash budget revenue estimates for FY76 (as of December 1975). The projections take into consideration the major policy objectives which are important for the reform of the Philippine revenue system. For instance, it is assumed that the share of tax revenues from international trade as a percentage of total national government tax revenues will decline from 45 percent in FY76 to about 40 percent in FY80 and 30 percent in FY85.

10.18 The Mission's estimates regarding direct taxation are rather optimistic. Assuming better enforcement of personal and corporate income taxes in the short-run as a result of the recently terminated tax amnesty program and determined Government efforts to introduce a comprehensive income tax reform, an average annual increase of about 23 percent in revenues from taxes on income and wealth is anticipated during the FY76-FY85 period. This would necessitate a sharp rise in tax elasticity from about unity in

the last few years to over 1.6 during the forecasting period as a result of both better collections and higher rates. Admittedly this is a very optimistic assumption. The estimates also assume a more rapid rise in the personal income tax, especially after FY78; a time lag is included in the forecast because of the time-consuming legislative work necessary for a tax reform in this field. Corporate tax revenues are expected to increase by 22 percent a year as a result of higher effective tax rates and a rapidly expanding corporate sector.

10.19 The Mission also expects that there will be a sharp rise in indirect taxes on domestic goods and services in the medium-term, as the Government compensates for some of the anticipated revenue losses in taxes on international trade and while revenues from direct taxation are not yet adequate to provide all of the needed revenues. The share of these indirect taxes would rise from 20 percent in FY76 to 26 percent in FY80 and about 30 percent in FY85. In brief, the national government would, in FY85, derive about 35 percent of its tax revenues from direct taxes (as compared to only 26 percent in FY76), while about 30 percent each would come from indirect taxes on international trade and on domestic goods and services.

10.20 A better tax effort will depend largely on improvements in tax administration. The Philippine revenue system lacks a strong, centralized authority in charge of revenue planning, legislation, and enforcement. The Bureau of Internal Revenue and the Bureau of Customs have worked as fairly independent agencies, collecting partly the same taxes, though from different sectors of the economy. Tax policy decisions affecting various economic sectors have frequently not been coordinated and this has contributed to the previously mentioned confusion in the incentive system. Other Government authorities also collect their own levies.

10.21 Even the simple monitoring of the revenue trends have proved to be difficult and detailed data have usually been available only after lengthy delays. Statistics issued by the various agencies have often been conflicting and have contained extensive double-counting. A thorough evaluation of the results of the tax amnesty, which would be important for the formulation of additional tax reform legislation, will be possible only in late 1976, since the relevant data cannot be provided earlier on a consolidated basis by the various agencies. A careful assessment of the tax amnesty, in particular, should aid in formulating the reform of the personal income tax and in improving the tools of tax enforcement to raise the very low effective rates of corporate taxes in various economic sectors.

10.22 The Mission believes that the entire complex of national government revenues, including the planning of tax policy, the drafting of legislation, the supervision and monitoring of collections, and the strict control of tax administration, should probably be concentrated in the Department of Finance. The formulation of further tax reforms, particularly a comprehensive review of the tax incentives for all areas of the economy, should also rest with the Department of Finance.

National Government Expenditures

10.23 The level of national government expenditures as a proportion of GNP was about 9 to 10 percent for many years. A large portion of the

current expenditures was devoted to education and social services. Capital expenditures were constrained by the low level of public savings and by the Government's limited capacity to prepare and implement projects. Since 1972, however, both current and capital expenditures have been increasing relative to GNP.

10.24 Current Expenditures: Throughout the 1960s, the overall level of national government current expenditures was low by international standards. Current outlays were about 8 to 9 percent of GNP. Since the early 1970s, however, particularly since FY72, the overall level of national government current expenditures has risen significantly in relation to GNP, and there has been a noticeable shift in the sectoral pattern of allocation (Table 10.4). Current expenditures on a obligational basis 1/ increased about 3.5 times, reaching nearly 11 percent of GNP. Much of the increase, especially in FY74 and FY75, was, of course, the result of severe inflationary pressures. Even at constant prices, however, the rise was around 65 percent, almost 11 percent per annum, which is substantially higher than the average annual real GNP growth of over 6 percent, and which reflects a large increase in Government activities. Actual spending in the cash budget showed similar increases during FY72 through FY75.

10.25 Betweeen the 1950s and the early 1970s, the allocation pattern of national government current expenditures remained roughly the same. Approximately 40 percent was spent for social services, about 30 percent for general administration (including 12-13 percent for national defense), and 18-20 percent for economic services, especially for transport and communication and, to a lesser degree, for agriculture and natural resources. Debt service (interest and repayments) was around 7 percent of the total. Subsidies and other nondefense transfers were very small. A special feature of current expenditures was the relatively high share (about one-third of current expenditures) allocated to education. Education expenditures in the overall context of the economy, however, were not excessive, being slightly less than 3 percent of GNP.

10.26 Since FY72 the sectoral distribution of current expenditures has been characterized by a substantial rise in defense expenditures, a significant relative decline in social service expenditures, and a large increase in subsidy payments in FY74 and particularly in FY75. Defense outlays, largely as a result of the civil unrest in Mindanao, rose from 14 percent of the total before FY72 to about 20 percent during FY73-FY75. The relative share of education expenditures declined to below 20 percent in FY75, and there was a decrease in the share of health expenditures. In addition, the relative share of current expenditures for agriculture,

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1/ Data on an "obligational" basis are derived from budget documents where receipts and expenditures are recorded on an accrual and obligational basis, respectively. In contrast, cash budget expenditures data are based on actual disbursements. The cash budget concept was only introduced in the Philippines in FY72 and a sectoral breakdown is not yet available. Therefore, for the discussion of the past, the Mission used obligational data. For projections, the Mission used the cash budget concept and applied roughly the same percentage breakdown by sector to the actual cash budget totals for FY73 through FY75.

Table 10.4. Percentage Allocation of National Government Current Expenditures a/

| Category | FY60 | FY65 | FY70 | FY71 | FY72 | FY73 | FY74 | FY75 |
|---|---|---|---|---|---|---|---|---|
| General administration | 30.8 | 30.6 | 32.1 | 32.3 | 32.6 | 30.2 | 30.5 | 30.4 |
| General government | 11.5 | 12.5 | 11.9 | 11.1 | 10.6 | 9.2 | 7.3 | 6.9 |
| Justice and police | 4.9 | 6.0 | 6.7 | 7.0 | 8.6 | 1.9 | 1.8 | 1.7 |
| National defense (including transfer payments) | 14.4 | 12.1 | 13.5 | 14.1 | 13.4 | 19.1 | 21.4 | 21.8 |
| Social services | 35.9 | 40.0 | 39.8 | 39.5 | 38.9 | 32.2 | 30.3 | 25.6 |
| Education | 28.1 | 32.5 | 32.0 | 32.1 | 31.1 | 24.6 | 23.4 | 19.6 |
| Health | 6.1 | 6.1 | 6.2 | 5.8 | 5.9 | 5.6 | 5.8 | 4.9 |
| Labor and welfare | 1.7 | 1.4 | 1.6 | 1.6 | 1.9 | 2.0 | 1.1 | 1.1 |
| Economic sectors | 20.8 | 19.3 | 18.4 | 17.6 | 17.2 | 25.5 | 23.7 | 19.1 |
| Agriculture and natural resources | 5.9 | 6.4 | 5.5 | 4.9 | 5.5 | 14.5 | 7.1 | 7.8 |
| Transport and communications | 11.8 | 9.4 | 7.2 | 8.8 | 8.2 | 7.5 | 9.3 | 7.1 |
| Commerce and industry | 0.8 | 1.5 | 1.2 | 1.4 | 1.4 | 1.0 | 2.9 | 1.0 |
| Other economic development | 2.3 | 2.0 | 4.5 | 2.5 | 2.1 | 2.5 | 4.4 | 3.2 |
| Subsidies and other transfer payments | 5.1 | 3.6 | 2.4 | 1.1 | 3.8 | 3.8 | 8.3 | 17.0 |
| Debt service | 7.4 | 6.5 | 7.3 | 9.5 | 7.5 | 8.3 | 7.2 | 7.9 |
| Interest | 3.0 | 3.0 | 4.5 | 5.7 | 5.2 | 5.0 | 4.4 | 5.0 |
| Repayment b/ | 4.4 | 3.5 | 2.8 | 3.8 | 2.3 | 2.3 | 2.8 | 2.9 |
| Total current expenditures | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |
| Total (in millions of pesos) | 1,050 | 1,843 | 3,328 | 3,758 | 4,371 | 5,901 | 7,915 | 11,620 |
| Total (as percentage of GNP) | 8.4 | 8.8 | 9.0 | 8.4 | 8.3 | 9.4 | 9.4 | 10.9 |

a/ Expenditures are on the basis of an obligational budget.

b/ Loan repayments and sinking fund contributions.

Source: Department of Finance, Budget Commission.

transport, and other productive sectors declined in FY75 after a significant rise in FY73 and FY74. Current outlays for agriculture, in fact, were around 7.5 percent in FY74 and FY75 compared to about 6 percent historically.

10.27 Another important aspect of the budget is the distribution of current expenditures by income groups and geographical regions. Although published financial statistics clearly show that most expenditure programs have benefitted the large urban centers, especially the Greater Manila area, and that Government services have not been equitably distributed among income rise in FY73 and FY74. Current outlays for agriculture, in fact, were around 7.5 percent in FY74 and FY75, compared to about 6 percent historically. groups, these problems have only recently been studied. 1/ It appears that, in general, the absolute value of benefits from Government expenditures received by families increases with the income level of the families. This is even the case with Government services that were designed to provide equal opportunities for the lower income groups, such as public education, medical care, and extension services in the rural areas. It is likely that the low incomes of the families, their location in relation to the source of the services, and their ignorance of the availability and the cost-benefits of the services have probably prevented low-income families from availing themselves of such services. Although the problem of access to services is present in the cities, it becomes more severe in the outlying rural areas. It has been found that the disparity in receiving Government services increases sharply the farther away the provinces are from the Greater Manila area. 2/ Most of the neglected provinces have received much less in services from the Government than they contributed to it through taxes, with primary education probably the only exception.

10.28 The Government has become increasingly aware of the need to improve income distribution in the Philippines, and has demonstrated its concern in major policy decisions such as the agrarian reform. A better distribution of Government financial benefits in favor of the lower income households has gained high priority within the Government, as is illustrated by the increases in Government subsidies in the last few years. Most of the subsidy payments for FY74 and FY75 were directed toward the subsidization of fertilizer, petroleum, and grain. 3/ These subsidies reflected

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1/ A national survey of households was undertaken between April and September 1974 for the purpose of obtaining allocators for the divible and traceable national government services. The survey results were applied to the FY71 national government budget figures. The study was summarized with the assistance of the National Tax Research Center. See Edita A. Tan, Taxation, Government Spending and Income Distribution in the Philippines (Quezon City: University of the Philippines Institute of Economics, 1975) pp. 37-42.

2/ Ibid.

3/ Subsidies in FY74 totalled ₱ 419 million, including ₱ 200 million for rice, corn, and sorghum; ₱ 132 million for petroleum; and ₱ 87 million for fertilizer. In FY75 subsidies amounted to ₱ 321 million, consisting of ₱ 150 million for fertilizer and ₱ 171 million for rice, corn, and sorghum (including ₱ 131 million for rice loan amortization payments). Other transfers in FY75 included a ₱ 1.3 billion direct transfer to the Philippine Coconut Authority.

the Government's desire to undertake some redistribution of income in favor of the poorer sections of both the rural and the urban populations; the magnitude of the subsidies were the result of the sharp rise in international prices for food, oil, and other raw materials.

10.29 In the future, the national government will be faced with an additional rise in current expenditures relative to GNP if government services, especially those related to social and economic development, are to be expanded. In the absence of official expenditure projections beyond FY76, forecasts were calculated of possible trends in national government current expenditures that would be needed to support the programs set out in the earlier chapters. The forecasts included substantially higher current outlays for economic and social services and increased national government financial support for local governments.

10.30 An increase in national government current expenditures to about 13 percent of the estimated GNP by FY80 seems feasible. Assuming that national government tax revenues would rise to 14 percent of GNP, and nontax revenues to about one percent, current outlays would allow a current account surplus of 2 percent of GNP, sufficient to finance an adequate share of the capital expenditures discussed below. Based on these assumptions, the Mission has made forecasts of national government current expenditures for FY80 derived from the actual cash budget performance in FY75 and the Government's estimated cash budget for FY76 (Table 10.5).

10.31 The forecasts assume that real wages will rise by 8 percent a year from FY77 through FY80. Another 5 percent a year upward adjustment of wages and salaries is applied in FY77 and FY88 to recompensate national government employees for income losses suffered in earlier years due to inflation. In addition, an inflation rate of 7.5 per annum, the same as for the GNP projections, is assumed throughout the forecasting period. The total amounts to wage and salary increases of 20.5 percent each in FY77 and FY78, and 15.5 percent annually in subsequent years. The assumed 8 percent annual increase in real wages should be used primarily to upgrade the quality of national government services; it should only to a lesser extent be used to hire an additional number of employees. As far as employment generation is concerned, the national government has been the fastest growing sector during the last ten years; further increases in national government employment should probably take place only as the scope of Government services extends into new fields, and as services in the outlying regions are upgraded.

10.32 The forecasts provide for a significant change in the allocational pattern of current expenditures. While the share of expenditures for general administration (including defense) is estimated to decline from 30 percent in FY75 to about 24 percent in FY80, the share of outlays for social and economic services is to rise sharply and reach around 30 percent each. This rise would reflect a considerable expansion of Government services in these areas. The rural extension, primary education, health and family planning sectors, in particular, need improvements in the quality of their staffs. While it would seem that the public sector continues to be competitive with the private sector in the lower income brackets, an upgrading of positions in the public sector is probably necessary for medium and upper level skilled positions.

Table 10.5 Forecasts of National Government Current Expenditures on a Cash Budget Basis (At current prices)

| Category | FY75 Millions of pesos | FY75 Percentage of total outlay | FY75 Percentage of GNP | FY80 Millions of pesos | FY80 Percentage of total outlay | FY80 Percentage of GNP |
|---|---|---|---|---|---|---|
| General administration | 3,750 | 30.4 | 3.1 | 6,790 | 24.0 | 3.0 |
| Defense | 2,690 | 21.8 | 2.2 | 4,585 | 16.2 | 2.0 |
| Other | 1,060 | 8.6 | 0.9 | 2,205 | 7.8 | 1.0 |
| Social services | 3,150 | 25.6 | 3.0 | 8,915 | 31.5 | 3.8 |
| Education | 2,420 | 19.6 | 2.3 | 6,540 | 23.1 | 2.8 |
| Health | 605 | 4.9 | 0.6 | 1,725 | 6.1 | 0.7 |
| Other | 135 | 1.1 | 0.1 | 650 | 2.3 | 0.3 |
| Economic sectors | 2,355 | 19.1 | 2.2 | 8,490 | 30.0 | 3.7 |
| Agriculture and natural resources | 960 | 7.8 | 0.9 | 3,255 | 11.5 | 1.4 |
| Transport and communication | 875 | 7.1 | 0.8 | 2,830 | 10.0 | 1.2 |
| Commerce and industry | 125 | 1.0 | 0.1 | 1,105 | 3.9 | 0.5 |
| Other economic development | 395 | 3.2 | 0.4 | 1,300 | 4.6 | 0.6 |
| Transfers | 2,100 | 17.0 | 2.4 | 1,980 | 7.0 | 0.9 |
| Debt service | 975 | 7.9 | 0.9 | 2,125 | 7.5 | 0.9 |
| Interest | 615 | 5.0 | 0.6 | 1,500 | 5.3 | 0.6 |
| Repayment | 360 | 2.9 | 0.3 | 625 | 2.2 | 0.3 |
| Total current expenditures | 12,330 | 100.0 | 11.6 | 28,300 | 100.0 | 12.3 |
| Allotments and other financial assistance to local governments | 653 | 5.3 | 0.6 | 1,553 | 5.5 | 0.7 |

Source: Mission projections

10.33 The decreasing allocation to education in the national government budget in recent years has caused concern. As discussed in Chapter 7, the relative decline in that sector's allocation of budget resources after 1972 appears to have been fairly drastic, especially since public education expenditures in the past had not been very high by international standards. Moreover, although in absolute figures the obligational budget expenditures for public education rose from ₱ 1.36 billion in FY72 to ₱ 2.23 billion in FY75, they actually remained at the FY72 level (expressed in constant prices and applying the GNP deflator), and on a per capital basis they declined by 15 percent in real terms. Consequently, per capital expenditures for education in FY75 were only US$8 (at constant prices), which was about the same level as in Thailand. 1/ It should be remembered, however, that private expenditures for education are very significant; the Catholic Church, especially, plays an important role in secondary and tertiary education. Nevertheless, it would be desirable for the share of education expenditures to grow in the future; expenditures for education should probably rise to almost 3 percent of GNP by FY80, or about 23 percent of current outlays, in order to support the expected expansion of public education.

10.34 The Mission forecasts propose that current expenditures for health services would rise to over 6 percent of total outlays, or 0.7 percent of GNP. This would be in line with the proposed expansion of health services in the rural areas and in urban areas outside the Manila area. 2/ The number of staff will have to be expanded in the health field proper and the quality of the staff workers in family planning and in rural health services will have to be improved. The Mission has also allowed for a relatively large increase in current expenditures for other social services, including social welfare, community development, and youth programs, since the Government has indicated on various occasions that it will become much more active in these areas as part of its regional development program.

10.35 Regarding economic services, the forecasts propose a sharp rise in current outlays for agriculture and national resources, which would amount to almost 1.5 percent of GNP by FY80, or 11.5 percent of total current expenditures. As mentioned earlier, such an increase will probably be necessary to improve the extension services and other services for rural development. The forecasts also include outlays for additonal maintenance associated with the various agricultural development projects in progress.

10.36 The need for more emphasis on maintenance is also the reason for raising current outlays for transport in the forecasts from 0.8 percent of GNP in FY75 to 1.2 percent by FY80. Maintenance of the road system has been neglected in the past and will require significantly more financial resources in the next few years. Moreover, Government transport services will have to be expanded in order to support the Government's efforts for more balanced regional development, which means that the expansion of port services

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1/ Per capita education expenditures in Korea were US$11 and in Malaysia US$32 in 1974.

2/ See Chapter 7 for a discussion of the health sector.

and the improvement of air transport links will become increasingly important. Telecommunication services will also need to be improved, especially in the outlying areas (e.g., in the Visayas and Mindanao).

10.37 Services for industry and commerce will also have to be improved in order to support the Government's promotion of medium- and small-scale industries and to aid the industrialization process in the less developed regions. The forecasts increase outlays for these services, which would amount to about 4 percent of total current expenditures, or 0.5 percent of GNP, by FY80. The forecasts also include a rise in current expenditures for supporting services such as electricity, and thus increase the outlays for the National Electricity Administration (which is part of the national government budget) in connection with the rural electrication program currently in progress.

10.38 The projections also assume a reduction of national government subsidies and other nondefense transfers from around 17 percent of current outlays to about 4 percent by the end of the decade. The present large subsidy payments may have been necessary as an emergency measure, but they should probably not become a permanent feature of Philippine price policies. A restructuring of Government services for the benefit of the lower-income groups would allow direct price subsidies to be reduced. However, the thrust of such a policy would probably have to differ in urban and in rural areas. In urban areas, especially the Greater Manila area, where the level of services has already been considerable compared to the rest of the country, more emphasis should probably be given to reaching the lowest income groups rather than to expanding the quantity of services. In many rural areas, on the other hand, some of the basic services will have to be begun or expanded from a very low level.

10.39 Capital Expenditures: Until FY72, the volume of capital expenditures by the central government was very low, accounting for only 10-15 percent of total national government expenditures, and averaging just over 1 percent of GNP. 1/ Most of the capital expenditures were for public investment in infrastructure, although some outlays were capital transfers for equity in public corporations and loans to the rest of the public sector. The sectoral composition of capital outlays shown in Table 10.6 reflects a heavy emphasis on transport, especially road construction, and on agriculture, due to the construction of major irrigation projects.

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1/ The Mission encountered serious statistical problems in its attempts to determine the amount of capital expenditures actually spent. "Obligational authority" figures substantially over-state actual tional government capital outlays; the cash budget concept, introced in FY71, probably gives the most accurate account, but may derstate somewhat the actual implementation of infrastructure

Table 10.6 National Government Capital Expenditures
(As a percentage of total capital expenditures)

| Category | FY60 | FY65 | FY70 | FY71 | FY72 | FY73 | FY74 | FY75 |
|---|---|---|---|---|---|---|---|---|
| General administration | 6.5 | 6.0 | 3.3 | 2.5 | 2.5 | 3.8 | 1.8 | 2.4 |
| Defense | 1.4 | 0.8 | 1.1 | 1.6 | 1.5 | 3.5 | 1.7 | 1.6 |
| Other | 5.1 | 5.2 | 2.2 | 0.9 | 1.0 | 0.3 | 0.1 | 0.8 |
| Social services | 17.6 | 4.7 | 12.4 | 8.0 | 5.5 | 6.1 | 4.4 | 7.5 |
| Education | 12.5 | 2.6 | 9.1 | 5.8 | 3.6 | 4.6 | 2.0 | 4.6 |
| Health | 5.1 | 1.7 | 3.0 | 1.0 | 1.8 | 1.3 | 2.2 | 2.7 |
| Labor and welfare | ... | 0.4 | 0.3 | 1.2 | 0.1 | 0.2 | 0.2 | 0.2 |
| Economic sectors | 75.9 | 89.7 | 84.3 | 89.4 | 91.9 | 90.0 | 93.9 | 90.2 |
| Agriculture and natural resources | 22.7 | 6.4 | 7.9 | 15.8 | 24.0 | 18.7 | 36.0 | 25.7 |
| Transport and communication | 41.7 | 76.8 | 61.3 | 46.5 | 35.5 | 37.2 | 24.0 | 41.4 |
| Commerce and industry | 0.5 | 0.8 | 2.3 | 9.4 | 1.8 | 0.8 | 4.7 | 3.4 |
| Other economic development | 11.0 | 5.7 | 12.8 | 17.7 | 30.5 | 33.3 | 29.2 | 19.5 |
| Total | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

Note: Data are on an obligational basis.

Source: Budget Commission.

10.40 Capital transfers to Government agencies, development banks, public corporations and Government enterprises have become a major component of the Government's capital outlays in recent years. This development is very significant. It demonstrates the Government's determination to provide public corporations and Government-controlled development banks with an adequate financial base to enable them to borrow sufficient funds for the financing of their development programs without a serious deterioration of their debt-equity ratios. For instance, increased capitalization of banks in the form of bonds reached ₱ 1.65 billion in FY74 1/ with the creation of financially strong development banks that could assist in the implementation of agricultural and rural development programs. Direct capitalization of Government institutions and enterprises rose sharply in FY75 and will probably be substantially larger in FY76. Such transfers amounted to about ₱ 650 million in FY75; 2/ as some of the transfer outlays originally budgeted for FY75 will be spent in FY76, total expenditures

1/ On a cash disbursement basis. ₱ 290 million went to the Development Bank of the Philippines, ₱ 530 million to the Land Bank, and ₱ 200 million to the Philippine National Bank.

2/ On a cash disbursement basis.

for the capitalization of Government institutions and enterprises in FY76 may rise to around ₱ 3.0 billion. 1/

10.41 The Mission's forecasts of national government capital expenditures are based on the projections of public sector investments discussed in Chapter 8 and on Mission estimates of required central government loans and equity contributions to public entities as explained later in this chapter. National government infrastructure expenditures are projected to rise rapidly in order to support the implementation of the Government's most important investment programs, particularly those in irrigation, flood control, and road construction. In addition, ambitious investment plans in the public corporate sector and expanded lending programs by Government-supported development banks will require significant capital subsidies and equity contributions to these institutions by the national government. Lending to local governments will also increase.

10.42 Under these assumptions, total national government capital outlays would need to reach a level of almost ₱ 12.0 billion at current prices, or 5.2 percent of GNP, by FY80. Of this amount, ₱ 8.0 billion, equivalent to 3.5 percent of GNP, would be for infrastructure investments by the central government, compared to ₱ 1.1 billion at current prices or 1.0 percent of GNP in FY75. Realizing this goal will require significant improvements in project preparation and implementation, as well as a considerable acceleration of the Government's ability to release appropriated funds for disbursement. Given the fact that cash releases for infrastructure investments in FY75 were already at a level of ₱ 1.54 billion while obligational authority was around ₱ 3.4 billion a year in FY74 and FY75, it is reasonable to assume that the disbursement process can indeed be accelerated. The allocation of infrastructure expenditures to various sectors is summarized in Table 10.7.

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1/ Roughly ₱ 3.6 billion was or will be spent in FY75 and FY76 combined for capital transfers; about ₱ 1.5 billion of this amount has been earmarked for the take over of MERALCO, ₱ 450 million for the capitalization of the National Power Company (NPC), and another ₱ 270 million for the National Electrification Administration (NEA). Around ₱ 50 million is allocated to the Philippine National Oil Company for its oil and natural gas exploration program. Capital transfers of ₱ 200 million will go to the National Irrigation Authority (NIA), ₱ 100 million to the Land Bank, and ₱ 340 million to the Agricultural Credit Administration (ACA) in order to broaden agricultural credit programs, especially those for rice and corn farmers and for the coconut revitalization program. Another ₱ 300 million is allocated for the equity of the Export Processing Zone Authority (EPZA) to expedite the establishment of the

Table 10.7. Mission Forecasts of National Government Capital Expenditures
(At current prices)

| Category | FY75[a] Amount (In millions of pesos | FY75[a] Composition (In percent) | FY75[a] Share in GNP (In percent) | FY80 Amount (In millions of pesos) | FY80 Composition (In percent) | FY80 Share in GNP (In percent) |
|---|---|---|---|---|---|---|
| General administration | 25 | 1.2 | 0.02 | 145 | 1.2 | 0.06 |
| Defense | 17 | 0.8 | 0.02 | 95 | 0.8 | 0.04 |
| Other | 8 | 0.4 | 0.0 | 50 | 0.4 | 0.02 |
| Social sectors | 80 | 3.9 | 0.08 | 1,150 | 9.6 | 0.5 |
| Education | 49 | 2.4 | 0.04 | 720 | 6.0 | 0.3 |
| Health | 29 | 1.4 | 0.03 | 240 | 2.0 | 0.1 |
| Other | 2 | 0.1 | 0.01 | 190 | 1.6 | 0.1 |
| Economic sectors | 980 | 47.4 | 0.90 | 6,770 | 56.6 | 2.9 |
| Agriculture and natural resources | 272 | 13.1 | 0.26 | 2,390 | 20.0 | 1.0 |
| Transport and communications | 440 | 21.3 | 0.41 | 3,830 | 32.0 | 1.7 |
| Other | 270 | 13.0 | 0.23 | 550 | 4.6 | 0.2 |
| Total infrastructure | 1,085 | 52.5 | 1.0 | 8,065 | 67.4 | 3.5 |
| Capital transfers to local governments | ... | ... | ... | 700 | 5.8 | 0.3 |
| Other capital outlays | 982 | 47.5 | 0.9 | 3,195 | 26.8 | 1.4 |
| Total capital outlays | 2,067 | 100.0 | 1.9 | 11,960 | 100.0 | 5.2 |

a/ Total capital outlays are preliminary actual cash disbursements during FY75. They include "prior years' accounts payable" which are assumed to comprise primarily appropriations for capital outlays made in earlier years but actually spent in FY75. The sectoral breakdown of infrastructure expenditure is analogous to the breakdown in the obligational budget.

Source: Mission estimates.

10.43 The amount of national government capital transfers to such entities as corporations, Government enterprises, and Government banks is projected to rise to ₱ 3.9 billion at current prices, or 1.7 percent of GNP, by FY80. It is difficult to predict a sectoral breakdown of equity transfers to these entities during the next few years, as allocations will depend on their individual investment programs. In addition, the extent to which Government funds will be required to provide financial backing to large industries such as steel, petroleum, and fertilizer could only be roughly estimated. The Mission did assume that by FY80 about ₱ 700 million would be granted as loans to local governments to finance part of their investment programs, in accordance with increased Government efforts to stimulate local government participation in economic development.

Financing National Government Expenditures

10.44 Throughout the 1960s, tax performance was inadequate and nontax receipts were low. As a result, national government savings on current account were insignificant, and even negative in FY69 and FY70. The situation began to improve markedly after FY71 because of the export boom and the successful implementation of tax reform measures. As Government revenues temporarily rose faster than current outlays, the Government's current account surplus increased considerably. In FY74, the current account surplus amounted to ₱ 3.85 billion, or 4.6 percent of GNP, but the current surplus fell to ₱ 2.85 billion in FY75, when tax receipts were somewhat below the budget estimates. The high level of Government savings on current account can be attributed in part to the national government's strict anti-inflationary fiscal management and in part to the significant improvement in revenue performance.

10.45 In both FY74 and FY75, the current account surpluses far exceeded total capital expenditures as cash disbursements for infrastructure and other capital outlays lagged considerably behind the rapidly rising appropriations. As the Government continued to borrow substantially from domestic and foreign sources, overall national government cash balances in FY74 and FY75 reached record surpluses of ₱ 3.2 and ₱ 2.8 billion, respectively. In FY74 and FY75 combined, net domestic borrowing totalled ₱ 4 billion, 70 percent of which was derived from the issuance of bonds. Net borrowing from abroad, which was used exclusively for the support of investment programs, amounted to the equivalent of only US$25 million in FY74. In FY75, as project implementation sped up, net borrowing from foreign sources on a cash disbursement basis rose to over US$80 million, which financed over 55 percent of national government infrastructure expenditures in that year.

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1/ The Government also plans to present for the first time a consolidated budget of the entire public sector by FY78. In addition, as mentioned earlier, the fiscal year is to be synchronized with the calendar year as of January 1, 1977.

10.46 The Mission's forecasts of national government finances in Table 10.8 assume that total current receipts by the national government will amount to 16.0 percent of GNP by FY80. If the projections of current spending are realized, expenditures would not exceed 12.3 percent of GNP by that year. This would allow national government savings of 3.7 percent of GNP, which would finance somewhat more than half of the Government's capital outlays. The balance, roughly ₱ 3.5 billion at current prices (US$460 million), or 1.5 percent of GNP, would have to be financed by net borrowing from foreign and domestic sources in that year. This financing would not include direct borrowing from domestic and external sources by public corporations and Government enterprises, such as the National Power Corporation or the National Steel Corporation, which would probably be guaranteed by the national government but which would not be channelled through its budget. 1/

10.47 The analysis in Chapter 8 indicates that about 30 percent of the national government's infrastructure expenditures would be financed through foreign loans. This would result in net borrowing from abroad of ₱ 2.3 million (US$300 million at the present exchange rate), which would be about 1.2 percent of the GNP estimated for FY80.

10.48 About ₱ 1.4 billion, or 0.5 percent of GNP, would have to be financed from domestic borrowing in FY80. The level would not be higher in FY80 than in FY75 at current prices, and in real terms there would be a significant decrease in domestic net borrowing. The underlying assumption is that claims on domestic savings from the private sector and from the briskly expanding public corporate sector will be very large.

10.49 As discussed in Chapter 9, the Mission expects the marginal domestic savings rate to rise from about 21 percent in 1975 to 25 percent of GDP by 1980. This is a significant increase and not easily achieved. But even with such a favorable marginal savings rate, the Mission believes that the national government may find it difficult to raise more than around ₱ 1.2 billion (Table 10.8) without preempting funds which would otherwise be sources of financing for the private and corporate public sectors. In other words, the success of a national government development program of the size discussed above will depend to a large extent on the availability of as much external finance as is possible at reasonable terms considering the constraints of the balance of payments.

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1/ The ₱ 3.9 billion would include all borrowing for national government infrastructure programs (e.g., for irrigation, port construction and education), as well as for loans and transfers to local governments for infrastructure programs and for capital transfers to public corporations.

Table 10.8 Summary National Government Finances on a Cash Budget Basis
(Amounts in millions of pesos at current prices)

| Category | Actual FY75 Amount | Actual FY75 Percentage of GNP | Estimated FY80 Amount | Estimated FY80 Percentage of GNP |
|---|---|---|---|---|
| Receipts | 15,637 | 14.7 | 36,810 | 16.0 |
| Taxes | 13,365 | 12.6 | 33,360 | 14.5 |
| Nontax receipts | 2,272 | 2.1 | 3,450 | 1.5 |
| Current expenditures | 12,785 /a | 12.0 | 28,300 | 12.3 |
| Current surplus | 2,852 | 2.7 | 8,510 | 3.7 |
| Capital expenditures | 2,067 | 1.9 | 11,960 | 5.2 |
| Infrastructure | 1,085 | 1.0 | 8,050 | 3.5 |
| Other capital outlays | 982 /b | 0.9 | 3,910 | 1.7 |
| Total cash deficit/surplus | 785 | 0.7 | 3,450 | 1.5 |
| Financing | | | | |
| Net borrowing | 2,041 | 1.9 | 3,450 | 1.5 |
| Foreign | 621 | 0.6 | 2,300 | 1.0 |
| Domestic | 1,420 | 1.3 | 1,150 | 0.5 |
| Treasury bills and notes | 881 | 0.8 | 550 | 0.25 |
| Bonds | 539 | 0.5 | 600 | 0.25 |
| Change in cash balance | 2,826 | 2.6 | -- | -- |

/a Includes Treasury Warrants from prior years outstanding and balances for guaranteed obligations minus collections of obligations of prior years as well as other so-called nonbudgetary operations on a net basis. These items are not included in current expenditures in the earlier tables.

/b Includes ₱ 329 million of "Prior Years' Accounts Payable," which was assumed to comprise primarily appropriations for capital outlays in earlier years actually spent in FY75.

Source: Department of Finance and Mission estimates.

## B. Public Corporations and Enterprises

10.50 Public corporations and Government-owned or controlled enterprises have traditionally played a relatively minor part in Philippine economic development. Their role has been primarily that of providing some basic services, including electricity (National Power Corporation), transport (Philippine National Railways), water supply and sewerage (Metropolitan Waterworks and Sewerage System), and gas (Manila Gas Corporation). The Government has operated a number of enterprises, but most of them have been quite small in size. A variety of self-governing boards, commissions, and agencies have also existed, but many have had no budgets of their own; instead, they have been included in the national budget. Several have had limited economic or legal responsibilities, although some of them, like the Board of Investments (BOI) have held key positions in formulating development policies. The primary exception to this pattern has been the Government-owned banks, particularly the Philippine National Bank and the Development Bank of the Philippines, which have played major roles in the field of finance.

10.51 By the end of FY73, Government agencies included 7 Government-financing companies, 5 public utility corporations, 39 Government developmental and other corporations, and 19 self-governing boards, commissions, and agencies with total assets of ₱ 38.3 billion. The overall financial condition of these 70 Government entities in 1972, 1973, and 1975 are summarized in Tables 10.9 and 10.10.

Table 10.9: Assets, Liabilities, and Net Income of Government and Government-Controlled Corporations
(In millions of pesos)

| Item | June 30, 1972 | June 30, 1973 |
|---|---|---|
| Assets | 28,506 | 38,265 |
| Liabilities | 22,828 | 29,951 |
| Liabilities (as a percentage of assets) | (79) | (78) |
| Net worth | 5,678 | 8,314 |
| Income | 3,340 | 3,940 |
| Expenses | 2,870 | 3,377 |
| Net income | 470 | 563 |

Source: Philippine Commission on Audit, 1973 Annual Financial Report of Government-owned or Controlled Corporations (Quezon City, 1973), p. 5.

Table 10.10: Assets and Liabilities of Selected Government Corporations, Enterprises, and Financial Institutions

(In millions of pesos)

| | FY73 - Actual | | FY74 - Estimate | | FY75 - Estimate | |
|---|---|---|---|---|---|---|
| Government Public Utilities | Assets | Liabilities | Assets | Liabilities | Assets | Liabilities |
| National Power Corporation (NPC) | 1,342.6 | 683.9 | 1,602.5 | 521.1 | 2,395.5 | 888.1 |
| Philippine National Railways (PNR) | 547.1 | 48.3 | 593.8 | 46.5 | 618.7 | 40.1 |
| Manila Gas Corporation (MGC) | 33.6 | 7.6 | 33.8 | 6.6 | 35.0 | 6.6 |
| Metropolitan Waterworks and Sewerage System (MWSS) | 1,490.9 | 649.1 | 1,475.9 | 677.2 | 1,508.7 | 700.8 |
| Total Government Public Utilities | 3,414.2 | 1,388.9 | 3,706.0 | 1,251.4 | 4,557.9 | 1,635.6 |
| Enterprises | | | | | | |
| Manila Hotel Company (MHC) | 4.4 | 2.3 | 4.3 | 2.2 | 4.2 | 2.0 |
| National Development Company (NDC) | 257.4 | 254.0 | 244.7 | 220.5 | 245.8 | 221.0 |
| National Shipyards and Steel Corporation (NSSC) | 138.7 | 137.8 | 109.8 | 111.0 | 107.6 | 110.2 |
| People's Homesite and Housing Corporation (PHHC) | 87.4 | 45.2 | 85.8 | 45.7 | 272.1 | 101.2 |
| Home Financing Commission (HFC) | 6.3 | 1.0 | 7.5 | 0.4 | 9.0 | 0.5 |
| Philippine Charity Sweepstakes Office (PCSO) | 36.8 | 34.2 | 35.9 | 32.8 | 35.4 | 31.9 |
| Philippine Coconut Administration (PCA) | 5.8 | 1.0 | ... | ... | ... | ... |
| Philippine Sugar Institute (PSI) | 41.5 | 1.5 | 45.0 | 1.6 | 47.0 | 1.5 |
| Philippine Tobacco Administration (PTA) | 45.3 | 7.7 | 49.6 | 4.2 | 59.3 | 4.2 |
| Philippine Virginia Tobacco Administration (PVTA) | 390.2 | 227.8 | 90.7 | 211.0 | 80.8 | 120.0 |
| Total Enterprises | 1,013.8 | 712.5 | 673.3 | 629.4 | 861.2 | 592.5 |
| Financial Institutions | | | | | | |
| Development Bank of the Philippines (DBP) | 4,702.9 | 2,843.6 | 5,279.4 | 3,304.1 | 7,475.9 | 7,324.4 |
| Philippine National Bank (PNB) | 5,309.8 | 4,776.6 | | | | |
| Land Bank of the Philippines (LBP) | 129.2 | 54.8 | | | | |
| Government Service Insurance System (GSIS) | 3,520.8 | 3,357.3 | 3,781.7 | 3,643.8 | 4,045.6 | 3,903.1 |
| Social Security System (SSS) | 1,891.9 | 130.9 | | | | |
| National Investment and Development Corporation (NIDC) | 348.7 | 88.8 | | | | |
| Central Bank of the Philippines (CBP) | 14,433.3 | 14,433.3 | 21,273.6 | 20,947.4 | | |
| Total Financial Institutions | 30,336.6 | 25,685.3 | | | | |
| Total Financial Institutions (Excluding CBP) | 15,903.3 | 11,252.0 | | | | |

Source: Department of Finance and annual reports of the various organizations.

10.52 The Mission estimates that investments by these corporations and enterprises were, on the average, probably less than 0.3 percent of GNP throughout the 1960s. However, this situation began to change in the 1970s as the Government started to expand public investment. The Mission believes that investments by the public utility corporations were probably equivalent to about 0.7 percent of GNP in the late 1970s. It is clear from the discussions in Chapters 5 and 8 that an even larger role for public corporations and enterprises is contemplated for the future. By 1980, investments by the public utility corporations could reach 2.2 percent of GNP, and investment by Government-controlled enterprises in basic industries, including fertilizer, petroleum refining, and steel making, could also be quite significant.

10.53 The magnitude of the proposed investments in public utilities and in basic industries represents a major change in the role of the Government in the Philippine economy. Apart from the obvious issue of the manner in which these investments will be financed, a number of other key issues will need to be resolved. One of these is the degree of autonomy in investment decision-making which should be given to the corporations and enterprises. Closely related to this is the way in which operating surpluses shall be dealt with: should the individual enterprise be allowed to reinvest earnings (either in its main line of business or in new and unrelated fields of production), or should at least some net earnings be transferred to the national government budget.

10.54 As investments are being expanded rapidly, various corporations and enterprises may run deficits. The question of covering the deficits will depend on how much the national government is willing or able to finance through the budget and to what extent public sector corporations and enterprises will have to borrow directly, either domestically or externally. The external borrowing of public sector corporations and enterprises could be very large and will have to be closely controlled to assure that the amount of borrowing remains within the limitations set by the balance of payments and by external debt management. As far as domestic borrowing is concerned, the competing claims of the public and private sectors will have to be resolved.

10.55 The expanding role of Government corporations and enterprises also raises the issues of how to organize the administration and control of these institutions and which entity within the Government will be responsible for their control. Obviously, the variety of administrative and financial control options is large. Perhaps the most logical arrangement is for the National Economic and Development Authority (NEDA) to supervise the direction and economic consequences of the operations of the public corporate sector, and for the Department of Finance to coordinate the financial and fiscal policies with regard to the public sector, including tax and pricing policies. Close cooperation with the Central Bank, which will have to set priorities as far as the amounts and terms of borrowing are concerned, will also be required. All of these issues are likely to become extremely important in the future, since the financial operations of the public entities are expected to significantly increase during the next decade.

Public Utility Corporations

10.56 At the present time, there are four primary public utility corporations in the Philippines: the National Power Corporation (NPC), the Philippine National Railways (PNR), the Metropolitan Waterworks and Sewerage System (MWSS), and the Manila Gas Corporation (MGC). In 1975, these coporations had combined assets of about ₱ 4.5 billion, equivalent to about US$600 million at the present exchange rate (Table 10.11). It is perhaps worth noting that in terms of assets, the NPC is by far the largest corporation in the Philippines, with assets totalling about ₱ 2.4 billion (US$300 million). 1/ The MWSS is also quite large by Philippine standards, with assets of about ₱ 1.5 billion (US$200 million).

10.57 Investments by public utility corporations have only been about 0.7 percent of GNP in recent years, but this situation is likely to change dramatically during the next decade. Total investments by the major public utility corporations may reach around 2.9 percent of GNP, or ₱ 4.2 billion at 1974 prices. In real terms, this would be over six times the average annual amount spent by the public utility corporations during 1970-74. Over 80 percent of these expenditures would be in the power sector, the largest portion of which will be spent by NPC on its expansion program; the proposed investment program for NPC would be equivalent to almost 2.5 percent of GNP by 1980. The Mission estimated capital outlays of about 0.1 percent of GNP for the PNR and other transportation corporations which may have been established by then. Another 0.3 percent of GNP would be invested in the expansion of other utilities, including large investments to upgrade services in some of the urban centers which are expected to grow significantly by the end of this decade. 2/

Table 10.11 Estimate of Investments by Public Utility Corporations
(At constant 1974 prices)

| | Annual Average, 1970-1974 | | FY1980 | |
|---|---|---|---|---|
| Public Utility | Millions of pesos | Percentage of GNP | Millions of pesos | Percentage of GNP |
| Power | 180 | 0.2 | 3,570 /a | 2.5 |
| Transport | 265 | 0.3 | 150 | 0.1 |
| Other utilities | 180 | 0.7 | 450 | 0.3 |
| Total | 625 | 0.7 | 4,170 | 2.9 |

/a Includes purchase of existing facilities from the privately owned Manila Electric Company.

Source: Mission estimates.

1 For comparative purposes, the largest private corporations in 1970 were the Manila Electric Company (MECO) and the Philippine Long Distance Telephone Company, with ₱ 0.9 billion each. Other large corporations included Iligan Integrated Steel Corporation (₱ 0.8 billion) and San Miguel Corporation (₱ 0.6 billion).

2/ For a discussion of these centers, see Chapter 3.

10.58 Investments of this magnitude create two major concerns for the public utility corporations. One is the manner in which the investments will be financed; the other is the need for continually improving the management capability of the corporations. On the matter of financing, the equity base of the corporations will need to be enlarged to a level commensurate with the investment program. Recently, the amount of long-term debt (with a maturity of over one year) in relation to equity, that is the debt-equity ratio, 1/ varied significantly among the individual corporations. Data for FY73 2/ show very unfavorable ratios for the PNR and MGC. 3/ The PNR's ratio was only 0.01, and the MGC had no long-term debt at all. The MWSS, on the other hand, showed a very unfavorable ratio of almost 50 because most of the investment in water supply and sewerage has been financed by incurring long-term debts (of ₱ 425.6 million), while very little equity (₱ 6.2 million) has been built up. The NPC's debt-equity ratio recovered to 1.13 in FY73.

10.59 The Government has recently begun to raise the equity of the ailing corporations to acceptable levels by direct budget grants. In 1974, the NPC's authorized stock capital was raised from ₱ 300 million to ₱ 2,000 million. In mid-1975, the PNR's authorized stock was raised from ₱ 650 million to ₱ 1.5 billion in order to widen the corporation's equity base to obtain loans for the further expansion of its network. Further increases in equity will probably be needed for all these corporations in the future. These increases will be financed from internally generated funds and/or transfers from the national government's budget. The amount of internally generated funds will, of course, depend on the Government's future price policy with regard to utilities. Because utility rates are highly political and have a great impact on the other sectors of the economy, the Government has kept rates down in the past, with negative effects on the corporation's net earnings. As a result, roughly ₱ 2.5 billion of additional equity at current prices will be needed between now and 1980; this amount would be financed largely by grants from the national government's budget. About ₱ 11 billion (US$1.47 billion), however, would have to be borrowed either externally or domestically. The largest portion would probably come from abroad; domestic borrowing would be primarily in the form of bonds. It is estimated that the foreign exchange component of the investments of the public utility corporations will be on the order of 65 percent, and it is assumed possible to provide virtually all of these funds from external sources.

10.60 Table 10.12 shows the Mission's estimate regarding the financing of investments by public corporations in FY80. National government equity transfers would amount to ₱ 850 million, or the equivalent of 0.4 percent

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1/ This ratio is the one generally applied by the World Bank; it relates to assets in use.

2 See the Philippine Commission on Audit, 1973 Annual Financial Report of Government-owned or Controlled Corporations (Quezon City, 1973).

3/ The favorable debt-equity ratios actively reflect the discouragingly low level of investments rather than sound financial management. In other words, the corporations did not use their borrowing capacity to make investments which may have been very important from a developmental point of view.

of GNP, while around ₱ 1,100 million, or 0.5 percent of GNP, would have to be borrowed in the domestic market. Foreign borrowing would cover 64 percent of the investments, or US$550 million.

Table 10.12: Mission Estimate of Financing Public Corporation Investments in FY80

| Category | Amount (In millions of pesos) 1974 prices | Current prices | Composition (In percent) | Share of GNP (In percent) |
|---|---|---|---|---|
| Foreign borrowing | 2,710 | 4,170 | 64.0 | 1.9 |
| National government equity contributions | 550 | 850 | 3.2 | 0.4 |
| Domestic borrowing | 710 | 1,100 | 16.8 | 0.5 |
| Other sources /a | 200 | 400 | 6.0 | 0.1 |
| Total investment | 4,170 | 6,520 | 100.0 | 2.9 |

/a Includes initial cash generation.

Source: Mission estimates.

10.61 Another key issue is the management of the corporations and the implementation of the investment program. The large amounts involved in the investment program point to the need for substantial improvements in the organization and administration of the corporations; these improvements might include intensive staff training, especially in the medium and higher skill levels, as well as the hiring of new staff with sufficient training to deal with the forthcoming issues. In addition, the accounting systems of virtually all public utility corporations need substantial improvement. All utility corporations need to collect the large accounts receivable, to systemize their billing in order to preclude the accumulation of unbilled production, and to conduct sustained studies on the advisability of transferring the control and operation of utilities in rural areas to local governments.

10.62 National Power Company (NPC): As mentioned earlier, the NPC is the largest corporation in the Philippines. Its assets increased by almost 80 percent from FY73 to FY75, reflecting the sharp increase in the power investment program. 1/ Originally created as a non-stock public corporation in 1936, the NPC was converted into a stock corporation in 1960 with a 100 percent Government subscription. Although it has been competing with a number of privately-owned utilities, particularly the Manila Electric Company (MECO), the NPC accounts for over a quarter of power generation in the Philippines.

10.63 With the promulgation of Presidential Decree 40 in November 1972, the NPC was made solely responsible for the construction of national grids,

1/ See Appendix III on the power sector in the Philippines.

and ultimately for owning and operating all generating facilities in the Philippines. MECO, at that time the largest generating as well as distributing company, will eventually become only a distribution utility. In order to meet the expected increased demand for power, the NPC has begun an expansion of its hydroelectric power facilities and the development of geothermal power plants. The NPC's construction program for FY76-FY85 is estimated to total ₱ 49 billion, or US$6.5 billion. At 1974 prices, the proposed program would require outlays of about ₱ 24 billion, or US$3.2 billion, compared to actual NPC expenditures of ₱ 1.1 billion at 1974 prices during FY67-FY75.

10.63 It goes without saying that such a large investment program will raise serious management problems for the NPC, which has up to now had a poor record of administrative and organizational performance with a much smaller investment program. The financial implications of the program are also significant; the proposed program dwarfs the NPC's existing fixed assets. Because of its very large size, the high foreign exchange component (64 percent), and the limited funds available domestically, the bulk of the financing will have to come from external borrowing. Assuming a tariff level which would allow the NPC to earn an 8 percent per annum return on fixed assets in operation, retained earnings are estimated to contribute about 14 percent of construction costs (including interest during construction). To obtain the required level of financing on favorable terms will require a significant increase in the NPC's equity base. A minimum contribution of ₱ 11 billion in current prices (US$1.5 billion), or about 25 percent of total investments, will be required from the national government to maintain an adequate debt service coverage.

10.64 Philippine National Railways (PNR): The PNR has expanded its facilities very little in recent years. The corporation has suffered losses in its operations in the last few years, although some administrative improvements have gradually reduced the losses. The Government has decided to rehabilitate the PNR with a minimum expenditure in the hope of allowing it to provide a competitive low-cost passenger and freight service. The corporation, currently limited to Central and Northern Luzon, plans to expand its network to the south of the island with the help of the Asian Development Bank (ADB). It is also considering a modernization of its rolling stock.

10.65 As mentioned earlier, the Government has increased the corporation's equity base to ₱ 1.5 billion to enable it to borrow on a larger scale, especially from abroad. Presidential Decree 741 of July 1975 explicitly empowers the PNR to contract loans with foreign governments and their agencies, international organizations, or with firms extending supplier's credits. It may also issue bonds in pesos or the equivalent in other currencies.

10.66 The Mission assumes that the PNR's investments over the next ten years will be about ₱ 200 million (US$27 million) a year. About 60 percent of the amount will be raised by foreign borrowing, which would cover the estimated 60 percent foreign exchange component of the program. The balance would come from domestic borrowing (about 10 percent) and from equity increases. Assuming that the Government will not allow a significant rise in tariffs, the Mission has allocated an average annual transfer of ₱ 50 million to the corporation from the national government's budget, which would be the equivalent of about 25 percent of the annual investment outlays. This share would be smaller if railway rates were raised to allow a higher rate of return.

10.67 Other Utility Corporations: The Metropolitan Waterworks and Sewerage System (MWSS) has undertaken substantial investments to enlarge its facilities in order to cope with the pressures of urbanization in the Greater Manila area. The Manila Gas Corporation (MGC) is the smallest of the corporations discussed here, with total assets of only ₱ 35 million in FY73. Its main problems in the past have been the inadequate collection of bills and enormous losses caused by gas leaks. The MGC has recently begun to improve its performance and has made some investments to modernize the gas distribution system. Its target is to reduce gas losses from almost 25 percent of production to only 10 percent. Only a very small allowance is made for capital transfers to the corporation by the national government in the future, although the corporation continues to have current liabilities of more than twice its assets. Its weak debt-paying ability will probably require more Government capital transfers in the long-term in order to finance necessary expansions of the system. However, because of the FY75 boost in the MWSS's equity by a ₱ 200 million transfer from the central government, other capital transfers from Government will probably be small in the medium-term.

Government-Controlled Industrial Enterprises

10.68 During the first decade after the Philippines gained independence, the Government created and operated a wide range of manufacturing and other industrial enterprises. According to Golay, the Government was "directly producing coal, cement, steel, pulp and paper, and textiles and yarns and operating a shipyard and engineering shops". 1/ In addition, the Government owned substantial investments in other manufacturing enterprises, in airlines, and in shipping. It was also indirectly involved in the production of a variety of manufactured goods through a Government-owned holding company. In this period, there was a persistent faith in the capacity of the Government to participate directly in industrialization, but the results of these activities led to an abrupt change in policy in 1954.

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1/ Frank H. Golay, The Philippines: Public Policy and National Economic Development (Ithaca: Cornell University Press, 1961), pp. 242-243.

10.69 In the wake of widespread charges of mismanagement of various business enterprises, the Government initiated action in 1954 to sell many of its enterprises to the private sector. This disposal was slow because of the poor financial conditions of the enterprises. During the 1960s and early 1970s, the Government largely confined its activities to public utilities, as discussed earlier, or to special Government functions such as marketing and price regulation or the establishment of promotional boards for certain economic sectors.

10.70 This period of quiescence has now begun to change and the Government plans to forge ahead with the build-up of key industries such as petroleum, petrochemicals, fertilizer, and steel. Investments over the next ten years are expected to be very large. 1/ This raises the question of to what extent domestic and external financing can be mobilized to fund these projects. Evidently, some of these projects will be too large for domestic investors, so the Government will probably have to provide financial support. Two major options are open for Government: (1) the central government could guarantee equity up to a controlling 51 percent, or (2) it could guarantee the borrowing of the corporations after having provided for an economically sound debt-service ratio. Equity contributions could possibly also be provided by Government-controlled financial intermediaries like the DBP, PND, or the National Investment and Development Corporation (NIDC).

10.71 At this preliminary stage of planning, it is difficult to make any precise estimates of the Government financing required, since the size and timing of major projects have not yet been determined. However, in order to give some indication of the implications such financial contributions may have on the Government's budget, the Mission lists below a few major industries which have large capital needs and where Government intervention is most likely. They include the Philippine National Oil Company (PNOC), the planned urea fertilizer complex, and the integrated steel project (PHIVIDEC). No Government participation was envisaged for the petrochemical complex (PINOC) in the medium-term, since this project is still at a very early state of preparation.2/

Table 10.13 Estimated Capital Requirements of Potential Government-Controlled Industries

| Industry | Capital Requirements (In billions of pesos at 1974 prices) | Construction period Planned by Government |
|---|---|---|
| Philippine National Oil Company (PNOC) | 5.0 | 1975-1980 |
| Urea Fertilizer Project | 1.4 | 1976-1978 |
| Integrated Steel Project (PHIVIDEC) | 7.7 | 1976-1979 |
| Total | 14.1 | |

Source: NEDA, BOI, and Mission estimates.

1/ See Chapter 6 for a discussion of industrialization.
2/ PINOC is estimated to require ₱ 7.0 million.

10.72 Although the time horizons of these projects are not yet clear, the Mission assumed considerable delays in implementation. A 70:30 debt-equity ratio was adopted as a desirable target for industrial enterprises. For the PHIVIDEC and the urea fertilizer project, it was assumed that the Government would want to acquire a 51 percent equity share. PNOC is already Government-controlled, but Government equity will be increased further. A 51 percent equity share by the national government in the former corporations would amount to about ₱ 1.4 billion at 1974 prices. Given a delayed period of construction and assuming that equity will be paid as construction progresses, the Mission estimates that national government equity contributions to the fertilizer and steel projects alone would be around ₱ 300 million annually by about FY80. Borrowing by the corporation will be guaranteed by the Government, with no immediate effect on the budgets. Apart from these contributions, the Government is also expected to transfer equity funds to PNOC of about ₱ 50 - 100 million for its oil and natural gas explorations.

Government-Controlled Banks and Financial Institutions

10.73 During the 1960s and early 1970s, when the Government withdrew from active participation in industry, Government-controlled financial intermediaries continued to play an important part in the development of the Philippine economy. These institutions included (apart from the Central Bank of the Philippines 1/), The Philippine National Bank (PNB), the Development Bank of the Philippines (DBP), the Land Bank of the Philippines, and the National Investment and Development Corporation (NIDC), a subsidy of the PNB. The two Government social security funds, the Government Service Insurance System (GSIS) and the Social Security System (SSS), are also part of the Government financial sector. Total combined assets of these institutions amounted to ₱ 28.9 billion (US$3.85 billion) at the end of FY73. The combined assets of Government banks, including the Central Bank, was equivalent to 54 percent of the total assets of the banking system; excluding the Central Bank, the combined assets of Government banks accounted for about 30 percent of total bank assets.

10.74 Since FY73, the Government banks have greatly increased their activities in the implementation of major development programs. PNB, the largest commercial bank in the Philippines, accounted for one-third of the commercial banking system's total assets in March 1975. 2/ As intermediary of Government funds and through its own borrowing abroad, the PNB has increasingly been involved in providing short and medium-term finance for manufacturing (especially for small- and medium-sized industries), commercial transport on land and at sea, and rural programs, particularly Masagana 99. The PNB's widespread network of branch offices in the provinces lends itself well to the implementation of rural programs, for which it also furnishes the services of its credit technicians. The Government increased

1/ Its functions and policies are discussed in Chapter 9.
2/ The commercial banking system more than doubled its assets in 1973 and 1974. The PNB's assets reached about ₱ 15 billion by mid-1975.

PNB's equity from ₱ 500 million to ₱ 700 million in 1974 to support its further expansion. This increase in equity will also provide additional finance for the PNB's long-term lending subsidiary, NIDC.

10.75 With the Government focusing on agricultural development, agrarian reform, and other rural development programs, the rural banking system has been expanded. In particular, the Land Bank, which has existed since 1963, has been revitalized and has been awarded an important role in the financing of the Government's development programs. In FY74, a Government budget transfer raised the Land Bank's equity from around ₱ 70 million to ₱ 600 million. Another ₱ 100 million transfer took place in FY75, and annual equity contributions of ₱ 100 million are scheduled over the next eight years. Total equity should reach ₱ 1.5 billion by FY83, which would make the Land Bank the major agricultural bank in the Philippines and enable it to be the main lending agency of the agrarian reform and Masagana programs.

10.76 The DBP is the most important provider of long-term finance in the Philippines. Its main private competitor, the Private Development Corporation of the Philippines (PDCP), holds only the equivalent of one-tenth of the DBP's total assets of ₱ 7.0 billion. The DBP finances projects in all sectors of the economy. In FY74 the Government almost doubled the equity of the DBP, raising it to over ₱ 1.7 billion. Given the sheer size and diversity of its financing operations, the DBP's contribution to the development of the Philippine economy is considerable.

10.77 An ex ante evaluation of returns and partial economic indicators on a sample of DBP-financed industrial projects does provide an impression of the economic benefits deriving from the DBP's operators. In FY73, the DBP provided financial assistance to 45 BOI-registered projects; its contribution totalled ₱ 592 million (US$84 million) out of a total investment of about ₱ 1.2 billion. When completed, these projects are estimated to generate around 8,300 jobs directly, and net foreign exchange earnings/savings derived are projected to be US$50 million annually. The ex ante average financial rate of return of these projects in FY73 was 20 percent, and the average economic rate of return 15 percent. The average cost of fixed investment per worker, about US$14,000, although high, was below the average for all BOI-registered projects.

10.78 With a sharp increase in lending volume, all Government banks would have to make considerable improvements in their organizations to ensure better project preparation and supervision. They would also have to enforce more systematic management of Government debt and strict observance of rules governing the reloaning of borrowed funds to their customers. The latter will involve more efficient collection of outstanding credits. Currently, the DBP, LDB, and PNB suffer from severe problems with respect to the collection of overdue amortizations, advances, and receivables of loan accounts.

10.79 Another important issue which may arise in the future is the extent of Government intervention. As banks borrow more funds from international organizations or bilateral donors, the Government, which will have to guarantee the loans, will want to supervise the banks' lending activities more closely. However, care will have to be taken that Government influence is not used to pressure these institutions into activities which are financially doubtful and whose developmental significance is small.

10.80 The Government's two social security funds, the GSIS and SSS, had combined assets of ₱ 5.4 billion at the end of FY73. The GSIS is the social security fund for Government employees and the larger of the two, since contributions from public employees are obligatory. The SSS, created in 1954 to provide social security 1/ to non-Government employees, had at that time only half the assets of the GSIS. Its coverage has been expanded by various legislative measures, but so far only a small minority of non-Government employees has become a member of the scheme. Social security contributions to both funds in the 1960s and early 1970s rose more slowly than GNP at current prices. In FY74, they amounted to ₱ 800 million, or about 1 percent of GNP, compared to ₱ 260 million, or 1.3 percent of GNP, in FY64.

10.81 Both the GSIS and SSS resources have been used primarily to provide housing loans to their members at subsidized interest rates. Middle and upper income groups have apparently benefitted the most from these loans. 2/ The record of the SSS has been similar. Another matter of concern is the fact that the funds use members' contributions to invest in short-term, money market instruments to offset the subsidies on the loans to their members.

10.82 Social security contributions are likely to rise faster in the future than in the past because the Government intends to effectively expand coverage and increase rates and benefits of the social security schemes. If contributions were to reach 1.1 percent of GNP by FY80 and 1.8 percent by FY85, total contributions would be on the order of ₱ 2.53 billion and ₱ 8.50, respectively. This would mean that the combined social security systems would have considerably more funds available than at present. As in other countries (e.g., Malaysia), the social security systems could be increasingly used as an important source of Government borrowing.

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1/ This includes disability, sickness, old age, and death insurance.

2/ During 1962-72, 46,000 member borrowers used GSIS funds; the average loan was approximately ₱ 23,000. The borrowers, 8 percent of total membership in 1970, had an average monthly family income of between ₱ 500-800, which represents the highest 20 percent of the income distribution. Currently, the GSIS is making 10 to 25-year housing loans at 6 percent per annum on amounts less than ₱ 30,000 and at 12 percent per annum on amounts from ₱ 30,000 to ₱ 70,000. See International Labor Organization (ILO), Sharing in Development, pp. 215-216.

10.83 The resources of these institutions represent an important source of long-term public capital which has so far been underutilized. Following the example of other developing countries (e.g., Malaysia), the institutions could be required to invest on a large scale in long-term Government bonds. The present policy in these institutions of borrowing long and lending short should probably be terminated, and more resources should be channelled into long-term Government infrastructure programs. The SSS and GSIS, for example, are particularly suited to finance the large-scale, low-cost housing program discussed in Chapter 3.

## C. Local Government Finance 1/

10.84 The Philippines has historically had a centralized form of government. Constitutionally, local governments have been considered creatures of the national government; provinces, cities, municipalities, and barrios possess only delegated powers. As a consequence, the local government system has been weak in every respect and local administration has been largely ineffective. Until recently, local government finance was one of the most neglected areas of national government development policies. Local governments had a very limited revenue base and depended heavily on central government contributions. Early attempts to improve the situation failed. The Decentralization Act of 1967 (Republic Act 5185) stated that it was "the policy of the State to transform local governments gradually into effective instruments through which the people can in a most genuine fashion govern themselves and work out their own destinies". Yet the act actually did little to revitalize local government administration and finances. In fact, even after its proclamation, local government revenues and expenditures as a percentage of combined national and local government revenues and expenditures continued to decline.

10.85 Since 1972 the national government has attempted to provide the local governments with more authority, better administration, and sounder finances. In the area of local government finance, the four most important measures have been: (i) a revision of the system for allotting national government revenues to local governments; (ii) the establishment of a Local Tax Code; (iii) increases in the local government real property tax; and (iv) the authorization for local governments to borrow from lending institutions in order to finance projects as well as to meet other budgetary needs. Moreover, the national government, with the help of some of its agencies (e.g., the National Tax Research Center) has begun to review the administrative and financial management of local governments in order to improve the Government's information base on them before further reforms are undertaken.

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1/ A detailed review of local government administration in urban and rural areas is provided in Chapters 3 and 4 of this report.

Past Revenue and Expenditure Trends

10.86 Local governments have derived their revenues from real property taxes, license taxes and, in some cases, profits and receipts from the operation of public utilities and other business enterprises, including public markets. The local governments' collected revenues have never exceeded 1.3 percent of GNP and in FY72 were only 0.9 percent. Since these revenues have usually fallen short of financing current expenditures, the local governments have received national government allotments consisting of a fixed percentage of all national internal revenue collections. In addition, there have been national grants-in-aid and loans for some development projects. The amounts have varied from year to year depending on need, the availability of funds, and the Government's attitude towards granting financial assistance to local units.

10.87 Because the local governments' revenue base has been restricted both in the number of revenue sources available to them and in the total amounts received, local units have been unduly dependent on national financial aid even for minor projects, such as the construction of feeder roads. Due to the inadequacy of their financial resources, they have been largely unable to assist in accelerating economic development. The local governments have undertaken only a few functions, while the national government, through the field offices of its various agencies, has administered most government services. 1/ National government contributions to local governments have also been subject to regional political pressures, so that the distribution of funds has often not been dictated by development needs, but has been the result of regional and local political influence at the national level.

10.88 Several futile attempts were made in the late 1960s to improve local government in the Philippines; the Decentralization Act of 1967, for example, sought to revitalize local governments by providing them with more functions and some additional financial resources. The results of the act have been disappointing and the dependency of local government finance on national financial aid has, in fact, increased. Although local government receipts and expenditures at current prices rose noticeably after the act was passed, in real terms and on a per capita basis there was hardly any rise until FY74. Since 1972, several important legislative measures have been undertaken in order to strengthen the finances of local governments, increase the efficiency of local revenue collections, and improve the system of revenue sharing.

10.89 One of these legislative measures was the promulgation of the Local Tax Code (Presidental Decree 231), which put into a single code all of the provisions related to the taxing and revenue-raising powers of different levels of local governments. In the past, the tax and other revenue-raising powers of local governments were stated in different laws, such as the Local Autonomy Law, the Revised Administrative Code, and various barrio and city charters, which frequently led to overlapping impositions by different levels of government. The new code transfers the collection authority of some of the national taxes to provinces and cities and redefines the extent and limitations of the taxing powers of each level of local government.

1/ Frank H. Golay, The Philippines: Public Policy and National Economic Development, p. 205.

Some of the new, although relatively minor, taxes transferred from the national government to the provinces, cities, and municipalities include taxes on the transfer of real property ownership and on business engaged in printing and publications, occupation taxes, and admission taxes on amusement. The Local Tax Code also establishes nationwide maximum rates for a number of levies and fees.

10.90 Tax Revenues: The single most important tax revenue source for local governments has always been the real property tax, which is imposed by local governments as an annual ad volorem tax on real properties within their jurisdiction, including land, buildings, other improvements, and machinery. 1/ Maximum tax rates, authorized by national legislation, have varied among provinces, municipalities, cities, and barrios. In many jurisdictions, the rates imposed by the councils of the local units have been significantly below the authorized levels. Also, the assessment of real property has remained far below actual market values; assessments averaged only 45 percent of market value in the 1950s 2/ and even less in the 1960s and early 1970s. Most assessments are still outdated and many taxable properties have not even been included in the assessment rolls due to the absence of tax maps and other basic assessment tools. A major cause for the ineffective identification of properties has been the absence of a nationwide cadastral survey. Because portions of many provinces and cities have not been surveyed, jurisdictional boundaries are frequently inadequately defined. Finally, local government real property taxation has been beset with the problem of under-collection. In the 1960s, only half of the real property taxes were collected; often, unpaid or back taxes exceeded taxes currently due. In FY70, back taxes accounted for about one-fourth of the total collections. Among the reasons cited for the lack of collections are inadequate staffing with underpaid, and consequently low quality, officials, and penalty provisions for tax evaders which are not sufficiently coercive.

10.91 Revenues from the property tax as a percentage of total receipts by local governments showed a declining trend until FY73 (Table 10.14), when the national government began to initiate its local government tax reform measures. The reform of the real property tax included measures dealing with the real valuations of properties, the correction of assessment levels for different types of properties, and improvements in the collection systems. Presidential Decree 76 (1973) made mandatory a new assessment of all properties, which required property owners to give sworn statements as to the true value of their properties and threatened high penalties for evaders. The decree also introduced fixed assessment levels for various types of properties, including progressive rates for residential

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1/ Eduardo Z. Romualdez, Sr., Angel O. Yoingco, and Antonio O. Casem, Jr., Philippine Public Finance (Manila: GIC Enterprises, 1973), pp. 457-64.

2/ Romualdez, et. al., Philippine Public Finance, pp. 463-464.

Table 10.14. Revenues of Local Governments by Major Sources
(In percent)

| Fiscal Year | Amount (in millions of pesos) | Revenue from Taxation | | Assistance from National Government | | All Others | Total b/ |
|---|---|---|---|---|---|---|---|
| | | Property Tax | Other a/ | Internal Revenue Allotment | National Aid | | |
| 1955 | 227 | 19.9 | 30.8 | 23.5 | 6.9 | 17.9 | 100.0 |
| 1960 | 300 | 19.0 | 34.2 | 23.5 | 12.0 | 11.3 | 100.0 |
| 1965 | 567 | 15.7 | 26.8 | 38.0 | 8.2 | 11.3 | 100.0 |
| 1966 | 634 | 15.5 | 26.2 | 33.7 | 9.6 | 15.0 | 100.0 |
| 1967 | 674 | 16.5 | 27.1 | 36.9 | 6.4 | 13.5 | 100.0 |
| 1968 | 741 | 16.2 | 27.5 | 35.8 | 9.2 | 11.3 | 100.0 |
| 1969 | 849 | 13.2 | 26.1 | 40.7 | 8.9 | 11.1 | 100.0 |
| 1970 | 999 | 18.2 | 22.1 | 38.4 | 8.7 | 12.5 | 100.0 |
| 1971 | 1,144 | 12.8 | 21.2 | 42.7 | 6.0 | 17.3 | 100.0 |
| 1972 | 1,293 | 12.6 | 20.2 | 46.9 | 8.5 | 11.8 | 100.0 |
| 1973 | 1,465 | 14.0 | 22.2 | 42.9 | 7.5 | 13.4 | 100.0 |
| 1974 | 1,676 | 12.0 | 21.1 | 43.9 | 8.4 | 14.6 | 100.0 |
| 1975 | 1,814 | 18.6 | 21.0 | 31.1 | n.a. | n.a | 100.0 |

a/ Including taxes on licences to engage in any occupation or business or to exercise priveleges; also fees charged for services rendered and for regulating certain activities.

b/ Including profits and receipts from operations of public utilities and from other business enterprises, including public markets.

Source: Annual Reports of the Commission on Audit on Local Governments (FY55 through FY73) and Department of Finance estimates (FY74 and FY75).

homes, 1/ and required a revision of real property assessment every five years. 2/

10.92 In more recent real property tax legislation, minimum tax rates of 1/4 percent for provinces and municipalities and 1/2 percent for cities have been imposed, with maximum rates of 1/2 percent and 2 percent, respectively. To strengthen the finances of the barrios, 5 percent of the collections of the municipalities and 10 percent of the collection of the cities goes to the barrios where the taxed property is located. Moreover, an annual tax of one percent on real property situated in a province or city (with an assessed value exceeding ₱ 3,000) accrues to the national government's Special Education Fund to support local schools.

10.93 In addition to the real property tax, local governments collect a variety of license taxes and fees from businesses conducted within their jurisdictions. The most important of these has been the municipal license tax, which usually accounts for over 10 percent of the total receipts of local governments. It is imposed upon persons engaged in any occupation or business, including manufacturers of drugs, proprietors of movie theaters, sellers, and so forth. The share of the municipal license tax, together with receipts from fees, declined sharply during the 1960s, however, and has only recently recovered as a result of the tax reform measures.

10.94 National Government Allotments: National government financial assistance has been largely in the form of the Internal Revenue Allotment, which consists of fixed portions of total collections of various national government taxes; the allotments are distributed from a central fund among local governments on the basis of prescribed formulas. In addition, there have been other national grants-in-aid and loans, the amounts of which have varied from year to year depending on the availability of funds. In the past, the formula for the distribution of the internal revenue allotment among the local governments frequently favored the rich and economically more active jurisdictions over the less developed areas.

10.95 The changes legislated in the last two years (especially Presidential Decree 144, which was later revised by Presidential Decree 559) have reduced the allotment as a whole, and have also redistributed it significantly. The new legislation decrees that the local governments are entitled to "20 percent of the national internal revenue tax collections of the third preceding fiscal year, not otherwise accruing to special

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1/ Assessment levels as a percent of "current and fair market value" were: 50 percent for commercial, industrial and mineral lands; 40 percent for agricultural lands; 30 percent for residential lands; and 15 percent (market value of ₱ 30,000) to 80 percent (over ₱ 500,000) for residential buildings.

2/ Any increase in the current assessment level will never exceed 10 percent of the prescribed levels or, in any case, exceed 80 percent of the current and fair market value of the real property, except upon prior approval of the Secretary of Finance.

Table 10.15. Expenditures of Local Governments

| Fiscal Year | Expenditures (In millions of pesos) | | | Composition of Total Expenditures (In percent) | | | | |
|---|---|---|---|---|---|---|---|---|
| | Current | Capital | Total | Administration | Economic Development | Social Services | Debt Service | Others |
| 1960 | 279 | 22 | 301 | 48 | 19 | 17 | 2 | 14 |
| 1965 | 465 | 76 | 541 | 46 | 19 | 14 | 1 | 20 |
| 1966 | 531 | 107 | 638 | 45 | 18 | 14 | 2 | 21 |
| 1967 | 570 | 128 | 698 | 44 | 17 | 15 | 1 | 23 |
| 1968 | 652 | 104 | 756 | 45 | 19 | 15 | 1 | 20 |
| 1969 | 701 | 116 | 817 | 46 | 19 | 13 | 2 | 20 |
| 1970 | 808 | 125 | 933 | 45 | 19 | 15 | 2 | 19 |
| 1971 | 937 | 144 | 1,081 | 45 | 18 | 17 | 2 | 18 |
| 1972 | 1,098 | 165 | 1,263 | 48 | 19 | 13 | 1 | 19 |
| 1973 | 1,216 | 145 | 1,361 | 50 | 17 | 14 | 2 | 17 |
| 1974 | 1,471 | 194 | 1,665 | 41 | 18 | 13 | 2 | 26 |
| 1975 a/ | 1,532 | 281 | 1,813 | 41 | 19 | 12 | 2 | 26 |

a/ Preliminary estimate

Source: Data for FY60-FY73 are from the Report of the Commission on Audit on Local Governments; data for FY74 and FY75 are from the Department of Finance.

funds and special accounts within the national government's general fund" 1/ Out of this 20 percent allocation to local governments, 25 percent will be earmarked for provinces, 40 percent for municipalities, 25 percent for cities, and 10 percent for barangays. Within each of these levels, the horizontal distribution of the allocation is to be determined by a formula which allocates 70 percent of the total according to population and 20 percent according to land area, with the remaining 10 percent distributed equally among the local units. For FY74 through FY76, transitional provisions ensured that local units would not gain more than 15 percent or lose more than 50 percent of the allotments they had received in FY71.

10.96 Other measures have made it mandatory that all local units set aside 20 percent of their annual shares from the national allotments for development purposes. Moreover, barrio development funds were established which are to be financed by the barrios' 10 percent share from the real property tax and by contributions from each province, city, and municipality to their barrios. 2/ However, another 5 percent of national internal revenue (not earmarked for special funds and accounts) has been set aside in a Local Government Fund, which is to be released by the president as an aid to local governments whenever necessary.

10.97 Additional national government allotments are transferred to local governments for the maintenance and repair of existing roads and bridges, as well as for new constructions and improvement projects. These allotments are financed from the national government's excise taxes on gasoline and other petroleum products. Twenty percent of these special allotments goes to provinces, 30 percent to municipalities, and 50 percent to chartered cities. Within each level, the sharing takes place according to the same 70-20-10 formula applied to the general allotments.

10.98 Expenditures: As pointed out earlier, local governments have played only a subordinate role in public sector activity. Their total expenditures have been the equivalent of around 2 percent of GNP; local government capital outlays have been very small, around 0.2 to 0.4 percent of GNP. The structure of local government expenditures has remained almost unchanged since the late 1950s, with 45 to 50 percent of total outlays being spent for administration, about 20 percent for economic development (especially the construction and maintenance of roads, bridges, and so forth), and around 15 percent for social services, particularly education (Table 10.15). As local government borrowing has until recently been restricted by law, the debt service has never exceeded 2 percent of total expenditures. About one-fifth and lately even one-fourth of expenditures are for other outlays which are mainly statutory obligations on the part of local governments, i.e., payments to agencies and corporations of the national government, as well as transfers to local government corporations.

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1/ For example, in FY77 the internal revenue allocation to the local governments will total 20 percent of the national tax revenues collected by the Bureau of Internal Revenue and not earmarked for special funds and accounts in FY74. An increase of the total allotment to 25 percent of total internal revenue is currently under consideration.

2/ The contributions are not to exceed ₱ 500 annually to each barrio.

The past geographical distribution of local government expenditures, like that of revenues, has favored the larger cities and especially the Greater Manila area, although the Government has stated that this inequity will be changed.

Borrowing by Local Governments

10.99 Another step in the direction of local financial autonomy was made in mid-1975 when the local governments were empowered to borrow - under certain conditions - from financial institutions (Presidential Decree 752). Local governments may borrow in order to avoid an impending financial dislocation that could disrupt vital public services or when local funds are not enough to finance development projects. The Land Bank, the Philippine National Bank (PNB), the Development Bank of the Philippines (DBP), and the GSIS are likely to be the main sources of financing for the construction, expansion and improvement of development projects or for other capital expenditures. For the purchase of heavy equipment, the local governments may even seek short-term domestic suppliers' credits. The Central Bank may grant short-term advances to cover urgent cash needs by the local governments, as long as they do not exceed 15 percent of the average income from regular sources by the borrowing local government. Provinces and cities are authorized to issue bonds, debentures, securities, collaterals, notes, and other obligations to finance self-liquidating or income-producing development projects if those projects are approved by the National Economic and Development Authority (NEDA). All local government bonds will be tax-exempt. Presidential Decree 752 also stipulates that the President may extend loans to a local government from foreign borrowing to finance development projects.

10.100 Strict rules have been established to discourage irresponsible local government borrowing. Failure of the borrowing local government to appropriate the annual debt service in its budget empowers the national government to declare the budget inoperative. The Secretary of Finance is then entitled to enforce payment of obligations by withholding corresponding amounts from the internal revenue allotments. Also, local government officials can, to a certain extent, be held personally liable for unpaid debts. In the long run, the new authorization to borrow can be interpreted as a first step toward replacing the national government's internal revenue allotment with direct borrowing. In the short run, it will allow richer jurisdictions, which will receive less in national government grants under the revised allotment formula, to make up for some of the losses.

Future Role of Local Government Finance

10.101 The recent reforms of the local government financial system have been important first steps in improving the financial viability of local administration. The reforms reflect the Government's concern to promote balanced regional economic development in the country and to mobilize grassroots support for its "New Society" program. The Government, however, will still have to decide which functions it is willing to delegate to or share with the local bodies and which administrative system is best suited to implement those tasks.

10.102 Although recent reforms have broadened the revenue base of local governments and have reduced financial discriminations among jurisdictions, they have so far done little to enhance the administrative autonomy of local governments, with the possible exception of the recent authorization to allow them to borrow from lending institutions. The reason for this may be that the administrative structure of most local governments is still weak and probably unable to handle an increasing volume of funds and projects. In the long run, however, more responsibilities should be allocated to the local levels in both rural and urban areas, and this can only be implemented if effective spending and borrowing powers are also delegated.

Chapter 10

# TECHNICAL NOTE I

## Tax Reform in the Philippines

1. As the previous analysis indicates, the ratio of taxes to GNP will have to be increased from its present level of around 12 percent if the Government is to succeed in improving the existing level of public services and expanding the public investment program. The Government fully recognizes the need for a substantial and sustainable increase in tax revenues for the financing of its long-term development program; it is studying various proposals for new tax legislation, as well as for improving collections and streamlining tax administration.

2. Since the late 1960s, the Philippine Government has also undertaken a series of major tax reforms in the form of legislative acts and decrees. Reform measures began with the introduction of the export stabilization tax in 1970 and an increase in the corporate income tax rates in 1972. Reform measures have been intensified since 1972 and over one hundred presidential decrees dealing with taxation have been promulgated. The most significant recent measures have included: (i) the enactment of a revised tariff and customs code with a simplified and standardized tariff structure, higher tariff rates, and a more rational tariff protection system; (ii) the introduction of a permanent export duty system with differential, and generally higher, rates; (iii) sharp rate hikes for selective excise taxes, especially on petroleum products, liquor, and tobacco products; and (iv) significantly higher rates for the stamp tax and the sales tax on automobiles. In addition, a tax amnesty for previously undisclosed or under reported income and wealth was proclaimed in 1973. Several administrative reforms to improve tax collection and administration as well as to combat corruption were also implemented, resulting in significant personnel changes in the Bureau of Internal Revenue and Customs. Finally, a major reform of local government finances to raise local government revenues by increasing their tax authority was initiated.

3. While the tax reforms have boosted national government tax revenues, the legislation has not resulted in any significant improvement in the structure of the revenue system, especially in the area of direct taxation. The share of direct taxes in total tax revenues did not increase as a result of the tax amnesty, apart from possibly "one-shot" boosts. The complex and time consuming task of overhauling the corporate and personal income tax system still has to be undertaken. Hence, income distribution features of the tax reform measures have so far been limited to increases in excise and import duty rates on some luxury consumption items and the taxation of windfall gains accruing to the exporters of primary products.

4. The thrust of the Government's future tax reform measures should probably be in two directions: (i) the heavy dependence of the tax revenues on international trade will need to be reduced and the domestic base widened, and (ii) the social equity of the tax system will need to be improved by an increase in direct taxation and higher indirect taxation of domestic goods and services consumed by the upper-income population. At the same time, a comprehensive overhaul of the existing tax laws, with their confusing and conflicting plethora of deductions, incentives, and rebates, should probably also be undertaken. Some of the major issues that will be involved in future tax reform program are discussed below.

Taxes on International Trade

5. The recent reform measures have heightened the already heavy dependence of revenues on the external sector, which rose to almost 50 percent in FY75 from around one-third in FY69. Import duties and export taxes accounted for most of the improvements in the growth elasticity of the national tax system, and contributed almost 55 percent of the increase in national tax revenues between FY72 and FY75. As mentioned above, this situation makes the financing of the budget extremely vulnerable to foreign market developments, as demonstrated by the shortfalls in export tax receipts in the latter part of 1975 when export taxes on copper, cement, copra, and wood products had to be suspended. Substantial shortfalls are also likely in FY76 as a result of the lagging effect of the current low international prices for most Philippine export commodities. It is obvious that this dependence has to be reduced in order to place the public development program on a more stable internal revenue base in the long term.

6. Export Taxes: Taxes on exports were introduced for the first time in 1970. 1/ They were imposed mainly on traditional raw material and agricultural exports in order to capture some of the gains resulting from the 1970 currency devaluation. These taxes were originally intended only as a temporary measure and were to be phased out by the end of FY75. In 1972, however, the Stabilization Tax Law was repealed and the export taxes were made a permanent feature of the Customs and Tariff Code, effective as of July 1, 1973. In addition to the export duties, the Government also introduced a premium export duty, effective from February 16, 1974, to capture some of the profits resulting from the commodity boom that began in 1973. Premium duties at rates of 20 to 30 percent were imposed on the difference between the current export price and a base price, which was initially set at 80 percent of the f.o.b. value of the exports established by the Bureau

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1/ Under the Export Stabilization Tax Law of May 1, 1970 (Republic Act 6125), export taxes were imposed on two major groups of export products: (a) 10 percent on logs, copra, sugar and copper ore and concentrates; and (b) 8 percent on mollasses, coconut oil, desiccated coconut, copra meal and cake, iron ore and concentrates, chromium ore, abaca, tobacco, wood products, canned pineapples, and bunker oil. The taxes were subject to diminishing rates in subsequent years, falling to 4 percent and 2 percent, respectively, in FY74.

of Customs in February 1974. 1/ The premium tax ceased to operate after the commodity price boom fell in 1974 and some of the export industries began to experience difficulties as a result of the recession in 1975. In the case of wood products, copper, and cement, the Government temporarily suspended the export tax altogether.

7. Among the advantages of the export tax are its ready enforcement, its broad coverage, 2/ and its flexibility both in coverage and in the level and structure of rates. The export tax and premium export duties were ideally suited to effectively tax the high export profits of FY73-FY75. Moreover, in the absence of a national land tax, and in view of the unsatfactory personal and corporate income tax system, the export tax currently represents the only significant tax on agricultural incomes and the only major levy on the exploitation of nonagricultural natural resources in the Philippines. By taxing hitherto untaxed or undertaxed sectors of the economy, the export tax has not only produced sizeable additional revenues (₱ 2.7 billion in FY74 and FY75 combined, equivalent to 1.4 percent of GNP) but, in the short run, has contributed to a more equitable application of the tax system.

8. In general, this report is in favor of maintaining some form of permanent export tax with a premium duty feature because it provides the Government with a means of siphoning off windfall profits resulting from temporarily high world market prices for certain products. It appears to have a permanent place in the Philippine tax system for other reasons as well, at least until more effective methods of taxing the domestic incomes derived from these productive activities (regardless of whether they are for export or local sale) can be implemented. 3/ To examine the question more completely, however, it is convenient to distinguish between agricultural commodity exports like sugar, coconut products, and bananas, and raw material exports (or items manufactured from them) such as wood products and minerals.

9. In the case of agricultural products, the analysis in Chapters 5 and II indicates that the value of these exports is not likely to grow very rapidly in the future, which means that these export taxes will not be a major source of growth in tax revenues. On the other hand, export taxes are one of the few means presently available to the Government for taxing

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1/ Should the current price of any export product be lower than the established base price, only the basic rate is applicable; that is, the premium tax is only flexible upwards.

2/ During FY70-FY73, 85 to 90 percent of Philippine exports, in terms of value, were subject to the tax.

3/ This discussion does not take up the question of whether export taxes can be used by the Philippines to restrict production for export, and hence influence international prices. There has been some discussion of this issue with respect to taxing coconut products, since the Philippines provides about 40 percent of the world supply of coconut oil. See ILO, Sharing in Development, pp. 262-263.

non-corporate agricultural incomes. There is a strong case for more effective taxation of these agricultural incomes on equity grounds alone. Apart from the export tax, which affects only a few agricultural products, agricultural activities in general contribute little to Government revenue. In the early seventies, only about 5 percent of the income taxes was attributed to the agricultural sector (including forestry) despite the fact that this sector accounts for one-third of GNP. The main disadvantage of using export taxes is that they are not really suited for taxing the agricultural sector adequately because their coverage, and hence their incidence, is very uneven. On the other hand, they do provide some form of taxation, however imperfect, and they have the advantage of being easy to collect and to administer. The real question is what alternatives there are for taxing agricultural incomes; the alternatives include comprehensive land taxes, which are discussed below, and increased charges for Government services.

10. The case of taxing extractive industries is somewhat different. Again there is a strong case to be made for taxation of these activities, which are depleting natural resources. Moreover, as the analysis in Chapters 6 and 11 indicates, the growth in receipts from these exports is likely to be quite rapid in the decade ahead, so they do provide a potentially important source of revenue growth for the public sector. But, unlike agriculture, exploitation of the Philippines' natural resources is dominated by the corporate sector, where a taxing mechanism already exists. The question is whether the level of taxation that is levied on resource exploitation in general is sufficient, regardless of whether the products are for local or export markets. It appears that the export taxes on mineral resources, which are additional to the corporate tax, should be maintained, at least until the corporate tax system has been overhauled. There may even be some scope for expanding the export taxes in the interim if world market prices again become favorable. Expanded taxes on copper, chromium, and, more recently, on nickel exports may ensure the Government a fair share in the exploitation of the nation's nonreplenishable natural resources by private domestic and foreign investors.

11. Differentiated rates could be used to encourage a higher degree of domestic processing, as has been done in the case of wood products through increased rates for unprocessed logs. In the case of wood products, the issue is the extent to which taxes should be levied on the value of forested land, as opposed to processed wood products. According to present investment plans, the wood processing industry will be a major manufacturing subsector in the 1980s. It would, therefore, seem more appropriate to tax this new industry by a more effective corporate tax system.

12. Import Duties: Import duties are currently an extremely important part of the Philippine revenue system, accounting for between 25 and 28 percent of national tax receipts. Prior to 1973, the Customs and Tariff Code was generally regarded as ill-suited to the Philippines' revenue and development needs; the average ratio of duty collections to import was only about 10 percent. Its main deficiencies were: (i) the exorbitant rates on some

items, which not only encouraged smuggling and false declarations, but also undermined collection and protection objectives; (ii) zero rates for a variety of goods declared "essential"; and (iii) the unsatisfactory structure of protection. The issue of protection is dealt with more fully in Chapter 6, but, in brief, the previous code encouraged local production of less desirable nonessential goods over essential goods, and it hampered industrialization by imposing heavier duties on machinery, equipment, and raw materials over finished goods.

13. A Revised Customs and Tariff Code was introduced in 1973. It greatly simplified the rate structure by reducing the previous specific rates from 271 to 2 and by fixing 6 ad valorem rates ranging from 10 to 100 percent for all other imports. The duty-free category was abolished. Following its introduction, there was a doubling in revenues from import duties in FY74 and another 35 percent rise in FY75 (which was, however, largely due to the rapid increase in imports). The ratio of duties to total imports rose moderately -- from 13 to 20 percent -- over the two years.

14. The report does not recommend major changes in the level and structure of the import duty system purely from the point of view of revenue generation. Consumer goods are the most highly taxed imports and, since their share is expected to decline steadily to less than 5 percent of total imports by the 1980s, it would appear realistic to expect the elasticity of customs revenue to GNP to remain at slightly less than unity as it has been over the past decade. Consequently, we would expect the increase in revenues in real terms from this source during the next decade to roughly match the growth in imports.

Taxes on Income

16. Taxes on personal and corporate income currently account for almost 25 percent of total collections by the national government. Over 70 percent of these collected taxes are derived from the corporate tax. Direct taxation in general, and personal income tax in particular, have been the most neglected areas of tax legislation. Therefore, a comprehensive reform of the income tax system should be given high priority in the next few years. Such a step is a prerequisite for making the tax system compatible with the goal of a more equitable society.

17. Personal Income Taxation: The main features of the personal income tax in the Philippines have not changed over the past fifteen years. The tax is levied on a relatively small part of the population, with most of the tax paid by a tiny fraction of this already small group. 1/ The rate of increase in returns filed has expanded steadily over the years, with a very sharp boost in 1973 due to the amnesty granted to previous nonfilers (Table II.1). As a percent of the entire Philippine population, the number of tax filers has risen from about 1.6 percent in 1960 to 3.5 percent in 1970 and 12.4 percent in 1973, which suggests that coverage of

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1/ See Bird, et al.,"Taxes and Tax Reform in the Philippines," p. 27.

the personal income tax in the Philippines is considerably wider than in many developing countries. But the proportion of returns which result in actual tax payments has continued to be very low, rising from only 0.4 percent in 1960 to 1.1 percent in 1970. Despite the sharp increase in the number of tax filers, the percentage of taxable filers to the total population has remained at around 1 percent.

Table II.1: Number of Income Tax Filers, 1960-1973

| Calendar Year | Individuals | | | Corporations | | |
|---|---|---|---|---|---|---|
| | Total Filers | Taxable | Percent Taxable | Total Filers | Taxable | Percent Taxable |
| 1960 | 422,770 | 103,337 | 24.4 | 6,335 | 3,586 | 56.6 |
| 1964 | 636,775 | 166,734 | 26.2 | 8,056 | 4,446 | 55.2 |
| 1969 | 1,146,865 | 356,044 | 31.0 | 12,118 | 6,544 | 54.0 |
| 1970 | 1,295,415 | 399,350 | 28.0 | 12,807 | 6,766 | 52.8 |
| 1971 | 1,431,024 | 468,514 | 32.7 | 13,856 | 7,190 | 51.9 |
| 1972 | 1,439,077 | n.a. | n.a. | n.a. | n.a. | n.a. |
| 1973 | 4,540,303 | 440,581 | 9.7 | 15,352 | 10,063 | 65.5 |

Source: Bird, et. al., Taxes and Tax Reform in the Philippines, p. 49A. Figures for 1973 are those reported by Bureau of Internal Revenue.

18. The reform of the personal income tax needs to be given high priority. According to a recent study, 1/ personal income tax rates in the Philippines are reasonably progressive. However, the beginning personal income tax rates are among the lowest in Asia, and should probably be raised. A recent consultants' report to the IMF 2/ recommended that the initial marginal rate should be increased from the current level of 3 percent to 10 percent. The report agrees with this suggestion. Other elements of a reform would include broadening the base of the personal income tax, reducing drastically the present system of personal deductions, and revising and simplifying the tax structure. There is a low basic exemption for any single individual, but this is offset by high exemptions for children. There does appear to be a case for changing the pattern of deductions for children to support the Government's efforts in family planning.

19. A comprehensive reform will take some time to be formulated and implemented, but it would improve the elasticity of the system (10 percent of tax revenue could be derived from the personal income tax by FY85 compared to only 6 percent in FY75), and, if structured and administered to capture an increasing share of increments in real and monetary incomes, could contribute to a more equitable tax system in general.

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1/ Gerardo F. Sicat, Taxation and Progress (Manila: National Economic Council, 1972).

2/ Bird, et al.,"Taxes and Tax Reform in the Philippines."

20. Corporate Income Taxes: The current corporate income tax rates of 25 percent on taxable incomes of under ₱ 100,000 per year and 35 percent on incomes exceeding ₱ 100,000 are not unduly low considering the need for investment incentives, although they are lower than in some other countries in the region like Malaysia, Singapore, and Taiwan. The main weakness of the corporate tax system seems to be its extensive and highly complex array of possible deductions. These are numerous loopholes, and intentionally built-in tax incentives are practically inoperative due to the very low effective rate of tax collection and the possibilities for tax evasion. It should be noted that high effective tax rates are not only important from a revenue point of view. The purpose of any tax incentive system, development or otherwise, can only be attained if effective rates of taxation are reasonably high. The lower the effective rate, the weaker the impact of the incentive systems.

21. A recent report on income tax returns of corporations 1/ revealed that out of about 15,350 registered corporations which filed tax returns, about one-third were exempt, with a recorded total gross income of ₱ 3.75 billion. Between 1959 and 1972, when there were fewer corporations registered, the ratio was between 50 and 60 pecent. The effective income tax rate of both taxable and exempt corporations decreased from an averae 6.8 percent of gross income in 1973 to 4.0 percent in 1974. Taxable corporations derived deductions of from 65 to 85 percent of their 1973 gross income. Exempt corporations claimed deductions of between 105 and 155 percent of their gross incomes; in 1974, taxable and exempt corporations combined claimed deductions of 74 and 84 percent. A sectoral breakdown showed that in 1973 the highest payers were agricultural and natural resource industries, with 9.7 percent of gross income, and manufacturing industries, with 8.8 percent. The finance and real estate sectors paid only 4.9 percent of gross income and other services paid 4.1 percent. The latter seems to have claimed abnormally high deductions or declared very low gross income.

22. Because of this situation, a complete review of the present corporate tax incentive system is needed aimed at raising the effective tax rates. This review deserves high priority. A consolidated and more easily administrable corporate income tax code will have to be established which closes loopholes and applies tax privileges and deductions to those sectors and activities which the Government actually wants to promote. 2/ This review will have to be comprehensive and would, therefore, be conveniently centralized under the direction of the Department of Finance.

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1/ Unpublished report submitted in April 1975 by Tomas C. Toledo, Director, Revenue Operations and Management Planning Division of the Bureau of Internal Revenue (BIR) to Misael P. Vera, Commissioner, BIR.

2/ As indicated earlier, economic sectors like agriculture and manufacturing which the Government wanted to aid have paid higher effective rates than the rest of the private corporate sectors in the past.

23. The implementation of a careful overall review will take time. In the interim, this report suggests that the Government raise the nominal corporation income tax rates, which, as mentioned earlier, are lower than in comparable developing countries. An increase of the lower rate from 25 to 30 percent and of the higher rate from 35 to 40 percent could probably be enacted without economic difficulties. Also, tax treatment of partnerships and closely-held corporations should be made uniform, and special rates for certain types of enterprises (e.g., building and loan associations) should be reviewed. The Government is currently considering the imposition of an additional five percent income tax on family corporations in order to induce these firms to go public. This would seem a welcome step in the direction of modernizing the corporate sector.

Indirect Taxation on Domestic Production, Goods and Services

24. At the present time, taxes on domestic goods and services provide about 20 percent of national government revenues, compared with more than 30 percent in the 1960s. This decline has been one of the striking characteristics of the Philippine Tax system. The so-called selective excise taxes 1/ - the most important source of national government revenues in FY54 - declined sharply in relative importance throughout the decade since rates remained very low. The principal tax on domestic production, the sales tax, proved even less responsive to GNP growth than the personal income tax. This was partly due to its obsolete rate structure (basically unchanged since 1939) and to the low priority given to its administration and collection by the Government. 2/

25. Luxury consumption should attract relatively heavier taxation than has been the case to date, but the Government should continue its present policy of abolishing or levying very low taxes on basic necessities, especially those consumed by low income groups. There is ample scope for raising revenues from indirect taxes such as sales taxes, excise duties, motor vehicles taxes, and taxes on services. Reforms in these areas would need to focus on the sales tax and on the motor vehicles tax, because they are the revenue sources which would most effectively contribute both to a rise in the elasticity of the tax system and also to some progressivity in the system, although to a much lesser degree than an income tax reform. While there is hope for increasing the selected excise duties on certain nonessentials, the excise taxes are the most regressive and inelastic components of the tax system and should only be raised if revenues from other sources are inadequate.

26. As far as the sales tax on domestic production is concerned, an increase in the current basic tax rate of 7 percent on most domestically-produced goods appears justified. The report concurs with the proposals

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1 Those on such items as tobacco products, alcoholic beverages, oils and fuels, and matches.

2/ There is no separate sales tax administration in the Philippines. Taxes levied at the import stage are collected by the Bureau of Customs, while sales taxes from domestic manufacturers are collected by the Bureau of Internal Revenue.

made by consultants reporting to the IMF 1/ that raising the basic tax rate to perhaps 15 percent would be a convenient means of increasing revenues. The report suggests that the present luxury rates of 40 and 70 percent be consolidated to a uniform 50 percent rate, and that the special low sales tax rates for essentials, particularly for staple food products, should be maintained. The sales tax on domestic products is considered a particularly convenient vehicle to raise tax revenues rapidly. Rate increases can be quickly decreed and can produce revenues without the time lags required in the case of income or land taxes.

27. A reform of the present Philippine sales tax administration will be necessary in order to provide for the efficient collection of the sales tax. Such a reform should greatly improve the elasticity of the tax system and should also indirectly increase the progressivity of the tax system as a whole, since a substantial portion of the poorer consumer groups will not be covered by the tax because they are either largely outside the market economy or consume mostly unprocessed (i.e., untaxed) food, which accounts for over half of the household budgets in the Philippines. 2/

28. The taxation of motor vehicles and fuels would be another area with scope for considerable increases in revenue collection. Following the example of the United States, the level of motor vehicle taxation has, in the past, been tied to the perceived financial needs of road construction and maintenance. The potential of such taxation as a source of general revenue and as a means for improving income distribution and resource allocations has never been fully recognized or utilized. The ILO report noted that the present domestic sales tax on domestically assembled cars ranges from only 10 percent for cars selling at not more than ₱ 20,000 to only 20.5 percent for cars selling at ₱ 40,000. It recommended that the beginning rate be raised to 40 percent. 3/ The Government is aware of this and recently raised the annual registration fee of private vehicles, in part as an energy conservation measure. The increased fee is not imposed on private vehicles serving as public transportation.

29. Gasoline taxes are relatively low by international standards (29 centavos per litre), and the diesel oil tax (10 centavos per litre) is even lower, for the benefit of non-automobile diesel oil users. The Mission believes that the gasoline tax may be doubled and the diesel oil tax significantly raised. However, the impact of both increases on urban mass transportation will have to be watched closely. The operation costs of jeepneys, in particular, may be seriously affected. Moreover, the sales tax on private automobiles (currently between 10 and 20 percent) could

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1/ Bird, et al.,"Taxes and Tax Reform in the Philippines."

2/ Ibid., pp. 120, 120A.

3/ ILO, Sharing in Development, p. 259.

probably be raised. 1/ In view of the high income elasticity of the purchase and use of automobiles, increases in fuel and motor vehicles sales taxes should have a particularly desirable distributive effect and raise the progressivity and elasticity of the tax system. Moreover, the administration of these forms of taxation is relatively simple.

Taxation of Land and Real Property

30. Another important aspect of the tax reform in the Philippines is the improvement of taxation on land and real property. As land becomes more scarce, windfall profits and rents on land should be taxed more heavily. This is a very complicated task, since such taxes should, on the one hand, provide significant revenues and contribute to equalizing discrepancies in incomes, while, at the same time, be simple enough to be enforceable and administrable in view of the relatively underdeveloped nature of the Philippine revenue administration. Moreover, the issues differ when one deals with the rural and the urban sectors. In any event, fast progress in this area of tax reform is unlikely to be achieved; consequently, the Mission has not made any allowance for revenues derived from such taxes in its projections. The following discussion will consider first the rural and then the urban sector.

31. A system of effective taxation of agricultural land would fill an important gap in the tax system by incorporating the non-exporting, crop-growing farmers into the revenue system; it would, therefore, be applied in particular to the rice, corn, and livestock farmers who, at present, are virtually untaxed. Introducing land taxation is a formidable task in any country, and the legislation and administration of a land tax in the Philippines will be time-consuming. In the long run, land taxes, if properly designed and administered, are able to produce significant revenues which would probably not be achieved by higher and better enforced income taxation. The Mission envisages a comprehensive land tax as a national tax, with possible revenue-sharing for local governments.

32. In designing a system of land taxation, the Government should focus not only on the raising of revenues, but also on nonfiscal developmental objectives such as better income distribution in the rural areas, more effective use of agricultural land, and bringing idle land into production. As the vast majority of the farmers have small farms and low income levels, 2/ the land tax would have to focus on higher income groups, with larger land holdings, through progressive taxation. Small landowners should also be effectively taxed, however, whenever the productivity of their land increases

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1/ Bird, et al., "Taxes and Tax Reform in the Philippines," p. 20. It is estimated that an increase in the minimum sales tax on private automobiles from the present 10 percent to 50 percent would produce about the same yield as a 5 percent raise in the corporate income tax.

2/ Ninety-four percent of all rice farmers have less than 4 hectares, and almost 70 percent have less than 2 hectares.

as a result of the Government's rural development programs (e.g., Masagana 99 and irrigation projects). The rate and collections will have to be as simple as possible to administer, and the effective rates of taxation should be high enough to realize the nonfiscal objectives of the tax. The land tax assessment will also have to take into account the service charges to be paid by the farmers for services rendered to them. If service charges, in addition to land taxation, become too high, fewer inputs may be utilized, with a resulting loss in productivity.

33. The issue of service charges in relation to the land tax is an important one. In a number of irrigation projects, for example, the collection of service charges has been significantly improved and some form of fair taxation has been established. The report does not intend to challenge this approach. In order to ensure that land users are charged for improvements on their land whenever services are available, the Mission suggests a heavy reliance on charges for the time being; these charges would be gradually replaced by the land tax in the long-term.

34. The most formidable preparatory administrative problem is the establishment of a uniform land cadastral system. Land title registration in the Philippines is very poorly administered and records are incomplete. There are two alternatives to determining the tax base which have been used in other countries: the estimate of agricultural income on the basis of assessed land value, as applied in Italy, and the assessment of income by the physical yield of different farm products on "standard" land, as is done in France. The latter amounts to an income tax substitute. Given the lack of information on land values and ownership in the Philippines, the report agrees with the ILO mission that the simplified Italian system may be better suited to Philippine conditions.

35. The taxation of urban land has different problems. There is currently no exclusively national tax on urban land. Provinces, cities, municipalities, and barrios are empowered to levy a real property tax on the assessed value of real property. As discussed earlier in this chapter, the rates range from 0.125 to 0.5 percent for the provinces, 0.125 to 2.0 percent for the cities, 0.25 to 0.5 percent for the municipalities, and up to 0.25 percent for the barrios. The national government also imposes a 1 percent tax on the assessed value which is earmarked for the Special Education Fund. There is an overall 3 percent ceiling on the total property tax that can be imposed.

36. Revenues from the real property tax constitute the most important revenue source for local government. As local governments should be strengthened financially, this tax should remain under the authority of the local governments. Yet the report proposes that the maximum rates which individual local governments may impose could be raised significantly, especially in the large metropolitan areas where the value of land has risen exorbitantly in recent years as a result of improvements in public services and increased

economic development. The Mission endorses the view of the ILO mission 1/ that the present 3 percent maximum rate of property tax in residential areas should become a minimum.

37. In addition, real property tax administration will have to be significantly improved. In the past, it has been characterized by low assessment levels and inadequate collections. In 1967, two-thirds of the provinces and one-half of the cities had no tax maps for property identification. Moreover, assessment lagged about 15 years behind real property value, which meant that effective tax rates were low. Considerable efforts of the Government will therefore be necessary to improve the enforcement of the real property tax on urban land.

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1/ ILO, Sharing in Development, p. 267

Chapter 10

TECHNICAL NOTE II

Mission Projections of National Government Tax Revenues

FY76-FY85

1. The following table presents in some detail the report's projections of national government tax revenues. The projections are based on the proposals for tax reforms set out in Technical Note I and assume a significant increase in collections. This would allow national government tax revenues to increase to 14.5 percent of GNP in FY80 and 16.5 percent in FY85. The structure of revenues indicates a shift in importance away from taxes on international trade in favor of a long-term continuous rise in the contribution from direct taxes and higher indirect taxes on domestic goods and services.

2. The base year for the projections is FY76; the Department of Finance's cash budget estimates for that year are used. For import duties, an average 20 percent tariff rate was applied to 70 percent of the value of imports, as projected in Chapter 11 of this report. The projections of export tax revenues apply the effective export tax rates of FY74 1/ of the various export commodities to the export receipts from these commodities as projected in Chapter 11. As the terms of trade are assumed to become less favorable than at present, only half of the special export duty rates are applied to the projected export earnings in the future.

3. Regarding direct taxation, an average 23 percent annual increase is assumed over the entire forecasting period. A slower increase is anticipated for both personal and corporate income tax revenues in the earlier years, as income tax reforms are assumed to take time. The projections also assume a sharp rise in revenues from the general sales tax and other taxes, including those relating to motor vehicles and gasoline, whose share in total national tax revenues would reach 26 percent in FY80 and 31.5 percent in FY85, compared to only 6 percent in FY76.

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1/ Bird, et al., "Taxes and Tax Reform in the Philippines," p. 175A.

Table 10.II

Projections of National Government Tax Revenues
(Amounts in millions of pesos)

| Source of Revenue | FY76 Amount | FY76 Per-cent | FY77 Amount | FY77 Per-cent | FY78 Amount | FY78 Per-cent | FY79 Amount | FY79 Per-cent | FY80 Amount | FY80 Per-cent | FY85 Amount | FY85 Per-cent |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Taxes on Income and Wealth | 4,230 | 25.6 | 5,160 | 26.0 | 6,400 | 27.0 | 7,945 | 28.5 | 10,010 | 30.0 | 27,300 | 35.0 |
| Corporate tax | 3,090 | 18.7 | 3,820 | 19.2 | 4,630 | 19.5 | 5,715 | 20.5 | 7,170 | 21.5 | 18,330 | 23.5 |
| Personal income tax | 975 | 5.9 | 1,170 | 5.9 | 1,540 | 6.5 | 1,950 | 7.0 | 2,440 | 7.3 | 7,800 | 10.0 |
| Others | 115 | 0.8 | 170 | 0.9 | 230 | 1.0 | 280 | 1.0 | 400 | 1.2 | 1,170 | 1.5 |
| Amnesty | 50 | 0.3 | ... | ... | ... | ... | ... | ... | ... | ... | ... | ... |
| Taxes on International Trade | 7,480 | 45.3 | 8,930 | 45.0 | 10,430 | 44.0 | 11,850 | 42.5 | 13,340 | 40.0 | 23,400 | 30.0 |
| Export tax | 1,000 | 6.0 | 1,330 | 6.7 | 1,500 | 6.4 | 2,035 | 7.3 | 2,335 | 7.0 | 4,680 | 6.0 |
| Import duty | 4,600 | 27.8 | 5,550 | 28.0 | 6,600 | 27.8 | 6,550 | 23.5 | 7,505 | 22.5 | 12,480 | 16.0 |
| Sales tax on imports | 1,880 | 11.4 | 2,050 | 10.3 | 2,330 | 9.8 | 3,265 | 11.7 | 3,500 | 10.5 | 6,240 | 8.0 |
| Taxes on Domestic Goods and Services | 3,640 | 22.0 | 4,500 | 22.7 | 5,690 | 24.0 | 6,970 | 25.0 | 8,675 | 26.0 | 24,570 | 31.5 |
| Excise tax | 2,720 | 16.4 | 3,130 | 15.8 | 3,320 | 14.0 | 4,045 | 14.5 | 5,005 | 15.0 | 13,260 | 17.0 |
| General sales tax and others | 920 | 5.6 | 1,370 | 6.9 | 2,370 | 10.0 | 2,925 | 10.5 | 3,670 | 11.0 | 11,310 | 14.5 |
| Other Taxes | 1,780 | 7.1 | 1,260 | 6.3 | 1,190 | 5.0 | 1,120 | 4.0 | 1,335 | 4.0 | 2,730 | 3.5 |
| Total | 16,530 | 100 | 19,850 | 100 | 23,710 | 100 | 27,885 | 100 | 33,360 | 100 | 78,000 | 100 |
| GNP (at current prices) | 131,080 | | 150,350 | | 173,050 | | 199,180 | | 230,055 | | 472,765 | |
| Ratio of Revenues to GNP | 12.6 | | 13.2 | | 13.7 | | 14.0 | | 14.5 | | 16.5 | |

Source: Cash budget forecasts for FY76 (as of May 1975) and Mission estimates.

# Chapter 11

## ROLE OF EXTERNAL TRADE AND FINANCE

Chapter 11

# ROLE OF EXTERNAL TRADE AND FINANCE

11.1 For most of the period after independence, the Philippines suffered from a chronic shortage of foreign exchange that periodically led to major policy adjustments, including currency devaluations. The root cause of this problem was the slow growth in export receipts relative to import demand, resulting primarily from wide fluctuations and a long-term decline in the terms of trade. The Philippines depended in large part on the export of agricultural products for its foreign exchange needs; given the relatively inelastic world demand for these products, export receipts did not keep pace with the growth in demand for foreign exchange. As the analysis in Chapter 6 indicates, the imbalance between the supply and demand for foreign exchange continued even after the adoption of import substitution policies in the 1950s and 1960s. Industrialization based on import substitution did not reduce import dependence in spite of substantial devaluations; it simply shifted the dependence from finished consumer goods to capital and intermediate goods. If the Philippines is to escape the past constraint on growth that has been imposed by a lack of foreign exchange, a substantially better performance in export growth will be needed in the decade ahead.

11.2 Exports must grow more rapidly than imports in order for the Philippines to reduce its current large resource gap. Whether they will be able to do so will depend on the country's ability to increase production for export, on the expansion of overseas markets, and on trade policies that will keep exports competitive. The ratio of the current account deficit to GNP in 1975 was about 6 percent, largely because of the sharply increased prices for imported petroleum and related products. For the reasons given in Chapters 6 and 8, a reasonably smooth adjustment to the higher costs of imported fuel and petrochemicals should be made by accelerating the rate of growth of exports rather than by reducing imports. But, as the earlier analysis indicates, it will be a number of years before the Philippine economy can complete a reasonably smooth transition to a point where these higher energy costs have been fully absorbed. Increased investments will have to be made in the export sector, in import-replacing industries, and in alternate sources of energy. Some of these investments are necessarily capital-intensive with large foreign exchange requirements.

11.3 In order to sustain the investment program outlined in Chapter 8, the volume of imports will have to expand by about 7 percent a year during 1975-85. Assuming a rate of import inflation of about 7-8 percent a year, the import payments would increase by about 14-15 percent a year over this period. Any cutbacks in the import level would probably be concentrated on capital goods imports and would have adverse effects on income and employment growth. Imports of finished consumer goods are only a small proportion of total imports and reductions in imports of intermediate goods would have an immediate and unacceptably adverse impact on production and employment, especially in the nontraditional manufacturing sector, where growth depends on these vital imports. Similarly, cutbacks in capital goods imports at this time, when locally available capital goods are in short

supply, would hamper the Philippines' adjustment to higher energy pprices and also have negative effects on programs aimed at expanding production and employment. Since gains from the external terms of trade are expected to be modest during the next ten years, the volume of exports will have to grow by about 9 percent a year. A critical assumption underlying all these projections is that the OECD countries will recover during the next decade and experience rates of economic growth comparable with those they enjoyed in the 1960s. Sustained OECD growth will also be required to make the projected capital inflow possible.

11.4 Even if the current account deficit can be reduced to about 4 percent of GNP by 1980 and to 2 percent by 1985, the Philippines would need average net foreign exchange inflow of around US$1 billion a year in the first half of the 1980s. The bulk of this amount will probably have to be in the form of medium and long-term loans. External requirements of this magnitude do not appear excessive in relation to current levels of inflows nor to reasonable prospects for future inflows. The Consultative Group and other official donors will have an important role to play in this area, since at least one-third of the loans should be on concessional terms to ensure that the ratio of debt service payments to exports does not rise beyond its present level of about 17 percent. For its part, the Government would need to develop a wider range of external capital sources. An inflow of the above magnitude would be sufficient to ensure that international reserves increase from the present level of about US$1 billion to about US$4 billion in 1985, a level equivalent to 3 months of imports. Considering the chronic shortage of foreign exchange that the Philippines has experienced in the past, prudent foreign exchange management in the future would require that reserves be maintained at this level and debt service ratio not exceed the level suggested above.

11.5 The outstanding amount of medium and long-term debt would rise from about US$2.3 billion at the end of 1975 to about US$11 billion by the mid-1980s. The service of such a debt depends, of course, both on the Philippines' future economic expansion and on the capital inflow which the Philippines can reasonably expect over the period. If the combination of loan maturities is along the lines suggested in this chapter, management of the debt and debt service should not present serious problems. Of course, the development program that the Government has set for the country itself and for the people of the Philippines will not be without difficulties. But there appears to be a recognition in the Philippines of the problems and uncertainties of further development, and the Government intends to modify and adjust policies and objectives as necessary to stay on a fairly even and manageable course, both internally and externally.

## A. External Trade and Foreign Exchange Needs

11.6 The Philippines cannot count on foreign inflows to finance the resource gap at its present level indefinitely and must reduce its dependence on such inflows to about 2 percent of GNP by 1985. However, the

Philippines requires imports of capital and intermediate goods which are not manufactured domestically but are essential to sustain the investment program. The Philippines will, therefore, have to expand the capacity to pay for these imports and aim for an average annual increase of about 19 percent a year in the value of exports during the next ten years. Since earnings from exports of traditional agricultural products will continue to expand at a slow rate, the required growth in foreign exchange receipts will have to come from an aggressive program aimed at expanding exports of wood products, minerals, and so-called nontraditional industrial exports.

11.7 Even with this growth in export earnings, the requirements of net inflows of foreign borrowings would be substantial, with at least one-third of the loans on concessional terms, during 1975-84. If the Philippines attempted a sustained expansion in its GNP of 7 percent a year in real terms when the volume of exports was growing at much less than 9 percent a year, it is extremely unlikely that the present heavy dependence on foreign inflows can be reduced, and the Philippines would face the prospect of the same kind of constrained growth of foreign exchange that was characteristic of the 1950s and 1960s. In this case, output and employment growth rates would have to be adjusted downwards.

Import Requirements for Sustained Growth

11.8 The volume of imports is projected to increase at about 7 percent a year during the next ten years, and, assuming that the unit value of imports increases by about 7-8 percent a year, total payments for imports would rise from US$3.4 billion in 1975 to US$6.9 billion in 1980 and US$13.4 billion in 1985 (Table 11.1).

11.9 Import requirements, however, would vary from year to year depending on the short-term changes in domestic incomes and savings and on the timing of individual investment projects. They are particularly vulnerable to prices of petroleum products, which accounted for more than 22 percent of total import payments in 1975. Petroleum prices will probably rise in line with international prices over the next decade, and any small change in this price projection, of even 10 percent, for example, would affect the import bill significantly. The annual import requirements would also vary according to the timing of individual large investment projects in power, mining, steel, fertilizer, and other industries. The total investment cost of these projects is expected to exceed US$7 billion during the next five years, with the individual cost of many of them exceeding US$200 million. As outlined in Chapter 6, Government policy provides various incentives for import substitution and for increasing the use of domestic components. Several investment projects are likely to come up in this area in the next few years. If these plans materialize, 1/ there is considerable scope for import substitution in the 1980s.

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1/ For a detailed discussion, see Chapter 6.

Table 11.1 Import Payments in Current and Constant Values and Price Indices

| Item | Actual 1960 | 1965 | 1970 | 1975 | Projected 1980 | 1985 |
|---|---|---|---|---|---|---|
| Current value (in millions of US dollars) | | | | | | |
| Cereals | 25 | 95 | 33 | 143 | 105 | 159 |
| Other consumer goods | 75 | 90 | 98 | 357 | 502 | 718 |
| Crude petroleum | 21 | 59 | 103 | 752 | 1,516 | 2,875 |
| Other raw materials | 260 | 281 | 442 | 1,098 | 2,421 | 4,987 |
| Capital goods | 223 | 283 | 414 | 1,000 | 2,327 | 4,626 |
| Total | 604 | 808 | 1,090 | 3,350 | 6,871 | 13,364 |
| Price Indices (1967-69 = 100) | | | | | | |
| Cereals | 62.5 | 68.2 | 72.0 | 214.2 | 245.5 | 354.1 |
| Other consumer goods | 100.7 | 112.1 | 91.6 | 244.0 | 354.2 | 496.8 |
| Crude petroleum | 115.2 | 102.2 | 99.9 | 832.8 | 1,198.4 | 1,680.8 |
| Other raw materials | 92.3 | 101.6 | 124.3 | 298.8 | 433.6 | 608.2 |
| Capital goods | 82.8 | 97.5 | 107.1 | 181.5 | 263.4 | 369.4 |
| Total | 89.4 | 95.8 | 108.8 | 274.1 | 392.0 | 549.5 |
| Constant Value (in millions of US dollars) | | | | | | |
| Cereals | 40 | 139 | 46 | 67 | 43 | 45 |
| Other consumer goods | 75 | 80 | 107 | 146 | 142 | 144 |
| Crude petroleum | 52 | 75 | 119 | 90 | 127 | 171 |
| Other raw materials | 239 | 258 | 344 | 368 | 558 | 820 |
| Capital goods | 269 | 290 | 387 | 551 | 883 | 1,252 |
| Total | 675 | 843 | 1,002 | 1,222 | 1,753 | 2,432 |

Source: Data for 1960, 1965, 1970 and 1975 are from the Central Bank of the Philippines; those for 1980 and 1985 are World Bank staff projections.

11.10 Imports of consumer goods (including cereals) currently account for about 15 percent of total import payments. Because of the growing capacity of domestic industries to meet the needs of consumers, the share of finished consumer goods (other than cereals) in total import payments has declined steadily to the current level of about 11 percent. This trend is expected to continue, and by 1985 these items may account for about 5 percent of total payments. Given a reasonable degree of success in expanding agricultural production programs along the lines discussed in Chapter 5, imports of rice and corn can be eliminated by 1980; imports of wheat would continue to grow, but by 1985 cereal imports would only be about 1 percent of total imports, compared with about 4 percent at present.

11.11 As a result of the sharp increases in prices, payments for petroleum crude and products have jumped from about US$180 million in 1973 to about US$750 million in 1975, and their share in total import payments has doubled to 22 percent. 1/ Payments for crude imports are now equivalent to about 5 percent of GNP. Since consumption of petroleum crude is projected to grow by about 8 percent a year in the latter half of the 1970s, the Mission projects imports to be about 100 million barrels in 1980. During the 1980s, a somewhat slower growth is expected since the Government's program to develop alternative energy sources should begin to have an impact on the demand for petroleum products by that time. 2/ Although there are reasonable prospects for discovering commercial quantities of petroleum, the Mission has assumed that all requirements will have to be met from imports, at least until 1985. Thus, imports of petroleum crude are projected at about 140 million barrels in 1985.

11.12 At the present time, the future course of petroleum prices is very uncertain. For the purposes of this analysis, the Mission has assumed that the price of crude will rise in line with international prices generally, which are assumed to increase by an average of 7-8 percent a year during 1976-85; therefore, the Mission used an oil price of US$15 a barrel in 1980 and US$21 a barrel in 1985. Payments for petroleum crude would thus be about US$1.5 billion in 1980 and US$2.9 billion in 1985; in other words, petroleum crude imports would still be about 21 percent of total payments in 1985.

11.13 Other raw materials and intermediate goods currently account for about 33 percent of total import payments; chemical products, iron, and steel account for more than half of the payments for this category. During the past decade, imports of these items have grown at an average of 6-7 percent a year in real terms, which is slightly higher than the GNP growth rate and roughly in line with the growth of industrial output. The Mission expects this trend to continue for the remainder of the 1970s, and has, therefore, projected an average increase of about 8 percent a year in real terms (the same as the projected industrial output growth rate). A slower growth of

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1/ For a more complete discussion of the role of petroleum in the Philippine economy, see Appendix II, volume II.

2/ For a detailed discussion, see Appendix II, volume II.

about 6 percent in imports of these items could be expected in the 1980s, when output from the proposed major investments in steel, fertilizer, pulp and paper, and chemicals should begin to replace imports. After allowing for an average increase in prices of 7-8 percent a year, total payments for imports of raw materials and intermediate goods are projected to be about US$5.0 billion by 1985, or about 37 percent of total import payments.

11.14 In the first half of the 1970s, there was not much growth in real terms in imports of capital goods. Given the scarcity of domestically available capital goods and the projected expansion in industrial investment and the program of public infrastructure investment described in Chapter 8, the Mission projects imports of capital goods to increase by about 8-9 percent a year during 1976-85, and, after allowing for an average increase of about 7 percent a year in prices, the payments for capital goods imports would rise to perhaps US$4.6 billion by 1985. This large amount means that the Philippines will need access to significantly greater amounts of external capital to finance these purchases. As the subsequent analysis indicates, the Philippines would need a net inflow of medium and long-term loans of around US$9 billion during the next ten years. The country will be confronted with a scale of external borrowing that is much higher than in the past, which will require concerted efforts on the part of both the Government and the international financial community to ensure these needs are met.

Expanding the Capacity to Import

11.15 If the Philippines is to be able to sustain a growth in imports of about 7 percent a year in real terms, there will have to be a sharp increase in the growth of exports. As already indicated, exports will have to grow by at least 9 percent a year in real terms during 1976-85. This will mean a substantially better performance in the volume of exports than in the past. According to statistics published by the Central Bank of the Philippines, the volume of exports grew at a relatively steady rate of 6-7 percent a year between 1950 and 1965. In the second half of the 1960s, there was no significant increase in the volume of exports, 1/ but a somewhat better performance was recorded in the first half of the 1970s, when the trend rate of increase was about 7 percent a year.

11.16 Prospects for Exports: The prospects for exports will depend on the implementation of an aggressive program aimed at expanding exports, particularly of nontraditional manufactures, with an emphasis on diversification of products as well as of markets. Traditional agricultural exports are expected to grow slowly, and increasing emphasis must be placed on the processing of primary products like copra and logs prior to export. Large investments are proposed in extractive industries to increase the value of mineral exports both as a result of the additional processing of mineral

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1/ However, some caution is needed in interpreting these statistics since there is reason to believe that the official trade statistics understate actual earnings.

ores and the exports of new mineral products. Exports for agro-industrial products--mainly copra, coconut, oil, sugar, fruits and vegetables--have traditionally provided the bulk of the Philippines' foreign exchange earnings. In the early 1950s, for example, they accounted for about 85 percent of export earnings, but since receipts from these products increased by less than 3 percent a year during 1950-70, their share had dropped to about 43 percent by 1970 (Table 11.2). Primarily as a result of the boom in international prices of these commodities, earnings have risen sharply since 1972, and this group of commodities accounted for about 59 percent of exports in 1975. From 1972-75, however, the volume of these exports increased only very moderately. As the analysis in Chapter 5 indicates, the Mission expects exports of these commodities to grow by about 4 percent a year in real terms during 1976-85, roughly in line with the projected growth in world demand for these items. Assuming an increase of about 6 percent a year in the unit value of these items, 1/ earnings would rise to about US$4.0 billion by 1985, compared with about US$1.4 billion at present. Since earnings from these exports increase at a slow rate, the required growth in export receipts will have to come from exports of wood products, minerals, and nontraditional industrial exports.

11.17 Exports of forest products were an increasingly important source of foreign exchange during the 1950s and 1960s. Starting from negligible amounts in the early 1950s, exports of logs and other forest products rose to about US$300 million by 1970 and accounted for 27 percent of export earnings. The growth in earnings in the first half of the 1970s was constrained by increasing difficulties in expanding log production and the relatively slow growth in overseas demand, especially in 1974-75. As the analysis in Chapter 6 indicates, however, earnings from wood products are projected to rise by an average of about 20 percent a year during 1976-85 as processed wood products replace exports of logs; exports of logs are expected to be phased out in this period. By 1985, earnings are projected to be about US$1.4 billion.

11.18 Exports of minerals, particularly copper and nickel, are expected to be an increasingly important source of foreign exchange earnings for the Philippines. From very small beginnings in the early 1950s, earnings from minerals have grown rapidly to the point where they now account for about 14 percent of export receipts. As the analysis in Chapter 6 indicates, production of minerals for export is expected to expand by about 12 percent a year during 1976-85. Earnings are projected to grow by about 25 percent a year to a total of US$3 billion by 1985.

11.19 For the reasons given in Chapters 5 and 6, it seems unlikely that substantially larger volumes of exports of traditional agricultural products, wood products, and minerals will occur during the next ten years, although actual earnings could be affected somewhat by different price outcomes. But

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1/ This is somewhat more rapid than the rate of increase in prices of the individual commodities. The reason is that the composition of the group would shift in favor of higher unit value commodities such as coconut oil (instead of copra), fruits, and vegetables.

Table 11.2. Export Earnings in Current and Constant Values and Price Indices

1960 - 85

| Item | Actual 1960 | 1965 | 1970 | 1975 | Projected 1980 | 1985 |
|---|---|---|---|---|---|---|
| **Current value** (in millions of US dollars) | | | | | | |
| Copra | 139 | 170 | 80 | 161 | 238 | 188 |
| Coconut oil | 16 | 68 | 96 | 217 | 530 | 1,157 |
| Sugar | 133 | 132 | 188 | 697 | 895 | 1,506 |
| Wood products[a] | 102 | 195 | 295 | 226 | 793 | 1,423 |
| Copper concentrate and copper | 30 | 47 | 185 | 196 | 900 | 2,414 |
| Other mineral products[b] | 31 | 30 | 39 | 134 | 304 | 621 |
| Other agricultural products[c] | 96 | 104 | 107 | 288 | 668 | 1,275 |
| Manufacturing and miscellaneous[d] | 13 | 22 | 93 | 392 | 1,384 | 4,291 |
| Total | 560 | 768 | 1,083 | 2,311 | 5,712 | 12,875 |
| **Price Indices** (1967-69= 100) | | | | | | |
| Copra | 98.1 | 109.3 | 64.0 | 115.7 | 207.7 | 357.9 |
| Coconut oil | 98.2 | 106.0 | 104.3 | 132.9 | 227.7 | 383.6 |
| Sugar | 81.9 | 87.1 | 102.8 | 262.8 | 251.2 | 352.4 |
| Wood products[a] | 97.7 | 87.6 | 99.4 | 112.9 | 239.5 | 368.5 |
| Copper concentrate and copper | 56.7 | 70.9 | 123.2 | 121.3 | 259.8 | 416.5 |
| Other mineral products[b] | 150.3 | 111.9 | 162.1 | 242.9 | 390.9 | 596.0 |
| Other agricultural products[c] | 145.0 | 109.2 | 138.6 | 187.4 | 267.4 | 375.1 |
| Manufacturing and miscellaneous[d] | 30.8 | 40.0 | 189.8 | 378.3 | 549.1 | 770.1 |
| Total | 92.3 | 92.8 | 108.6 | 186.1 | 291.3 | 468.5 |
| **Constant value** (in millions of US dollars) | | | | | | |
| Copra | 142 | 156 | 125 | 139 | 114 | 53 |
| Coconut oil | 16 | 64 | 92 | 163 | 233 | 302 |
| Sugar | 163 | 152 | 183 | 265 | 356 | 427 |
| Wood products[a] | 104 | 223 | 291 | 200 | 331 | 386 |
| Copper concentrate and copper | 53 | 66 | 150 | 162 | 346 | 580 |
| Other mineral products[b] | 21 | 27 | 24 | 55 | 78 | 104 |
| Other agricultural products[c] | 66 | 86 | 77 | 154 | 250 | 340 |
| Manufacturing and miscellaneous[d] | 42 | 55 | 49 | 104 | 252 | 557 |
| Total | 607 | 828 | 998 | 1,242 | 1,961 | 2,748 |

a/ Includes plywood, veneer, lumber, pulp and paper
b/ Includes nickel ore, gold, chrome, iron ore and other minerals
c/ Includes desiccated coconut, oil cakes, molasses, bananas, pineapples and other fruits, marine products, abaca and tobacco
d/ Includes re-exports, artifacts, jewelry, and other minor products.

Source: Data for 1960, 1965, 1970 and 1974 are from the Central Bank of the Philippines; those for 1980 and 1985 are World Bank staff projections

if the projects concerned with the processing of primary products (e.g., copra and logs) and the additional processing of mineral products were to be realized, earnings from these products would rise by 16 percent a year to about US$9 billion in 1985. This would be substantially less than the minimum level of export earnings of about US$13 billion that would be needed by 1985 to support the projected level of imports. Earnings from nontraditional industrial exports and other miscellaneous items must, therefore, be expanded to about US$4 billion in 1985 if there is to be sufficient foreign exchange for sustained growth of 7 percent a year in GNP. If the unit value of this group of exports increases by 7-8 percent a year in line with the report's assumptions about the behavior of international prices generally, an average growth in the volume of these exports of about 18 percent a year would be required.

11.20 This growth can be achieved if the kinds of programs and policies set out in Chapter 6 are pursued. For most industries in which a large increase in export sales is projected, the main uncertainty on the supply side would appear to be the willingness of entrepreneurs to undertake the kinds of investments that will be needed to attain the targets. As the analysis in Chapter 6 indicates, for a broad range of manufactures, the effective exchange rate apparently continues to favor investments in capacity that are primarily intended to serve the domestic market. It would appear that the relative attractiveness of investments in capacity for exporting will have to increase by changes in the structure of incentives for export and import substitution industries. This will probably require changes in the effective exchange rates for nontraditional industrial exports relative to those for import substitution industries.

11.21 External Terms of Trade: The other factor that will influence the capacity to import is the behavior of the external terms of trade. The instability in the international commodity markets in recent years has been a forceful reminder of the extent to which import capacities can be affected by changes in the terms of trade; it has also been a reminder of the importance of having adequate foreign exchange reserves to minimize the disruptive effects of slumps in export earnings.

11.22 For the Philippines, the magnitude of the fluctuations in the external terms of trade in the past few years has been without parallel. In common with many other countries at the time, the Philippines experienced a modest secular decline of about 2 percent a year in external terms of trade during the 1950s, but in the 1960s there was very little change (Table 11.3). This situation altered dramatically in the 1970s. During 1970-72, the terms of trade declined by about 20 percent, only to be followed by a recovery during 1973 and 1974, and a decline of about 25 percent again in 1975. The Philippines is a relatively open economy (the ratios of exports and imports to GNP are about 22 percent and 26 percent, respectively), and, as the analyses in Chapters 9 and 10 indicate, these wild swings in the terms of trade have posed major problems in managing the economy in the first half of the 1970s and they have had profound effects on the distribution of incomes.

Table 11.3. Actual and Projected External Terms of Trade.
(1967-69 = 100)

| Year | Export Price Index[a/] | Import Price Index[a/] | Net Terms of Trade |
|---|---|---|---|
| Actual | | | |
| 1960 | 91.7 | 87.1 | 105.3 |
| 1965 | 93.6 | 96.0 | 97 5 |
| 1970 | 106.1 | 104.6 | 101.4 |
| 1971 | 105.3 | 112.9 | 93.2 |
| 1972 | 98.5 | 120.2 | 82.0 |
| 1973 | 140.0 | 142.9 | 97.9 |
| 1974 | 249.8 | 255.3 | 97.9 |
| 1975 | 203.0 | 274.5 | 74.0 |
| Projected | | | |
| 1980 | 310.2 | 393.8 | 78.8 |
| 1985 | 485.7 | 552.0 | 88.0 |

a/ Goods and nonfactor services

Source: Data for 1960 to 1975 are from the Central Bank of the Philippines; data for 1980 and 1985 are Mission projections

11.23 In accordance with World Bank staff forecasts of international commodity prices, only a marginal recovery in the external terms of trade has been projected between 1976 and 1980. In the 1980s, there would be a further recovery because of the estimated increasing importance of higher value commodities in Philippine exports. But when set against the recent background of international price behavior, these statements about recovery in the terms of trade during 1976-85 can only be put forward tentatively. The balance of payments outcome is obviously quite sensitive to fluctuations in export prices that cannot be predicted. Fortunately, the Philippine Government has in the past few years shown itself to be quite adept at contending with large short-term fluctuations in prices, and if efforts are made to maintain an adequate level of foreign exchange reserves, as discussed later in the chapter, it should be possible for the Philippines to ride out adverse short-term trade situations in the future.

Earnings from Invisibles and Transfers

11.24 The principal growth in receipts from services would come from tourism and interest earnings on foreign exchange reserves. International tourism in the Philippines is still at a very early stage of development and provides a good potential for sustained growth. The Government has already identified several areas as having priority for tourist development, and substantial investments in hotels and tourism-related industries are already taking place. The markets which offer promising prospects for tourists to the Philippines include short stopovers on round-the-world or Asian tours, as well as longer stopovers by tourists from North America, Europe, Australia, and Japan. Receipts from tourism are projected to increase by about 17 percent a year and to reach US$500 million by 1985.

11.25 During the next ten years there should be significant increases in freight and insurance payments resulting from the projected expansion in the Philippines' merchandise trade. These payments are likely to increase by about 15 percent a year and reach US$1.4 billion by 1985. Dividend payments on growing foreign investments and interest payments on a much higher level of external borrowings would also expand rapidly; the total debt outstanding on a disbursement basis is likely to more than double in the next five years, and interest payments, for example, would exceed US$900 by about 1985, compared to nearly US$200 million at present. However, net transfers are expected to grow considerably during the next ten years, which would largely offset the outflows on the services account. A reduction in official transfers would be accompanied by a steady growth in private transfers, primarily from the large and growing number of Filipinos who live and work overseas and who remit portions of their earnings to relatives in the Philippines. Together, total net transfers are expected to grow from about US$240 million in 1975 to about US$500 million by 1985. (Table 11.4).

Table 11.4 Summary Balance of Payments
(In millions of US dollars)

| Item | Actual 1960 | 1965 | 1970 | 1975 | Projected 1980 | 1985 |
|---|---|---|---|---|---|---|
| **Trade account** (net) | -29 | -24 | -7 | -1,039 | -1,160 | -490 |
| Exports | 575 | 784 | 1,083 | 2,311 | 5,710 | 12,870 |
| Imports | 604 | 808 | 1,090 | 3,350 | 6,870 | 13,360 |
| Services (net) | -115 | 62 | -141 | -120 | -460 | -1,000 |
| Transfers (net) | 140 | 99 | 119 | 300 | 370 | 500 |
| Current account balance | -4 | 137 | -29 | -859 | -1,250 | -900 |
| Direct investment | 29 | -10 | -29 | 100 | 150 | 200 |
| Medium and long-term loans | 36 | 50 | 134 | 300 | 940 | 840 |
| Short-term capital | -1 | -117 | 76 | 40 | 270 | 400 |
| Capital n.i.e.[a/] | -33 | -113 | -133 | 343 | 170 | 58 |
| Change in reserves (- = increase) | 27 | -53 | 19 | 75 | -280 | -500 |

a/ Includes net IMF inflows and errors and omissions.

Source: Data for 1960 1965 and 1970 are from the Central Bank of the Philippines; those for 1975, 1980, and 1985 are World Bank staff projections.

Issues in Trade Policy

11.26 The extent to which the Philippines can successfully expand her exports as projected will depend not only on the ability to increase production for export, but also on the expansion of overseas markets through promotional activities and measures to keep exports competitive. The long established concentration of trading with the United States has somewhat declined in the last couple of years and Japan is emerging as an important trading partner. Trade with other countries has also grown gradually in recent years. As mentioned in Chapter 8, the recent policy changes related to the encouragement of foreign investments have already been reflected in the increasing participation of foreigners in local enterprises. These foreign investors can play an important role in the diversification of trade sources and the exploration of new markets through their contracts with the international market. The Philippines is also involved in several bilateral and multilateral trade relationships which might lead to widening the scope of its international trade.

11.27 Historically, the Philippines has depended heavily on the United States both as a market for exports and as a source of imports. In the early 1950s, for example, the United States accounted for about three-quarters of the Philippines' external trade. This dependence declined gradually during the 1950s and 1960s as trade with Japan expanded; by 1970 the United States and Japan each absorbed about 40 percent of the Philippines' exports, and they each provided about 30 percent of her imports (Table 11.5). By 1974, the United States and Japan together purchased more than three-quarters of the Philippines' exports, but because of the increase in the relative importance of petroleum in total import payments, these two countries accounted for only about half of the imports.

11.28 The only major trade agreement in the past was with the United States. The preferential treatment for the Philippines' exports in the United States market has now been phased out with the expiration of the Laurel-Langley trade agreement in July 1974 and that of the United States Sugar Act in 1974. The United States and the Philippine Government are presently considering a treaty to replace the Laurel-Langley agreement. In the meantime, the United States Congress has passed the Trade Reform Act, which provides some concessions to developing countries, including the Philippines. In the longer term, as long as the Philippines is able to stay competitive at international prices, it should be able to maintain its share in the United States market.

11.29 The Government has been active in attempting to reduce the dependence of Philippine exports on the markets of the United States and Japan although the Japanese Generalized Scheme of Preferences is likely to be of particular benefit to exporters of agricultural and fishery products as well as to those of mining and manufactured products. Efforts have been made to eliminate legal obstacles and promote trade agreements with the East European nations and the Peoples Republic of China, for example. Some arrangements have already been made on the exchange of certain primary export commodities

Table 11.5 Directions of External Trade
(In percent)

| Trade Partner | 1960 | 1965 | 1970 | 1971 | 1972 | 1973 | 1974 |
|---|---|---|---|---|---|---|---|
| Exports | | | | | | | |
| United States and Canada | 50.7 | 45.7 | 41.8 | 40.8 | 41.0 | 36.5 | 42.9 |
| Europe | 19.5 | 20.6 | 9.3 | 14.1 | 16.6 | 16.2 | 14.2 |
| Japan | 21.9 | 28.4 | 39.7 | 35.1 | 33.8 | 35.8 | 34.8 |
| Other Asian countries | 3.4 | 3.8 | 7.7 | 8.4 | 6.8 | 9.1 | 5.2 |
| Others | 4.4 | 1.5 | 1.5 | 1.6 | 1.8 | 2.4 | 2.9 |
| Total | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |
| Imports | | | | | | | |
| United States and Canada | 45.5 | 36.6 | 30.5 | 27.2 | 27.4 | 29.4 | 24.5 |
| Europe | 13.2 | 16.7 | 18.4 | 19.4 | 15.6 | 14.9 | 15.2 |
| Japan | 26.5 | 24.3 | 31.7 | 30.3 | 31.8 | 32.4 | 27.5 |
| Other Asian countries | 9.0 | 12.7 | 8.1 | 11.0 | 9.0 | 6.9 | 7.1 |
| Others | 5.8 | 9.7 | 11.3 | 12.1 | 16.2 | 16.4 | 25.7 |
| Total | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

Source: Central Bank of the Philippines

for Chinese products. These arrangements open a new source for imports of oil and rice in exchange for a potential export market for items like sugar, wood, and coconut products. A trade agreement with Canada was also signed in 1972. The Philippines' membership with the Association of Southeast Asian Nations (ASEAN) might also lead to increasing trade with neighboring countries through the removal of trade restrictions and the promotion of preferential arrangements. In an effort to promote multilateral trade relationships, the Philippines became a member of the General Agreement and Tariffs and Trade (GATT) in 1973, thus obtaining most favored nation treatment from more of its trading partners.

11.30 One aspect of trade policy that may become increasingly important in the future relates to the pattern of trade deficits. Currently, the trade deficit of about US$1 billion consists of a deficit of about US$700 million with the oil-producing states, primarily those of the Middle East, and the remaining US$300 million with other trading partners. Payments for oil are projected to be about US$3 billion in 1985, and, unless the Philippines can expand exports to these oil-producing countries by a substantial amount, it will have to run large trade surpluses with other trade partners. For example, if exports to the oil-producing countries were increased to only about US$500 million in 1985, as projected by the Mission, the trade surplus with the rest of the world would have to be about US$2.0 billion.

## B. External Capital Inflows

11.31 If the projections of current account receipts and payments outlined in the previous sections are realized, the cumulative deficit would be about US$5 billion during 1976-80 and about US$6 billion in the subsequent five year period; that is, the projections imply an average current account deficit of over US$1 billion a year during 1976-85. These figures make no provision for increases in external reserves, and, as the subsequent discussion indicates, prudent balance of payments management suggests that they should be kept at the equivalent of at least 2-1/2 to 3 months of imports. This means that reserves should increase by about US$1 billion during 1976-80 and then by a further US$2 billion in 1981-85. Thus, the Philippines would require a net inflow of foreign exchange of about US$15 billion during 1976-85, which would have to be met from inflows of direct private investment, short-term trade finance, and medium and long-term loans (Table 11.6). As the discussion in Chapter 8 indicates, net inflows of direct private investment are expected to increase in the future and could provide a total of US$1.6 billion during 1976-85. Short-term trade finance will probably increase in line with the volume of trade to be financed. For the ten-year period as a whole, it may be reasonable to expect a net inflow of about US$4.4 billion.

11.32 The balance of about US$9 billion would have to come from net inflows of medium and long-term loans. The corresponding gross inflow will depend on the particular proportions that come from commercial and official sources. The need is large, and excessive reliance on commercial loans with relatively short maturities would almost certainly raise the debt service ratio to unacceptable levels. 1/ As a rough guide for debt management, the Government should aim at not allowing the debt service ratio to rise much beyond the present level of about 17 percent. It should be possible to obtain some loans with medium and long-term maturities from private or quasi-official sources. However, the bulk of these resources would have to be obtained from official sources, including the members of the Consultative Group. 2/ Assuming that about 40 percent of the medium and long-term loans do, in fact, have these longer maturities, gross disbursements of about US$19 billion would be needed to support the required total net inflow of US$9 billion (Tables 11.6 and 11.7).

Foreign Aid and the Consultative Group

11.33 For the reasons given above, the Government should plan to try to obtain about one-third of the gross loan inflows in the form of development assistance from official sources. This will ensure that the present good maturity structure of the external debt is maintained, and it would go a long way in helping to keep the debt service ratio not rise beyond the present level of 17 percent.

11.34 Thus, the Philippines would need a gross inflow of about US$6 billion from loans obtained from official sources. Disbursements would need to rise from an actual level about US$280 million in 1975 to about US$600 million by 1980 and then to about US$780 million by the mid-1980s. To support this level of disbursements, commitments of new loans from official sources would need to be about US$7 billion during 1976-85. Although this would be a major increase over the volume of aid extended to the Philippines in past years, it would not require a really major increase in the current level of commitments by members of the Consultative Group. New commitments of loans were about US$500 million in 1975 and these would need to be raised to about US$600 million in a year or so, after which a somewhat slower increase would be warranted.

11.35 Role of Foreign Aid in the Past: Historically, foreign aid has played an important role in the economic development of the Philippines.

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1/ The debt service ratio is the ratio of amortization and interest payments on medium and long-term debt to receipts from exports of goods and non-factor services.

2/ The Consultative Group for the Philippines was formed in 1972 following the post-devaluation stabilization program and re-scheduling of some short and medium-term external debt. It was a concerned international effort to help the Philippines deal with its long-term development problems after the Government had taken steps to deal with the short-term financial difficulties; the primary objective of the Group was to coordinate the provision of capital assistance by its member countries and channel it to high priority development projects.

Table 11.6 Actual and Projected Foreign Exchange Requirements and Sources, 1966-85
(In millions of US dollars)

| Item | Actual | | Projected | |
|---|---|---|---|---|
| | 1966-70 | 1971-75 | 1975-80 | 1981-85 |
| Requirements | 576 | 1,526 | 6,520 | 8,500 |
| Deficit on current account | 375 | 1,131 | 5,480 | 6,470 |
| Trade deficit | 770 | 1,373 | 5,640 | 4,830 |
| Services and transfers | -395 | -242 | -160 | 1,640 |
| Increase in reserves and other | 201 | 395 | 1,040 | 2,030 |
| Sources | 576 | 1,526 | 6,520 | 8,500 |
| Direct investment | -50 | 105 | 650 | 900 |
| Short-term trade finance | 85 | 457 | 2,140 | 2,230 |
| Medium and long-term loans (net) | 541 | 964 | 3,730 | 5,370 |
| Plus: amortization | 823 | 1,392 | 3,000 | 7,490 |
| Gross inflow | 1,364 | 2,356 | 6,730 | 12,860 |

Source: Actual data for 1966 75 are from the Central Bank of the Philippines; those for 1976-85 are World Bank staff projections.

Table 11.7 Actual and Projected Levels of Commitments and Disbursements of Medium and Long Term Loans, 1971-85
(In millions of US dollars)

| Source | Commitments | | | | Disbursements | | | |
|---|---|---|---|---|---|---|---|---|
| | Actual | | Projected | | Actual | | Projected | |
| | 1971 | 1975 | 1980 | 1985 | 1971 | 1975 | 1980 | 1985 |
| Public loans | 300 | 760 | 1,570 | 1,770 | 150 | 360 | 1,220 | 1,760 |
| **Official Development Assistance** | 140 | 510 | 780 | 760 | 50 | 280 | 590 | 780 |
| **Commercial sources** | 160 | 250 | 790 | 1,010 | 100 | 80 | 630 | 980 |
| Commercial loans to private sector | 280 | 300 | 620 | 960 | 100 | 300 | 600 | 960 |
| Total loans | 580 | 1,060 | 2,190 | 2,730 | 310 | 660 | 1,820 | 2,270 |

Source: Data for 1971-75 are from the Central Bank of the Philippines; those for 1980-85 are World Bank staff projections

During the 1950s and 1960s, foreign aid was provided mainly for rehabilitation activities and institutional development. Most of the foreign assistance during the 1950s came from the United States, primarily in the form of grants and grant-like assistance. Multilateral sources provided a significant proportion of foreign aid during the 1960s. Taking the 1950s and 1960s together, foreign aid provided about 10 percent of the Philippines' foreign exchange requirements, and the total inflow was about 1 percent of GNP.

11.36 The importance of foreign aid increased dramatically in the 1970s after the formulation of the Consultative Group for the Philippines in 1971. The total official development assistance committed in 1971-74 was larger than that in the previous twenty years. On a disbursement basis, foreign aid provided about 14 percent of the foreign exchange requirements in 1970-74 compared with 7 percent in 1965-69. Since 1970 there has also been a considerable change in the composition of foreign aid. The proportion of grants and grant-like assistance fell from about 60 percent of the total during 1952-69 to about 18 percent in 1970-74. 1/ Loans from multilateral sources, which accounted for only one-third of the total assistance in the earlier period, provided about half of the total in 1970-74. Another noteworthy feature is that the amount of aid provided by the Japanese Government has grown very rapidly in the last three years; prior to 1971, the level of assistance from the Japanese Government was very low. Assistance from the United States for commodity loans and project loans has also increased substantially during the same period.

11.37 There have also been major changes in the sectoral distribution of aid in recent years. As Table 11.9 indicates, the share of development loans going to agriculture has remained relatively stable at about 20 percent, but there have been large decreases in the shares of industry and power, with corresponding increases in transportation and other sectors.

Expanding the Use of Commercial Loans

11.38 The average gross disbursements of medium and long-term commercial loans of about US$1.4 billion a year during 1976-85 would be consistent with prudent balance of payments and debt management. Disbursements of commercial loans would need to rise from the present level of about US$400 million to about US$1.2 billion in 1980 and to about 1.9 billion in 1985. To support these disbursement levels, new commitments of commercial loans would need to rise from the current level of US$600 million to over US$1.4 billion a year by the early 1980s.

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1/ Although it is convenient to discuss grants and grant-like assistance here, it should be noted that they are part of the current account transactions in the Philippines' balance of payments. Since they are a part of the item called "transfers", they are included in the requirements side of Table 11.6.

Table 11.8 Commitments of Official Development Assistance 1952-74

(In millions of US dollars)

| Source and Type of Aid | 1952-69 | 1970 | 1971 | 1972 | 1973 | 1974 |
|---|---|---|---|---|---|---|
| Grants and grant-like assistance | 501 | 44 | 50 | 62 | 61 | 28 |
| United States | 439 | 38 | 44 | 55 | 57 | 23 |
| Japan | 7 | 1 | 1 | 5 | 3 | 3 |
| Other | 55 | 5 | 5 | 2 | 1 | 2 |
| Development loans | 253 | 37 | 125 | 225 | 195 | 510 |
| Commodity loans | 10 | 10 | 62 | 107 | 6 | 44 |
| United States | 10 | 10 | 20 | 35 | 1 | 4 |
| Japan | ... | ... | 42 | 72 | 5 | 36 |
| Others | ... | ... | ... | ... | ... | 4 |
| Project loans | 243 | 27 | 63 | 118 | 189 | 466 |
| Bilateral | 10 | 1 | 12 | 35 | 37 | 156 |
| United States | ... | ... | 1 | 34 | 32 | 78 |
| Japan | 10 | ... | ... | ... | ... | 72 |
| Others | - | 1 | 11 | 1 | 5 | 6 |
| Multilateral | 233 | 26 | 51 | 83 | 152 | 310 |
| World Bank | 233 | ... | 22 | 40 | 98 | 227 |
| Asian Development Bank | ... | 26 | 29 | 43 | 54 | 83 |
| Total assistance | 754 | 81 | 175 | 287 | 256 | 538 |
| Total assistance (at constant 1967 prices) | 733 | 75 | 153 | 226 | 159 | 274 |

Source: NEDA; Central Bank of the Philippines; Mila Bulan, "A Study of Official Development Assistance to the Philippines FY1952-72", M.A. Thesis, University of the Philippines, 1973.

Table 11.[illegible] Sectoral Allocation of Official Development Loans, 1952-74

| Sector | Actual | |
|---|---|---|
| | 1952-69 | 1970-74 |
| Agriculture | 22.0 | 20.0 |
| Industry | 29.0 | 14.0 |
| Transportation | 11.0 | 23.0 |
| Power | 36.0 | 15.0 |
| Other a/ | 2.0 | 28.0 |
| Total (in percent) | 100.0 | 100.0 |
| Total (in millions of US dollars) | 253 | 1,092 |

a/ Includes water supply, education, and population loans.

Source: NEDA; Central Bank of the Philippines;

11.39 This increased use of commercial loans would occur in both the public and private sectors of the Philippines. In the past, the public sector has used commercial loans mainly for financing commodity imports; for example, lines of credit have been obtained from the Commodity Credit Corporation of the United States to finance imports of wheat, cotton, and tobacco, the Canadian Wheat Board (wheat), and the Governments of Taiwan and Thailand (rice). During 1971-75, a total of over US$300 million was disbursed, primarily for these purposes. In the future, there will almost certainly be a substantial increase in the use of commercial loans by the public sector. Aside from their continued use to finance wheat and other commodity imports, a large portion of the power program will have to be financed from these sources. The Mission estimates that gross disbursements of foreign loans needed to finance imported equipment for the power program would be about US$2.7 billion during 1976-85. Other major investment projects that would require direct borrowing by the public sector, or the issue of government guarantees, would include the fertilizer and steel projects, and perhaps some petrochemical projects. Taking account of these various possibilities, new commitments of commercial loans to the public sector may account for over one-half of the total commitments of commercial loans during 1976-85.

11.40 It is difficult to assess the prospect of reaching inflows of this size and reliability in the next few years. If it is a realistic prospect, it would be unfortunate for the Philippines to unnecessarily curb its potential for rapid development. Foreign donors could play an important role by helping the Government to obtain suitable co-financing arrangements for major projects both with bilateral partners and with the private sector. There is considerable scope for diversifying the sources of finance by tapping markets in Europe and the OPEC countries. The Philippines has already begun to do this and has obtained substantial amounts of capital from the Euro-dollar market in recent years. Nevertheless, it is apparent that sustained and vigorous efforts will be needed to ensure that the volume of funds available is sufficient for the Philippines' needs.

## C. Management of External Debt and Foreign Exchange Reserves

11.41 In the latter part of the 1960s, imports grew at higher rates than exports, and there was substantial use of foreign commercial loans with relatively short maturities to finance the deficits. By 1970 about 60 percent of the debt outstanding had short maturities of less than five years. This was one of the factors that precipitated the foreign exchange crisis in the early part of 1970, which in turn resulted in a major devaluation of the currency, a rescheduling of some external debt, and the introduction of tighter controls over foreign borrowings. The Central Bank established a system for approving, recording, and monitoring all public and private

external debt contracted in the Philippines in 1970. As a result of subsequent careful debt management policies, there has been a substantial improvement in the maturity structure of the external debt and a consequent reduction in the burden of debt service. The present careful control over external borrowings will undoubtedly continue, and, provided the composition of future loan inflows is along the lines already indicated, the projected increase in external debt and debt service, while large, is not expected to pose serious management difficulties.

Amount and Composition of External Debt

11.42 The outstanding amount of medium and long-term debt (on a disbursement basis) increased by about US$900 million during 1970-75, 1/ and at the end of 1975 stood at US$2.3 billion. Most of the increase was accounted for by loans from Consultative Group members, and a large part of the medium-term debt that was contracted in the late 1960s was retired. As a result, there was a significant improvement in the maturity structure of the debt; for example, the share of long-term maturities in the public debt increased from 38 percent at the end of 1969 to 70 percent at the end of 1975 and the share of public debt rose to more than half of the total debt outstanding (Table 11.10). This improvement has been the result of the careful debt management policies of the Government, and the generous support of Consultative Group members whose loans have had substantially better terms than loans from commercial sources. 2/

11.43 According to the Mission's projections, the amount of outstanding medium and long-term external debt would rise to about US$6.0 billion in 1980 and to about US$11 billion in 1985. By the mid-1980s, the public sector might hold about three-quarters of the amount outstanding (Table 11.10). Because of the "softer" repayment terms, the share of debt held by official sources is expected to rise steadily from the present level of about 40 percent to 50 percent by the mid-1980s, after which it would begin to decline.

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1/ This includes an amount of US$200 million of short-term debt (that is, with maturities of less than one year) that was rescheduled at the time of the 1970 policy reforms.

2/ The average terms of loans from donors during 1952-75 were as follows:

| Donor | Average Interest Rate (In percent) | Average Maturity (In years) |
|---|---|---|
| U.S. Government | | |
| PL480 loans | 2.83 | 23.0 |
| USAID development loans | 3.05 | 35.9 |
| Japanese Government | 3.45 | 23.6 |
| Other governments | 2.79 | 27.1 |
| World Bank | 6.18 | 22.0 |
| Asian Development Bank | 6.53 | 23.1 |

Table 11.10: Composition of Medium and Long-Term External Debt
(Outstanding at end of period)

| Category | Actual | | | Projected | |
|---|---|---|---|---|---|
| | 1964 | 1969 | 1975 | 1980 | 1985 |
| Public debt (in percent) | 47.8 | 29.3 | 53.8 | 70.0 | 72.0 |
| ODA sources | 21.5 | 14.1 | 39.5 | 46.0 | 50.0 |
| Other sources | 26.3 | 15.2 | 14.3 | 24.0 | 22.0 |
| Private debt (in percent) | 52.2 | 70.7 | 46.2 | 30.0 | 28.0 |
| Total (in percent) | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |
| (in billions of US dollars) | 0.39 | 1.36 | 2.32 | 6.0 | 11.0 |

Sources: Data for 1964, 1969 and 1975 are from the Central Bank of the Philippines; data for 1980 and 1985 are based on Mission projections.

11.44 Because of the heavy reliance in the late 1960s on commercial loans with relatively short maturities, the ratio of debt service payments to export receipts rose steadily. By 1971 this debt service ratio stood at 27 percent. But as a result of careful debt management policies and the rapid increase in export receipts since 1972, the burden of debt service payments has eased substantially. Amortization and interest payments on medium and long-term loans were about US$320 million in 1970, and, although they had risen to about US$500 million by 1975, the ratio of these payments to export receipts declined to about 17 percent by 1975. If the amount and composition of medium and long-term loan inflows required during 1976-85 is along the lines previously discussed, and if the Mission's projection of export receipts is realized, debt service payments would not rise much beyond 17 percent of export receipts during the next ten years.

## Management of External Reserves

11.45 Because of the chronic shortage of foreign exchange, the Philippines' external reserve position had been inadequate until the commodity boom in 1973-74. This was true no matter which definition of the Philippines' foreign exchange reserves was used. (The different definitions of the Philippines' external reserves are indicated in Table 11.11). For the purposes of this report, the Mission will rely on the definition of international reserves 1/ which is used by the Central Bank of the Philippines

1/ The gross foreign exchange holdings of the Central plus the foreign exchange holdings of the commercial banks net of short-term liabilities.

in its reserve management policies. International reserves stood at US$1.1 billion at the end of 1975. This was in sharp contrast to earlier years when international reserves were rarely more than US$200 million, and usually less than 2 months of imports. It is perhaps worth drawing attention to the distinction between international reserves and the net foreign assets of the banking system (liabilities of the Central Bank are netted out of international reserves). The net foreign assets of the banking system were negative from the mid-1960s until 1972, but later they increased sharply and at the end of 1974 reached a level of US$600 million. Due to a sudden deterioration in the terms of trade in 1975, the net reserves again fell substantially, to about US$100 million at the end of 1975.

Table 11.11: Various Indicators of the Philippines' External Reserve Position, 1964-75

| Category | 1964 | 1969 | 1974 | 1975 |
|---|---|---|---|---|
| International reserves (in millions of US dollars) | 38 | 119 | 1,166 | 1,090 |
| Gross foreign exchange holdings of Central Bank | 123 | 121 | 1,503 | 1,455 |
| Net foreign exchange holdings of commercial banks | -85 | -2 | -337 | -365 |
| Net foreign assets of banking system (in millions of US dollars) | 9 | -78 | 602 | 100 |
| International reserves as months of imports | ... | ... | 3.5 | 3.0 |

Source: Central Bank of the Philippines.

11.46 Despite the large trade deficits that currently confront the Philippines, these reserves do provide the authorities with room for maneuver in balance of payments management in the immediate future. For the longer term, import payments are expected to rise sharply and from this viewpoint these reserves may not be judged as adequate. The Government is, therefore, likely to continue to make use of IMF facilities in managing the balance of payments. There has been a standby agreement with the IMF each year since 1970 and purchases outstanding stood at US$80 million at the end of 1975. 1/ In 1975 the Philippines also made use of the IMF Oil Facility, drawing a total of US$116 million.

1/ The Philippines currently has a quota of 155 million SDRs with the IMF.

11.47 In view of the large amounts of external capital that the Philippines will need to attract in the coming years, it is essential that external reserves continue to accumulate. International reserves should be maintained at the equivalent of about 2-1/2 to 3 months of imports of goods and nonfactor services. The foregoing projections of capital inflows would provide for a buildup in reserves to these levels and they should be sufficient to ensure that debt service repayments on the one hand, and the flow of essential imports on the other, can be maintained if export earnings slump as a result of downturns in economic activity in overseas markets.