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PROGRAM ASSISTANCE INITIAL PROPOSAL

BUDGET SUPPORT PROGRAM III

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BUDGET SUPPORT PROGRAM III
Program Assistance Initial Proposal

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I. SUMMARY

The purpose of this document is to (1) seek A.I.D./W's approval of this Program Assistance Initial Proposal (PAIP), and (2) request a redelegation of authority for the Mission Director to approve the PAAD and authorize the proposed Budget Support Program III (BSP III) at the Mission level.

This PAIP establishes the basis to develop a \$75 million grant assistance program to the Government of the Philippines (GOP). The grant will be sourced from the Fiscal Year (FY) 1988 ESF appropriation for the Philippines and will be obligated in FY 1988. The estimated completion date for the BSP III will be in FY 1989.

After two years under the Aquino Administration, the Philippine economy, helped by structural adjustments, policy reforms, and political changes, has shown strong signs of recovery with a real 1987 Gross National Product (GNP) growth of 5.05 percent. Inflation was moderate, lending rates were reduced, consumer demand perked up, the balance of payments (BOP) after exceptional financing was positive and per capita GNP increased for the first time in seven years.

Economic prospects for 1988 look promising, although the recovery (and Philippine democracy itself) remains frail, due to pressures from insurgencies, militant labor and armed forces factions. Financial problems compound the pressures on the GOP. The 1988 budget deficit, even with expected ESF transfers, is expected to be ₱27 billion (more than \$1.3 billion) or 3.5 percent of GNP.

BSP III will help relieve the financial pressures by providing a cash transfer as general budget support. By programming the generated pesos, BSP III will encourage the realization of a large portion of the amount budgeted for selected, high priority items in health and education and possibly the establishment of a revolving fund to facilitate the implementation of Development Assistance (DA) projects. The GOP will use the dollars to pay official debt to multilateral institutions such as Asian Development Bank (ADB), International Bank for Reconstruction and Development (IBRD) and International Monetary Fund (IMF). Other peso and dollar uses may be agreed to. In addition, BSP III will encourage continued implementation of economic policy reforms through a prior-to-signing joint review of progress in planning and implementing reforms in the first part of the year. After signing, the entire \$75 million will be disbursed immediately upon the satisfaction of the grant's legal and administrative Conditions Precedent.

Hence like BSP II, BSP III will be linked to policy reform implementation. However, because of the reduced size of the grant (down from \$150 million), generally good progress by the GOP, and severity of pressures on the GOP, conditionality will be placed on a single tranche and in pre-signing negotiations.

While the consultations will cover the whole range of the Mission's policy agenda, at least in terms of informational requests, attention will center on selected issues. The Mission's agenda covers a gamut of policies grouped under these categories:

- o Supportive macroeconomic framework
- o Reduced government involvement in and regulation of the economy
- o Greater focus on rural development
- o Improvement in proper government functions.

Within this framework, initial focus is expected to be on implementation actions for:

- o Maintaining an internationally competitive foreign exchange rate
- o Constraining the fiscal deficit
- o Speeding up privatization, especially of public corporations
- o Improving the rural financial system through the reduction of intermediation costs
- o Improving public accountability.

II. THE SETTING

A. Political Environment

The Aquino Administration ended its second year of office with a 5.05 percent annual growth in real output in 1987, thus strengthening economic recovery. The continuing popularity of President Aquino and her restoration of democratic institutions, which the country lost in the 14 years of martial law under deposed President Marcos, contributed to the renewed business confidence behind this growth achievement. Immediately after being installed in the "people power revolution" of February 1986, the Aquino Administration replaced senior members of the judiciary, undertook military reforms and restored press freedom. In February 1987, an overwhelming majority of voters ratified the new Philippine Constitution and in July, the bicameral legislature convened, ending President Aquino's cautiously exercised transitional legislative powers and thus effectively re-establishing the system of checks and balances. Provincial and municipal elections in January 1988 marked another major step in the transition to full political normalcy. Village elections, scheduled for May 1988, should complete the process.

Democracy in the Philippines remains frail, however. Leftist and Muslim insurgencies, the increasing militancy of the labor sector, and the restlessness of certain factions in the Armed Forces, which culminated in the failed August 28, 1987 coup attempt, are undermining the stability of the Aquino Administration and pose threats to economic recovery. The resurrection of democracy itself permitted the re-emergence of traditional no-holds-barred Filipino politics with its penchant for protracted argument (even violence) rather than compromise and for personal aggrandizement rather than public service, a press which regularly exceeds the bounds of freedom, and hostile confrontations between labor and management. While the local elections saw the repudiation of some political dynasties, others remain deeply entrenched and new ones arose, each having its own interests to protect.

These developments have complicated the process of obtaining consensus on major reforms. Over the next few months, the Aquino Administration will be faced with major issues which will test its commitment to the basic reform program--competitive foreign exchange rate, responsible monetary and fiscal policies, trade liberalization, tax reforms, privatization, the comprehensive agrarian reform program, decentralization and government reorganization, and the delivery of basic services. The Aquino Administration's ability to mobilize a political consensus for continuing economic reforms will largely depend on how well it can handle pressures arising from various interest groups without undermining economic stability and business confidence.

B. Economic Conditions

1. Recent Developments

As the impact of structural adjustments, policy reforms, and political changes became more apparent, the Philippine economy gained growth momentum last year, as the Gross Domestic Product (GDP) posted a 4.6 percent rate of growth. (See Table 1.) With this growth, unemployment eased up slightly from the previous year's level. Inflation, while still at a relatively low level, increased during the year, reflecting renewed economic activity.

a. Production and Income

GDP grew by 4.6 percent in 1987, a commendable rate, despite a turbulent political setting. Growth last year represents the second year of positive performance of the economy since severe crisis in 1983 to 1985. Real GNP likewise increased by 5.05 percent. With an estimated population growth of 2.4 percent (GOP estimate), real per capita GNP rose by 2.6 percent, a reversal from the 1.1 percent decline in 1986 and the first positive improvement in seven years. (With USAID estimate of population growth of 2.7 percent, the increase was only 2.3 percent.)

Table 1
National Income Indicators
(Constant 1972 Prices)

	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>% Change 1986-87</u>
Gross National Product (₱ Million)	87,766	89,115	93,617	5.05
Gross Domestic Product (₱ Million)	89,803	90,791	94,931	4.56
By Expenditure Shares				
1. Personal Consumption Expenditures	65,977	66,597	68,671	3.11
2. Government Consumption	8,205	8,551	9,244	8.10
3. Capital Formation	11,124	10,205	12,230	19.84
By Industrial Origin				
1. Agriculture, Fishery, Forestry	26,252	27,233	27,430	0.72
2. Industry Sector	29,000	28,204	30,433	7.90
a. Mining & Quarrying	1,768	1,558	1,521	(2.37)
b. Manufacturing	21,541	21,717	23,317	7.37
c. Construction	4,258	3,382	3,919	15.88
d. Electricity, Gas & Water	1,433	1,547	1,676	8.34
GNP Per Capita (Pesos)*	1,605	1,591	1,632	2.58

*Consistent with a 2.41 percent growth rate (GOP estimates).

Source: National Economic and Development Authority (NEDA)

Last year's performance appears to have been bolstered by renewed consumer spending, heightened optimism and confidence of private investors, stability of the local currency and manageable domestic price increases. Personal consumption expenditures rose by 3.1 percent, as compared to less than a percent in 1986. This consumer-led growth drew its strength from several factors, including confidence among the citizenry, the government's emergency employment program and favorable prices for agricultural commodities. Although prices were creeping up, causing the peso to lose about four percent of domestic purchasing power, the impact was relatively insignificant or was wiped out by increased income in most sectors.

Also noteworthy was the significant increase in domestic investments, as indicated by the 19.8 percent rise in gross domestic capital formation. Last year's growth reversed the downtrend of the crisis years. Investments in fixed capital in the form of construction and purchase of durable equipment rose by 13.7 percent and 6.9 percent, respectively. Investments in durable equipment improve industrial production capacity. This improvement on investment provides some indication of increasing investors' confidence due in part to changes in government policies and activities such that they now support, rather than compete with, the private sector.

In terms of production, agriculture grew by a disappointing 0.72 percent, in contrast to official government expectations of a 4 percent growth. Natural disasters--typhoons and drought--were considered responsible for most of the dismal performance. In comparison, the industrial sector emerged as the growth leader, posting a 7.9 percent growth for the year. The construction subsector paced the industrial sector with a 15.9 percent turnaround from a 20.6 percent fall in 1986. Government projects and small and medium sized construction, including private housing construction, spurred the subsector's revival. Utilities (electricity, gas and water) followed construction with an 8.3 percent growth rate. Meanwhile, manufacturing posted a lower growth rate of 7.4 percent. However, as manufacturing accounts for about one fourth of GNP, the contribution was significant.

b. Prices

After stabilizing in 1986, prices started creeping up again in 1987. While the Consumer Price Index (CPI) during the first three months of 1987 was still below the levels for the same period in 1986, the CPI for the following months was above 1986 levels and steadily rising. In fact, an upward monthly trend in the price level started in August 1986 and continued until December last year. By December 1987, the December to December inflation rate had risen to 7.45 percent, eroding further the domestic purchasing power of the peso.

Prices in all areas of the country were up. In Metro Manila, the inflation rate more than doubled to 8.9 percent in 1987 (December to December) from only 4.1 percent in 1986. For areas outside Metro Manila, prices rose by 7.2 percent in 1987 as compared to a negative rate of 1.2 percent in 1986. On the whole, however, the upward trend in the general price level did not stifle consumer spending. Through prudent exercise of monetary stimuli for economic expansion, the monetary authorities have so far been successful in maintaining a relatively stable price level.

2. Balance of Payments Situation

a. 1987 Performance

The Philippine balance of payments (BOP) position worsened in 1987 from the 1986 level. (See Table 2.) Without inflows of new money and rescheduling of debt obligations, the year-end BOP deficit stood at \$1.742 billion, or 172.6 percent higher than in 1986. The current account balance suffered from a significant surge in imports of goods and services, while the expansion in exports was substantially less. After some improvements in 1986, the merchandise trade balance dropped to a deficit of \$754 million. The services account likewise recorded a deficit, adding to the negative balance.

Inflows of direct investments and short term capital improved from the previous year's levels. However, payments outflows for long-term investments increased during the year, causing a net outflow of long-term capital. There was a slight improvement in the capital account, although it remained in deficit.

With the inflow of new money from official sources (\$577 million) plus the impact of reschedulings concluded during the year, the overall balance of payments position, after new money and reschedulings, improved to \$291 million. About \$599 million in Paris Club debt service payments and \$857 million for commercial banks were rescheduled in 1987.

b. 1988 Program

For 1988, the BOP position is expected to improve slightly from last year's level. Before exceptional financing, the country's BOP deficit is projected at \$1.245 billion or 28.5 percent lower than in 1987. The current account deficit is expected to widen further to about \$529 million as compared to \$386 million last year. A larger trade gap (about \$1.016 billion) expected for this year will mainly account for the increase in the current account shortfall. The continuing increase in imports will result from the trade liberalization program currently underway and the recovery of the economy.

Table 2
Balance of Payments 1987-1988
(In Million U.S. Dollars)

	1987		1988 (Projected)	
	Before Exceptional Financing	After Exceptional Financing	Before Exceptional Financing	After Exceptional Financing
Merchandise Trade	-754	-754	-1,016	-1,016
Exports	5,696	5,696	6,385	6,385
Imports	6,450	6,450	7,401	7,401
Non-Merchandise Trade	-151	-151	-24	-24
Inflow	3,379	3,379	3,702	3,702
Outflow	3,530	3,530	3,726	3,726
Transfers, Net	519	519	511	511
Current Account	-386	-386	-529	-529
Long-Term Loans	-1,716	317	-1,670	80
Inflow	402	2,435	377	2,127
Outflow	2,118	2,118	2,047	2,047
Direct Investments, Net	215	215	207	207
Short-Term Capital, Net	79	79	347	347
Errors and Omissions	-142	-142	0	0
Gold Monetization	359	359	400	400
Revaluation Adjustment	-151	-151	0	0
Capital Account	-1,356	677	-716	1,034
Overall Balance	-1,742	291	-1,245	505

Source: Central Bank of the Philippines

The level of net outflow of long-term capital is expected to decline by a slight 2.7 percent. Direct investments are expected to remain at about the 1987 level. Meanwhile, inflows of short-term capital are expected to increase to \$347 million, as compared with only \$79 million in 1987. An expected net infusion of short-term capital will help improve the capital account position from a deficit of \$1.356 billion last year to a projected deficit of \$716 million this year. Total inflow of new money and reschedulings with Paris Club and commercial creditors will decline slightly from 1987 level. However, the final balance of payments position, after accounting for exceptional financing, is expected to improve to a positive \$505 million.

3. External Debt Situation

a. Levels

Total external debt stood at \$27.798 billion as of September 30, 1987, virtually at the same level as the previous year. This level is lower than the outstanding debt in June 1987 (\$28.475 billion) as well as in December 1986 (\$28.256 billion). Of the total foreign debt, about 33.7 percent is owed by the banking sector (commercial banks and the Central Bank), while 65.9 percent is public and private (non-bank) debt and the rest is export advances. This sectoral distribution is unchanged from the pattern last year. However, due to the impact of rescheduling agreements, the maturity profile has improved, with about 85 percent now in medium- and long-term obligations.

b. Debt Service

In 1987, debt service took up 32.4 percent of total receipts from exports of goods and services for that year. Without reschedulings, last year's debt service ratio would have been around 44 percent. For 1988, with rescheduling, the debt service ratio is expected to be 30.1. By 1992, the debt service ratio is projected to fall further to 26.9 percent, assuming export targets are met. The present commercial bank rescheduling package covers \$13.2 billion in debt. This includes previously rescheduled debts due between 1983 and 1986 of \$5.8 billion, those maturities falling due from 1987 until 1992 worth \$3.5 billion, and the 1985 facility consisting of the \$3 billion trade credit and \$925 million in new money.

c. Past Programs

A.I.D.'s country strategy for the Philippines is to encourage and support GOP reforms in macroeconomic and sectoral policies as well as to continue the longer gestating, but equally important, investment and institutional development activities. In response to the onset of the economic crisis in 1983, the Mission began to provide Economic Support Fund (ESF) program assistance to help provide financial flexibility to the GOP. Since 1984, the

Mission has provided four such programs--the Rural Productivity Support Program (RPSP) - \$47.5 million; the Development Support Program (DSP) - \$45 million; the Budget Support Program (BSP) - \$300 million; and the Budget Support Program II (BSP II) - \$150 million.

Both RPSP and DSP provided BOP support to the Philippines. The generated RPSP and DSP pesos were originally intended to provide additional resources during the 1985 and 1986 calendar years (CYs), respectively, to selected foreign-assisted projects whose implementation had been hampered by the critical lack of peso counterpart. Following the February 1986 revolution, the Mission amended the RPSP agreement to allow the remaining RPSP balance to be used in 1986 and amended the DSP agreement to eliminate the additionality requirement so that DSP could supply the regular GOP counterpart for selected projects from March 1, 1986 through March 31, 1987. The GOP completed disbursement of the RPSP pesos and the DSP pesos by the third quarter of CY 1986 and second quarter of CY 1987, respectively. BSP provided CY 1986 peso budget support to the GOP so that it could continue financing, in the midst of a severe budget crisis, basic services in the priority sectors of education, health and agriculture.

BSP II provided CY 1987 peso budget support for the education and health sectors. The BSP II dollars were used for repayments to the IMF. A.I.D. provided the dollar grant in two tranches with the first disbursed soon after grant signing and in consideration of policy reform progress at that time. A.I.D. disbursed the second tranche in the last quarter of CY 1987 upon GOP satisfaction of additional conditions precedent. These conditions included mutual agreement that progress had been satisfactory in implementing mutually agreed upon policies in the areas of providing a macroeconomic framework supportive of private sector led growth and reducing government involvement in the economy. Consultations between A.I.D. and GOP representatives leading to mutual agreement on policy reform progress under BSP II afforded the Mission a chance for extensive policy dialogue with the GOP on the whole range of the Mission's policy reform agenda. GOP implementation of the agreed upon actions was quite satisfactory overall.

The GOP's reports on unaudited disbursements for BSP eligible budget categories indicate that such disbursements had well exceeded the amount of BSP generated pesos and the minimum amount the GOP had agreed to disburse on the budget categories. GOP submission of the final BSP audited disbursement report is expected by the end of February 1988.

Reported unaudited cumulative disbursements on BSP II eligible budget categories as of the end of the third quarter of 1987 indicate that such disbursements had already exceeded the amount of BSP II pesos. The GOP also completed disbursement of the BSP II dollars by the end of the fourth quarter of 1987. A.I.D. expects the GOP to submit the 1987 fourth quarter unaudited peso and dollar disbursement reports by March 31, 1988 and the final audited disbursement reports by September 30, 1988.

Despite GOP attempts to close it, the domestic fiscal gap is likely to continue for some time. In addition, BOP problems associated with economic recovery are likely to recur. Hence, the country's medium-term economic outlook depends not only on the implementation of reforms but also on the availability of foreign resources to ensure financial stability. Therefore, over the medium-term, the Mission expects that program assistance will continue to play a significant role in its overall portfolio.

III. ANALYSIS OF NATIONAL GOVERNMENT BUDGET SITUATION

A. 1987 Performance

In 1987, the national government expenditure program reflected efforts to use fiscal measures to stimulate further growth beyond the frail performance in the preceding year. These efforts were reflected in the 13.6 percent increase in total expenditures and a 31 percent increase in tax revenues from 1986 levels. (See Table 3.) To the extent that the demand inducing components of the 1987 budget were translated into higher salaries and increased spending for infrastructure and other development projects, the national government was in some sense successful in pushing the economic recovery forward.

Total expenditures of the national government for the year were P125.5 billion. However, this level was lower than the projected level of P127.8 billion for the year. The lower actual expenditures have been attributed to below target disbursements for maintenance and other operating expenses and capital outlays other than infrastructure. Given some apparent underspending plus higher realized revenues, the budget deficit was pared down to P23.5 billion or 3.4 percent of GNP. The actual budget deficit for the year was 8.9 percent lower than earlier projected and 24.9 percent lower than in 1986. The GOP appears to have maintained a delicate balance between fiscal expansion and controlling the budget deficit.

B. 1988 Program

1. Levels

The national government's budget deficit for 1988 is expected to increase to P27.1 billion from about P23.5 billion last year. The deficit is equivalent to 3.5 percent of GNP. The P27.1 billion deficit results from estimated cash disbursements of P145 billion and expected revenue receipts of P117.9 billion. The GOP considers this budget deficit level as manageable, considering expected resources from both internal tax measures and foreign financing. While projected expenditures are 15.5 percent higher than actual expenditures in 1987, the GOP does not consider this fiscal stimulation as inflationary.

Table 3
National Government Cash Budget, 1986-1988
(In Billion Pesos)

	1986	1987		1988 Program
		Program	Actual	
Revenues	79.3	102.0	102.0	117.9
Tax Revenue	65.5	81.3	85.8	93.0
Non-Tax Revenue	13.8	20.7	16.2	24.9
Expenditures	110.5	127.8	125.5	145.0
Current Operations	66.9	101.1	98.2	115.1
Capital Outlays <u>1/</u>	16.1	15.1	12.6	19.9
Transfers to Government Corporations <u>2/</u>	27.5	11.6	14.7	10.5
Surplus/Deficit	(31.3)	(25.8)	(23.5)	(27.1)
Percent of GNP	5.1	3.8	3.4	3.5
Financing Account				
Net Borrowings	31.3	25.8	23.5	27.1
Domestic	27.7	20.9	15.3	27.0
Foreign	3.6	4.9	8.2	0.06

1/ Includes outlays for infrastructure, other capital outlays and capital transfers of ₱4.4 billion to the Philippine National Bank and the Development Bank of the Philippines in 1986.

2/ Includes equity and net lending to government corporations.

Source: Department of Budget and Management

The bulk of the expenditure program for 1988 will be for current and capital outlays (P135.0 billion), excluding funding for foreign assisted projects and net lending to corporations. Interest payments for outstanding liabilities to both domestic and foreign creditors will increase by about P3.0 billion. The bulk of interest payments will go to domestic creditors.

The bulk of revenues will come from domestic sources. Domestic based revenues will total P115.2 billion or 97.7 percent of total revenues from all sources. Foreign based sources of revenues, including the ESF and grants from other foreign governments, will be around P2.7 billion.

2. Financing

The budget deficit is planned to be financed mainly by borrowings from domestic sources (e.g., sale of treasury securities to the non-bank sector). Net borrowings from domestic sources will reach some P27.0 billion. This level is almost the same level of actual net domestic borrowings in 1986, but almost twice the level last year. Borrowing from external sources is projected to total only P64.0 million. If this target is realized, net external borrowings will drop sharply from P8.2 billion last year.

IV. POLICY REFORMS

A. Objectives

In January 1987, the GOP launched its blueprint for economic recovery through its Medium-Term Philippine Development Plan, 1987-1992. The Plan embodies a framework for policy reform and an economic agenda which endeavor to create conditions which encourage a private sector led development that is broad based and income and employment generating. Objectives of current policy efforts which the Mission judges as critical are:

- o Supportive macroeconomic framework
 - Market oriented foreign exchange policy
 - Fiscal responsibility
 - Monetary responsibility

- o Reduced government involvement in and regulation of the economy
 - Privatization of acquired assets and selected public corporations
 - Trade liberalization
 - Appropriate investment incentives

- o Greater focus on rural development
 - Free agricultural input and output pricing with effective grains price stabilization program
 - Healthy rural financial system
 - Improved rural infrastructure
 - Comprehensive agrarian reform program
- o Improvements in proper government functions
 - Decentralization
 - Effective delivery of basic services
 - Increased public accountability.

Through its policy dialogue, the Mission aims to encourage implementation of all these needed policy reforms. Within BSP III, the most likely areas of attention will be reducing government involvement and intervention in the economy, providing a supportive macroeconomic framework, implementing financial sector reforms and improving public accountability. These are critical areas which are at once central to the economic structural adjustment of the country and at the same time are relatively difficult to implement. While some of these areas also receive attention from the IMF and World Bank, the Mission believes that further encouragement will be useful in focusing attention, speeding up the decision making process, and overcoming resistance to change.

B. 1987 Accomplishments

In its second year, the Aquino Administration continued to implement policy reforms on all fronts. The formal policy review, conducted in October 1987 between the Mission and GOP representatives, indicates that substantial progress has been achieved in the areas of fiscal and monetary policies, privatization, trade liberalization, reforms in agricultural pricing, employment generation, and public accountability. A summary of the major accomplishments in 1987 are as follows:

- o Macroeconomic growth and stability
 - Firming up the process of recovery through a 5.05 percent growth in real output
 - Reduction in lending rates to an average of 14 percent
 - Maintenance of a free foreign exchange market

o Foreign debt management

- Agreements with the IMF on \$505 million of credit
- Agreement with the Paris Club on the rescheduling of \$870 million foreign debt
- Agreement with the country's 483 creditors on the rescheduling of \$13.2 billion in commercial loans

o Fiscal responsibility

- Implementation of 18 tax measures to improve incentives and efficiency
- Budget realignment in favor of basic services and maintenance and operating expenditures
- Constraining the public sector deficit

o Monetary responsibility

- Domestic price stability
- Keeping within monetary expansion targets

o Privatization

- Development and execution of the operating guidelines for the Committee on Privatization (COP), which has overall responsibility for privatization, and the Asset Privatization Trust (APT), the Government's privatization agent
- Presidential approval of the privatization of 86 public corporations and the subsequent issuance of privatization guidelines and appointment of disposition entities by the COP
- Transfer of 390 corporations with a total booked exposure of P108 billion from Philippine National Bank (PNB) and Development Bank of the Philippines (DBP) to APT
- APT's net sales of nonperforming assets of P4.35 billion as of December 31, 1987

- o Trade liberalization and tariff reform
 - Issuance of CB Circulars liberalizing 164 items in 1987
 - Passage of a tariff reform bill
 - Reorganization of the Bureau of Customs
- o Investment incentives
 - Establishment of One-Stop Action Center which has set a policy of acting on investment applications in 20 days
 - Operationalization of the "one-stop" shop for imports
 - Signing into law the Omnibus Investment Code which consolidated the investment promotion laws and incentive schemes administered by the Board of Investment and the Export Processing Zone Authority
 - Launching of the government's debt-equity conversion program and its expansion to include the sale of APT assets and government-acquired commercial banks
- o Liberalization of agricultural markets
 - Closure of state-owned retail stores (Kadiwa)
 - Continued partial deregulation of the importation/distribution of fertilizers
 - Completion of divestment studies for Food Terminal Inc. (FTI)
 - Maintenance of free export of copra
- o Development of rural finance
 - Consolidation of most agricultural credit programs under the Comprehensive Agricultural Loan Fund
 - Implementation of the Rural Bank Rehabilitation Program to restructure rural bank arrearages with the Central Bank and to infuse private capital into them
- o Improvement in rural infrastructure
 - Completion of projects financed under the Community Employment Development Program

- Refocusing priority from infrastructure construction to maintenance
- o Public accountability
 - Adoption of transparency as a matter of policy in all government transactions
 - Effective restoration of a system of checks and balances with the convening of Congress and the establishment of a Commission on Appointments
 - Cabinet revamps in response to public clamor
 - Creation of a Presidential Committee on Public Ethics.

The year 1987, however, was not without policy setbacks. A prolonged drought and a series of typhoons curbed growth in agriculture, forcing the government to undertake a massive rice productivity enhancement program involving subsidized fertilizer use in lieu of the less politically palatable option of direct cereal importation. Worldwide experience, however, shows that providing inputs at below market rates leads to rationing, diversion and rent seeking activities. The urgency for decisionmakers to adopt policies that would avert the pending production shortage is clear. However, the subsidy program may impose costs that far exceed potential benefits.

The instability following the failed August 28 coup precipitated significant Central Bank direct and indirect intervention in foreign exchange trading. Such policy, while directed at exchange rate stability, precluded full benefits of a flexible exchange rate regime.

Deregulation and privatization could have proceeded more speedily. Signs of vacillations in the pursue of these programs have sent wrong signals to the business community. The role of the APT was limited largely to the disposal of nonperforming assets and only ten government corporations have been turned over to it. The tariff bill remained in Congress for some time, and the final tariff structure presented for presidential approval shows slippages, a clear sign of strong lobbying by affected parties. In the wheat flour and fertilizer sectors, government intervention in trading was replaced by private sector oligopolistic arrangements.

The government also found it politically difficult to adhere strictly to market oriented pricing principles in the power and transportation sectors. Consumer subsidies have not been totally eliminated.

The comprehensive agrarian reform program (CARP), a campaign promise of President Aquino, remains on the legislative agenda. The CARP Executive Order was signed by the President in July 1987 but the matter of retention limits

and other critical issues were left for Congress to decide. The evolution of the draft bills shows increasing moderation of the program, which may not be acceptable to tenants and landless workers.

Overall, 1987 marked continued progress in a structural adjustment process that had begun many years before, but has received renewed and critical impetus from the coming-to-power of the Aquino Administration. The cumulative impact of the process became clearer with the 1987 economic growth. Except for rare cases like the removal of the ban on copra, individual policy changes have little impact in themselves, but added together they represent a basic reorientation of the economy which is leading to broader based, more employment generating growth.

C. 1988 Focus

Despite considerable and sustained progress, the GOP's policy reform program is far from complete. There remain issues to be resolved and tasks to be accomplished before the full benefits of the program are realized. For 1988 and the succeeding few years, the resolution of issues may be complicated by the legislative process as well as by the tendency of policymakers and implementors to backtrack from the reform program due to pressures from constituencies and interest groups. It is therefore imperative that the Aquino Administration focus its policy reform agenda on the most urgent tasks at hand.

Most pressing is a need to maintain a market oriented exchange rate policy. At present, the Central Bank remains an influential participant in foreign exchange trading and has shown a tendency to prop up the peso and thereby distort the exchange rate. Such temptations must be resisted. Actions to defend the exchange rate against clear economic signals for depreciation can ruin the export sector, run down international reserves, and derail medium-term structural adjustment.

The fiscal deficit remains a major problem. Financing it needs to be done in a manner that does not accelerate inflation or crowd out private investment. While external savings could help finance part of the deficit, structural measures such as the continued implementation of tax reforms and increased collection efficiency are needed. In this regard, the implementation of the value added tax (VAT) system is urgent. A massive information program has to be launched and strict penalties imposed on noncompliance. Closer monitoring of government owned and controlled corporations is also necessary.

There are still constraints in the monetary and financial sector. While certain adjustments have already been made (e.g., the lowering of the reserve requirement), intermediation cost is still very high. The tax on interest income is a disincentive to financial saving and must be reduced, if not eliminated.

The pace of the privatization program has to accelerate. Presidential announcements on the disposal of large public corporations must be followed up with a firm commitment to sell. The COP has to resolve issues on the direct debt buyout formula which APT has proposed for approval; the Monetary Board has to clarify its policy on who can qualify for debt to equity conversion; the issue of who has jurisdiction over the disposal of sequestered assets has to be resolved between APT and the Presidential Commission on Good Government(PCGG); and disposition entities such as the National Development Corporation (NDC) have to speed up their privatization programs.

Even after the import liberalization program is fully implemented in April 1988, there will still be 635 items covered by quantitative restrictions, including those covered under industry rationalization programs. There is a need to ensure that additional restrictions maintained on grounds of protection be replaced with tariffs. The tariff reform program itself must not be allowed to slip via higher-than-necessary tariff walls for specific commodities such as garments. Also, effective anti-smuggling and anti-dumping enforcement and better customs procedures must be put in place to ensure that the import liberalization program succeeds. There may likewise be a need to amend GOP's contract with SGS, an import surveillance company, to cover most, if not all, source countries.

The new Omnibus Investment Code undercut some of the reforms made in 1983, especially its reaffirmation of the measured capacity concept which is a departure from the GOP commitment to greater competition. In fact, the positive effects of trade liberalization may be negated by the certain protective provisions of the Code. A comprehensive study of the Code is in order. If necessary, Congressional amendment should be sought. The principle of free competition should also apply to the choice of firms in the progressive manufacturing development programs.

In agriculture, the passage of a workable agrarian reform program consistent with the provisions of the Constitution is urgent. Such a program is expected to provoke social disputes and involve massive bureaucratic and financial resources; the government must be ready for these. The government is also expected to attend to the other reform areas already initiated or in the process of being developed, such as further liberalization of the coconut sector, e.g., milling and dessication; sugar sector rationalization; drawing up of a grains' price stabilization program and corn production and importation policy; establishment of effective measures against restraint of trade in wheat and flour; programs for the divestment of FTI and other public corporations in agriculture; further liberalization in fertilizer trade; strengthening the rural financial system; and improvement in rural infrastructure, especially shipping and port services.

Government functions and the delivery of basic services can be improved further with a sincere effort at reorganization and decentralization. Although the government has deferred implementation of the program to overhaul

the entire bureaucracy due to the specter of massive layoffs, smaller scale reorganization has been going on in various government agencies and this should continue. The decentralization process also needs to be expedited through the strengthening of Regional Development Councils, greater fiscal autonomy to local government units, and the expansion of planning and implementing responsibilities to departments and bureaus involved in the delivery of basic services and rural infrastructure.

Bureaucratic and political corruption remains an endemic problem of the country and the matter of public accountability should be given high priority. Necessary for the reduction of corruption in the government bureaucracy are the strict enforcement of civil service rules, deregulation of government operations where applicable, further decentralization and reduction of the approval process, strengthening of GOP agencies' legal services and internal audit, and separation of licensing functions from service delivery functions. The judicial system has to be strengthened.

BSP III will provide a forum in which most, if not all, of these reform concerns can be discussed. Primary attention for BSP III in discussions with the GOP is expected to center on:

- Maintaining an internationally competitive foreign exchange rate
- Constraining the fiscal deficit
- Speeding up privatization, especially of public corporations
- Improving the rural financial system through reduction of intermediation costs
- Improving public accountability.

D. Relationship to Other Donors

A.I.D.'s policy reform focus complements those undertaken by both the IMF and the World Bank. The domestic sector performance criteria of the GOP's Adjustment Program under the current IMF Standby Arrangement emphasize fiscal responsibility (public sector deficit) and monetary responsibility (money supply growth). Exchange rate policy is also subject to program reviews. In addition, the Adjustment Program has six main elements of policy reform and structural adjustment: tax reform, public expenditure program, public non-financial corporations, public financial institutions, trade liberalization and agricultural reform.

The World Bank's \$300 million Economic Recovery Program (ERP) and the accompanying \$10 million Economic Recovery Technical Assistance Project (ERTAP) also support basic policy changes in four of the six areas included under the GOP Adjustment Program, i.e., tax reform, public expenditure

program, public financial corporations, and trade liberalization. The World Bank is proposing to handle the public non-financial corporations separately through a planned \$150 million Government Corporate Sector Rationalization Loan. This loan is conditioned on GOP's issuance of administrative orders to monitor strictly the performance of government owned and controlled corporations.

The World Bank is also initiating policy reforms in specific sectors of the economy. It expects to commit this year or next a \$150 million Housing Sector Program; a \$177 million power sector loan to complete the Bacon-Manito geothermal plant, release of which is premised on the completion of an energy sector study to assess the short- and long-term options of the energy sector; and a \$70 million Sugar Rehabilitation and Diversification Program.

In view of the importance of policy reform as a precondition for sustained economic recovery, there is an increasing interest in the donor community to provide resources that are policy-based. A more active and careful coordination among donors is required and a concerted approach to policy reform is necessary. The World Bank has suggested a mini-consultative group meeting sometime in 1988 and this should provide a proper forum for further discussion of donor activities and policy conditionalities.

V. PESO USES

The delivery of basic education and health services remains a major concern of the Aquino Administration. Limited budget appropriations for these two crucial sectors, however, impairs the government's ability to meet its targets. Therefore, A.I.D. will support these efforts through contributing ESF generated pesos to the education and health budgets. Other mutually agreed upon high priority areas may also be supported. This support will not be in addition to budgeted levels, but will ensure that a good proportion of these levels will be actually realized in the face of the tight fiscal conditions. In addition, A.I.D. will negotiate with the GOP for the creation of a revolving fund to supply advances in support of the implementation of A.I.D. development assistance projects.

A. Education

The Philippine education sector has expanded considerably over the past two decades. The number of elementary schools has increased by 50 percent since 1965, and the secondary and tertiary schools by well over 100 percent. Despite the implied magnitude of this investment, secondary enrollments stand at 65 percent of school-age population and tertiary at approximately 30 percent (universal primary enrollment was attained in 1960, but may not be still true today). Despite GOP commitment to expand the secondary sector in the next five years, high population growth rates will restrict net growth to less than 5 percent over this period. The literacy rate in the Philippines

(about 75 percent) disguises the magnitude of illiteracy and low skill level among Filipino youth. The average elementary school completion rate for the nation is approximately 60 percent and only slightly higher for students enrolling in secondary schools. Poor quality of schools and instruction is further evidenced by consistently poor achievement scores by students from all regions on primary and secondary school standard exams. Internal efficiency, as measured by repetition and dropout rates and test performances are markedly poorest in areas most distant from the national capital.

The fiscal incapacity of the GOP has caused problems of system growth, access to schools and poor quality. The Aquino Administration has redressed a number of these problems. The education budget has been increased substantially to P15.1 billion in 1988 and teacher salaries have been upgraded and nationalized (i.e., paid by the national rather than local government). However, free public secondary education has been enshrined in the new Constitution and this is expected to put further strains on the education budget. Hence, despite the GOP's commitment to redress problems in education, sector investments will depend heavily on donor assistance in the near future.

The government's Five Year Development Plan for Education (1987-92) focusses on improving the quality of the system and meeting the provision of the new Constitution for free universal secondary education. Teacher salary increases, upgrading teacher quality, new construction, and increased textbook production are the major vehicles identified by the GOP for realizing increased educational opportunity and greater internal efficiency and quality of instruction. Implementation of these ambitious plans will rely largely on foreign loans/assistance. The World Bank is currently engaged in an education sector assessment.

B. Health

Over the last few years, the overall health and nutritional status of the average Filipino, especially children in 0-5 year age grouping, has declined. Life expectancy and child survival rates have slowed down since 1985 and the mortality situation has not improved since 1980. A 1986 immunization coverage survey found only 21 percent of children under five fully immunized. A 1987 report by the Department of Health (DOH) showed one-half of the country's provinces having combined rates of second and third degree malnutrition among children of 20 percent or more and five provinces with more than 30 percent. Meanwhile, the health sector continues to be beset by institutional, financial and manpower constraints. Problems of high health personnel turnover and shortages, severe restrictions in medical supplies, and hampered implementation of outreach programs remain. Communicable and infectious diseases continue to be prevalent, requiring the expansion of vaccination and disease prevention programs.

A.I.D. has already initiated significant efforts to improve child survival through national Oral Rehydration Therapy (ORT), immunization, and child feeding programs. However, the magnitude of the financial, manpower and institutional constraints on resolving the country's health and medical problems require a higher level of resources. Further, the policy and operational decisions already taken by the GOP leadership in the sector indicate positive steps toward reducing the constraints noted above and should be encouraged by additional support. For example, DOH has already targeted high cost curative hospitals for improvement, through closings, improvements in operations, and reductions in inefficiencies. DOH facility planning is now focused on logical catchment areas rather than political expediency. A medical manpower study of medical schools aimed at closing high cost, low quality production of doctors is on top of the DOH agenda as are financing studies aimed at reducing recurrent costs of the medical system and other DOH operations.

C. Budget Requirements

In 1988, the budget of the Department of Education, Culture and Sports is ₱15.1 billion of which 87 percent is for current operating expenditures. By major category, regional operations accounts for 91 percent of the total budget. The 1988 Department of Health budget amounts to a smaller ₱5.0 billion, with current operating expenditures accounting for 90 percent. Major budget categories include regional operations, general administration and special projects.

The intent of BSP III is to sustain, or at least minimize any cuts in, programmed levels of selected budget items under the pressures of continuing financial constraints. In particular, BSP III is expected to support such categories as regional elementary education operations for regions relatively lagging in student performance and regional field health services.

D. Revolving Fund

BSP III will also provide ₱100 million (or around \$5 million) to capitalize a GOP Revolving Fund for A.I.D. assisted projects. A Mission contracted study on the GOP financial management system indicates that despite the conversion into grants of the USAID development assistance portfolio in 1986, implementation of A.I.D. assisted projects continues to be slow. First in terms of sequence among major factors contributing to the continued poor rate of implementation of projects are: a) GOP accounting regulations require grant proceeds to be on hand prior to release by the Department of Budget and Management (DBM) of A.I.D. local currency funds as well as GOP peso counterpart; b) advances of funding by A.I.D. to meet this requirement must be on a contract-by-contract basis; and c) U.S. Treasury regulations limit advances of funds to 90 days and to the amount of the recipient's actual cash needs for such period.

The Revolving Fund is intended to address these constraints by consolidating advances for all A.I.D. assisted projects. The Revolving Fund will be reserved for monthly releases from the GOP to A.I.D. assisted projects in amounts approved by DBM. With GOP agreement, BSP III will capitalize the Revolving Fund through an initial deposit of P100 million. The GOP in turn will use the fund to provide the cash necessary to implement A.I.D. development assistance projects. The GOP will replenish the fund as reimbursements are received from A.I.D. The effect of this mechanism will be to cut one entire step from the current two step advance and reimbursement process. It will also serve to speed the issuances of contracting authorities to the implementing agencies from DBM as the deposits required for the releases will already be in the hands of the GOP in the Special Revolving Fund.

VI. PROGRAM

A. Objectives

The objectives of the proposed program are to provide ESF funds as general budget support to the GOP and to encourage continued implementation of economic policy reforms.

B. Description

The grant will provide \$75 million to the GOP for budget support. The dollars will be used for servicing GOP official debt to multilateral development institutions such as the IMF, IBRD and ADB. The generated pesos will be for budget support for the priority sectors of education and health as well as, if acceptable to the GOP, for the establishment of a revolving fund to provide advances for A.I.D. DA projects. Other dollar and peso uses may also be agreed to.

Grant signing will be contingent on Mission determination that the GOP has achieved further acceptable progress in 1988 in the planning for and the implementation of policy reforms. To determine this, the GOP and the Mission will hold a joint review of progress through the first quarter of 1988 and plans for the rest of 1988. After grant signing, A.I.D. will disburse the entire \$75.0 million in a single tranche upon satisfaction of the program grant's legal and administrative conditions precedent (CPs).

The following are the procedures which the Mission will require of the GOP for the dollars and the pesos.

1. Dollar Transfers

Upon satisfaction of the legal and administrative CPs to disbursement of dollars to the GOP, A.I.D. will disburse on behalf of the GOP the \$75.0 million for deposit in a separate account or accounts with the bank or banks specified by the GOP--most likely, the New York branch of the Philippine National Bank. The separate bank accounts into which dollars disbursed are deposited will be referred to collectively as the "BSP III Dollar Special Account." Funds deposited in this Account will not be commingled with funds from any other source. The Account will include any interest earned from funds held in this Account. The Account will be used for payments of debt obligations to multilateral development institutions in accordance with mutually agreed upon implementation plans or for such other agreed upon purposes.

Prior to the disbursement of any dollars from the Dollar Special Account, the GOP will furnish A.I.D. a dollar implementation plan specifying: (i) the responsibilities and interrelationships of the entities involved in the disbursement of funds from the Account; (ii) a schedule of payments--identifying payees, amounts and due dates--proposed to be made by the GOP; and (iii) the type of documentation to be obtained and maintained by the GOP evidencing uses of the dollars.

2. Peso Generations

Within one business day of deposit of dollars by A.I.D. in the Dollar Special Account, the GOP will establish one or more separate bank accounts (collectively the "BSP II Peso Special Account") and will deposit therein an amount of pesos equivalent to the dollar disbursement. Funds deposited in the BSP III Peso Special Account will not be commingled with funds from any other source. The BSP III Peso Special Account will include any interest in respect to funds held in this Account.

Prior to the initial transfer of pesos from the BSP III Peso Special Account to the GOP General Fund, the GOP will furnish to A.I.D.: (i) a copy of an implementation plan specifying the responsibilities and interrelationships of the entities involved in the implementation of the budget support component; (ii) a statement of the budget categories and eligible programs within those categories, based on the GOP 1988 Budget Year, against which disbursements in 1988 for costs incurred or to be incurred in 1988 will be reported for purposes of BSP III and a statement of the minimum amount of pesos agreed to be disbursed in 1988 in those budget categories for such costs; and (iii) a statement of estimated disbursements through the end of the second quarter of the GOP 1988 Budget Year that the GOP and A.I.D. agree is reasonable for the budget categories specified. Upon A.I.D. notification that the above conditions have been satisfied, the GOP will transfer, to the extent available, pesos from the BSP III Peso Special Account to the General Fund in an amount sufficient to cover the above estimated disbursements.

Prior to any subsequent transfer, the GOP will be required to furnish A.I.D. unaudited quarterly reports of disbursements for costs incurred in the agreed upon budget categories and a statement of estimated disbursements for up to two quarters following the reported period. Upon notification by A.I.D. that the report is satisfactory, the GOP will transfer pesos, to the extent available, contained in the BSP III Peso Special Account to its General Fund in an amount which when added to (i) the amount by which the cumulative amount of pesos previously transferred from the BSP III Peso Special Account exceeds the amount that the report shows to have been disbursed as of the end of the reported on period for costs incurred on or after January 1, 1988 in the agreed upon budget categories, equals (ii) the amount of pesos that A.I.D. and the GOP mutually agree is reasonable during the one or two fiscal quarters following the reported period. The transfer of pesos from the BSP III Peso Special Account to the General Fund will continue in this fashion until all pesos in the BSP III Peso Special Account have been transferred.

3. Monitoring and Reporting

Monitoring and reporting of dollar and peso transactions will include:

a. Quarterly reports of unaudited disbursements which will be due by the end of the following quarter. The BSP III dollar report will include each disbursement from the Special Account with a specification for each disbursement of the payee and the amount and date of payment, together with a certification that the GOP has obtained and is maintaining documentation for each disbursement. The peso report will include cumulative actual disbursements by specific budget category through the end of the period reported upon for costs incurred in the GOP's Budget Year in the agreed upon budget categories, together with a certification that all the disbursements or at least an amount equal to the amount of pesos released from the Peso Special Account to the General Fund as of the date of certification has not been reported against other external assistance available for disbursements for such costs.

b. A final report audited by the GOP Commission on Audit which will be provided by September 30, 1989. The report will cover (i) the use of dollars disbursed from the BSP III Dollar Special Account, and (ii) peso disbursements through the end of 1988 for costs incurred during CY 1988 in the budget categories agreed upon.

In addition to reports generated within the program, the Mission is working to better follow policy reforms and impacts through the use of Project Development and Support (PD&S) funds. The Mission has contracted the University of the Philippines School of Economics to design a system and identify major indicators of policy reform actions and impacts. The report is expected to be submitted by March or April 1988 with follow-on work likely. An appraisal of Mission program assistance efforts to date, involving American and Filipino economists, is also planned for the summer. The appraisal will

include an attempt to analyze impacts and suggest future policy reform focus. These activities will provide important inputs for monitoring impacts of BSP III and for the design and evaluation of future program assistance.

C. Funding Source

In December 1987, the U.S. Congress approved an ESF appropriation for the Philippines. A.I.D. is currently negotiating with the GOP to allot \$75 million of this appropriation to fund this proposed program.

D. Program Design

Upon approval of this Program Assistance Initial Proposal (PAIP), the Mission will proceed to complete the Program Assistance Approval Document (PAAD). USAID does not anticipate that any A.I.D./W TDY or outside assistance will be required.

VII. ISSUES

1. The Mission has opted to make the joint policy review a condition to signing the proposed grant rather than establish the review as a condition precedent to disbursement. This procedure will delay obligation of the funds. However, this is considered preferable because it would be best not to have the USG in the position of negotiating conditions to base compensation moneys at the same time the 1988 base negotiations are underway. A reasonable assumption is that the GOP will be attempting to secure USG agreement at that time to place minimal controls over the use of ESF (the rent vs aid issue).

2. Is servicing GOP official debt to multilateral institutions still an acceptable use of the dollars?

In fulfilling the congressional requirement on tracking the dollars, this PAIP proposes to continue the BSP II practice of allowing the GOP to use the dollars to pay obligations to the ADB, IBRD, and IMF. (Under BSP II, the GOP actually used all the dollars for payments to the IMF.)