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Philippines Economic Update
JUNE 2021 EDITION

Navigating a Challenging Recovery

Preface

The Philippines Economic Update (PEU) summarizes key economic and social developments, important policy changes, and the evolution of external conditions over the past six months. It also presents findings from recent World Bank analyses, situating them in the context of the country's long-term development trends and assessing their implications for the country's medium-term economic outlook. The update covers issues ranging from macroeconomic management and financial-market dynamics to the complex challenges of poverty reduction and social development. It is intended to serve the needs of a wide audience, including policymakers, business leaders, private firms and investors, and analysts and professionals engaged in the social and economic development of the Philippines.

The PEU is a biannual publication of the World Bank's Macroeconomics, Trade, and Investment (MTI) Global Practice (GP), prepared in partnership with the Finance, Competitiveness and Innovation (FCI); Poverty and Equity; Social Protection and Jobs (SPJ); and Governance Global Practices. Lars Christian Moller (Practice Manager for the MTI GP), Souleymane Coulibaly (Lead Economist and Program Leader), and Rong Qian (Senior Economist) guided the preparation of this edition. The team consisted of Kevin Chua (Senior Economist), Kevin Cruz (Economist), Karen Lazaro (Research Analyst), Eduard Santos and Ludigil Garces (Consultants) from the MTI GP, Isaku Endo (Senior Financial Sector Specialist) and Heejin Lee (Private Sector Specialist) from the FCI GP, Nadia Belghith (Senior Economist) and Sharon Piza (Economist) from the Poverty & Equity GP, Yoonyoung Cho (Senior Economist), Ruth Rodriguez (Social Protection Specialist), and Arianna Zapanta (Consultant) from the SPJ GP, and Ronald Mutasa (Program Leader), Ramana Gandham (Consultant), Ekaterina Vashakmadze (Senior Economist), and Ergys Islamaj (Senior Economist). Kevin Cruz, Karen Lazaro, Cha Crisostomo (Consultant), and Eduard Santos prepared the Special Focus Note on the Local Public Service Delivery in the Context of the Mandanas Ruling with inputs from Ahya Ihsan (Senior Economist), Blane Lewis (Consultant), Eli Weiss (Senior Agriculture Economist), and Lewis Hawke (Lead Public Sector Specialist), and under the guidance of Rong Qian, Madhu Raghunath (Sector Leader), and Lewis Hawke. The report was edited by Oscar Parlback (Consultant), and the graphic designer was Pol Villanueva (Consultant). Peer reviewers were Yue Man Lee (Senior Economist), Chadi Bou Habib (Lead Economist), and Kai Kaiser (Senior Economist). Logistics and publication support were provided by Elysse Miranda (Team Assistant) and Kristiana Rosario (Team Assistant). The Manila External Communications Team, consisting of Clarissa David (Senior Communications Officer) and David Llorito (Communications Officer), prepared the media release and web-based multimedia presentation, and Stephanie Margallo provided team assistance.

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For more information about the World Bank and its activities in the Philippines, please visit www.worldbank.org/ph.

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Abbreviations and acronyms

ACT	Access to COVID-19 Tools
ASEAN	Association of Southeast Asian Nations
ASF	African swine fever
BARMM	Bangsamoro Autonomous Region in Muslim Mindanao
BLGF	Bureau of Local Government Finance
BOP	Balance of payments
BPO	Business process outsourcing
BSP	Bangko Sentral ng Pilipinas
CAR	Capital adequacy ratio
CDPs	Community development plans
CEPI	Coalition for Epidemic Preparedness Innovations
CIT	Corporate income tax
CLUP	Comprehensive land use plan
COA	Commission on Audit
COs	Capital outlays
COVAX	COVID-19 Vaccines Global Access
COVID-19	Coronavirus disease 2019
CREATE	Corporate Recovery and Tax Incentives for Enterprises Act
DA	Department of Agriculture
DBM	Department of Budget and Management
DILG	Department of the Interior and Local Government
DOF	Department of Finance
DOH	Department of Health
DPWH	Departments of Public Works and Highways
DTP	Devolution transition plans
EAP	East Asia and the Pacific
ECQ	Enhanced community quarantine
EMDEs	Emerging market and developing economies
EO	Executive order
ERs	Budget execution rates
FDI	Foreign direct investment
FIA	Foreign Investment Act
FINL	Foreign investment negative list
FPI	Foreign portfolio investments
FSI	Financial soundness indicators
FSSA	Financial system stability assessment
GDP	Gross domestic product
GOP	Government of the Philippines
GPS	General public services
IIF	Institute of International Finance
IMF	International Monetary Fund
IRA	Internal revenue allotment
LFPR	Labor force participation rate
LFS	Labor force survey
LGC	Local government code
LGUs	Local government units
MOOE	Maintenance and other operating expenses
NDVP	National deployment and vaccination plan
NEDA	National Economic and Development Authority
NG	National government
NGAs	National government agencies
NHA	National Housing Authority
NPL	Non-performing loans
OECD	Organisation for Economic Cooperation and Development
OFWs	Overseas Filipino workers
PCIP	Provincial commodity investment plans
PMI	Purchasing Managers' Index
PRDP	Philippine Rural Development Project
PS	Personnel services
PSA	Philippine Statistics Authority
RTLA	Retail Trade Liberalization Act
U.S.	United States
UNCTAD	United Nations Conference on Trade and Development
WHO	World Health Organization

Executive Summary

Recent Developments

The resurgence of COVID-19 cases and reimposition of more stringent quarantine measures held back the early signs of an economic rebound. The downside risk of a resurgence of infection, identified in the PEU December 2020 edition, has unfortunately materialized. The number of daily cases increased from an average of 1,400 in December 2020 to nearly 10,000 in April 2021. The surging cases prompted the authorities to reimpose stricter quarantine measures in Metro Manila and nearby provinces for more than one-and-a-half months between April and May. Since then, daily cases have gone down gradually and critical care occupancy rates have eased. However, the quarantine and movement restrictions have hampered people's mobility, adversely affecting domestic activity.

The economy contracted by 4.2 percent year-on-year in the first quarter of 2021 amid prolonged implementation of containment measures. The country registered the worst growth performance among peers in the region such as Thailand (-2.6 percent), Indonesia (-0.7 percent), Malaysia (-0.5 percent), and Vietnam (4.5 percent). The growth contraction was fueled by weak domestic demand, driven by the combination of containment measures, weak confidence, and rising inflation. Meanwhile, tepid external demand was driven by the sharp contraction in services exports amid lingering restrictions and weak demand for international tourism while goods exports recovered. The public sector was the main driver of growth with an expansionary budget.

The authorities are supporting the economic recovery by accelerating public spending. Stimulus spending and infrastructure investment drove public spending from 19.1 percent of GDP in the first quarter of 2020 to 23.4 percent of GDP in the same period in 2021. The spending is in line with the continuing implementation of the pandemic response measures under the "Bayanihan to Recover as One" Law (Bayanihan 2) which was extended to June 30, 2021. The higher spending comes at a time when public revenues fell from 17.2 percent of GDP in the first quarter of 2020 to 16.0 percent of GDP in the same period in 2021. This resulted in an increase in the fiscal deficit to 7.4 percent of GDP in the first quarter of 2021 from 1.9 percent of GDP a year ago. The widening deficit was accompanied by an increase in the public debt ratio from 54.5 percent of GDP by end-2020 to 60.4 percent of GDP as of end-March 2021.

The central bank continues to be accommodative despite inflation breaching the target range. The Bangko Sentral ng Pilipinas (BSP) maintained its key policy rate at 2.0 percent throughout the first four months of 2021 to support the economic recovery. This is despite headline inflation averaging 4.5 percent in the first four months, breaching the 2-4 percent inflation target range. Elevated food prices were caused by harvest losses due to typhoons in end-2020, and lower pork supply due to a disease outbreak. Stable core inflation and supply-driven price pressure solidified the view that the uptick in inflation is transitory. In addition to keeping the key policy rate steady, the BSP has previously engaged in open market operations, and continued the implementation of regulatory measures to minimize the economic fallout of the pandemic, suchas the zero percent risk weight for the guaranteed loans of micro, small, and medium-sized enterprises,and the fee waivers for fund transfer transactions through the BSP's payment and settlement system.

Despite signs of a labor market recovery in the first quarter of 2021, the quality of jobs is of concern. The labor force participation rate reached 65.0 percent in March 2021, surpassing the pre-pandemic level of 61.7 percent in January 2020 and peaking to its highest level since January 2018. Notwithstanding the increasing number of workers in the labor force, the unemployment rate decreased to 7.1 percent in March 2021 after remaining steady at 8.7-8.8 percent in the past five months. Among the employed, however, there was an increase in the share of self-employed and non-paid workers, while the share of part-time workers remained significantly higher than the pre-pandemic level. Likewise, the underemployment rate remained at around 16-18 percent in the first quarter of 2021, higher than the pre-pandemic level.

Outlook and Risks

The growth prospects hinge on the country's ability to manage the COVID-19 health crisis. The medium-term growth trajectory depends on effective pandemic containment, delivery of mass vaccination, and further loosening of mobility restrictions. The sudden surge in COVID-19 cases in March-April 2021 showed the difficult challenge at hand. While mass vaccination began in March, global vaccine supply constraints and vaccine hesitancy among Filipinos may delay widespread local inoculation. Following the government's vaccination plans, the growth projection assumes that vaccination will accelerate in the second half of 2021 with the arrival of more vaccine supplies.. Consequently, domestic demand is expected to gradually pick up this year, before accelerating in 2022.

The economy is projected to expand at 4.7 percent in 2021, before accelerating to 5.9 percent in 2022 and 6.0 percent in 2023. The recovery is anchored on an anticipated global rebound, including in the country's key trading partners. This will translate into higher export demand and better prospect of remittances. Domestically, as vaccination efforts progress and the rate of infection slows, consumer and business confidence will gradually improve and normalize. The administration's continued commitment to delivering infrastructure projects will contribute to public investment growth. However, market uncertainty and weaker lending activities may temper private investment. Following the deep contraction in 2020, a base effect will also contribute to increased growth in 2021, while the national election is projected to boost economic activity in 2022 as it has done in previous election cycles.

Growth prospects are subject to significant downside risks. A resurgence of infection due to the entry of new virus variants is the most significant risk, which may yet overwhelm the healthcare system. Scaling up testing, tracing, isolation, and treatment measures, along with the rollout of the vaccination program are key to the public health response. However, tight global production supply and vaccine nationalism risk delaying the arrival of vaccines. Failure to effectively contain the virus or implement the mass vaccination program may extend mobility restrictions, which could lead to further job and income losses, disrupt businesses, and delay economic recovery. There are also external risks including the risk of a slower-than-expected global recovery, disruptions in international logistics and global value chains, and trade protectionism.

The key health policy response remains the management of the virus spread, complemented with the roll out of the vaccination program. Public health protocols such as mask wearing and physical distancing remain the first line of defense to manage the spread of the virus specially as case numbers remain elevated. Testing, tracing, isolation and case management have to be scaled up, along with expedient roll out of vaccines. The vaccination program requires stringent planning, effective implementation, and more importantly, seamless coordination between the national government, local government units (LGUs), and the private sector. As vaccine hesitancy remains high, the authorities may consider dialogue-based or incentives-based interventions to encourage more Filipinos to get vaccinated.

The effective delivery of social protection programs will help to reduce the extent to which the crisis adversely affects long-term human capital accumulation. COVID-19 pandemic-related shocks, including hunger incidences, have manifested in higher levels of child malnutrition, especially among the poor. It is important to reduce the extent of these losses, and mitigate the shocks from resulting in a persistent impact on wellbeing and future economic opportunities. Social programs, including cash transfers, can help alleviate food and subsistence conditions. However, moving swiftly to provide transfers and support to poor households will require an improvement in the government's delivery and implementation capacity. National and local government authorities need to coordinate their efforts to ensure timely and efficient deployment of public programs.

Mobilizing private sector participation in public infrastructure projects will be important as the government faces limited fiscal space in the short term. The public financing needs will remain elevated as public revenues are tempered by the weak economy while public expenditures increase to address the pandemic. The limited fiscal space will compel the authorities to pursue fiscal consolidation in the medium term. The government's infrastructure investment agenda will strongly benefit from greater private sector participation through a renewed focus on public-private partnership, for which the country has successful experience. Part of the formula s relaxing foreign direct investment (FDI) restrictions. Regulations related to foreign investments remain restrictive in the Philippines. The Philippines faces even tighter competition, as some regional peers also recently implemented various incentives to attract investors. The passage of three investment reform bills: Public Service Act, Retail Trade Liberalization Act, and the Foreign Investment Act, will help improve the country's competitiveness in the region.

Special Focus: Subnational Finance

The authorities need to prudently manage institutional changes including the implementation of the Mandanas Ruling in 2022. The Mandanas Ruling will raise Internal Revenue Allotment transfers to LGUs by 55 percent in 2022, reaching Php1.08 trillion (4.8 percent of GDP) from 3.5 percent of GDP in 2021. The substantial increase in transfers has prompted the national government to rethink its approach towards decentralization, which remains below its potential for effective service delivery. The implementation of the Ruling comes at a time of limited fiscal space. Moreover, the Philippines' experience in decentralization has demonstrated significant gaps in the effectiveness of local public service delivery.

Effective service delivery has been constrained by four structural challenges that have negatively affected the incentives and capacity of local governments to fulfill their primary role as basic service providers. First, LGUs collect insufficient revenues and this contributes to a mismatch given service delivery responsibilities. Second, the intergovernmental fiscal transfer system creates horizontal fiscal imbalances and inequality across local governments. Third, overlapping service delivery responsibilities across different levels of government diffuse accountability. Fourth, LGUs continue to depend on national government for the delivery of devolved public services due to the lack of technical capacity.

In addition to these structural weaknesses, the government faces several policy challenges in implementing the Mandanas Ruling. To maintain fiscal sustainability, the increase in inter-governmental fiscal transfers need to be compensated by additional revenue or expenditure reducing measures. As a result, the national government plans to transfer devolved functions currently assumed by the national government back to local government units equivalent to 1 percent of GDP during the implementation of the Ruling. However, coordination challenges between the national government and LGUs could jeopardize the quality and quantity of service delivery. Lastly, the mechanisms for holding local chief executives accountable for performance are weak and frequently ineffective.

Overcoming the structural challenges while managing the transition towards increased decentralization require the following: (i) address horizontal inequity through strong fiscal equalization; (ii) provide capacity building support to LGUs; and (iii) create an environment of increased demand for transparency and accountability. In the short-term, addressing the implementation challenges due to the Mandanas Ruling requires immediate clarification on the re-devolved functions, and communicating these clearly to national government agencies and LGUs. In the medium-term, the national government must provide strong fiscal equalization by continuing to support LGUs that lack capacity and resources. The national government and implementing agencies could strengthen local government capacity on providing an enabling environment for LGUs that assigns responsibilities according to available capacity and ensures a highly participatory process involving learning by doing. In the long-term, revisiting the Local Government Code is needed to address systemic issues on own-source revenue generation, address the horizontal fiscal imbalances created by the current Internal Revenue Allotment formula, and clear assignment of service delivery responsibilities.

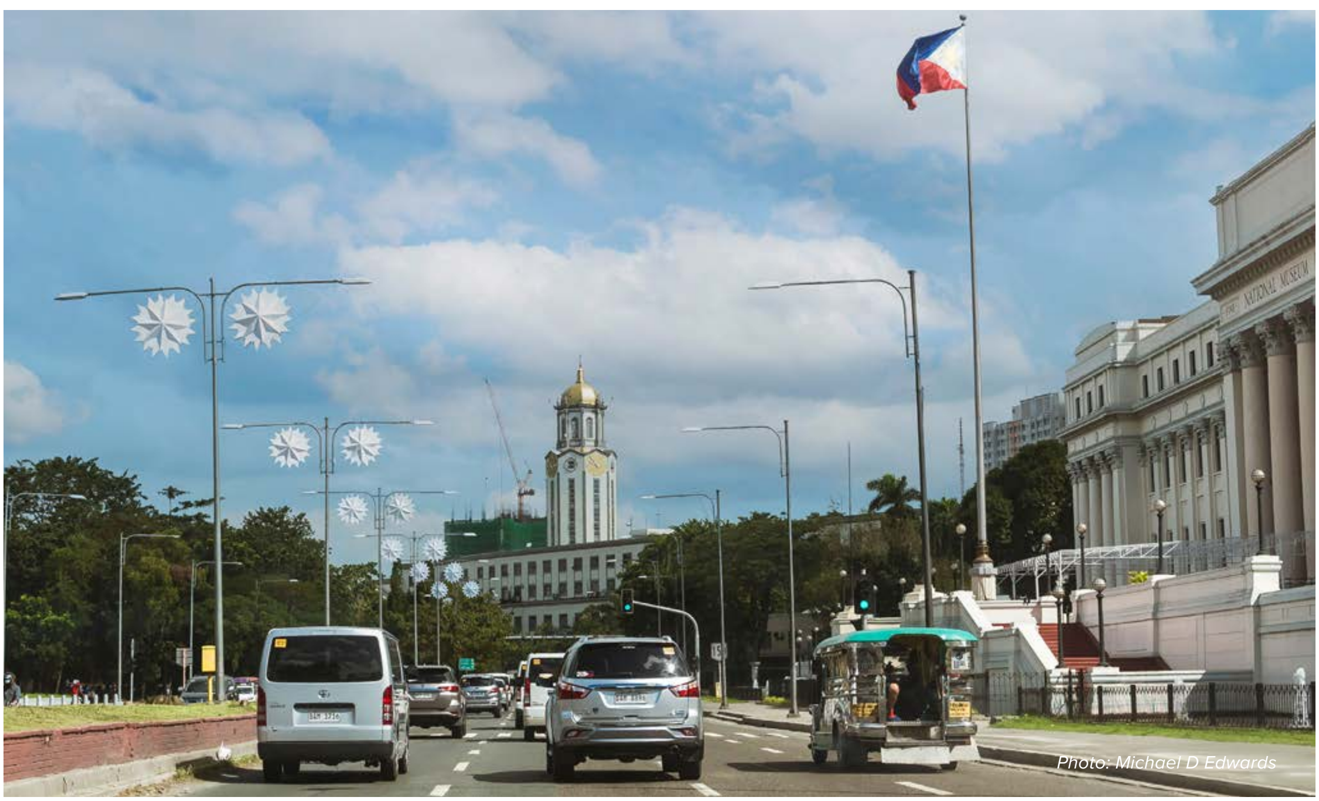


Photo: Michael D Edwards

Photo: ultramansk

Part I

Recent Economic and Policy Developments

The recent surge in COVID-19 cases and the return to strict containment measures in Metro Manila and nearby provinces have derailed the early signs of an economic rebound. Rising inflation, driven by higher food prices, has also emerged as a key challenge in early 2021. While there have been improvements in job creation and labor force participation in recent months, underemployment and the share of part-time workers have risen. The authorities have continued to support the economy by expanding public spending, led by stimulus and other support measures as well as infrastructure spending, while maintaining an accommodative monetary policy stance.

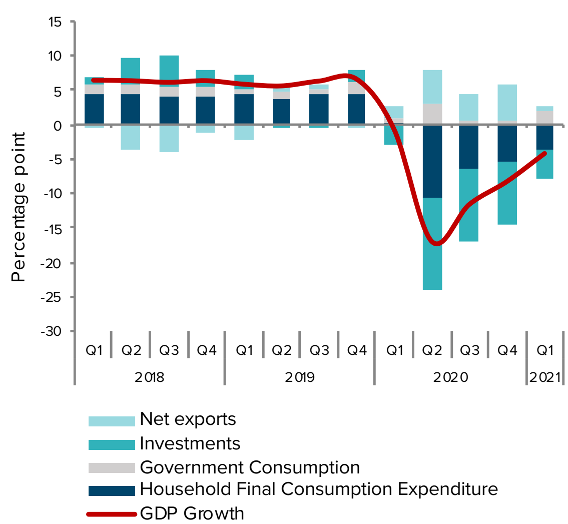
1.1 Economic Growth: Cost of Containment

The Philippines registered a contraction for the fifth consecutive quarter in Q1 2021, the longest recession since the 1985 debt crisis. The contraction was driven by the continued slump in private domestic demand amid rising inflation, income losses, and continued implementation of containment measures.

The resurgence of new COVID-19 cases has derailed the early signs of the country's economic rebound in 2021. The gradual reduction in new COVID-19 cases from the initial peak of 4,477 per day in mid-August to around 1,100 in January 2021, led to a relaxation of restrictions on the economy. This improvement paved the way for a rebound in mobility and economic activity in early 2021. As lockdown restrictions were relaxed, employment and earnings generally improved though not enough to offset the earlier declines. Moreover, the Philippines benefited from an improved external environment, as goods trade expanded amid an improving global environment. High frequency data in the first three months of 2021 suggested a recovery in economic activity was on its early stages. However, the surge in COVID-19 cases beginning in March, and rising inflation derailed the recovery momentum as economic growth fell short of market expectations.

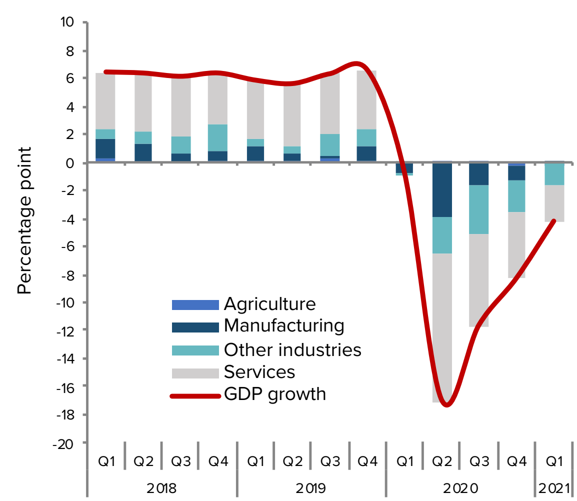
The economy contracted by 4.2 percent in the first quarter of 2021 amid prolonged implementation of containment measures and a deterioration in domestic demand conditions. The country registered the worst growth performance among peers in the region in Q1 2021 such as Thailand (-2.6 percent), Indonesia (-0.7 percent), Malaysia (-0.5 percent), and Vietnam (4.5 percent growth). The pandemic continues to impact the economy through both external and domestic channels. Through the external channel, services exports contracted sharply owing to lingering restrictions and weak demand for international tourism and travel while goods exports recovered. Through the domestic channel, the Philippines continues to implement containment measures, which further tightened towards the end of the first quarter amid a surge in cases to a peak of about 15,000 in early April. The public sector was the main driver of activity, benefitting from an expansionary budget which aims to support economic recovery.

Figure 1. The Economy contracted for the fifth consecutive quarter.



Source: Philippine Statistics Authority (PSA).

Figure 2. The contraction was broad-based.



Note: Other industries are mining and quarrying, construction, electricity, gas, and water.
Source: PSA.

1 All growth numbers are year-on-year unless otherwise stated.

Private domestic demand continued to drive the growth contraction. Private consumption contracted by 4.8 percent in the first quarter of 2021 driven by movement restrictions that suppressed consumption, and declining incomes amid poor employment outcomes and rising inflation. The consumption of non-essential goods and services and those impacted by mobility restrictions continued to experience the sharpest contractions. Meanwhile, investment activity was dampened by elevated levels of uncertainty, a deterioration in business confidence, loss of revenue and incomes, and limited access to finance. Investment contracted by 18.3 percent, in which, investments in private construction and durable equipment fell by nearly 30 percent.

Despite a recovery in goods exports, services trade remained depressed owing to lingering restrictions in travel and tourism. Exports fell by 9.0 percent in the first quarter of 2021, driven by the 21.0 percent contraction in services exports. Travel restrictions weighed heavily on travel and transport exports services, which contracted by 97.7 percent and 34.1 percent, respectively, in the first quarter of 2021. However, merchandise exports expanded by 2.4 percent in the first quarter of 2021, benefitting from the recovery in global economic activity (Box 1). In particular, the goods trade has shown signs of recovery since late 2020 as the country benefitted from a recovery in global demand for its exports, particularly in electronic products. Meanwhile, imports declined by 8.3 percent, driven by the sharp contraction in services imports (-33.2 percent), most notably in travel and transportation, amid ongoing travel restrictions and weak demand for international tourism. Meanwhile, merchandise imports contracted marginally by 1.6 percent.

On the production side, strict containment measures and weak demand led to the decline in industry and services output. Soft demand and production disruptions resulted in the contraction of industry output by 4.7 percent in the first quarter of 2021. The decline in output was led by the large contraction in the private construction sector, likely driven by delays and postponement of construction projects[2]. Improved global trade led to a slight uptick in manufacturing output (0.5 precent), the first expansion since the fourth quarter of 2019. Meanwhile, the services sector contracted by 4.4 percent, impacted by mobility restrictions, falling incomes, and a change in consumer behavior. However, sectors such as health, information, communication, and finance registered positive growth, benefitting from increased reliance on their services. In particular, both the communication and finance sectors benefitted from the shift of many activities online, adapting to 'new normal' conditions.

Agricultural output fell for the second consecutive quarter, driven by the contraction in livestock and poultry supply. The agriculture sector contracted by 1.2 percent, primarily due to a significant contraction in livestock (-23.2 percent) and poultry (-7.4 percent) output.[3] In particular, the sharp decline in livestock output was driven by the ongoing outbreak of the African Swine Fever which has affected around one-third of the country's hog population. Meanwhile, crop production recovered in the first quarter of 2021, as crop output grew by 3.5 percent. Crop output benefitted from relatively fair conditions in the first quarter of 2021, in contrast to the previous quarter, as output suffered from damages due to several strong typhoons.


Photo: Stephane Bidouze

2 Approved construction projects fell by nearly 40 percent in 2020, based on approved building permits collected by the PSA.
3 These sectors account for roughly a fifth of total agricultural output.

Box 1. Recent Global Developments.

Following a heavy contraction in 2020, the global economy recovered in the first few months of 2021. The global economy contracted 4.3 percent in 2020, with advanced economies and emerging markets and developing economies (EMDEs) contracting by 5.4 percent and 2.6 percent, respectively (Figure 3). Nonetheless, China's economy was already recovering in the second half of 2020 and was a notable exception among EMDEs, which collectively experienced an economic contraction more severe than previously forecasted. Recent high-frequency data, such as the purchasing managers index (PMI), point toward a broad recovery. The global PMI rose to 54.8 in March—a 79-month high—as advanced economies and EMDEs, especially in East Asia and the Pacific (EAP), ramped up their manufacturing production.

The economic recovery has been uneven across countries. The recovery in some advanced economies is supported by fiscal support packages and loose monetary policy. The manufacturing sectors of advanced countries and EMDEs in EAP have continued to recover on the back of stronger external demand. The United States' recovery is accelerating due to an uptick in the rollout of vaccines and renewed fiscal support. Stimulus checks pushed retail sales upward by 9.8 percent in March, a notable turnaround from the -8.7 percent in March 2020. Still, a resurgence of COVID-19 infections in some large euro area economies is weighing on economic activities and forcing governments to maintain stringent lockdowns. The euro area composite PMI rose slightly in February but remained in contractionary territory at 48.8. Among EMDEs, commodity exporters such as Russia, Saudi Arabia, Nigeria, and South Africa have benefited from the broad-based increase in commodity prices. The recovery in commodity importers is also gaining traction due to reduced drag from the pandemic and spillovers from the global recovery.

Global trade has largely recovered to pre-pandemic levels (Figure 4). The rapid recovery of the global trade in goods has largely mirrored the rapid recovery in industrial production. The recovery has not, however, been homogeneous across countries, with China and advanced economies largely leading the rebound. Furthermore, the rapid recovery in trade has led to a sharp increase in freight prices amid congestions at shipping ports, which, together with supply chain disruptions, contributed to moderating the momentum. Finally, trade in services remains subdued, with tourist arrivals remaining way below their January 2020 levels.

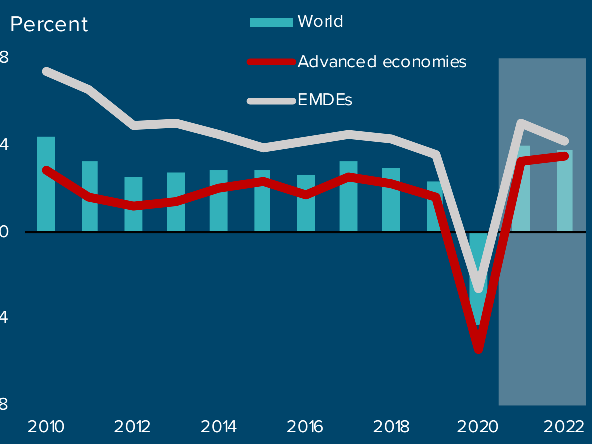
Financial markets expect an economic recovery as the spread between short- and long-term interest rates widen, although EMDEs face mounting headwinds as capital inflows slow down. The widening of short- and long-term interest rates has been observed across most advanced economies and has reduced negative-yielding debt since January, with significant spillover effects on other financial markets. In the United States, 10-year US Treasury yields have increased by 33 basis points, their sharpest increase in five years. Yields on local currency and dollar-denominated bonds of EMDEs are also increasing, although capital inflows lost momentum due to rising global yields and concerns over a tightening of monetary policy in the United States. Finally, more subdued recovery projections for EMDEs relative to advanced economies were reflected in the decrease in bond issuance across EMDEs in February.

The recovering global environment has had impact on the Philippines. Merchandise exports expanded in the first quarter of 2021 as the country benefitted from a recovery in global demand for its exports, particularly in electronic products. This contributed to the recovery in manufacturing activities which grew by 0.5 percent in the first quarter of 2021 from a 3.3 percent contraction in the same period in 2020. Still, given continuing restrictions in international travel and closed borders in many countries, tourism and the deployment of overseas Filipino workers remain weak relative to pre-pandemic levels.

Source: Global Economic Prospects, January 2021; and Global Monthly, March 2021.

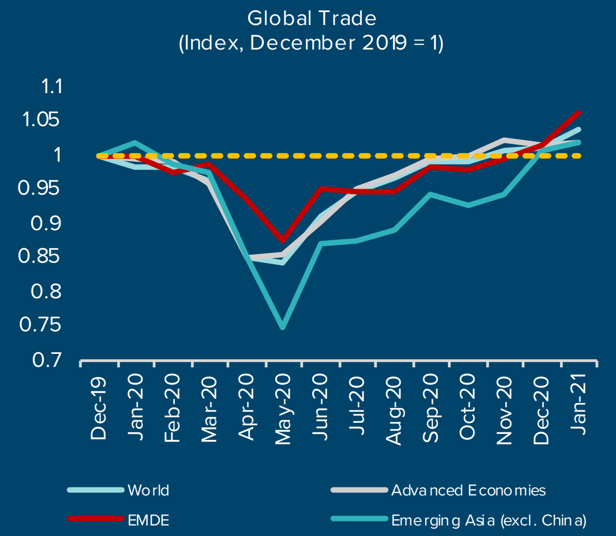
Photo: Chema Grenda

Figure 3. The global economy contracted 4.3 percent in 2020.



Source: World Bank.

Figure 4. The global trade in goods has returned to December 2019 levels.



Source: World Bank.

Photo: Michael D Edwards

1.2 The Exchange Rate and the External Sector: Stronger Stable Peso Amid Recovery

The balance-of-payments (BOP) surplus more than doubled to 4.4 percent of GDP in 2020, driven by a substantial current-account surplus due to a double-digit import contraction. This led to a steady appreciation of the peso throughout 2020, which remained stable in the first four months of 2021.

The trade deficit narrowed substantially in 2020, resulting in a current-account surplus. The current account improved from a deficit of 0.8 percent of GDP in 2019 to surplus of 3.6 percent of GDP in 2020, driven by a significant narrowing of the trade deficit (Table 1). In 2020, goods imports saw steeper declines than exports as domestic economy collapsed, and global demand weakened. Yet in early 2021, both recovered with goods exports growing faster than imports in March 2021 due to improving global demand (Figure 5). Meanwhile, net services exports grew by a mere 0.3 percent in 2020, a substantial drop from 12.3 percent in 2019, as travel restrictions crippled the tourism sector[4] and the business process outsourcing (BPO) sector recorded lower earnings.[5] Moreover, remittances only grew at 0.8 percent in 2020, compared to 3.9 percent in 2019, due to the repatriation of more than 325,000 overseas Filipino workers, mostly from Middle Eastern countries. Nonetheless, total remittances has reached US$8.5 million as of March 2021, 2.9 percent higher than remittances inflow in the first quarter of 2020.

Smaller but sustained net capital inflows contributed to the BOP surplus in 2020. Net inflows to the capital and financial accounts softened to US$4.7 billion (1.3 percent of GDP) in 2020, as FDI fell by 24.6 percent to US$6.5 billion (Figure 6). This was partly due to the weak external environment and the country's poorer FDI attractiveness compared to most regional peers, driven in part by restrictions on FDI (Box 2). Net portfolio investments (FPI) registered net outflows of US$0.5 billion (0.1 percent of GDP) in 2020, stemming from the increase in foreign debt securities investments by the BSP. Meanwhile, an increase in public and private foreign loans led to substantial net inflows in the other investments account. This contributed to the overall BOP surplus more than doubling to US$16.0 billion (4.4 percent of GDP) in 2020. However, preliminary data indicate a cumulative BOP deficit of US$2.8 billion in Q1 2021, as the government repaid its maturing foreign loans and the external goods trade posted a deficit.

The Philippine peso appreciated in nominal and real terms in the first four months of 2021. The peso appreciated by 4.4 percent in nominal terms in 2020 amid weak imports, capital inflows, and weakness in the U.S. dollar. In the first four months of 2021, it registered an average of 5.5 percent year-on-year gains against the U.S. dollar on the back of narrower merchandise trade deficit[6] and higher remittances. On a monthly basis, the peso began to gradually depreciate amid merchandise import recovery[7], rising U.S. Treasury yields, and global oil prices returning to pre-pandemic levels. The country's real effective exchange rate also appreciated during the first four months of 2021 at a time when the currencies of regional peers depreciated. This may adversely impact the country's exports competitiveness. After reaching an all-time high of US$110 billion by end-2020, gross international reserves fell to US$107.2 billion in April 2021, equivalent to 12.3 months' worth of imports of goods and payments of services and primary income.


Photo: Michael Leslie

4 Tourist arrivals plummeted by 83 percent between 2019 and 2020. Source: Department of Tourism http://tourism.gov.ph/Tourism_demand/Arrivals2020.pdf.

5 Villanueva, Joan. "Economist sees new record-highs for PH foreign reserves." Philippine News Agency. March 12, 2021. https://www.pna.gov.ph/articles/1133440.

6 In the first two months of 2021, total goods imports amounted to US$16.0 billion, 5.6 percent lower relative to the value of goods imported during the same period in 2020. Likewise, goods exports contracted by 3.6 percent in the first two months of the year to US$10.8 billion, resulting in a merchandise trade deficit.

7 In Q1 2021, goods imports amounted to US$25.6 billion, 3.2 percent higher than the value of imports in Q1 2020.

Table 1. Balance of Payments, 2016–2020

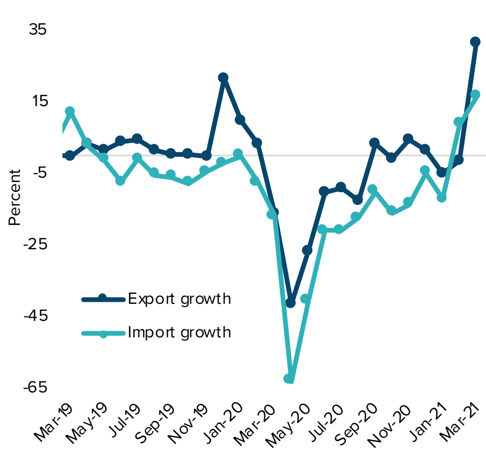
In percentage of GDP	2016	2017	2018	2019	2020
Current account	**-0.4**	**-0.7**	**-2.6**	**-0.8**	**3.6**
Goods	-11.2	-12.2	-14.7	-13.1	-8.8
Exports	13.4	15.8	15.0	14.2	13.1
Imports	24.6	28.0	29.7	27.3	21.9
Services	2.2	2.6	3.3	3.5	3.6
Primary Income	0.8	1.0	1.1	1.4	1.2
Secondary Income	7.8	8.0	7.7	7.4	7.6
Capital and Financial accounts	**-0.0**	**0.9**	**2.7**	**2.2**	**1.3**
Capital account	0.0	0.0	0.0	0.0	0.0
Financial account	0.1	-0.9	-2.7	-2.1	-1.3
Direct investment	-1.8	-2.1	-1.7	-1.4	-0.8
Net acquisition of financial assets	0.8	1.0	1.2	0.9	1.0
Net incurrence of liabilities[1]/	2.6	3.1	2.9	2.3	1.8
Portfolio investment	0.5	0.7	0.4	-0.7	0.1
Financial derivatives	-0.0	-0.0	-0.0	-0.0	-0.1
Other investments	1.4	0.5	-1.4	-0.0	-0.5
Net unclassified items[2/]	0.1	-0.5	-0.8	0.7	-0.4
Overall BOP position	**-0.3**	**-0.3**	**-0.7**	**2.1**	**4.4**
Memo:					
Basic Balance	1.5	1.5	-0.9	0.6	4.4
Gross International Reserves (in billions US$)	80.7	81.6	79.2	87.8	110.1
Import Coverage (in months)	8.8	7.8	6.9	7.6	12.6

1/ Net incurrence of liabilities refers to net foreign direct investment (FDI) to the Philippines.
2/The term "Net unclassified items" is a balancing figure. There are two methods of computing the BOP position: the first approach uses the change in net international reserves due to transactions, while the second approach computes the sum balances of the current account, capital account less financial account. The two measures do not necessarily tally. The BSP uses the first approach to determine the overall BOP position.

Note: Following the BSP presentation, the BOP balance = Current Account Balance + Capital Account Balance - Financial Account Balance + Net Unclassified Items.

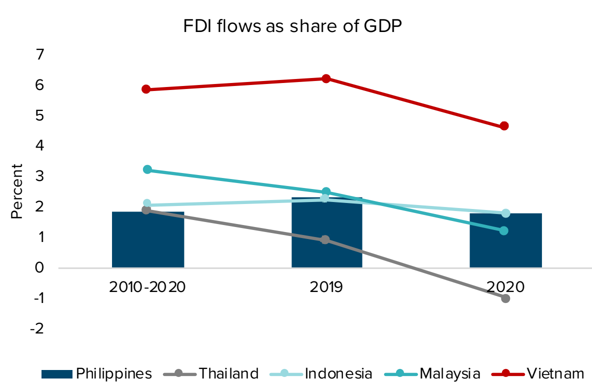
Source BSP.

Figure 5. From mostly sharp contractions throughout 2020, both imports and exports of goods indicate recovery in early 2021.



Source: BSP.

Figure 6. The contraction in FDI was less pronounced in the Philippines than in many other regional peers in 2020.

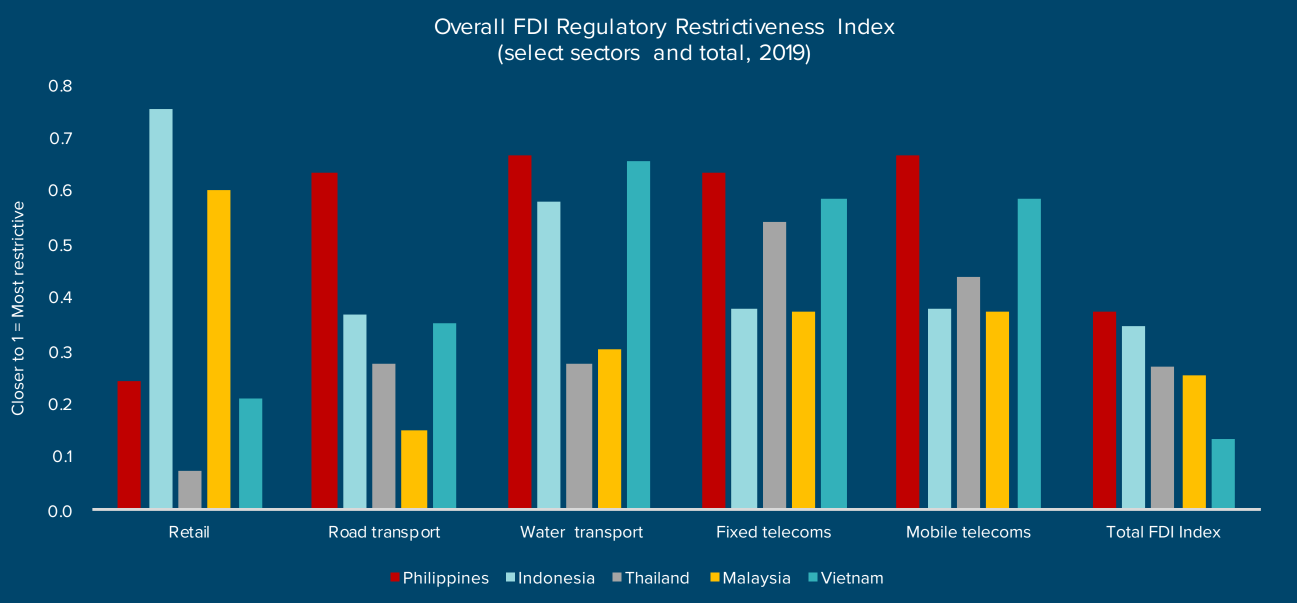


Source: Institute of International Finance (IIF).

Box 2. Foreign Direct Investment Restrictiveness in the Philippines.

The Philippines lags its regional peers in FDI inflows, which increases the risk that the country may be unable to leverage key growth opportunities during the economic recovery. From 2010-2019, the Philippines received US$45 billion worth of FDI, lagging behind Indonesia (US$178 billion), Viet Nam (US$112 billion), Malaysia (US$96 billion), and Thailand (US$74 billion). An outdated legal and policy framework has limited the inflow of FDI for decades. In 2019, the Philippines had the most restrictive regulatory framework (Figure 7) and the most stringent foreign equity limits among peers (Table 2). The restrictive foreign equity limits have caused the domestic industries to miss out on capital, technology, and productivity gains through knowledge spillovers. Moreover, the outdated framework will potentially limit the country's ability to leverage growth opportunities during the recovery, including the potential spillover effects from the US$1.9 trillion U.S. stimulus through investment channel.

Figure 7. Across key sectors, the FDI regulatory framework is more restrictive in the Philippines than in regional peers.



Source: Organisation for Economic Cooperation and Development (OECD).

Table 2. Foreign Equity Limits on FDI among ASEAN Countries.

	Telecomunications-Fixed	Telecomunications - Mobile	Trasportation - Road	Trasportation - Water
Indonesia	67%	***	49%	49%
Malaysia	100%	100%	49%**	49%**
Philippines	40%	40%	40%	27.3
Thailand	<50%	<50%	60%-75%	60%-75%
Vietnam	49%	49%	49%*	49%*

Source: OECD FDI Regulatory Restrictiveness Index 2019 and local laws.
*Note: * ASEAN: 51 percent; **Depending on license and subsector; *** No information indicated in the OECD FRI*

Three bills that aim to ease restrictions on FDI are currently pending in Congress. The president recently certified these bills as urgent, effectively allowing Congress to fast-track their passage. These three bills amend the Public Service Act, Retail Trade Liberalization Act (RTLA), and the Foreign Investment Act (FIA).

The amendment to the Public Service Act is envisioned to augment infrastructure investments. Foreign ownership caps on public utilities are limiting the size of foreign investment in critical infrastructure like water, power, transportation, and telecommunication. In the amended bill, only three sectors are identified as public utilities: the transmission of electricity, distributions of electricity, and water works and sewerage systems, which will still face foreign ownership caps. To ensure flexibility, future legislation can classify additional sectors as public utilities, and the National Economic and Development Authority (NEDA) is mandated to recommend the classification of a business, or service as a public utility to Congress. Additionally, the bill contains a clause for creating an appropriate mechanism for fixing rates based on reasonable returns and the efficiency of public service delivery. Moreover, administrative enforcement will be strengthened to disincentivize investor neglect.

The amended FIA aims to increase investments and attract foreign skilled professionals. To attract FDI, the employment threshold for non-Filipinos investing at least US$100,000 in small and medium-sized enterprises will be lowered from 50 to 15 direct employees. This policy is supported by an annual review of the foreign investment negative list (FINL), regular updates to the declaration of policy to incorporate the current dynamics of global and regional economies, and the establishment of a joint web portal that will serve as a one-stop shop for foreign investors. Aside from attracting FDI, the amended FIA also aims to increase foreign skilled labor in the country by removing the practice of profession from the negative list. The influx of foreign professionals could help to reduce the shortage of skilled labor in the country, and potential knowledge spillovers would help to upskill Filipino workers.

Finally, the amended RTLA aims to increase competition in the retail sector. The senate bill aims to increase the foreign participation in retail by reducing the required minimum paid-up capital from US$2.5 million to US$300,000. There are also several deleted provisions in the revised bill, including: (i) the 60 percent limit on the foreign ownership of local retailers; (ii) the requirement that retail trade enterprises, of which 80 percent of the stocks are foreign owned, need to offer a minimum of 30 percent of their equity to the public within 8 years of starting their operations; (iii) the requirement that foreign retailers need to have a minimum net worth of US$200 million in its parent corporation for those classified under categories B and C and US$50 million for those under category D; (iv) have 5 retail branches or franchises anywhere around the world, with at least one store capitalized at a minimum of US$25 million; and (v) have a 5-year track record in the retail business.

Photo: By Walter Eric Sy

1.3 Inflation and Monetary Policy: Accommodative Policy Amid Rising Inflation

Rising food prices due to supply shocks brought by a series of typhoons in 2020 and the outbreak of African Swine Fever (ASF) pushed inflation above the BSP target in the first four months of 2021. Despite inflationary pressure, the BSP kept its key policy rate steady to support the economy.

Inflation breached the upper bound of the BSP target range in the beginning of 2021 due to food supply shocks. The headline inflation rate averaged 4.5 percent in the first four months of 2021, higher than an average of 2.6 percent during same period in 2020 and above the BSP's inflation target range of 2-4 percent (Figure 12). Elevated food prices, caused by harvest losses due to a series of typhoons in 2020, and a lower pork supply, caused by the outbreak of ASF, were the main drivers of inflationary pressure. Transport inflation also rose due to higher fares brought on by the implementation of quarantine restrictions, and the rise of global oil prices back to pre-pandemic levels.[8] Excluding volatile food and energy items, the core inflation averaged 3.5 percent in the first four months of 2021, slightly higher than the average of 3.1 percent in the same period last year. The small increase in core inflation suggests that rising food prices had little spillover effects to other goods and services. Compared to neighboring countries, domestic inflation is higher than Indonesia (1.4 percent), Malaysia (1.7 percent), Thailand (3.4 percent), and Vietnam (2.7 percent).

The BSP continued its accommodative policy stance by keeping the key policy rate unchanged. It maintained the key policy rate at 2.0 percent in March 2021 to continue to support the economic recovery. Stable core inflation, along with the government's adoption of trade and other measures to address the low pork supply, solidified the view of the BSP that the uptick in inflation is transitory. The BSP has previously engaged in open market operations and also continued the implementation of other regulatory measures to minimize the economic fallout of the COVID-19 pandemic, such as adopting zero percent risk weight for the guaranteed loans of micro, small, and medium-sized enterprises, as well as waiving the fees for fund transfer transactions through the BSP's payment and settlement system.

The Philippine financial system maintains a high level of liquidity, but banks remain risk averse to lending. Domestic liquidity remained high at Php14.0 trillion in February 2021, despite liquidity growth declining year-on-year from 16.2 percent in June 2020 to 9.4 percent in February 2021. Banks continue to be risk averse, with the outstanding loans of universal and commercial banks falling by 2.7 percent between February 2020 and 2021 to reach Php8.9 trillion. Credit to private sector sharply shrank amid the COVID-19 pandemic and is expected to further decline due to the renewed lockdown in April 2021. Credit to private sector contracted by 2.4 percent in February 2021 (Box 3).

Photo: Walter Eric Sy

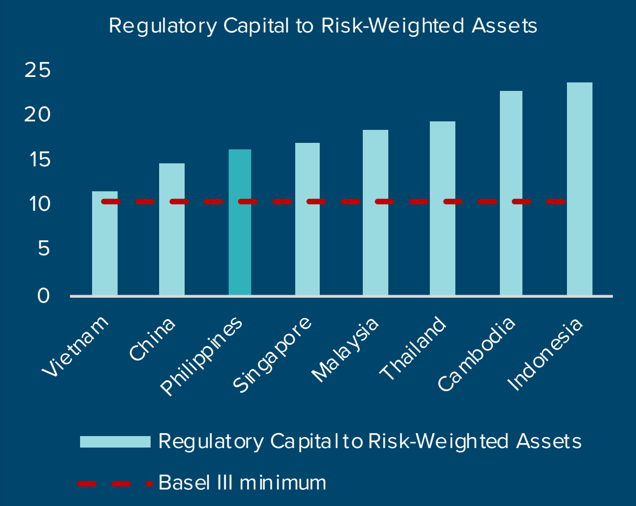
8 Transport inflation averaged 12.7 percent in the first four months of 2021, partly due to the increase in global oil prices, with the Brent crude oil price benchmark growing by 20 percent, quarter-on-quarter.

Box 3. Recent Developments in the Financial System

The financial system has broadly withstood the impact of COVID-19 but it faces significant downside risks due to uncertainty around the pace of recovery and high interconnectedness with non-financial corporates. The banking sector's overall capital adequacy ratio (CAR) remains stable at about 16 percent, well above BSP's regulatory threshold of 10 percent (Figure 8). The overall liquidity of the banking sector is sufficient to absorb funding shocks with a liquidity coverage ratio of above 150 percent. In terms of asset quality, The gross NPL ratio rose to 4.1 percent as of end-February 2021 compared to about 2.2 percent as of the end of February 2020 (Figure 9). Furthermore, the banking system saw a significant increase in its restructured loans, from 0.4 percent in January 2020 to 1.9 percent in December 2020. As a result, the capital at risk ratio (NPL net of provision to capital ratio)[9] has risen from 4.6 percent at the end of 2019 to 6.2 percent at the end of 2020.

The economic contraction is elevating credit risks, especially from the corporate sector. As noted by the recent IMF Financial System Stability Assessment (FSSA),[10] non-financial corporates are highly interconnected with the financial system through mixed conglomerate structures. While banks can withstand the exceptionally severe shocks in the baseline scenario, they could experience a systemic solvency impact if additional downside risks materialize. The firms are likely to experience substantial distress even in the baseline scenario. The GDP shocks are expected to reduce corporate earnings across different sectors as well as the debt servicing capacity of the corporates. Moreover, the recent national COVID-19 survey conducted in November 2020, indicates that a large share of firms reported acute liquidity constraints, with reports of not having enough cash and have fallen behind in payments (Figure 10). Thus, the negative impact of COVID-19 on the solvency of non-financial corporates poses significant risks to the financial system.

Figure 8. The financial system appears to have adequate capital buffers.



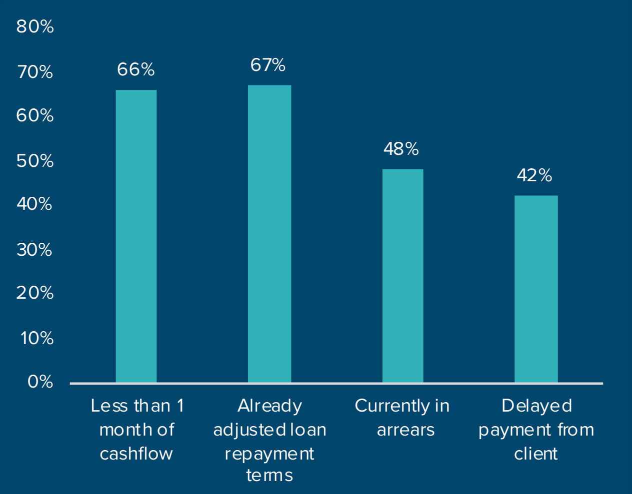
Source : International Monetary Fund (IMF) FSI (Q4 2020 or latest available)

Figure 9. NPLs remain manageable, as in most regionalpeers, but asset quality needs close monitoring.

Source : World Bank staff calculations; Haver Analytics

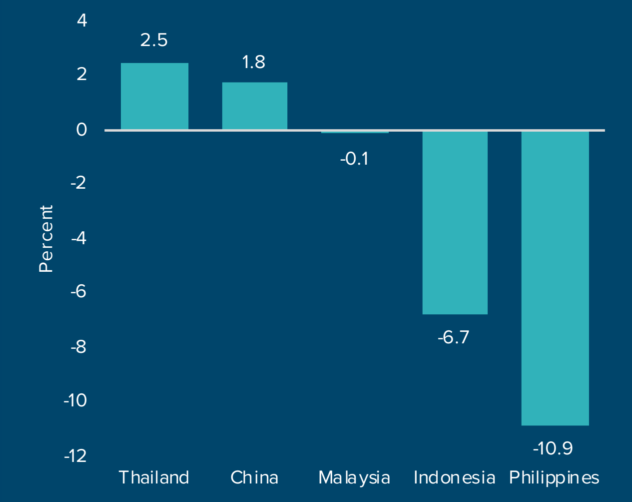
9 This indicator measures the capacity of bank capital to withstand losses from NPLs, once specific provisioning has absorbed part of those losses.
10 IMF, Philippines Financial System Stability Assessment, April 2021.

Figure 10. Firms experiencing financial constraints (% firms).



Source: Philippines COVID-19 Firm Survey, Nov 2020, World Bank

Figure 11. Absolute Change in Nominal Credit Growth in Select EAP countries (January 2020, latest available month, percentage points).



Source: FCI GP Macro-Financial Unit, March 2021.

The decline in economic activity, limited operations by firms, and increase in firms' insolvencies have led to a sharp contraction in credit. Since January 2020, the Philippines has experienced a decline in private credit growth of -10.9 percentage points, which is higher relative to other large EAP economies (Figure 11). Over the same period, China and Thailand have seen a 1.8 and 2.5 percentage points increase, Malaysia has seen a -0.1 percentage points decline whereas Indonesia has recorded a decline of -6.7 percentage points. As noted by the aforementioned COVID-19 survey, 7 percent of firms reported having closed permanently.[11] Moreover, while more firms were in operation compared to July 2020, about 9 out of 10 firms were operating at below capacity.

The increase in firms' insolvencies and NPLs, underscore the need to strengthen the insolvency practice that is currently limited. The Philippines has a relatively robust legislative framework for debt enforcement and collective insolvency proceedings. However, due to weak implementation of the legislation and challenges with the supporting professionals and institutions, credit recovery is relatively low. For instance, the 2019 Doing Business Insolvency credit reports that creditors recover 21.1 cents on the dollar on average, compared to 92.1 cents on the dollar in Japan and 84.3 cents on the dollar in South Korea. There is no insolvency regulatory authority and no professional associations for insolvency practitioners. One of the major obstacles reported is the length of time to go through court processes. Accordingly, banks are reluctant to use formal proceedings. Thus there is a need to develop judicial capacity in insolvency law, promote alternate dispute resolution mechanisms, strengthen qualification criteria for insolvency practitioners and implement an insolvency regulatory authority with adequate supervisory powers.[12]

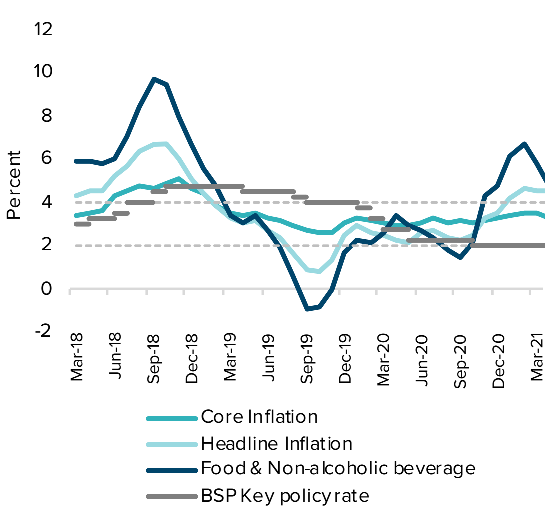
Photo: structuresxx

11 This is a lower figure compared to 16 percent in July 2020, which may be explained by a likelihood that firms that permanently closed in March and April 2020 may have been less likely to participate in the survey in November 2020.

12 World Bank 'Review of Philippines Insolvency and Debt Enforcement', forthcoming.

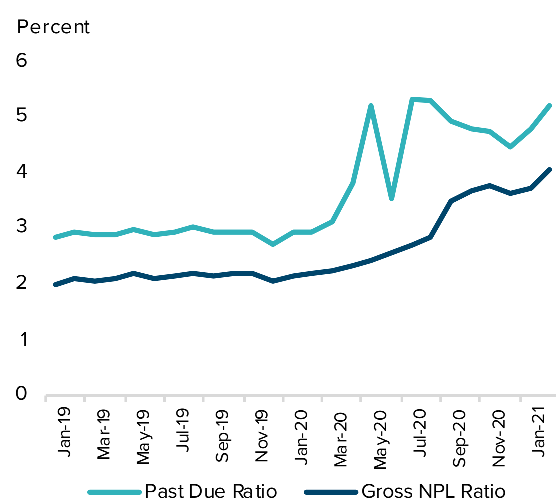
Philippine banks remain capitalized amid deterioration in bank asset quality. The banking system total capital adequacy ratio (CAR) rose to 16.7 percent in December 2020 from 15.6 percent in December 2019.[13] This is above the 10 percent regulatory minimum requirement. Bank profitability, however, has declined with the return on asset from 1.3 percent to 0.8 and return on equity by 10.5 percent to 6.6 percent. The risk aversion of lenders was compounded by the deteriorating asset quality of banks. After the expiration of a 60-day loan moratorium under performing assets and non-performing loans to special asset management firms Bayanihan 2,[14] past due loan began to increase, reaching 5.2 percent in February 2021 from 3.0 percent in February 2020 (Figure 13). A large share of firms reported acute liquidity constraints. 66 percent of firms did not have enough cash to pay all costs and payments such as payroll, suppliers, taxes or loan repayment beyond 1 month.[15] Gross non-performing loans (NPL) also continues to rise to 4.1 percent in February 2021 from 2.2 percent in the same month last year. The enacted Financial Institutions Strategic Transfer Act enables financial institutions to dispose their non-performing assets and non-performing loans to special asset management firms.

Figure 12. Inflation breached the BSP's target range in the first three months of 2021.



Source: Philippines COVID-19 Firm Survey, Nov 2020, World Bank

Figure 13. The past-due loans ratio and the share of non-performing loans rose.



Source: FCI GP Macro-Financial Unit, March 2021.

13 The latest available figure as of April 20, 2021

14 Loan payment for principal or interest, including amortizations, that fell due between September 15 and December 31, 2020 may be paid after 60 days, without incurring interest on interests, penalties, fees or other charges.

15 Monitoring COVID-19 Impacts on Families and Firms in the Philippines: http://www.worldbank.org/philippines/covidmonitor. Firm Survey Results: Round 2 – November 2020

1.4 Fiscal Policy: Balancing Support and Sustainability

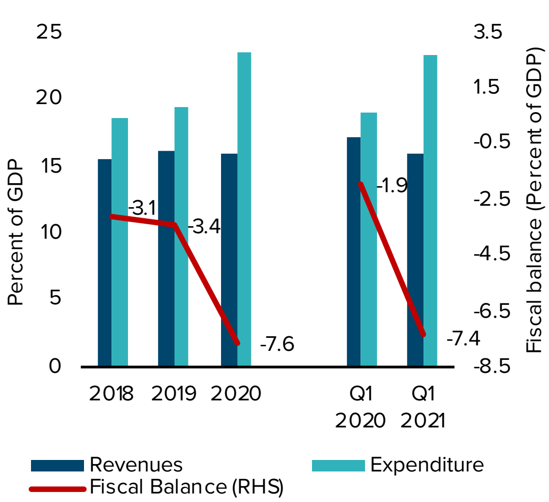
The national government's fiscal balance continues to show signs of deterioration in early 2021, as revenue generation remained subdued. The authorities continue to increase public spending, led by the implementation of stimulus and other support measures as well as infrastructure spending.

The fiscal deficit continued to widen in the first quarter of 2021, leading to an increase in public debt. The fall in public revenues and the surge in public spending led to an increase in the fiscal deficit in the first quarter of 2021 to 7.4 percent of GDP from 1.9 percent of GDP a year ago (Figure 14). The widening deficit resulted in the public debt ratio reaching 60.4 percent of GDP as of end-March 2021 (Figure 15), the highest level since 2005. Publicly guaranteed debt remained low at 2.5 percent of GDP as of March 2021. While a portion of the debt mix relies on external funding, 72.5 percent of outstanding debt is peso-denominated, and long-term debt accounts for about 94.2 percent of the external portfolio, as of March 2021.

Public revenues remain weak amid a sharp decline in non-tax revenues and subdued economic activity. National government (NG) revenues fell to 16.0 percent of GDP in the first quarter of 2021 from 17.2 percent in the same period in 2021, as non-tax revenues were halved to 1.6 percent of GDP in the first quarter of 2021 owing to the base effect of large dividend remittances a year ago. Meanwhile, tax revenues inched up by 0.9 percent to reach 14.4 percent of GDP in the first quarter of 2021 from 14 percent of GDP a year ago.[16] The uptick in tax collections was driven in part by improved collections from the Bureau of Customs, as merchandise trade improved and base effects from a sharp downturn in tax collections in the latter half of Q1 2020.

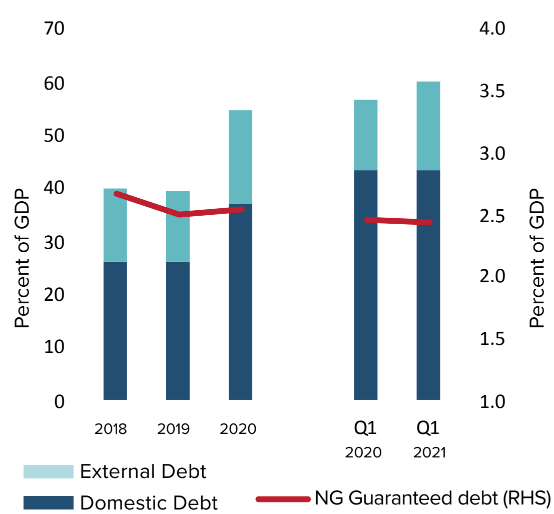
The growth in public spending accelerated, anchored on continuing fiscal stimulus measures and a resumption in public investment. NG spending rose from 19.1 percent of GDP in the first quarter of 2020 to 23.4 percent of GDP in the same period in 2021, driven by the adoption of stimulus measures and infrastructure spending. The rise in public spending was fueled by a surge in capital outlays as the government continued to implement the "Bayanihan to Recover as One" Act (Bayanihan 2) after it was extended to June 30, 2021. In particular, strong disbursement growth was boosted by several Bayanihan 2 programs such as the release of equity infusions to several public financial institutions, the Rice Resiliency Program, and various health programs of the Department of Health. Public spending also benefitted from the resurgence in infrastructure outlays in the first quarter of 2021 and steady growth in recurrent spending.

Figure 14. The fiscal deficit reached a record high in 2020 amid a sharp rise in public spending.



Source: Department of Budget and Management (DBM), PSA.

Figure 15. The debt-to-GDP ratio rose to its highest level since 2006.



Source: DBM, PSA.

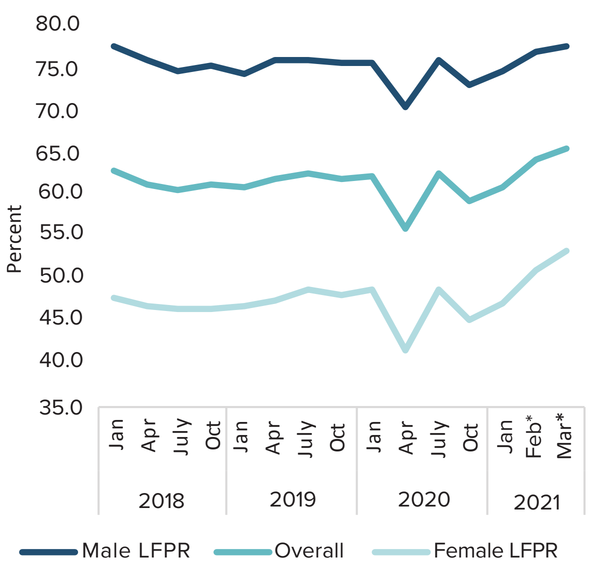
16 To offset the anticipated shortfall in tax collections due to the impact of the pandemic and containment measures, non-tax revenues nearly doubled in the first quarter of 2020 due to early dividend remittances from the BSP and government-owned and controlled corporations to the Bureau of Treasury.

1.5 Employment and Poverty: Rise of Low-Paying Jobs Despite Labor Market Rebound

Improvements in job creation and labor force participation have been tempered by a rise in the share of part-time workers and underemployment. A fall in earnings, business income, and remittances, along with new community quarantines in April 2021, will likely contribute to elevated levels of poverty despite the government's mitigation efforts.

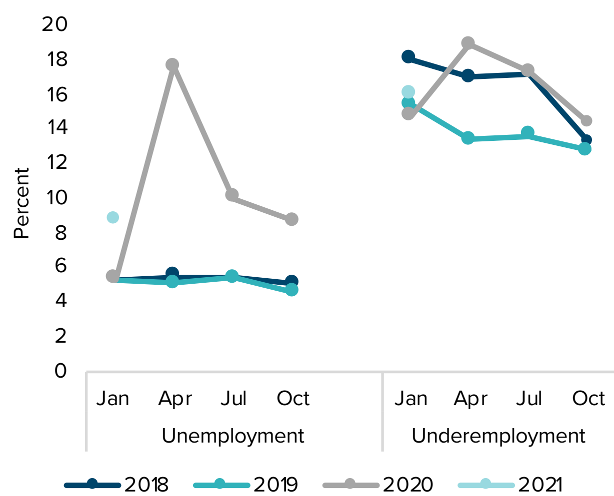
More people started looking for work as the economy gradually re-opened. The labor force participation rate (LFPR) reached 65.0 percent in March 2021, surpassing the pre-pandemic level of 61.7 percent in January 2020 and peaking to its highest level since January 2018 (Figure 16). This translates into about 3.5 million people entering the labor market between January and March 2021. The increase in the LFPR is observed for both men and women, with the latter driving the significant increase. Notwithstanding the increasing number of workers in the labor force, the unemployment rate decreased to 7.1 percent in March 2021 after remaining steady at 8.7-8.8 percent in the past five months (Figure 17).[17] While the unemployment rate in March 2021 is higher than the pre-pandemic level (5.4 percent recorded in January 2020), it is significantly lower than the level recorded during the peak of community quarantines in April 2020 (17.6 percent). The youth unemployment rate averaging around 19 percent between October 2020 and February 2021 also dropped to 15.4 percent in March 2021. By gender, the unemployment rate in March 2021 is slightly higher among women (7.8 percent) than men (6.6 percent), with the gender gap widening starting from February 2021.

Figure 16. Labor Force Participation Rate, January 2018–March 2021.



Source: PSA-LFS Labor Force Survey (LFS) (various rounds).
Note: a/Population projections based on the 2015 Population Census has been adopted to generate the labor force data.

Figure 17. Unemployment and Underemployment Rates, January 2018–March 2021.



Source: LFS (various rounds) and PSA.
Note: /Population projections based on the 2015 Population Census has been adopted to generate the labor force data.
*Starting February 2021, the LFS is conducted on a monthly basis to produce more timely data.

17 The unemployment rate increased slightly to 8.8 percent in February 2021 from 8.7 percent in January 2021.

Job creation has accelerated between October 2020 and March 2021. About 5.5 million jobs were added during this period, with about 40 percent of the new jobs (2.2 million) added between February and March 2021. Gains in jobs creation were driven by the service sector,[18] which accounted for 48 percent of the increase in jobs between October 2020 and March 2021. However, the boost between February and March 2021 came from construction which explains over half of new jobs added during that time. Meanwhile, some sectors, such as education and real estate activities, experienced employment losses in the midst of overall gains. The shedding of jobs in education was likely associated with the limited school and training operations as well as reduced enrollment due to the pandemic.[19]

Despite signs of a labor market recovery, the quality of jobs is of concern. The underemployment rate remained at around 16-18 percent in the first quarter of 2021, higher than in the last quarter of 2020 (14.4 percent in October 2020) and the pre-pandemic level (14.8 percent in January 2020). The newly underemployed came from the agriculture sector, which may be in part attributed to temporary disruptions in agricultural output caused by the outbreak of ASF. Among the employed labor force, the share of part-time workers -- those working less than 40 hours a week -- remained significantly higher (around 38 percent in January and February 2021 and 36.7 percent in March 2021) than the pre-pandemic level (31.6 percent in January 2020). Moreover, the share of wage and salary workers and employers in the total labor force was 63.7 percent in March 2021, almost 4 percentage points lower than before the pandemic (67.6 percent in January 2020) with an increase in the share of self-employed and non-paid workers. By occupation, the share of elementary occupations (commonly associated with low-pay jobs) increased from around 25.6 percent in October 2020 to 27.3 percent in January and to almost 30 percent in March 2021.

The increase in underemployment, the fall in hours worked, the shift to non-wage employment, and agricultural disruptions have contributed to earnings losses and the fall in household income. The nationwide high-frequency monitoring household survey conducted between December 2020 and January 2021 shows that more than 40 percent of households reported lower incomes and earnings compared to the pre-pandemic level, despite a rise in employment. While this share is significantly lower than 57 percent reported in July 2020, it reflects ongoing financial distress among households.

The significant fall in household earnings, combined with reduced business income and remittances, will likely lead to an increase in poverty despite government assistance. The COVID-19 pandemic may have resulted in the national poverty rate increasing from 16.7 percent in 2018 to an estimated 21.0 percent in 2020, even after accounting for the effects of government subsidies (e.g., the social amelioration program). With an increase in employment and a rebound in earnings, the poverty rate was initially projected to be marginally lower in 2021 if no further quarantine measures were imposed. However, the adoption of new enhanced community quarantine (ECQ) in NCR and neighboring provinces in April 2021, along with a relatively low level of public assistance, risk raising the poverty rate further.

Photo: Ezra Acayan

18 In particular, wholesale and retail trade, and repair of motor vehicles and motorcycles added a significant number of jobs (about 1.9 million) between October 2020 and March 2021.

19 Based on enrollment data for school year 2020-2021, enrollees in private schools dropped by 48 percent from last year, while public school reported a 10 percent drop. In addition, of the total 14,435 private schools in the country, 865 did not operate this school year. Of these, 374 schools were forced to suspend operations due to low or no enrollment and another 333 schools would be non-operational due to COVID-19 pandemic.

Part II

Outlook and Risks

The economy is projected to grow at 4.7 percent this year, before accelerating to 5.9 percent in 2022. The prospect hinges on the effective pandemic containment, mass vaccination, and further loosening of mobility restrictions, which will result in the return of domestic activity. An improving external environment will also lend a boost. Risks, however, are tilted on the downside with the potential entry of more contagious virus variants, and the tight global supply of vaccines that can slow progress in mass vaccination. A prolonged pandemic will adversely impact firm solvency, resilience in the banking sector, public financing needs, and debt levels. A commitment to structural reforms, easing of foreign investment restrictiveness, and addressing the socioeconomic impact of the pandemic must remain priorities of the government.

Photo: Jed Regala

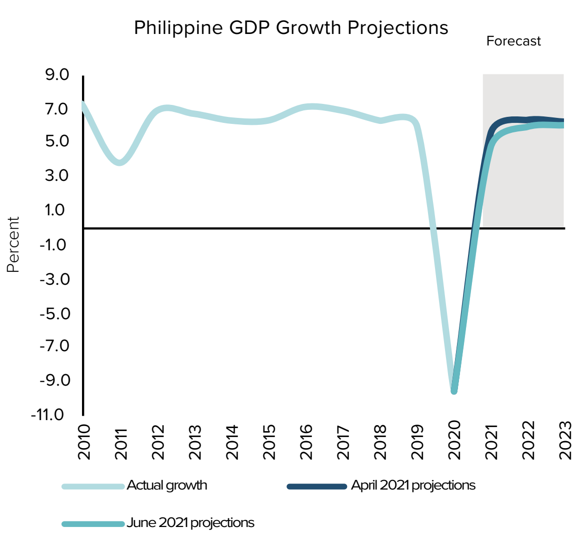
2.1 Growth Outlook

Economic growth is expected to recover to 4.7 percent in 2021 and 5.9 percent in 2022, alongside an improvement in the external environment and the return of domestic activity, predicated on the ability to effectively manage the COVID-19 pandemic and deliver vaccines in a timely manner.

Growth prospects hinge on the ability to manage the COVID-19 health crisis. The medium-term growth trajectory depends on effective pandemic containment, mass vaccinati on, and further loosening of mobility restrictions. The surge in COVID-19 cases in March and April has momentarily derailed the country's economic recovery as tighter community quarantine measures have been implemented. While mass vaccination began in March, global vaccine supply constraints and vaccine hesitancy among Filipinos may delay widespread local inoculation (Box4). Following the government's vaccination plans, the growth projection assumes that vaccination will accelerate in the second half of 2021 the arrival of more vaccine supplies.

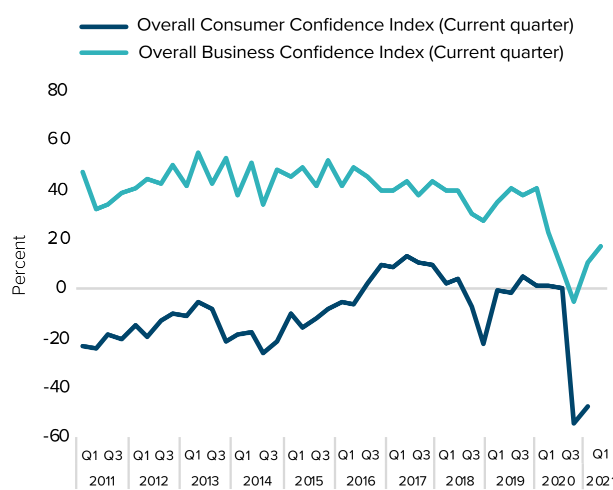
The economy is expected to recover over 2022-2023, following the deep recession in 2020. Economic growth is projected at 4.7 percent in 2021, before accelerating to 5.9 percent in 2022 and 6.0 percent in 2023 (Figure 18). These projections reflect downward revisions from the forecast published in the World Bank East Asia and Pacific Economic Update in April 2021. The downward revision for this year was driven by the larger-than-expected contraction in the first quarter,[20] the realization of case resurgence and reimposition of stricter quarantines, and the lingering challenges from elevated inflation and household income losses. Nonetheless, the growth trajectory is positive over the forecast horizon and is expected to close in on the potential growth of 5.7 percent over 2020-2029. It anchors on the global recovery, including with key trading partners, which will translate into higher export demand and better prospect of remittances. Domestically, as vaccination efforts progress and the infection rate slows, household confidence returns while business confidence improves driving more robust activity (Figure 19). The administration's commitment to deliver infrastructure projects will contribute to investment growth. Following the deep contraction last year, a base effect will also contribute to increased growth in 2021, while the national election is projected to boost economic activity in 2022.[21]

Figure 18. Economic growth is expected to recover in the medium term.



Source: PSA; World Bank staff estimates.

Figure 19. Consumer sentiments remained in negative territory in early 2021.



Source: BSP.

20 The economy contracted 4.2 percent year-on-year in the first quarter of 2021 against an expected 3.0 percent drop.
21 The national election can boost economic activities from moneys spent on campaign activities, media advertisements, ballot printing, among others.

The growth projection assumes that the fiscal deficit remains elevated in 2021 but declines over the medium term. The fiscal deficit is projected to stay elevated at 7.3 percent in 2021 from 7.6 percent in 2020 because of continued public spending to address the pandemic. In the medium term, however, the fiscal deficit is expected to decline as the government winds down its pandemic response and the economic recovery contributes to higher public revenues. In particular, the expected domestic recovery and better external environment are expected to lead to increased tax collection on consumption and trade. In terms of expenditures, public capital outlays are expected to grow faster in 2021, but the pace will slow in succeeding years, constrained by the narrower fiscal space. The government remains committed to pursue its infrastructure investment agenda, with infrastructure spendingrepresenting 5.4 percent of GDP in the 2021 budget, although expected to fall to 5.1 percent of GDP in 2022.[22]

Photo: Ezra Acayan

22 The projected decline is the result of an increase in transfers from the central government to LGUs beginning in 2022, which are expected to encounter challenges to fully absorb the capital outlays transferred to them.

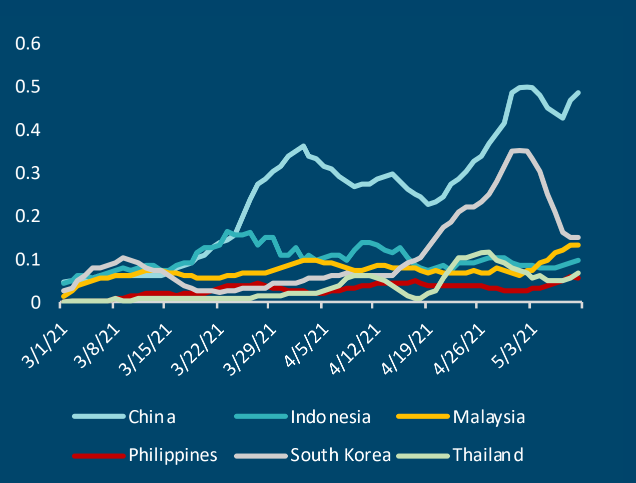
Box 4. The Impacts of COVID-19 Vaccination on the Economy Match its Impacts on Public Health.

The resurgence of COVID-19 cases in March-April prompted a reimposition of stricter lockdown. Average daily infection cases rose from around 1,600 in January 2021 to around 9,600 in April, before slowing to 6,700 by mid-May. Cases of deaths followed a similar trajectory averaging 131 in April, before slowing to 123 by mid-May. In early April, the authorities responded with the resurgence of cases by placing Metro Manila and adjoining provinces under enhanced community quarantines that limited people's mobility and hampered the virus spread. Unlike in lockdowns in 2020, however, the quarantine measures were recalibrated and allowed for more activities in construction, manufacturing, and public transportation. As a result, the 26.6 percent average drop in community mobility in non-residential areas in April 2021 was less severe than the 66.0 percent drop in April 2020.

Mounting an effective response to contain the pandemic is the foremost challenge and prerequisite for economic recovery. Only then can policy makers create conditions to safely reopen the economy and families to resume normal lives. Scaling-up testing, tracing, and case management, along with rolling out a well-coordinated and prioritized vaccination program, form the most critical immediate health emergency response for the Philippines. Vaccination makes strong economic sense. The IMF estimates cumulative global losses of US$12 trillion over the period 2020-2025, relative to pre-pandemic projections.[23] These losses are compounded several-fold if we consider the long-term effects of the pandemic on education, health services, and lost human capital.

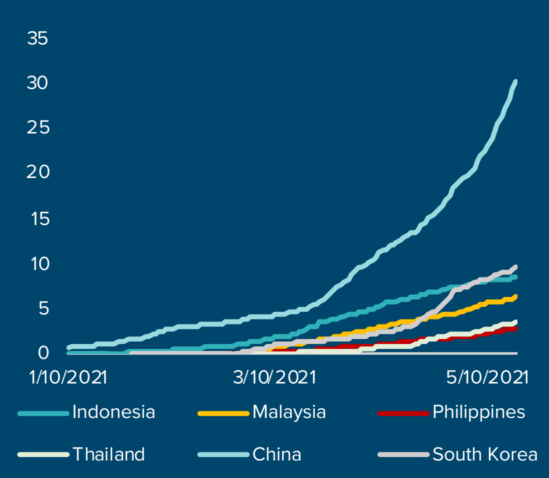
The Philippines must accelerate vaccinations and catch up with its East Asian peers (Figure 20 and Figure 21). With limited COVID-19 treatment options and therapeutics, safety behaviors—such as mask wearing, handwashing, and physical distancing—and rapid roll-out of vaccinations have emerged as the primary tools to fight the pandemic. At present, the principal goal of vaccination is to prevent disease and death among the most vulnerable populations. While evidence on duration of efficacy and impact on infectivity is still limited, wider and more equitable vaccination coverage is expected to help containment by enhancing population immunity. The government of the Philippines (GOP) has in place a National Deployment and Vaccination Plan (NDVP) which was developed and approved during the first quarter of 2021. The NDVP lays out an ambitious plan to vaccinate approximately 71 million adult Filipinos within the shortest possible time, subject to availability of vaccines.

Figure 20. Regional comparison of vaccine doses administered per 100 people.



Source: Our World in Data.

Figure 21. Cumulative vaccine doses administered per 100 people.



Source: Our World in Data.

23 G. Gopinath; "A Race Between Vaccines and the Virus as Recoveries Diverge; IMF blog; 26 January 2021. https://blogs.imf.org/2021/01/26/a-race-between-vaccines-and-the-virus-as-recoveries-diverge/

However, the Philippines is navigating a complex global vaccine market. The Philippines—under the Vaccination Task Force—has had to navigate a tight vaccine supply market heavily skewed in favor of vaccine manufacturers and richer nations. The GOP has adopted a portfolio-based approach to its vaccine procurement as a way to ensure that the country can access vaccines for its target population within the shortest possible time. A portfolio-based approach enables the Philippines to access approved vaccines from various suppliers and to deploy them across the country concurrently. However, deployment of a portfolio of vaccines requires robust planning and responsive delivery systems to avoid risks of comingling vaccines in the supply chain system. More importantly, sound planning enables systematic administration of two-dose vaccines and tracking of any adverse events following inoculation. The portfolio of vaccines is being developed through: direct bilateral purchase agreements with vaccine manufacturers; bilateral agreements with governments to purchase excess stock; and pooled arrangements such as the COVAX Facility.[24] As an eligible COVAX Advance Market Commitment Facility country, the Philippines has signed agreements with the COVAX Facility to cover 20 percent of the population.

Ramping up the pace and geographic coverage of the vaccination program involves addressing a host of challenges. By end-April, the Philippines has administered more than 1.8 million doses to Priority Group A beneficiaries in the first two months of vaccine deployment.[25] Deployment of vaccines to the general population is expected to ramp up from the second quarter of 2021 in light of an anticipated increase in vaccine deliveries to the country. In addition to tight supply markets, governments must overcome vaccine hesitancy. About six in ten Filipino adults polled in February did not want a COVID-19 vaccine, about a quarter of Filipino adults were unsure whether they would get vaccinated, while 16 percent affirmed that they would.[26] The situation is further complicated by the mix of vaccines offered, and that vary in cold chain requirements, dosing, and adverse events. Although the GOP has progressed vaccine procurement through development and roll-out of a comprehensive vaccine delivery road map, varied capacities of LGUs, risks for a fragmented private sector roll-out, and delays in operationalizing a robust IT infrastructure (for registration, scheduling, supply logistics, digital vaccine certification, and data analytics) could impede efficient planning and delivery.

Photo: Ezra Acayan

24 COVAX is the vaccines pillar of the Access to COVID-19 Tools (ACT) Accelerator and is co-led by Gavi, the Coalition for Epidemic Preparedness Innovations (CEPI), and the World Health Organization (WHO). Its aim is to accelerate the development and manufacture of COVID-19 vaccines, and to guarantee fair and equitable access for every country. https://www.gavi.org/covax-facility.

25 This top priority group of beneficiaries—including healthcare workers on the frontline, senior citizens, and individuals with comorbidities.

26 Asia Research's February 2021 Ulat ng Bayan Survey: Media Release on COVID-19 26 March 2021. Vaccine hesitancy has been relatively higher in the Philippines than with regional peers. Studies show that the vaccine acceptance rate in Malaysia is at 94.3 percent, China at 72.6 percent, and Singapore at 67.9 percent. See M. Sallam, COVID-19 Vaccine Hesitancy Worldwide: A Concise Systematic Review of Vaccine Acceptance Rates, Vaccines 2021, February 2021.

The projection assumes an accommodative monetary policy as headline inflation is managed within the target range. Headline inflation is expected to reach an average of 4.0 percent in 2021, the upper bound of the 2-4 percent inflation target range, before declining in succeeding years. The rise in inflation this year is projected to be driven by supply-side constraints on key food commodities and the rise in global oil prices. The global average crude oil price is expected to increase from US$41.3/bbl in 2020 to US$56.0/bbl in 2021, as trade and industrial activity recover. As the government addresses domestic supply constraints and oil prices stabilize starting next year, inflation is expected to retreat to within the target range. The central bank is expected to keep its accommodative monetary policy stance to support the weak economy. Likewise, monetary policy accommodation in advanced economies is expected to continue, especially as the U.S. Federal Reserve has indicated that interest rates will be kept near zero in the near term.

A conducive external environment will improve the growth prospects for Philippine exports. The global economy is expected to grow at 4.0 percent in 2021, driven by recoveries in advanced economies specially the United States and large EMDEs like China.[27] Annual growth in advanced economies is projected to rebound from -5.4 percent in 2020 to 3.3 percent in 2021 (Box 5). This expansion will help to prop up demand for Philippine goods exports, as roughly 70 percent of the country's exports are destined for high-income economies. Net services exports will also benefit from the BPO sector capitalizing on sustained demand, but tourism may be muted, as some international travel restrictions could remain. Meanwhile, import growth will likely accelerate this year as the government implements infrastructure projects, with renewed demand for capital goods, especially construction materials. As a result, the current-account surplus is expected to narrow to 1.3 percent this year, before turning to deficits in 2022 onwards (Table 3).

Table 3. Economic Indicators for the Baseline Projections.

	2018	2019	2020	2021	2022	2023
	Actual			Projected		
Real GDP growth, at constant market prices	**6.3**	**6.1**	**-9.6**	**4.7**	**5.9**	**6.0**
Private Consumption	4.2	4.3	-5.7	3.4	4.0	4.3
Government Consumption	1.5	1.1	1.3	1.3	1.4	1.2
Capital Formation	2.9	0.9	-9.1	1.8	3.3	2.7
Exports, Goods and Services	3.4	0.8	-4.7	2.0	2.9	2.7
Imports, Goods and Services	5.7	1.0	-8.7	3.9	5.8	4.9
Real GDP growth, at constat factor prices	**6.3**	**6.1**	**-9.6**	**4.7**	**5.9**	**6.0**
Agriculture	0.1	0.1	00	0.1	0.2	0.1
Industry	2.2	1.7	-4.0	1.5	1.7	1.7
Services	4.0	4.3	-5.6	3.0	4.0	4.1
Inflation (period average)	5.2	2.5	2.6	4.0	3.2	3.0
National government balance (% of GDP)	-3.1	-3.4	-7.6	-7.3	-6.5	-5.5
Current account balance (% of GDP)	-2.6	-0.8	3.6	1.3	-0.9	-1.4

Source: PSA; World Bank staff estimates.
Note: Growth sub-components show contributions to growth


Photo: Ungureanu Catalina Oana

27 See Global Economic Prospects, June 2021 edition for the updated global growth projections.

Box 5. Global Economic Outlook.

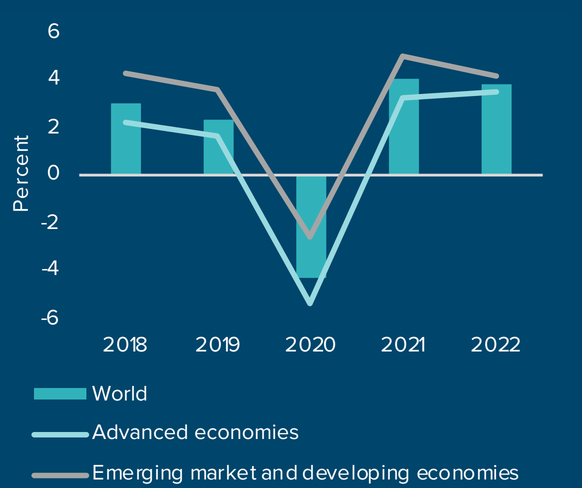
The global economy is projected to expand over the forecast horizon, but the recovery is likely to be uneven. Global economic output is expected to grow by 4.0 percent in 2021 and 3.8 percent in 2022, predicated on an effective management of the pandemic, progress in the vaccination rollout, and continued monetary policy accommodation (Figure 22). Additional fiscal stimulus in a few large economies, including the United States, is expected to have positive spillovers on other countries, which will further boost global growth. However, the path to recovery will be uneven across economies. Advanced economies, where vaccination efforts are ramping up, are expected to grow by 3.3 percent in 2021, while EMDEs are projected to expand by 5.0 percent, driven by the economic rebound of China (Table 4). Excluding China, the economic recovery of EMDEs will be more muted at 3.4 percent in 2021.

The global recovery remains fragile, as the COVID-19 pandemic continues to pose downside risks. A surge in COVID-19 infections could lead to the resumption of lockdowns and other mobility restrictions, putting the recovery at risk. The emergence of new SARS-CoV-2 variants that could be more infectious, lethal, and resistant to available vaccines is the biggest challenge to pandemic containment measures in 2021. Consequently, countries with slow vaccination efforts and a poor pandemic response will be more vulnerable to outbreaks and economic downturns. If high COVID-19 infections materialize, global economic growth is forecasted to be subdued at 1.6 percent in 2021 (Figure 23).

International trade is expected to improve, but the services trade will likely remain muted. After contracting by 9.5 percent in 2020, global trade is expected to increase by 5.1 percent in 2021. The rebound in trade is due to the easing of restrictions and the pickup in economic activity. While manufacturing will likely be the primary beneficiary of the economic recovery, the services trade like international tourism is expected to recover tepidly amid persisting fears of COVID-19 and restrictions on international travel.

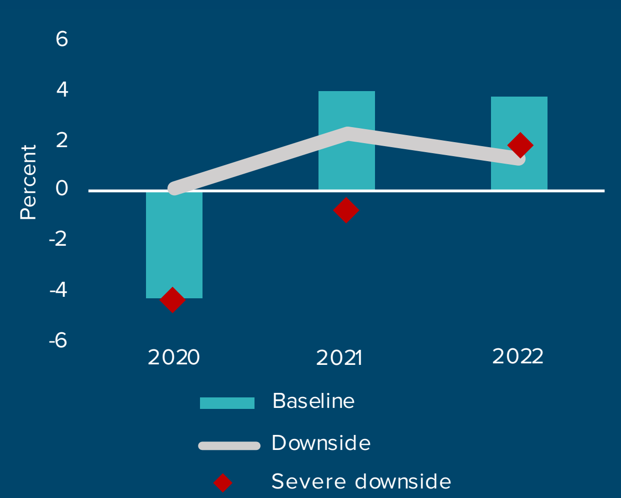
Financial markets are recovering, but vulnerabilities persist. The unprecedented support of monetary authorities around the world prevented the global financial system from collapsing in 2020. In advanced economies, monetary policies are expected to tighten in 2021 as inflation expectations rise due to improvements in economic prospects. Global yield curves steepened in the first quarter of 2021 as financial markets priced in the recovery of United States, an early indication of optimism. However, there are challenges to this outlook. For EMDEs, these developments could adversely affect their economic recovery, as higher interest rates could dampen investment spending, while the expectation of tighter monetary policy in advanced economies could slow capital inflows. Globally, the continued rise of debt burdens to historic levels, along with the deterioration of bank asset quality and bank profitability, could threaten the resilience of the global financial system.

Figure 22. While the global economy is expected to grow by 4.0 percent in 2021, ...



Source: Global Economic Prospects January 2021.

Figure 23. ... there are downside risks to the projections.



Source: Global Economic Prospects January 2021.

Table 4. Real Growth Projections.

	2018	2019	2020e	2021f	2022f
World	3.0	2.3	-4.3	4.0	3.8
Advanced economies	2.2	1.6	-5.4	3.3	3.5
Emerging market and developing economies	4.3	3.6	-2.6	5.0	4.2
East Asia and Pacific	6.3	5.8	1.2	7.4	5.4
Philippines	6.3	6.0	-9.6	5.5	6.3

Note: Developing East Asia & Pacific includes Cambodia, China, Fiji, Indonesia, Lao PDR, Malaysia, Mongolia, Myanmar, Papua New Guinea, Philippines, Solomon Islands, Thailand, Timor-Leste, and Vietnam.
Source: Global Economic Prospects January 2021; East Asia and Pacific Economic Update April 2021.

Private consumption is expected to rebound this year as economic conditions improve, but weakness is expected in the first half of the year due to inflation and higher COVID-19 cases. Household consumption is expected to recover this year as remittances recover and employment slowly improves. It may, however, weaken in the first half of the year amid higher inflation and the resumption of a strict community quarantine in the National Capital Region and nearby provinces. Consumer confidence levels remained in negative territory in the first quarter of 2021. The loosening of restrictions is expected to revitalize business activities, which would help create jobs and address household income losses, while a recovery of foreign markets is likely to lead to an increase in the demand for overseas Filipino workers. Private consumption is anticipated to expand by 4.7 percent in 2021, before accelerating to 5.4 percent in 2022, supported by election-related activities and spending.

Following a significant contraction in 2020, capital formation is projected to recover in the next two years. Capital investment is estimated to expand by 8.3 percent in 2021 from a contraction of 27.5 percent in 2020, driven by the rollout of public infrastructure investment projects. The government remains committed to pursuing its infrastructure investment agenda, as ramping up capital spending will help to restore business confidence and accelerate the economic recovery. However, private investment spending may remain tepid this year due to uncertainty and subdued bank lending. Some large corporations continue to see a deterioration of their balance sheets amid the ongoing pandemic. Nonetheless,as economic conditions improve and business sentiment strengthens, private investment is expected to contribute more strongly to capital formation next year. It will be important to attract private sector investment, including FDI, as the government's fiscal space continues to dwindle because of increasing pandemic-related expenditures.

Services and manufacturing activities are expected to rebound and drive growth in 2021. The services sector is expected to lead the growth recovery in 2021. The reopening of the economy and loosening of restrictions bode well and will bring vitality for transportation, restaurant and food services, and wholesale and retail trade. Some subsectors have strongly withstood the pandemic and expected to sustain its growth such as the information and communication, and financial and insurance. However, as some social distancing measures will likely remain, the expected 5.0 percent growth in the services sector in 2021 is lower than pre-COVID levels. Meanwhile, manufacturing activities will likely gather steam as domestic and external demand return, benefitting from the economic recovery in China and the U.S. fiscal stimulus-induced consumption which will increase demand for Philippine exports (Box 6). Construction activities will have to rely on public infrastructure investments as private investors remain cautious of the uncertain environment. Finally, agriculture is expected to grow at 1.1 percent in 2021, but unresolved productivity challenges and vulnerability to weather-related shocks preclude a growth acceleration in the near term.

Photo: Jed Regala

Box 6. Spillover to the Philippines from the U.S. Fiscal Stimulus.

The U.S. fiscal stimulus is expected to boost global growth which will generate spillover effects on the Philippine economy. The US$1.9 trillion (9 percent of GDP) additional fiscal stimulus in the United States will support global recovery and materially raise global growth.[28] The stimulus will boost incomes and raise U.S. consumption for both domestic and imported goods, which bodes well for countries with strong linkages to the U.S. The Philippines can potentially benefit from positive spillovers from the U.S. fiscal stimulus through the trade, investment, remittance, and confidence channels. At the same time, the stimulus-driven demand amid fast vaccination rollout in major advanced economies, may lead to higher transitory inflation and push interest rates higher earlier-than-expected. If the global steepening of yield curves or earlier-than-expected tightening of global financing conditions triggers an abrupt market correction, capital inflows could decline sharply, and cause financial turbulence.

The Philippines is likely to experience favorable spillovers through the trade channel as the U.S. fiscal expansion boosts global and Philippine exports. As with most of its regional peers, the Philippines is integral to the East Asian regional value chain with its exports mainly going to advanced economies. In 2020, 15.2 percent of the country's exports (2.7 percent of GDP) went to the U.S., 15.5 percent (2.7 percent of GDP) to Japan, and 10.7 percent (1.9 percent of GDP) to the European Union (Figure 24). Estimates based on pre-pandemic data suggest that the direct impact of the U.S. stimulus and the indirect impact through the increased growth among trade partners on Philippine exports could boost GDP growth in the Philippines by an additional 0.6 percentage points per year over the next two years. Exports of services are likely to remain muted, though. Tourism activities are unlikely to restart in 2021 as international travel and routes remain closed. However, the BPO sector is likely to grow as the U.S. accounts for 60 percent of BPO services in the Philippines. Considering the offsetting impact on tourism and BPO, the net impact on services exports is expected to be small.

The Philippines may benefit, but only marginally, from increased FDI inflows. The growth contribution of foreign capital is relatively limited for the Philippine economy with foreign direct investments (FDI) representing only 1.8 percent of GDP. Spillovers to FDI inflows could be marginal as binding constraints such as restrictive FDI regulations are among the major reasons behind lagging FDI inflows. The Philippines ranked as the most restrictive relative to its peers per OECD's FDI restrictiveness index. Several restrictions relate to equity restrictions, stemming from the foreign ownership limitation of 40 percent across multiple sectors, the lowest allowed share of foreign ownership among regional peers. Domestic business regulations are also highly restrictive, and the Philippines has one of the highest levels of market concentration among major ASEAN countries.

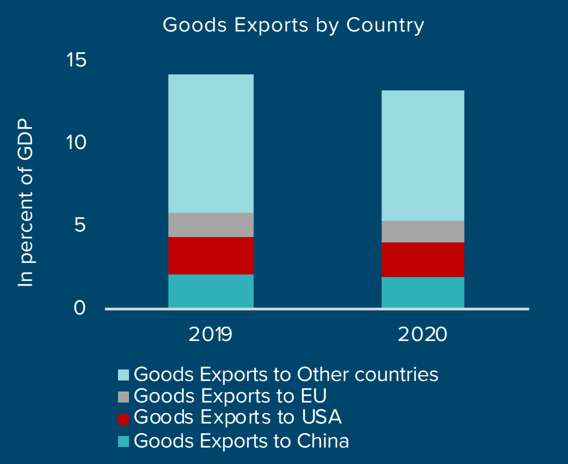
There is risk that foreign capital may leave emerging markets and return to safer advanced economy markets, resulting in financial turbulence. The Philippines may suffer from episodes of capital outflows from emerging markets such as those seen during the 2018 U.S.-China trade war and 2013 taper tantrum. This divestment of assets, a result of investors flying to safer markets, can contribute to swings in the foreign exchange market and weaken the peso. For instance, the increase in U.S. treasury bond yields during the 2013 taper tantrum resulted in a 24.0 percent decline in the Philippine Stock Exchange index, and a 7.2 percent depreciation of the peso by end-2013. These adverse developments, though not expected to impact growth directly, may cause financial volatility and may compromise the country's macrofinancial stability.

Overseas remittance inflows are an important channel through which the stmulus can impact the Philippines. The U.S. has been a significant source of remittances to the Philippines. In 2020, nearly 40 percent of total remittances (3.2 percent of GDP) came from the U.S. (Figure 25). The flow has continued in the first two months of 2021 where remittances from the U.S. grew 6.5 percent year-on-year in the first two months of 2021. In addition, positive spillovers to the global economy could further boost remittance flows in general, given the diversity in overseas Filipino deployment in terms of occupations and country of deployment. The resilience of remittances amid the pandemic likely rests on a number of factors including the strong familial ties among Filipinos, and increased digital adoption of financial technology that formalizes the remittance channel, and the countercyclical nature of remittances.[29]

28 Please see the Global Economic Prospects, June 2021, for the revised World Bank global forecast.

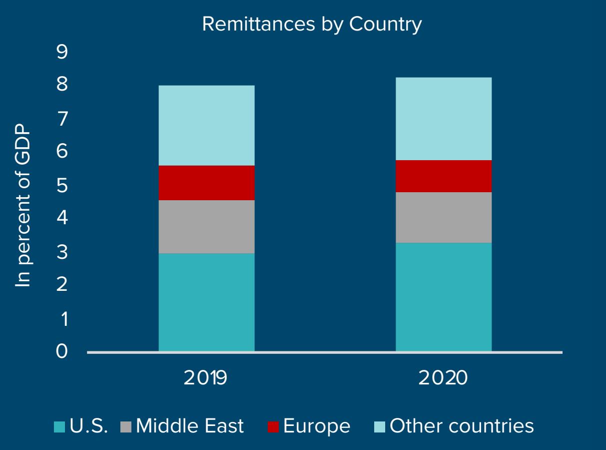
29 OECD, 2017. "Interrelations between Public Policies, Migration and Development in the Philippines," Paris: OECD. See also E. Tan, 2006. "Overseas Filipinos' Remittance Behavior," UPSE Discussion Paper 2006-03. Quezon City: University of the Philippines

Figure 24. The Philippines may benefit from an increase in exports to the U.S. and other advanced economies.



Source: PSA.

Figure 25. Faster global growth could lead to an increase in overseas remittance inflows.



Source: BSP.

Photo: SasinTipchai

2.2 Poverty and Shared Prosperity

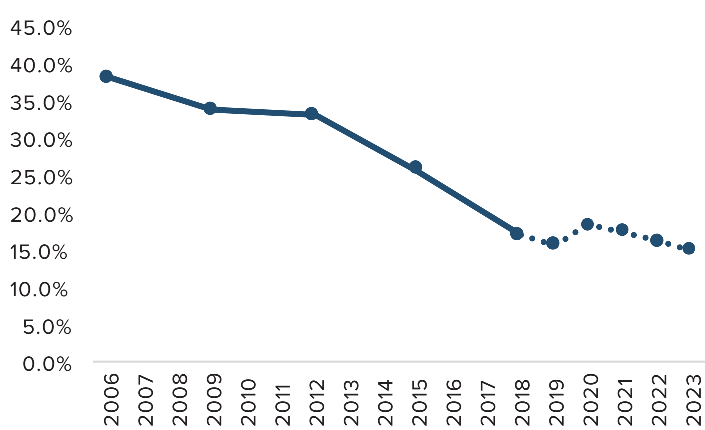
The pandemic continues to put pressure on household income which posts further risks to household welfare. Poverty is estimated to increase by around 1.4 percentage points, representing about 2.0 million more poor Filipinos, between 2018 and 2020, before declining and maintaining a downward trend to 2022.

The recent surge in COVID-19 pandemic posts further risks to household welfare. The return to stricter community quarantine measures that began in end-March and the uncertainty as to when these will be relaxed, further push back the rebound of economic activities. Like last year, this will result in job losses and further erosion of household incomes. Findings from the World Bank COVID-19 monitoring surveys (December 2020 – January 2021) show that households continue to experience income losses, with 41 percent of households reporting decreased or no income compared to their pre-pandemic usual income.

Without sufficient support from government, poor and vulnerable households are likely to experience food insecurity and further inequities to social and human development. In the most recent World Bank household survey, 2 in 5 households were worried of not having enough food for the following week. Households had difficulty accessing health services due to lack of finances. Three in five households cited this reason for not obtaining the needed medical treatment. Most of households reported that their school-aged children were enrolled but effectiveness of distance learning was a big concern especially among poor households. Lack of internet access likely explains the gap in access to various types of learning modalities. Only 40 percent of the poorest households had internet access compared to the 70 percent share of the richest households. These strains to human development will likely lead to adverse outcomes affecting human capital and productivity.

Continued pressure on household income will likely cause the poverty to increase in the short term. Poverty is estimated to increase by around 1.4 percentage points between 2018 and 2020 (based on the lower middle-income poverty line of 3.2 dollars a day, 2011 PPP). This represents around two million more poor Filipinos in 2020 than in 2018. The reimposition of stricter community quarantines risks raising poverty further. However, if wage and nonfarm employment increase with the anticipated GDP growth and inflation is stable, the poverty rate will likely decline back to its 2018 level by 2021 and maintain a downward trend through 2022 (Figure 26).

Figure 26. Actual and projected $3.20-a-day povery rates (%)



Source: World Bank Staff Estimates

2.3 Risks and Policy Challenges

Emerging virus variants, tight global vaccine supply, and slower progress towards mass vaccination are key downside risks to the growth projection. These may prolong the pandemic which will adversely impact firm solvency, banking sector resilience, public financing needs, and debt levels. Risks also emanate from the external sector through a slower-than-expected global recovery, trade disruption, and trade protectionism. A commitment to structural reforms, easing of foreign investment restrictions, and addressing the socioeconomic impact of the pandemic must remain priorities of the government.

The most significant downside risk remains to be the resurgence of COVID-19 cases. Flattening the infection curve is the primary challenge for the authorities amid the recent news of a more contagious virus variant that has entered the Philippines. A potential resurgence of infection may yet overwhelm the country's healthcare system. Testing, tracing, isolation, and treatment measures, along with the vaccination program are key to the public health response; however, tight global production supply and vaccine nationalism risk delaying the arrival of vaccines. Failure to effectively contain the virus or implement the mass vaccination program may extend mobility restrictions, which could lead to more losses of jobs and income, delaying the domestic economic recovery.

The impact of the health crisis on firms poses a risk to the financial system. In a national COVID-19 survey conducted in November 2020,[30] a large share of firms reported acute liquidity constraints, including not having enough cash and falling behind in payments. About two-thirds of respondent firms did not have enough cash to service obligations such as payroll, suppliers, taxes, or loan repayment beyond a month. This low solvency among firms poses significant risks to the financial system. Moreover, the financial system is highly interconnected with non-financial corporates through mixed conglomerate structures.[31] With a significant share of assets in the banking sector related to mixed conglomerates, a key source of contagion among banks is their common exposure to large conglomerates. In 2018, about 80 percent of bank loans in the Philippines went to non-financial corporates, higher relative to regional and international peers, reflecting in part the country's underdeveloped corporate debt and equity markets.

A slower growth recovery risks widening the fiscal deficit, resulting in the need for more aggressive fiscal consolidation. Slower economic growth, resulting from a prolonged health crisis, could widen the deficit through a decline in tax revenues, increasing the pressure on the country's increasingly limited fiscal space. In response, the government would likely resort to more aggressive fiscal consolidation to ensure long-term fiscal sustainability.[32] This approach could further dampen the country's short-term growth prospects, as fiscal policy has largely been supportive of growth in recent years. In particular, the implementation of the country's infrastructure investment program, which is expected to slow in 2022 due to re-devolution in relation to the Mandanas Ruling,[33] could dampen the country's short and long-term growth prospects.

Public debt remains sustainable, predicated on the expected growth recovery and fiscal consolidation. With the anticipated high financing needs in the near term, the debt-to-GDP ratio is projected to increase from 54.5 percent in 2020 to nearly 60.0 percent in 2023. Yet, debt remains sustainable, as debt dynamics are expected to revert to a downward trajectory after 2023 due to fiscal consolidation and the return to a positive interest-growth differential. To keep debt levels sustainable, the government is expected to temper the growth of public expenditure and increase tax revenues. While a portion of the debt mix relies on external funding, 69.4 percent of outstanding debt is peso-denominated, and long-term debt accounts for about 94 percent of the external portfolio, as of end-2020. The debt composition is expected to remain stable, with low shares of short-term debt and foreign-currency-denominated debt, in

30 Monitoring COVID-19 Impacts on Families and Firms in the Philippines: http://www.worldbank.org/philippines/covidmonitor. Firm Survey Results: Round 2 – November 2020.

31 This interconnectedness is characterized with overlapping ownerships between banks and non-bank companies, and the provision of loans from banks to conglomerates.

32 The fiscal adjustment needs to protect in the short term those categories of spending with critical impact on service delivery and long term economic and social development. Those lines are often related to the provision of inputs and maintenance. These categories of spending have several characteristics: (1) they are critical for the operation of sectors (internal efficiency) and for the continuation of service delivery (social returns); (2) they often have a relatively low amount of funds; and (3) they are much easier to reduce or cut and constrain than the more politically sensitive wages and subsidies.

33 Set for implementation in 2022, the Mandanas Ruling clarifies that the Internal Revenue Allotment share of LGUs should come from all national taxes, such as customs duties, and not just from taxes collected by the Bureau of Internal Revenue.

line with the government's debt management strategy.

There are also external risks. The risk of a slower-than-expected global recovery, arising from new waves of COVID-19 cases in some major economies, may lead to sluggish demand for Philippine exports and lower levels of FDI and remittance inflows. Disruptions in international logistics and global value chains, if not timely resolved, may heavily impact the country's external trade. With international flights still limited, the prospect for international tourism remains weak, which affects the Philippines, where tourism represented 12.7 percent of GDP in 2019. Moreover, trade protectionism may intensify, given ongoing trade tensions between the United States and China and emerging vaccine nationalism, with supplies cornered by wealthy countries.

The key health policy response remains the management of the virus spread, complemented with the roll out of the vaccination program. Public health protocols such as mask wearing and physical distancing remain the first line of defense to manage the spread of the virus specially as case numbers remain elevated. Testing, tracing, isolation and case management have to be scaled up, along with expedient roll out of vaccines. The vaccination program requires stringent planning, high fidelity of stringent planning, effective implementation, and more importantly, implementation, and more importantly, seamless coordination between the national government, local government units, and the private sector. As vaccine hesitancy remains high, the authorities may consider dialogue-based or incentives-based interventions to encourage more Filipinos to get vaccinated.

The effective delivery of social protection programs will help to reduce the extent to which the crisis adversely affects long-term human capital accumulation. COVID-19 pandemic-related shocks, including hunger incidences, have resulted in higher levels of child malnutrition, especially among the poor. It is important to reduce the extent of these losses, and mitigate the shocks which may lead to a persistent impact on wellbeing and future economic opportunities. Social programs, including cash transfers, can help alleviate food and subsistence conditions. However, moving swiftly to provide transfers and support to poor households will require an improvement in the government's delivery and implementation capacity. National and local government authorities need to coordinate their efforts to ensure timely and efficient deployment of public programs.

Relaxing restrictions on FDI is expected to boost the economic recovery. Regulations related to foreign investments remain more restrictive in the Philippines than in regional peers. The Philippines faces even tighter regional competition, as its regional peers recently implemented various incentives to attract investors. For example, Indonesia's recent Omnibus Law on Job Creation removed critical restrictions on investment, while Vietnam's retail trade sector only has a minimum paid-up capital of US$10,000. The urgent passage of three investment reform bills, which seek to relax FDI restrictions, will help improve the country's competitiveness in the region (Box 2).

Drawing in greater private sector participation in public infrastructure projects will be important as the government faces limited fiscal space in the short term. The public financing needs will remain elevated as public revenues are tempered by the weak economy while public expenditures rise to address the pandemic. The limited fiscal space will compel the authorities not only to improve the efficiency in public expenditures, but also cut on public investments. While the government remains committed to pursue its infrastructure investment agenda, it is advisable to draw in greater participation from the private sector through a renewed focus on public-private partnership, for which the country has successful experience. Ramping up infrastructure spending will accelerate the recovery through job creation, and narrow the infrastructure gap to boost productivity growth and expand growth potential in the long term.

The authorities need to prudently manage institutional changes in 2022 and address challenges related to upcoming institutional transitions. There are two key institutional changes in 2022: the change in administration and the implementation of the Mandanas Ruling. The national election will usher in a new administration, but not without raising temporary uncertainty surrounding the direction of future economic policy. Swiftly and decisively establishing policy clarity will help to reassure the domestic and foreign business community. The Mandanas Ruling, which will increase transfers to LGUs, represents a risk to budget execution and service delivery. The implementation of the ruling will result in an additional increase in Internal Revenue Allotment allocations to LGUs of around 1.0 percent of GDP beginning in 2022. Several national government agencies will re-devolve the funding and execution of programs, projects, and activities back to LGUs. However, the transition toward re-devolution comes with several operational challenges. Part III of this report discusses the likely impact of the transition and explores policy options to manage the transition and maximize the unrealized potential of increased devolution in the Philippines.

Part III

Understanding the Fiscal Impact of the Mandanas Ruling

This chapter assesses the potential fiscal impact of the Mandanas Ruling using a novel subnational fiscal database. Local government units will receive a permanent and substantial increase in fiscal transfers starting in 2022 of around 1 percent of GDP (Php234 billion in 2022). This increase is due to a decision by the Supreme Court (the Mandanas Ruling) that increased the share of national government tax revenue transferred to local governments. This development has prompted the national government to revisit its approach towards decentralization and paves the way for the country to address long-standing structural challenges which have limited the full potential of decentralization. However, while the Mandanas Ruling provides an opportunity to strengthen decentralization, a poorly managed implementation of the Mandanas Ruling represents a significant risk to local development. In particular, local governments are likely to face issues on weak budget execution, while the transition towards re-devolution could lead to gaps in service delivery. Overcoming these structural challenges while managing the transition towards increased decentralization requires several short and long-term policy recommendations focused on building capacity, improving horizontal equity through strong fiscal equalization, and improving transparency and accountability.

The chapter is structured as follows. Section 3.1 provides the historical context and recent developments of decentralization in the Philippines. Section 3.2 describes the four key structural challenges of decentralization which has led to its underperformance. Section 3.3 provides the key policy challenges in the implementation of the Mandanas Ruling. Section 3.4 uses the information provided by the subnational fiscal database to estimate the potential fiscal impact of the Mandanas Ruling. Section 3.5 provides policy recommendations.

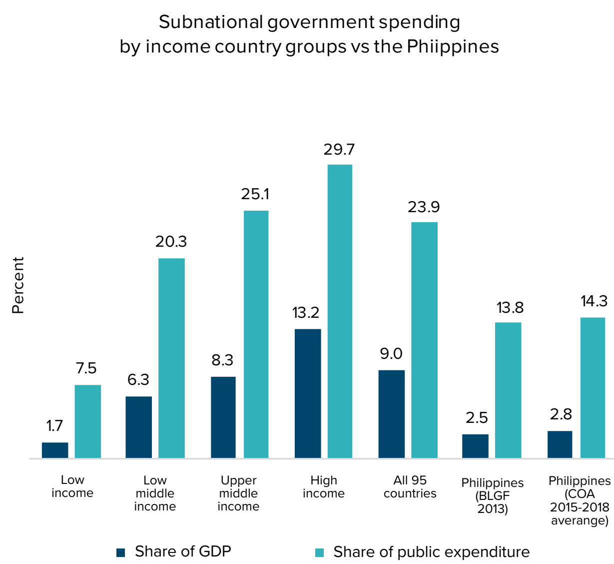
Photo: Michael D Edwards

3.1 Revisiting Decentralization in the Philippines

The passage of the 1991 Local Government Code marked a significant shift in the approach to local development and service delivery. It provided the framework for the devolution of local public administration and service delivery responsibilities to local government units (Box 7). It also provided local governments with enhanced revenue-mobilization powers and access to financing, which would accompany the increase in spending on devolved mandates. The objectives were to improve local service delivery and facilitate widespread socioeconomic development by bringing resource allocation and prioritization closer to constituents. However, decentralization under sub-optimal conditions could lead to inefficient outcomes, particularly in terms of service delivery.[34]

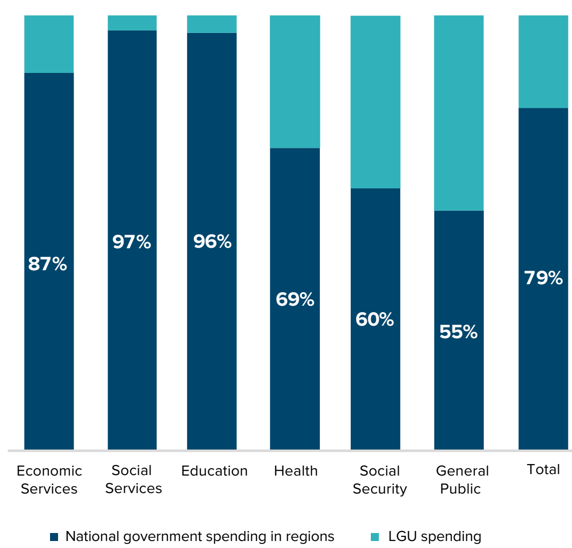
Three decades since the passage of the Local Government Code, decentralization has fallen short of its potential to improve service delivery. Local government spending in the Philippines remains low compared to peer countries that have undergone decentralization (Figure 27). While a large set of basic services has been devolved to local governments, the national government continues to spend an overwhelmingly large share on local public expenditure. This is true even for heavily devolved sectors such as health, economic services (e.g., agricultural extension and local public works), and social services (Figure 28).

Figure 27. Despite devolution, public spending remains heavily centralized in the Philippines...



Source: IMF; DBM; and Bureau of Local Government Finance (BLGF).
Note: 2013 data was used for the income country country groups and 95 countries in the OECD 2016 paper.

Figure 28. ...even for heavily devolved sectors such as health and economic services.



Source: DBM and BLGF.

Photo: Michael D Edwards

34 However, the potential trade-offs, especially under weak institutional settings, include hold-ups in decision-making processes (Treisman, 2007), lower economies of scale for service deliveries (Bardhan and Mookherjee, 2006), or higher local elite captures in developing countries (Reinikka and Svensson, 2004). Note: 2013 data was used for the income country country groups and 95 countries in the OECD 2016 paper.

Box 7. The 1991 Local Government Code.

The Local Government Code transfers statutory responsibility for providing and financing several basic services from the national level to local government units. The local government structure in the Philippines is composed of three levels, with provinces and highly urbanized cities at the highest level, followed by municipalities and component cities, and barangays (or villages) at the bottom tier (Atienza 2006, OECD 2016). Devolved mandates to local government units include local public works, health services, social welfare services, land-use planning, agricultural extension and on-site research, community-based forestry, waste management systems, and the operation and maintenance of various water supply systems. Functions are assigned based on the incidence of benefits, with provinces mandated to deliver intermunicipal services such as bridges tertiary health services, low-cost housing, and intermunicipal infrastructure for telecommunications and waterworks. Municipalities and barangays provide "proximity services" such primary health care, municipal/barangay roads and bridges, and solid waste collection.[35] While cities provide services of both provinces and municipalities.

To complement the increase in spending mandates, the Code expanded the resource base of local government units. Sources of revenue are classified into own-source and external-source revenues.[36] Own-source revenues are largely comprised of tax and non-tax revenues, with taxes representing the largest share. Provinces and cities are authorized to levy real property taxes, while municipalities and cities can levy community and local business taxes (Manasan 2004; UN Habitat 2011). Meanwhile, external-source revenues include grants and aid to local governments, loans and borrowing, and a share of national tax revenue specified by law. Shares from national taxes include the Internal Revenue Allotment as well as allocations from specific tax sources.

The Internal Revenue Allotment comprises around 90 percent of external-source revenues and accounts for around 60 percent of all local government revenues. The Internal Revenue Allotment is an unconditional grant given by the national government, which is mandated by law to share 40 percent of all national taxes to local government units. The distribution of the Internal Revenue Allotment across local governments is based on a formula that depends on the type of local government, population size, land area, and equal sharing considerations. The Code also mandates the automatic release of the Internal Revenue Allotment. Apart from fiscal transfers, credit financing is another external source of funds, which usually take the form of loans. However, the Code imposes several restrictions on borrowing by local governments and is, therefore, rarely used as a means of augmenting funds.[37]

Yet, large regional disparities in local service delivery still persist since the passage of the Local Government Code. In the health sector, while several studies note some improvement in child health outcomes, such as infant mortality,[38] the quality of health services remains uneven across the country (Capuno 2008; Cuenca 2018). For example, bed capacity has declined since 1990 despite devolution.[39] Overall, the weak relationship between local government spending and health service delivery and outcomes is attributed to: (i) disparities in local government unit spending; and (ii) a mismatch between the cost of devolved functions and sources of financing (Uchimura 2012; Cuenca 2020). Similar outcomes can be seen in local public works: road density varies across regions, and there is a sizable local infrastructure investment gap that needs to be addressed to improve local road infrastructure (World Bank 2011; Diokno-Sicat et al. 2020a).

The Mandanas Ruling provided the impetus for the national government and local government units to revisit decentralization in the Philippines. In April 2019, the Supreme Court confirmed its 2018 decision in favor of the petitions raised by governors Hermilando Mandanas and Enrique Garcia Jr., who contended that local governments

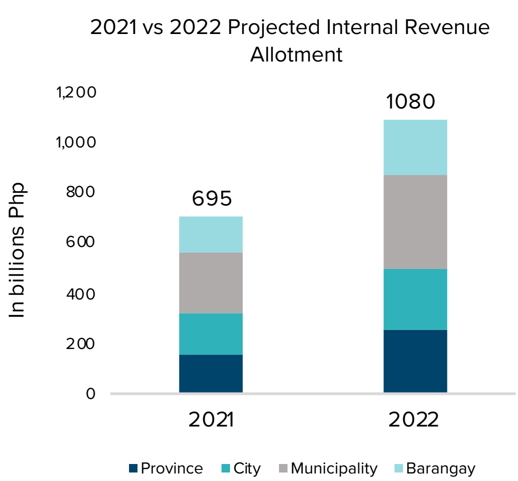
35 Proximity services include services whose benefits are limited to a specific area.
36 The Bureau of Local Government Finance (BLGF) provides detailed information on the sources of revenue. Source: https://blgf.gov.ph/wp-content/uploads/2015/08/SIE_CY_2004_Volume_1_new.pdf.
37 Under the Code, local governments are constrained by a legal borrowing capacity and can only borrow from national lending institutions. A more detailed description of the restrictions is available in section 2 of PD No. 752.
38 The number of infant deaths has declined from around 40,000 in 1990 to around 20,000 in 2016.
39 Bed capacity per 1,000 population declined from around 14.4 in 1990 to 9.9 in 2014.

have not received their just share of national tax collections through the Internal Revenue Allotment system.[40] As a result, Internal Revenue Allotments are programmed in the 2022 national budget to increase by 55 percent, reaching Php1.08 trillion (4.8 percent of GDP) compared to 3.5 percent of GDP in 2021 (Figure 29 and Figure 30). The substantial increase in transfers has prompted the national government to rethink its approach towards decentralization, by first re-devolving service delivery mandates currently funded and executed at the national level. For local government units, the increase in resources addresses one of the key binding constraints towards efficient service delivery. However, further strengthening decentralization will require collaboration between the national government, national government agencies[41], and local government units in order to create an enabling environment in delivering meaningful decentralization to its people.

However, the large increase in the budget of local government units raises concerns on local absorptive capacity and inefficient budget implementation. Many local government units, often smaller rural ones, are ill-equipped to assume devolved responsibilities. Local governments often lack the manpower and technical capacity to properly plan, prepare, implement, and monitor projects and services. This limitation in capacity is reflected in underspent budgets as measured by the budget execution rate, undermining effective service delivery. The analysis presented in this chapter shows that local government units suffer from low budget execution, particularly in terms of capital outlays, which are likely to worsen post-Mandanas Ruling. Recent experience of local government units that received a large increase in their budgets shows that they have limited absorptive capacity to effectively manage and implement large budget increases, leading to idle resources and delays in service delivery.

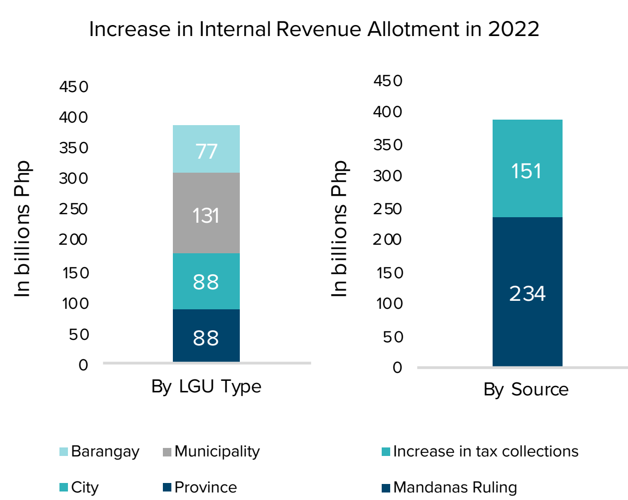
In the midst of the country's worst socioeconomic and health crisis brought on by the COVID-19 pandemic, low budget execution denies the Filipino people of much needed services. Fiscal space is currently more limited, as fiscal balances have deteriorated amid a historic recession. Limited fiscal space has resulted in a competition for public resources at a time when public health is under constant threat and poverty is worsening. Under these challenging times, it is important to ensure proper allocative and implementation efficiency to respond to the needs of the people and improve service delivery. In the short-term, this means properly leveraging the increased local government revenues to help restore inclusiveness and strengthen resilience as the country recovers from the COVID-19 crisis. In the long-term, doing so would require a collaborative relationship between the national government and local government units to understand who needs to spend on what, and determine at what level of devolution.

Figure 29. The Mandanas Ruling will lead to a sharp increase in Internal Revenue Allotment allocations...



Source: DBM and World Bank staff calculations

Figure 30. ... which is projected to increase the share of Internal Revenue Allotment in 2022.



Source: DBM and World Bank staff calculations

40 The Mandanas Ruling mandates the inclusion of customs duties and several other national taxes in the computation of the IRA beginning in 2022. Tax revenues from the Bureau of Customs account for roughly 20 percent of total tax collections.
41 National Government Agencies refer to units of the national government, including executive departments created by law and the bureaus and offices that fall under their respective departments.

3.2 Unfulfilled Promise of Decentralization

Existing Weaknesses in Decentralization Design and Implementation[42]

Effective service delivery has been constrained by the four structural challenges that have negatively affected the incentives and capacity of local governments to fulfill their primary role as basic service providers. These structural challenges weaken the mechanisms for ensuring accountability from local governments which are important to ensure that increased decentralization translates into improved service delivery. First, the lack of mobilization of own revenues by local government units which contributes to a substantial vertical fiscal gap (i.e., the mismatch between spending responsibilities and own-source revenues). Second, the design of the intergovernmental fiscal transfer system, which creates horizontal fiscal imbalances. Third, overlapping service delivery responsibilities across different levels of government which diffuse accountability. Fourth, the lack of technical capacity at the local level resulted in their continued dependence on national government agencies in the delivery of devolved public services.

The vertical fiscal gap faced by local government units is among the main factors preventing them from fulfilling their devolved mandates. Total local government spending increased from 1.6 percent of GDP in 1992 to 3.2 percent of GDP by 2019. However, own-source revenue generation by local government units remained limited, as several aspects of the Local Government Code limited the revenue generating powers of local government units (Figure 32). For example, the Local Government Code substantially limits the power of local government units to set local tax rates, further contributing to their weak revenue generation capacity.[43] In addition, while local tax assignment is generally consistent with the criteria of appropriateness (economic efficiency, equity, and administrative feasibility), the most productive tax bases are left to the national government (Manasan 2004; World Bank 2010). Among local taxes, only the real property tax and business tax generate substantial revenues.

This vertical fiscal gap leads to a large share of spending on general public services at the expense of spending on devolved mandates. The limited resources for local governments leads to general public services accounting for a large share of local government spending (Figure 31). For example, spending on sectors such as health and social services is lower than general public services. Moreover, the share of spending on general public services is relatively large for local governments with limited resources. This leads to lower levels of spending on key sectors for resource-constrained local government units. For areas with a high poverty incidence, a high share of spending on general public reservices results in less spending on key sectors such as social services (Figure 32). These spending dynamics contribute to the uneven outcomes typically associated with inefficient decentralization and lead to persistent inequities across regions in the Philippines.

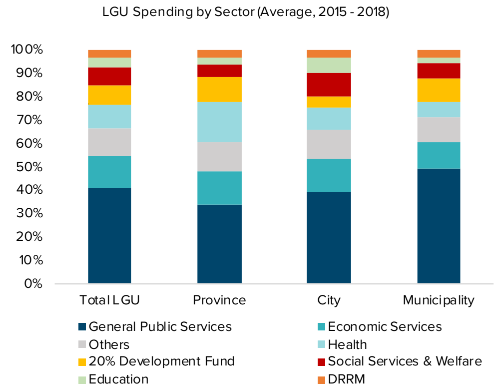
Weak revenue generation has led local government units to rely on external-source revenues to bridge the fiscal gap (Figure 34). To address this vertical fiscal gap, the Local Government Code provides increased access to fiscal transfers, primarily through the Internal Revenue Allotment. As own-source revenue generation remains relatively weak, local governments are typically highly dependent on the Internal Revenue Allotment (representing over 60 percent of revenues, on average) to finance local spending. Across local government units, city governments are the least reliant on internal revenue allotments, benefitting from their productive resource base and more expansive taxation powers, as their own-source revenues account for more than half of total revenues. In addition, own-source revenues usually represent only a small share of total revenues for many rural local governments, leading to an even greater dependency on the Internal Revenue Allotment for the country's poorest local governments (Figure 35 and Figure 36).

Photo: Pal Nikolaisen

42 This section reviews existing literature on decentralization in the Philippines, focusing on core governance issues that constrain efficient local service delivery. Established findings are supported by recent LGU fiscal data from the Commission on Audit.

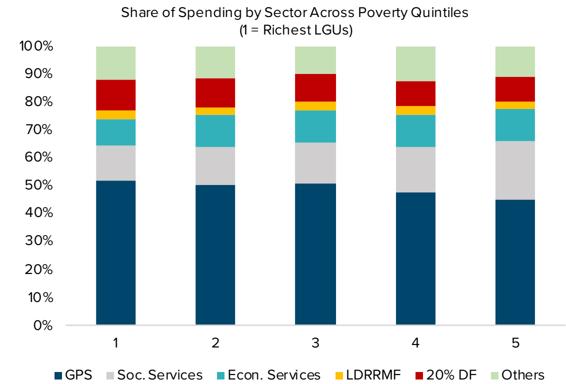
43 First, the LGC fixes the tax rates of some taxes that are assigned to LGUs (e.g., the Special Education Fund, the real property tax, and the community tax). Second, the LGC sets limits (floors and ceilings) on the tax rates that LGUs may impose under their discretion. Finally, the LGC mandates that tax rates can only be adjusted (Manasan 2004).

Figure 31. Spending on General Public Services represents the largest share of LGU budgets.



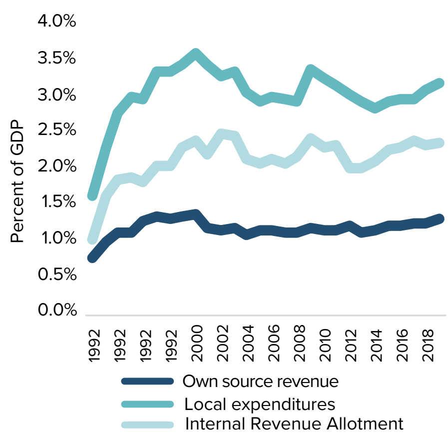
Source: Commission on Audit (COA) and World Bank staff calculations.

Figure 32. Poorer local governments need to allocate a larger share of their budgets to general services.



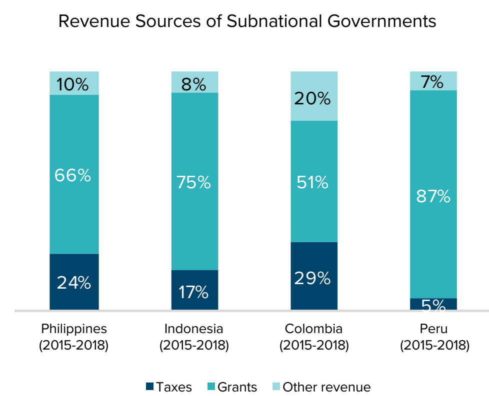
Source: COA, PSA, and World Bank staff calculations
Note: Local governments are divided into quintiles based on local poverty incidence and the type of local government..

Figure 33. Following devolution, there has been a mismatch between local governments' ability to generate own revenues and their expenditure responsibilities.



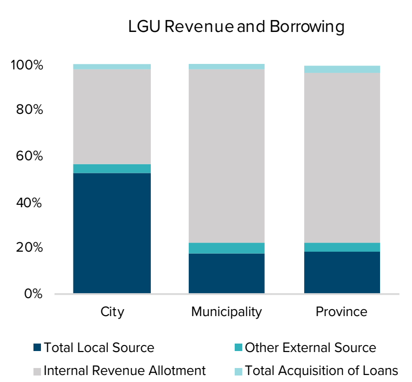
Source: BLGF.

Figure 34. Local governments in the Philippines rely on intergovernmental transfers to bridge the fiscal gap, similar to other countries.



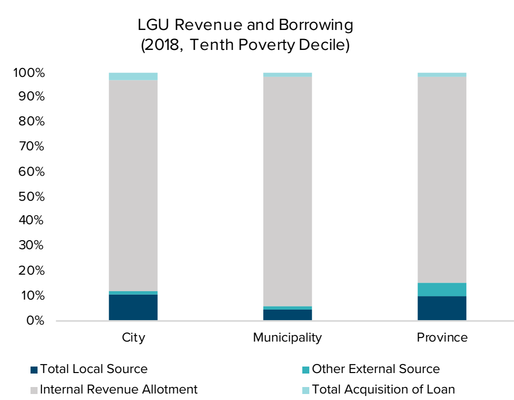
Source: IMF and DBM.

Figure 35. City LGUs are less dependent on the IRA than their provincial and municipal counterparts.



Source: World Bank staff calculations; PSA; and DBM.

Figure 36. Poorer LGUs are almost solely reliant on the IRA to finance spending.



Source: World Bank staff calculations; PSA; and DBM.

The dependence of local government units on Internal Revenue Allotments leads to weak incentives for own-revenue mobilization. Low own-revenue mobilization weakens the link between citizen tax/charge payments and local government spending and service delivery, which constrains horizontal accountability. Moreover, as local authorities are reluctant to increase tax collection given its political implications, the most common coping strategy is to lobby the national government or Congress to allocate discretionary funds to finance local infrastructure or services, perpetuating patronage and reducing allocative efficiency.

In addition, the Internal Revenue Allotment formula fails to address the horizontal fiscal imbalance across local government units. The current formula does not compensate for the varying levels of fiscal capacity between local government units, often worsening the horizontal imbalance among local government units at the same level (Manasan 2007; World Bank 2010). Moreover, the Internal Revenue Allotment fails to equalize the vertical (across different income classes) and horizontal (within the same income class) discrepancies, as it does not consider varying levels of poverty (World Bank 2016). These inefficiencies in the broad intergovernmental fiscal system hinder its main purpose of addressing inequalities across local governments in a comprehensive and systematic way, constraining rural and poorer local government units from delivering adequate services.

Overlapping service delivery responsibilities between different levels of government diffuse accountability and disincentivizes local government units from fully assuming devolved functions. The Local Government Code allows national government agencies to provide services and infrastructure if local governments do not have sufficient resources and technical capacity.[44] This incentivizes national government agencies to keep local government technical capacity low to retain a large share of service delivery responsibilities and resources. As a result, many national government agencies, such as the Departments of Public Works and Highways, Health, Agriculture, and the National Housing Authority, retain a substantive role in local service delivery and have a much larger budget than local government units. This has resulted in a complex institutional arrangement that has led to fragmentation in the planning, budgeting, and delivery of services and diffused lines of accountability.

Lastly, the lack of local technical capacity perpetuates the dependence of local governments on the national government (World Bank 2016). Local government units, particularly smaller and rural local governments, are not equipped to assume the responsibilities mandated under the Local Government Code. They lack the manpower and technical capacity to adequately plan, prepare, implement, and monitor service delivery. Local development plans are often developed without adequate citizen participation and lack accountability to address local needs. Implementation often lacks transparency, resulting in citizens being uninformed about what is being provided and at what cost. This has led to a situation where national government agencies do not relinquish their responsibility over service delivery due to lack of local capacity, but the capacity of local government units are not improved because they continue to depend on the national government.

Photo: Frolova_Elena

44 Section 17(c) of the LGC provides the legal justification for NGAs to continue implementing devolved public services as long as these are funded by the NG under the General Appropriations Act, special laws, or executive orders, or funded by foreign sources. Section 17(f) allows the NG or the next higher level of LGU to "provide or augment the basic services and facilities assigned to a lower level of local government unit when such services or facilities are not made available or, if made available, are inadequate to meet the requirements of its inhabitants."

3.3 The Mandanas Ruling: Policy Challenges and Initial Response

While the four structural challenges mentioned in the previous section are expected to persist beyond 2022, the Mandanas Ruling provides its own unique set of challenges. From a fiscal perspective, the national government's initial policy challenge is to maintain its fiscal health. Internal Revenue Allotments are set to increase by 1.7 percent of GDP in 2022, of which around 1.0 percent of GDP is due to the ruling. This increase in transfers can lead to a wider fiscal deficit, exacerbating fiscal sustainability risks during a historic recession and global health crisis. In this context, the national government has two options to ensure fiscal sustainability: (i) raise additional revenues worth 1.0 percent of GDP; or (ii) cut spending on functions already devolved to local governments. However, under the current socioeconomic and political climate, only the second option is feasible. As a result, the national government plans to ensure fiscal sustainability by re-devolving functions to local government units equivalent to 1 percent of GDP during the implementation of the Mandanas Ruling.

Beyond the immediate fiscal implications, the government faces several challenges which could compromise service delivery. Coordination challenges between the national government, which plans to reduce spending on devolved services, and local government units, which are expected to bridge the financing gap through an increase in Internal Revenue Allotments, could undermine the quality and quantity of service delivery, as evidenced by past experience (World Bank 2011). Moreover, local governments suffer from weak budget execution capacity, which will likely constrain the effectiveness of re-devolution. Lastly, the mechanisms for holding local chief executives accountable for performance are weak and frequently ineffective. Therefore, efforts are needed to implement mechanisms that can incentivize local governments to improve service delivery, such as strengthening demand-side accountability from citizens.

The national government is taking steps to manage the transition to increased decentralization. To facilitate the transition towards increased devolution, the national government is expected to issue a forthcoming executive order that transfers national government spending on devolved functions back to local government. As part of the executive order, the national government has instructed national government agencies to prepare devolution transition plans to ensure proper continuity in the provision of public goods and services at the local level. The transition plans would identify national government programs, projects, and activities that would be re-devolved (in both funding and execution) to local government units beginning in 2022. National government agencies will take on a more strategic role, with an increased emphasis on their oversight and steering functions and provision of capacity building support to local government units.

However, local government units have raised concerns with the national government's approach in managing the transition[45]. Although the process towards re-devolution has started at the national level, local government units have raised concerns regarding the uncertainty surrounding the process of re-devolution. For instance, there are reports of local governments being approached by various national government agencies to discuss functions which will be re-devolved, some of which are not covered by the Local Government Code. In addition, there is a lack of clarity in which functions would be devolved to local government units. Some local governments have also raised concerns that the fiscal cost of re-devolution may outweigh the increase in resources. These issues highlight the need for increased planning and coordination between all levels of government to ensure a successful transition towards re-devolution and improved service delivery post-Mandanas Ruling.

45 This paragraph benefitted from insights from a round table discussion with different local government executives.

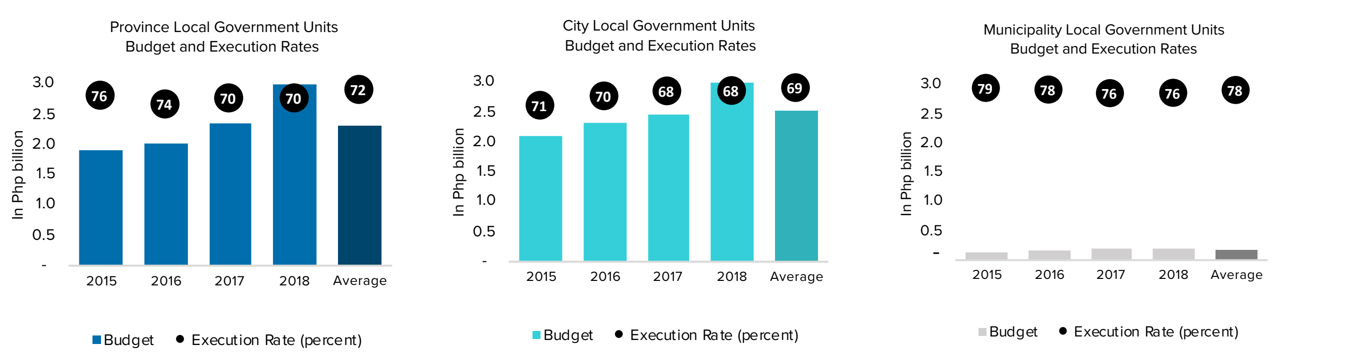
3.4 Potential Fiscal Impact of the Mandanas Ruling

The Mandanas Ruling is expected to raise local government spending due to the increase in local resources, although concerns regarding absorptive capacity and fiscal imbalances remain. Using the subnational fiscal database, the analysis shows that, underspending by governments is likely to worsen post-Mandanas Ruling as many local governments do not have the capacity to absorb a significant increase in revenues. As previously mentioned, limited absorptive capacity is a product of incentives for national government agencies to keep local government technical capacity low to retain a large share of service delivery responsibilities and resources. Moreover, the analysis in this section applies to all types of local government units, as results were robust to different local government type and capacity. In addition, estimates on aggregate local government spending show that the vertical fiscal gap and horizontal fiscal imbalances are not addressed by the Mandanas Ruling. This section discusses these issues in detail, highlighting the likely risks faced by local governments in the implementation of the Mandanas Ruling.

Drivers of Local Government Unit Budget Execution: Budget Size and Capital Outlays

Large and increasing budgets lead to lower budget execution due to weak absorptive capacity of local governments government units. Between 2015 and 2018, the budget execution rates of local government units have declined as their budgets have steadily increased (Figure 37). However, the decline in budget execution rates has been smaller for municipal governments than for their city and provincial counterparts, as municipal budgets increased at a relatively lower rate. On average, budget execution rates for municipal governments were around 10 and 5 percentage points higher than that of city and provincial governments, respectively. In addition, this discrepancy can be partly explained by the substantial disparity in the size of local government budgets.

Figure 37. The size of the budget is one of the key drivers of budget execution among local government units.

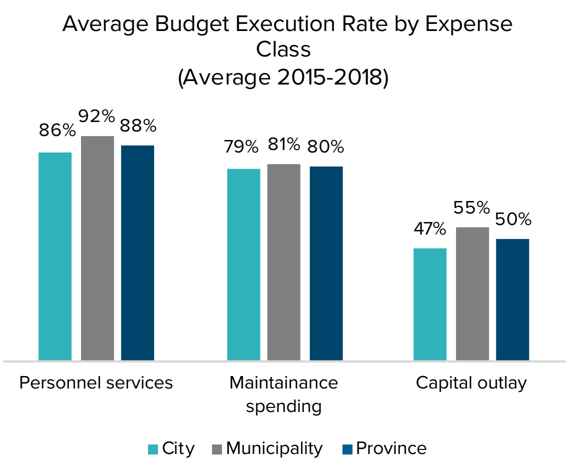


Source: World Bank staff calculations using COA LGU Financial Statements.

Photo: wutzkohphoto

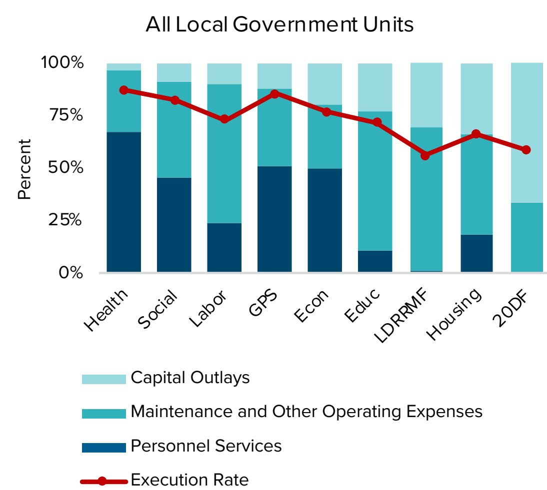
Constraints to absorptive capacity are also reflected in lower budget execution rates as the budget share of capital outlays increases. In general, capital outlays have significantly lower budget execution rates than personnel services or maintenance and other operating expenses (Figure 38). As a result, a larger share of capital outlays in the budget results in overall lower budget execution, regardless of sector and local government type (Figure 39 and Figure 40). This is not surprising given the complexity of capital spending, nor is this outcome unique to local governments, as certain national government agencies have similar, if not lower, execution rates for capital outlays. However, the budget for capital outlays is significantly higher at the national level than at the local government level. An ordinary least squares regression using the subnational fiscal database revealed a significant inverse relationship between that budget execution rates and capital outlays budget shares (Annex 1, Table A2). Case studies of select local government units are likewise conducted to further investigate the relationship (Box 8). Low budget execution could, therefore, indicate delayed, incomplete, or unimplemented capital-intensive infrastructure projects.

Figure 38. The execution of capital outlays is far lower than that of recurrent spending.



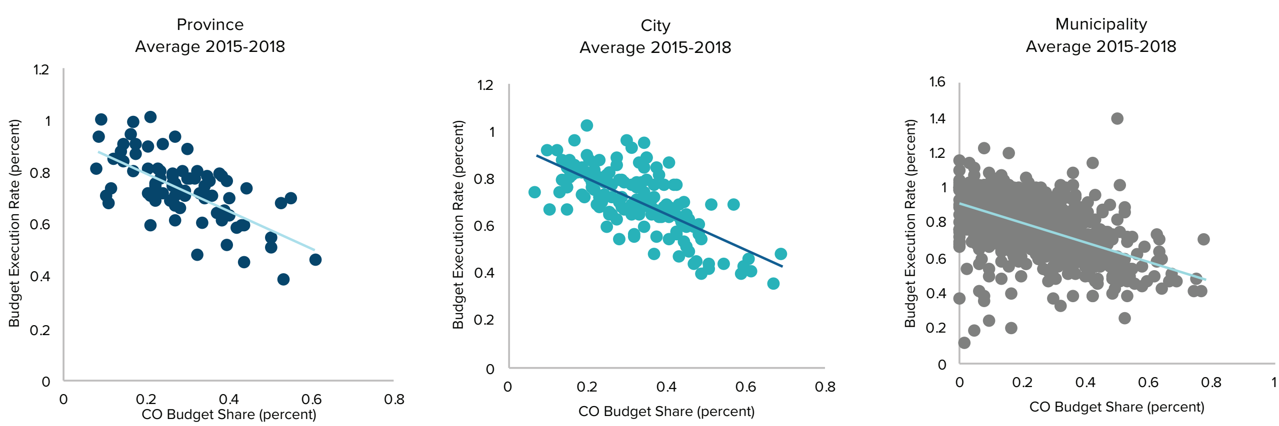
Source: World Bank staff calculations using COA LGU Financial Statements.

Figure 39. A higher share of the capital outlays is associated with lower budget execution rates regardless of sector...[46]



Source: World Bank staff calculations using COA LGU Financial Statements.

Figure 40. ...a trend also observed across local government levels.



Source: World Bank staff calculations using COA LGU Financial Statements.

46 The chart presents 2015-2018 average expense class shares from sector budgets as well as sector budget execution rates of an average local government unit. Sectors are categorized as general public services (GPS); education services (educ); health services (health); labor and employment (labor); housing and community development (housing); social services and social welfare development (social); economic services (econ); Local Disaster Risk Reduction Management Fund (LDRRMF); and 20% Development Fund (20DF).

Box 8. Case Studies of Select LGUs on Falling Budget ERs Associated with Budget Increases and Higher Allocations to COs[47]

The experience of select local government units that had significant increases in funds could provide insight into how similar local governments may respond to the Mandanas Ruling. The granular nature of the subnational fiscal database allows for an analysis of local government units that have received a large increase in their budgets. The database was built from audited financial statements with budget and spending data of local governments from 2015 to 2018. The team selected local governments of different types and capacity[48] to observe how local governments of different levels have responded in the past to a substantial increase in revenues. Results indicate that even for local governments with excess absorptive capacity (lower-than-average budgets but higher-than-average execution rates), budget execution rates fell as the local government budget is increased. Declining execution rates is also associated with higher budget allocations for capital outlays. A review of audited local government financial reports reveal implementation issues for local infrastructure projects, challenges that are also relevant to the national government's infrastructure programs.

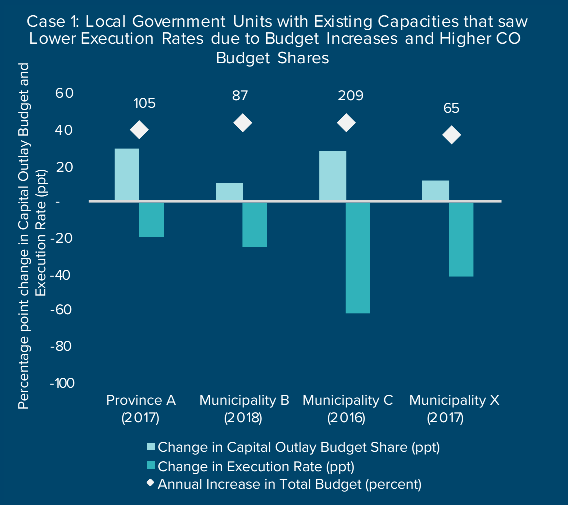
A surge in new revenues may lead to a significant decline in budget execution, even for local governments with the capacity to absorb more resources (Figure 41). For instance, Province A (name withheld) seemed to have additional capacity to absorb more resources. Between 2015 and 2017, Province A's budget execution rate was greater than that of its peers, though its total budget was below the provincial average. In 2018, Province A received additional shares from the national government's excise tax collections on tobacco products, which expanded its budget by 105 percent. Province A's budget execution rate fell by 25 percentage points (ppt). Similarly, Municipality B experienced a sizeable increase in locally sourced revenue (77 percent) that led to an 87 percent increase in its budget. Its budget execution rate then dropped by 32 percentage points. Also, Municipality C and X saw significant rise in their shares from national government tax collections in 2016 and 2017, respectively. Their budgets subsequently inflated by 209 and 65 percent, respectively. Their respective budget execution rates dropped double-digits. This result is consistent with other countries, where revenue windfall is associated with reduced efficiency in spending.[49]

Higher allocations to capital outlays that accompanied the budget increase contributed largely to the sharp declines in budget execution rates. Although the selected local government units' (Figure 41) recent performance suggests that they could accommodate additional resources, the increase in their budgets was too large and led to significant underspending. Most of the additional resources went to the budget for capital outlays. For instance, Province A saw its capital outlay budget share climb by 38 ppt given the surge in its revenues. Likewise, faced with more funds, Municipalities B, C, and X also increased their budgets for capital outlays. These increased capital outlay allocations contributed to the deterioration of budget execution rates partly due to the complexity of capital outlay project implementation (Box 9).


Photo: Sasithorn Sareesuk

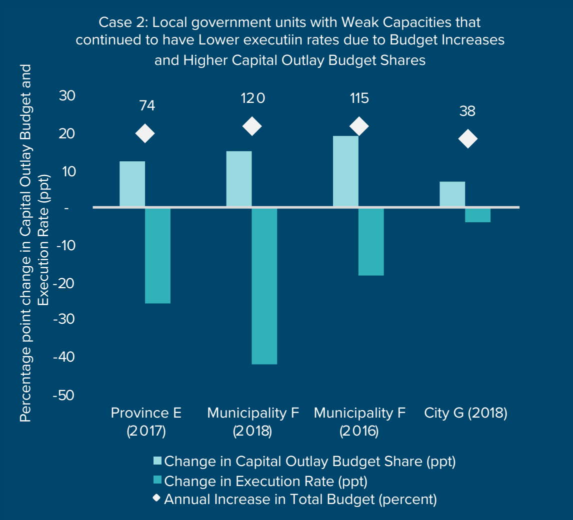
47 The local government units included in the case study and whose COA reports were closely reviewed by the team are anonymously referred to as Province A, Municipality B, Municipality C, Municipality X, Province E, Municipality F, and City G.
48 Proxied by budget execution rates.
49 Studies in Latin America show reduced efficiency in subnational spending following fiscal windfalls (Ardanza & Tolsa ,2015; Manzano & Gutierrez 2019). both their budgets and allocations to capital outlays.

Figure 41. Change in budget, capital outlay share, and execution rates under Case 1 [50]



Source: World Bank staff calculations using data from COA financial statements.

Figure 42. Change in budget, capital outlay share, and execution rates under Case 2 [51]



Source: World Bank staff calculations using data from COA financial statements.

Budget execution rates of local governments with weak capacity further declined as higher capital outlay allocations accompanied their budget increases (Figure 42). Province E registered a below average local government execution rate of 46 percent in 2016 despite its below average budget, which suggests already existing capacity challenges. In 2017, Province E expanded its budget by 74 percent as both local and external sources of revenues increased. The province also decided to raise the budget for capital outlays, reducing its already low budget execution rate by 26 ppt. Meanwhile, Municipality F's revenue from other national taxes increased in 2016, while both its local and external revenues grew in 2018. Municipality F then more than doubled its budget and increased CO budget shares, in 2016 and 2018, respectively. As expected, its below average budget execution rates fell further. Lastly, due to higher own-source revenues in 2018, City G also ramped up its budget by 38 percent and increased its capital outlay budget share. Thus, its low budget execution rate further dropped.

Potential Impact of the Mandanas Ruling: Lower Budget Execution and Unaddressed Fiscal Imbalances

An increase in local government budgets following the Mandanas Ruling is likely to result in lower budget execution rates unless capacity concerns are addressed. As infrastructure projects tend to involve complex procurements and implementation capacity constraints (Box 9), budget execution rates are expected to deteriorate if local governments continue to allocate most budget increases to capital outlays. For example, allocating the entire increase in the budget to capital outlays[52] is projected to reduce budget execution rates by an average of 14 and 13 ppt for province and city governments, respectively (Figure 43). The decline in budget execution is projected to be even more substantial for municipalities, at around 24 ppt, suggesting that municipal governments face more severe capacity constraints than provinces and cities. As expected, budget execution is expected to improve as local governments reduce their budget allocations to capital outlays (Scenarios 2 and 3 in Figure 43).

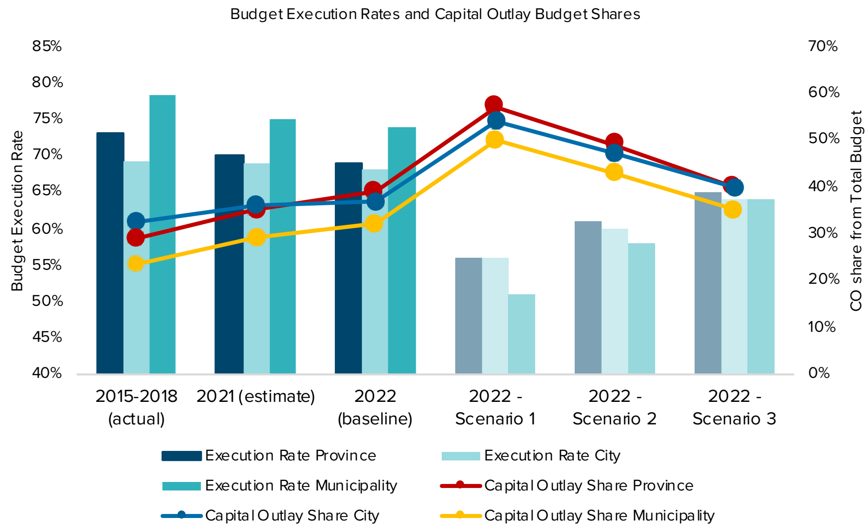
Photo: Aldrinho

50 Case 1 LGUs: LGUs with capacity (low budget and high execution rates) in the previous year but lower ERs in the current year increased their budgets and allocations to capital outlays.

51 Case 2 LGUs: LGUs with weak capacity (low budget and low execution rates) in the previous year and even lower ERs in the current year increased

52 Under this scenario, the capital outlay budget shares in 2022 compared to 2021 are expected to increase by an average if 22, 18, and 21 percentage points for provinces, cities, and municipalities, respectively.

Figure 43. Budget execution is expected to fall post-Mandanas Ruling, as the share of capital outlays rise.[53]



Source: COA; BLGF; and World Bank staff estimates.

The vertical fiscal gap will widen following the Mandanas Ruling, increasing the dependence of local governments on the Internal Revenue Allotment. The increase in local government budgets is projected to increase total local government expenditure to Php962 billion (4.5 percent of GDP) by 2022. However, the taxing powers of local governments will remain anchored on the provisions laid out by the Local Government Code, which historically have not improved the ability of local governments to significantly generate own-source revenues. This will result in a larger vertical fiscal gap post-Mandanas Ruling (Figure 44). The wider vertical fiscal gap will be addressed by an increase in Internal Revenue Allotments, resulting in a much higher dependency ratio[54] across all local governments (Figure 45). A stronger dependence on the Internal Revenue Allotment may further weaken local fiscal autonomy and accountability (UN-HABITAT 2011).

Photo by: EzracAcayan

53 Baseline refers to post-Mandanas estimates. Scenario 1 considers all budget increases are allocated to CO budget. Scenario 2 assumes that only 75 percent of total budget increase goes to CO budget. Lastly, Scenario 3 assumes 50 percent of the increase is earmarked for CO.
54 IRA dependency was computed by dividing the IRA received by the LGU by its total revenue.

Box 9. Local Infrastructure Project Implementation Challenges

Government infrastructure projects typically suffer from poor budget execution. They need to be carefully planned and coordinated due to their complex and capital-intensive nature, the involvement of several authorities, and their long implementation period. Infrastructure projects also involve complex procurement processes, as they require large public investments. However, implementing agencies that lack the technical capacity to create, execute, and maintain an investment plan face challenges in fully implementing quality projects on time. Delayed, incomplete, or unimplemented infrastructure projects contribute to poor budget execution at the national and local level. The select local governments featured in the case studies highlight several issues faced in terms of infrastructure project implementation that contribute to poor budget execution.

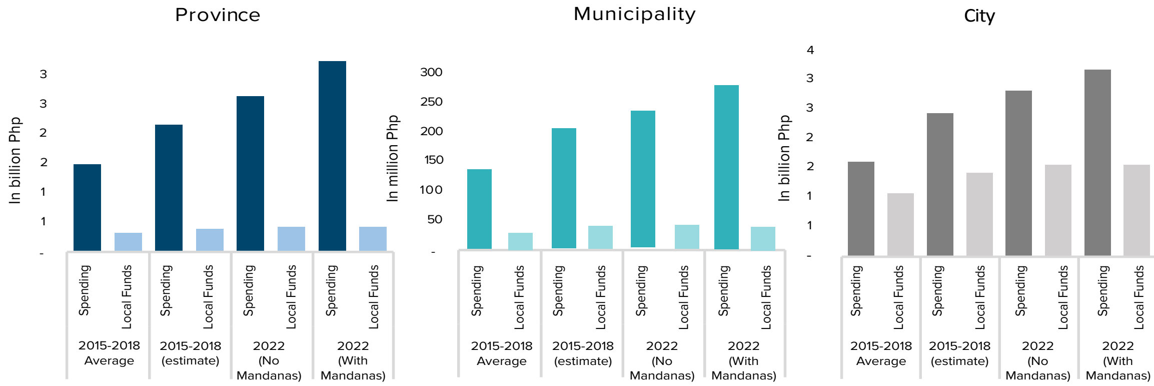
Weak technical capacity, leading to low budget absorption, is a major reason for delayed implementation of local infrastructure projects in the Philippines (Manasan and Mercado 2001). For instance, multi-year development plans by even the largest city local governments were not backed by investment cost estimates or operating expenditure implications (World Bank 2010). Lack of skilled personnel is a commonly cited factor that weighs heavily on the technical capacity of local governments. Without enough skilled manpower to properly account for, evaluate, and monitor ongoing projects, it would be difficult to ascertain if expenses are utilized according to their intended purposes, or if a project was completed properly and completely (e.g., Province A, Municipality C and Municipality X).

Poor planning and weak coordination can also adversely affect implementation. In 2016 and 2017, the Commission on Audit identified poor planning, monitoring, non-prioritization in the implementation of development projects, as the main drivers of the low utilization rate of the Local Development Fund for several local governments, which is mostly comprised of spending on capital outlays (Diokno-Sicat, et. al. 2020a). For instance, a survey of 1,373 municipalities reveal that only 5 percent of oversight agencies have an updated comprehensive land use plan, while only 40 percent of the comprehensive development plans are recent and updated (Diokno-Sicat, et. al. 2020a). Lack of concrete plans leading to project delays can be attributed to a highly discretionary project prioritization, heavily influenced by local chief executives (Province A). Difficulty in complying with national government agency-mandated project briefs can likewise contribute to substandard planning quality (Diokno-Sicat, et. al. 2019). Inadequate budget preparation planning can also lead to unmet project needs and contribute to poor, uneven, or unimplemented projects (Municipalities B and X). Lastly, lack of coordination can delay or even cancel projects of local governments due to similar projects implemented by the national government in the same area (Province A and Municipality C).

Poor adherence to procurement processes and questionable administrative procedures were also notable pain points in the implementation of infrastructure projects. A complex procurement process has long been recognized as one of the main bottlenecks in the execution of infrastructure projects. Under the most ideal scenario, in which there are no procurement mistakes, the whole bid process would take one month (Diokno-Sicat, et. al. 2020b). In the sample of local government units analyzed, procurement issues can be largely divided into: (i) administrative lapses in procurement (Municipality C); (ii) unclear or non-conformance to key performance indicators when disbursing funds (Municipality F); (iii) delays in the delivery of goods and services (City G); and (iv) the selection of non-experts or unqualified contractors to implement projects (Province E). Moreover, general administrative lapses can be categorized into: (i) lousy record keeping, which prevents the Department of the Interior and Local Government to evaluate certain projects (Municipalities C and X); and (ii) the non-transmittal of records and financial statements to Commission on Audit (Province E).

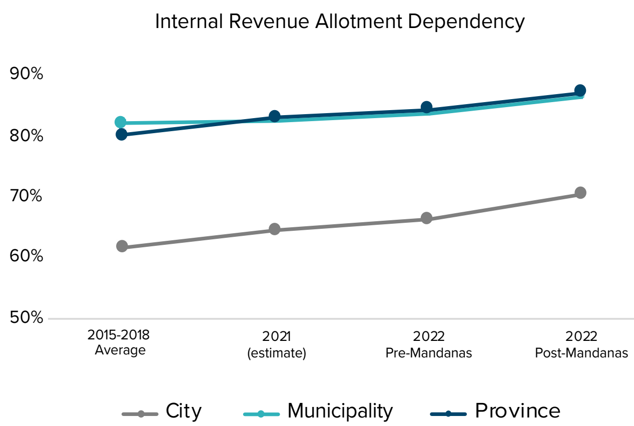
Photo: Jed Regala

Figure 44. Existing vertical imbalances among LGUs are likely to widen with the implementation of the Mandanas Ruling.



Source: BLGF; COA; and World Bank Staff Estimates

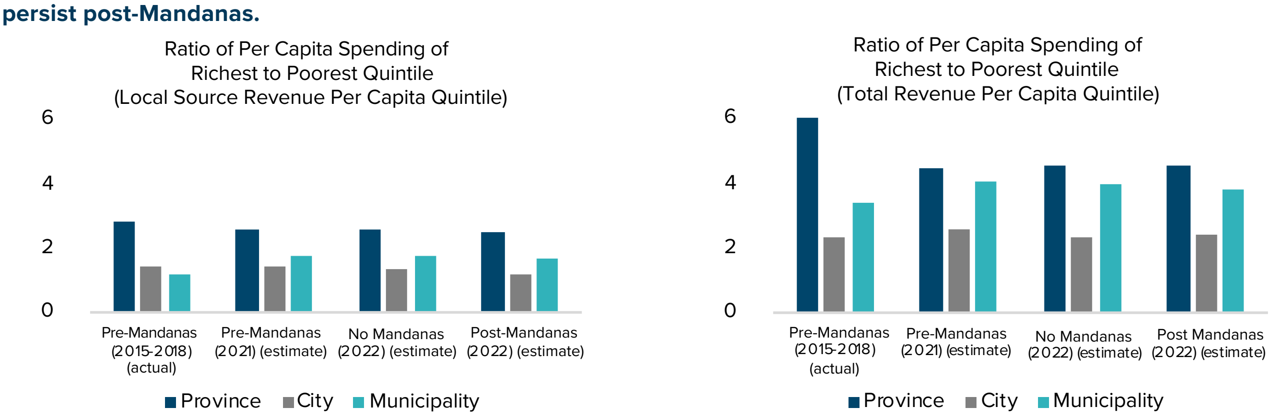
Figure 45. Internal Revenue Allotments are expected to represent an even larger share of local government units' total revenues following the Mandanas Ruling.



Source: COA; BLGF; and World Bank staff estimates

In addition, existing horizontal fiscal imbalances among local governments are expected to persist following the Mandanas Ruling. At present, the Internal Revenue Allotment formula has been found to be counter-equalizing (Manasan 2004), as it does not consider poverty levels or the local governments' revenue mobilization capacity. This has led to a horizontal fiscal gap[55] across local governments, as reflected by higher total per capita spending among richer local government units (Figure 46). The disparity between richer and poorer local governments is more pronounced among provinces and municipalities relative to cities. This is due to cities' larger tax base, allowing them to generate higher levels of own-source revenues, and their higher population resulting in higher Internal Revenue Allotment allocations. These observations highlight the inequities caused by the Internal Revenue Allotment system (National Tax Research Center, 2008), which are expected to persist even after the implementation of the Mandanas Ruling since no changes will be made to the current Internal Revenue Allotment formula.[56]

Figure 46. The horizontal gap between the spending per capita of rich and poor local governments is expected to persist post-Mandanas.



Source: COA; BLGF; and World Bank staff estimates. *Source: COA; BLGF; and World Bank staff estimates.*

55 A horizontal fiscal imbalance occurs when jurisdictions within the same local government level do not have the same capability to raise own revenues, which could be due to difference in capacity or the different needs of geographical areas. For example, richer municipalities that have a broader tax base and are able to generate own-source revenues are likely to have higher per capita expenditure than poorer municipalities

56 Internal Revenue Allotments are distributed as follows by local government type: Province and City (23 percent), Municipality (34 percent), and Barangay (20 percent). It is further distributed by population (50 percent), land area (25 percent), and equal sharing (25 percent).

3.5 Policy Recommendations

The increase in Internal Revenue Allotment allocations to local governments in 2022 due to the Mandanas Ruling represents a significant risk to local development if not managed properly. This analysis highlighted the main drivers of poor budget execution and the extent of its impact on local government spending. From a fiscal perspective, the main drivers of poor budget execution at the local level are: (i) the size of the local government budgets; and (ii) the share of capital outlays in the budget—both of which are expected to increase significantly following the Mandanas Ruling. While the Mandanas Ruling partly addresses the resource challenges faced by local governments, it does not address the four structural challenges which have constrained effective service delivery and led to an inefficient decentralization. Moreover, the Mandanas Ruling does not address existing issues related to vertical and horizontal fiscal imbalances that have significant equity implications in terms of overall socioeconomic development.

Minimizing service delivery risks requires a change in the approach towards decentralization by both the national and local government. The national government, which has focused on addressing the fiscal sustainability risks associated with the Mandanas Ruling, has started to identify spending responsibilities for select devolved mandates to be transferred back to local government.[57] However, local governments, have raised concerns surrounding financial and technical capacity to absorb re-devolved mandates, while maintaining full autonomy in planning and managing the additional resources from the Mandanas Ruling. As a result, the re-devolution process could lead to a large gap in service delivery, as a lack of coordination between the national and local government and weak implementation capacity could delay the transition towards increased decentralization. Addressing these weaknesses in planning and coordination is a first step towards improving decentralization outcomes and managing the transition towards re-devolution. However, overcoming the structural challenges of decentralization requires several short and long-term policy recommendations focused on improving horizontal equity, building capacity, and improving transparency and accountability.

To effectively address challenges related to the Manandas Ruling and decentralization in general, the authorities should consider:

Short-Term Policy Recommendations

The national government should clearly define re-devolved functions and communicate these clearly to both national government agencies and local government units. National government agencies are currently in the process of preparing their respective devolution transition plans. Improving coordination and alignment between national government agencies and local government units, and between local government units of different tiers, especially in identifying the functions to be re-devolved, could improve allocative efficiency. The authorities need to ensure that the development goals of the national government and local governments are well-aligned, and that service delivery gaps are minimized. This will require the national government and local government units to review the division of labor between the national government agencies and local government units in re-devolving functions, while keeping fiscal and absorptive capacity in mind. Lastly, ensuring that this process is supported by the national government budget is important, to avoid implementation overlaps and inefficiencies given the likelihood of budget insertions.

Channeling the increase in Internal Revenue Allotments allocations towards local government's COVID-19 response efforts to mitigate budget execution risks while providing much needed support to local constituents. This chapter has argued that increasing the share of capital outlays in local government budgets may lead to a fall in budget execution. Moreover, local governments have the propensity to channel revenue increases toward capital outlays. Idle resources and allocative inefficiencies are particularly harmful during the COVID-19 pandemic, as the opportunity cost for inaction is a further deterioration in poverty levels. As such, the increase in resources for local government units post-Mandanas Ruling is an opportunity to provide immediate relief while managing budget execution risks. For example, a highly urbanized city government revealed that in 2019, the city government scrapped numerous capital outlay projects in favor of social services in order to build proper technical capacity and ensure efficient use of public resources. Local governments could benefit from a similar approach to the increase in resources in 2022 to improve budget execution while providing immediate relief to their constituents. This process is not without risk, as local governments have struggled to effectively provide

57 The extent of which remains unclear, as devolution transition plans of various NGAs are currently being prepared.

support to their constituents. Local governments, particularly those with low capacity, would need support from various national government agencies in properly designing and implementing appropriate response programs.

Medium-Term Policy Recommendations

Providing capacity building support to local government units to improve their implementation capacity and overall service delivery. This includes capacity building support focused on augmenting local government's manpower needs and technical skills in core public financial management functions, including budget and project preparation and medium-term planning. However, capacity building support must go beyond training human resources. Effective capacity building requires a change in the national government's approach, focusing on providing an enabling environment for local government units that assigns responsibilities according to available capacity and ensures a highly participatory process involving learning by doing. The Philippine Rural Development Project (PRDP) provides a useful model for capacity building, as this shows that a collaborative approach between the national government, national government agencies, and local government units could improve service delivery, dramatically improving service outcomes (Box 10);

Planning and coordinating the work between the national government, national government agencies, and local government units, as well as among local governments. In the medium term, national government agencies need to regularly share their country development plans and milestones with local governments and review their development plans to improve alignment. For example, local government units could be involved in developing local indicators, baselines, and targets, which could also help identify priority areas in their jurisdiction and the local government's contribution to national development. This requires that local government units and implementing national government agencies work in close coordination with the national government oversight agencies (National Economic and Development Authority, Department of Interior and Local Government, Department of Budget and Management, and Department of Finance). Meanwhile, to maximize economies of scale, coordination issues between local government units within the same geographical region must be addressed, which requires a strategic approach that leverages provincial governments. For example, findings from field case studies have shown that development-oriented and resourceful provincial governors have the ability to initiate and support inter-local government initiatives (e.g., South Cotabato's common solid waste management facilities) and align municipal priorities with provincial objectives and strategies (World Bank 2010);


Photo: r.nagy

Box 10. The Philippine Rural Development Program: A Model for Capacity Building

The PRDP is the national government's flagship project for agriculture and rural development and provides best practice examples for capacity building. The PRDP promotes sustainable and equitable growth in productivity and the income of farmers and fisherfolks through science-based planning and synergistic partnerships among national government agencies, provincial and municipal governments, and the private sector. The PRDP has championed the local government's adoption of science-based tools and provided them with the capacity to establish systematic and objective decision-support platforms devoid of political biases. This has allowed local government's to design holistic roadmaps for local agricultural development, which are embodied in the Provincial Commodity Investment Plans. The PRDP has also improved the technical capacity for planning and subproject implementation of all 81 provincial local government units in the country, producing a total of 81 Provincial Commodity Investment Plans and 10 City Commodity Investment Plans that are anchored on 125 value chain analyses covering 74 commodities. The PRDP has advocated learning-by-doing approaches in order to build local government capacity, while strengthening transparency and accountability. The project guided the transition from national government agency-implemented to local government-implemented rural infrastructure and enterprise development. With technical guidance from the PRDP, local government units —as co-financers of investments—gained the capability to carry out subproject planning, procurement, and engineering. The project also introduced cutting-edge digital solutions to improve local government accountability and transparency.[58] The PRDP was able to mainstream many innovations and best practices into the regular functions of the Department of Agriculture and local government units to shift public investments toward a modern, value-chain oriented, and climate-resilient agriculture and fisheries sector.

Addressing horizontal inequity through strong fiscal equalization and gradual re-devolution. The transition to increased decentralization in 2022 and beyond needs to consider the fiscal capacity of local government units to prevent worsening inequities across regions. The national government aims to address this issue partially through the creation of a growth equalization fund.[59] However, the scale of this fund is unlikely to be enough to result in a robust fiscal equalization. As such, the national government must continue to provide support to local government units that lack proper capacity and resources. Understanding the unique challenges faced by local government units in the Bangsamoro Autonomous Region in Muslim Mindanao (BARMM) region, for example, should be a point of emphasis for the national government, as the Mandanas Ruling will have implications beyond the Internal Revenue Allotment to BARMM local government units (Box 11). In rolling out its transition plan for re-devolution, the national government and national government agencies must manage the pace of re-devolution while considering the capacity limits of local government units;

Photo by: Amors photos

58 These digital tools and innovations for enhanced governance include: (i) a geographic information system analysis, satellite imagery overlays, and utilization of drones for subproject approval, and monitoring and impact assessments; (ii) geo-tagging and geo-videos for real-time subproject implementation monitoring; and (iii) best practices for social and environmental safeguards measures.

59 The forthcoming Executive Order will create a growth equalization fund that seeks to address the vertical and horizontal fiscal imbalances present in the current system.

Box 11. Impact of the Government Responses to the Mandanas Ruling in BARMM

The precise impact of the government's response to the Mandanas Ruling in BARMM is not completely clear, as it will involve further analysis at all levels of government on the benefits and burden of reallocated funding and responsibilities. At the aggregate level, there will be an increase in funding for the BARMM regional government, offset to some extent by the reduction in the block grant it receives from the national government. Based on the current allocation formula, the Internal Revenue Allotment is projected to increase by around 55 percent in 2022, while the BARMM block grant is projected to be reduced by around 10 percent in the same year. In later years, the peso-value of the Internal Revenue Allotment will fall due to the sharp contraction in national tax collections due to the COVID-19 crisis. The impact on the BARMM block grant after 2022 will be a further reduction in the peso-value of the grant.

The impact of the government's response to the Mandanas Ruling on services in the BARMM region is more complicated. It will require a careful analysis and discussion among stakeholders at all levels of government due to the many interrelated potential linkages. Some of the main questions include: (i) how pre-existing partial devolution arrangements will be affected in areas such healthcare; (ii) what will be the impact on supplementary support to local governments from the regional government, including support for staff salaries and other operating expenses; (iii) how will it change the various approaches to implementing national programs in BARMM; and (iv) what will be needed in terms of recalibrating programs and resource allocation in response to an expansion or contraction of available funds at all levels of government.

An important consideration in assessing the impact on the BARMM region is the extent to which local governments will be able to fill the gaps in quality and availability of services they are responsible for by law. Research have highlighted the relative disadvantages and weaker response of poorer regions to significant changes in funding levels, particularly in the context of COVID-19. BARMM contains many local government units with fragile economic, social, and environmental conditions that present major challenges for the efficient and effective use of government resources.

Long-Term Policy Recommendations

Addressing fundamental weaknesses in fiscal decentralization, which have constrained local government units from fulfilling their responsibilities, by amending the Local Government Code.[60] First, the authorities need to review the Code to clarify expenditure assignments across different levels of government (national government vs. local government units, and for different tiers of local government units) in order to address unnecessary overlap between national government agencies and local governments (World Bank 2016). Second, the revenue mobilization ability of local governments needs to be strengthened in the Code to promote their fiscal autonomy and improve accountability. As Manasan (2004) proposes several amendments that would provide local government units with greater discretion in setting tax rates and increasing own-source revenues.[61,62] In terms of intergovernmental transfers, the ideal reform would be to revise the Internal Revenue Allotment formula in the Code to strengthen its equalization properties. This would address issues related to the horizontal fiscal imbalance caused by the current system. Moreover, introducing a performance element into the Internal Revenue Allotment conditional on service delivery could further incentivize local government performance and strengthen service delivery; and

Creating an environment that fosters increased demand for transparency and accountability. The lack of accountability between local chief executives and their constituents is among the key binding constraints to efficient service delivery. Targeted interventions aimed at achieving greater supply-side accountability are extremely complex and rigid, particularly as tools that could improve vertical accountability are complex and hard to change. Demand-side accountability can be strengthened using mechanisms that improve

60 These recommendations draw heavily from the established literature on addressing accountability failures to improve service delivery.
61 These include raising the ceiling on tax rates, adjusting the frequency in which local governments can adjust tax rates, and relaxing restrictions on the size of the tax rate adjustments that LGUs can make.
62 Although this study is nearly two decades old, the study continues to be relevant given the absence of changes to the Local Government Code, three decades since its passage.

citizens' demand for accountability. Although the goal of strengthening transparency and accountability is seen as a long-term agenda, number of quick wins could be implemented in the short to medium-term, especially in the context of improving digitalization.

In the short-term: Leveraging on previous open data initiatives and the shift towards increasing digitalization could help strengthen and improve transparency and accountability. This includes initiatives aimed at strengthening of citizen participation in budgeting and expenditure processes; public hearings on budget information; civic monitoring of intergovernmental transfers; and monitoring of local service provision. The government should also provide citizens with more information through open data initiatives to increase transparency, allow citizens to hold the local governments accountable, and increase citizen participation in the process to minimize discretionary prioritization by the Local Chief Executives.

In the long-term: There are currently several bills[63] in the legislative pipeline that aim to strengthen the links between transparency, accountability, and improved governance which could strengthen service delivery. In addition, establishing a subnational database that goes beyond fiscal indicators and includes service delivery outcomes would provide citizens with the information needed to hold local executives accountable.

Photo: Leo Altman

63 These include the Freedom of Information Bill, the Anti-Political Dynasty Bill, and the The People's Participation in Budget Deliberations Bill.

Annex 1: Methodology in Estimating Post-Mandanas Budget Execution Rates

Local government budgets were estimated by deriving the revenue elasticity of budget from the 2015-2018 subnational fiscal dataset and using this to project budgets. The Internal Revenue Allotment to be received by each local government was calculated using the current distribution formula and national tax collections in 2019. Other revenue sources were assumed to follow the nominal growth of the national economy, given the lack of output data beyond regional aggregates. These projected revenue components were summed up to obtain the total revenue for each local government. From the subnational fiscal data, local government budgets were then estimated using elasticities obtained from ordinary least squares regression of budgets on revenues for each local government type: province, city, and municipality (Table A1). The capital outlay budgets in 2022 were similarly estimated using capital outlay budget elasticity with respect to total budget obtained from the data.

Different hypothetical scenarios regarding increases in capital outlay budgets were tested to estimate the effect on execution rates. Following the earlier approach, the budget execution rate is regressed with the capital outlay's budget share for each level of local government to calculate the relevant elasticities (Table A1). Three scenarios were considered, each varying in the allocation of the additional budget to capital outlay. The shares assumed for the three scenarios are 100, 75 and 50 percent respectively. As the capital outlays' budget share was adjusted, the residual budget was distributed among the other expense classes assuming they maintain their historical distribution. With the estimated elasticities, the budget execution rates for each scenario with varying capital outlay budget shares were estimated.

Table A1. Estimating elasticities of total budget on total revenue using ordinary least squares regression

Dependent variable: log(total budget)			
Independent variable	Province	City	Municipality
log (total revenue)	1.0584*** (0.0242)	1.0371*** (0.0220)	0.8800*** (0.0138)
Constant	-1.0535** (0.5102)	-.5771 (0.4583)	2.2806*** (0.2564)
Observations	314	522	5,158
R-squared	0.8601	0.8102	0.441

Note: Standard errors are indicated in parentheses.
* Significant at 10 percent level, ** at 5 percent level, and *** at 1 percent level
Source: COA and WB Staff Calculations.

Table A2. Estimating elasticities of total budget execution rate on capital outlay budget share using ordinary least squares regression.

Dependent variable: log(total budget execution rate)			
Independent variable	Province	City	Municipality
log(capital outlay budget share)	-0.1826*** (.0163)	-0.1862*** (0.0149)	-0.0683*** (0.0043)
Constant	-0.5909*** (0.0253)	-0.6268*** (0.0212)	-0.4087*** (.0093)
Observations	313	518	5,070
R-squared	0.2867	0.2322	0.0472

Note: Standard errors are indicated in parentheses.
* Significant at 10 percent level, ** at 5 percent level, and *** at 1 percent level
Source: COA and WB Staff Calculations.

Photo: Jocelle Jardin

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