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Private Sector Assessment (PSA)

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CURRENCY EQUIVALENTS

July 11, 1994	-	Pesos 26.9
Average 1993	-	Pesos 27.1
Average 1992	-	Pesos 25.5
Average 1991	-	Pesos 27.5
Average 1990	-	Pesos 24.3
Average 1989	-	Pesos 21.7

ABBREVIATIONS AND ACRONYMS

ADB	-	Asian Development Bank
APT	-	Asset Privatization Trust
ASEAN	-	Association of Southeast Asian Nations
BER	-	Basic Economic Report
BOI	-	Board of Investments
BOO	-	Build-Operate-Own
BOT	-	Build-Operate-Transfer
BSP	-	Bangko Sentral ng Pilipinas
BTO	-	Build-Transfer-Operate
CAB	-	Civil Aeronautics Board
CB-BOL	-	Central Bank-Board of Liquidators
CBP	-	Central Bank of the Philippines
CCPAP	-	Coordinating Committee for Philippine Assistance Program
CEM	-	Country Economic Memorandum
CIB	-	Credit Information Bureau
CISO	-	Conference of International Shipowners and Operators
CMA	-	Central Monetary Act
CMTS	-	Cellular Mobile Telephone Service
COA	-	Commission on Audit
COP	-	Committee on Privatization
CPCN	-	Certificate of Public Convenience and Necessity
CPSD	-	Consolidated Public Sector Deficit
DBP	-	Development Bank of the Philippines
DENR	-	Department of Environment and Natural Resources
DGES	-	Directorate General of Electricity Supply (Malaysia)
DO	-	Department Order
DOE	-	Department of Energy
DOTC	-	Department of Transportation and Communications
DPWH	-	Department of Public Works and Highways
DST	-	Documentary Stamp Tax
DSWD	-	Department of Social Welfare and Development
DTI	-	Department of Trade and Industry
ECO	-	Expanded Cofinancing Operation
EIS	-	Environmental Impact Statement
EO	-	Executive Order
EPR	-	Effective Protection Rate
EPZ	-	Export Processing Zone
EPZA	-	Export Processing Zone Authority
ERB	-	Energy Regulatory Board
ERL	-	Economic Recovery Loan

ABBREVIATIONS AND ACRONYMS (cont.)

ESAP	-	Energy Sector Action Plan
ESW	-	Economic and Sector Work
FCDU	-	Foreign Currency Deposit Unit
FDI	-	Foreign Direct Investment
FIA	-	Foreign Investment Act
FIAS	-	Foreign Investment Advisory Services
FTAA	-	Financial and Technical Assistance Agreement
FSAL	-	Financial Sector Adjustment Loan
GATT	-	General Agreement on Tariffs and Trade
GDP	-	Gross Domestic Product
GFI	-	Government Financial Institution
GFSME	-	Guarantee Fund for Small and Medium Scale Enterprises
GMCC	-	Government Monitoring and Coordinating Committee
GMDSS	-	Global Maritime Distress and Safety System
GNP	-	Gross National Product
GOCC	-	Government-Owned and -Controlled Corporation
GRT	-	Gross Receipts Tax
GSIS	-	Government Service Insurance System
GT	-	Gross Ton
IBRD	-	International Bank for Reconstruction and Development
IFC	-	International Finance Corporation
IMF	-	International Monetary Fund
IPO		Initial Public Offering
IPP	-	Independent Power Producer (Power Sector)
IPP	-	Investment Priorities Plan
ISIC		International Standard Identification Code
JEXIM	-	Export-Import Bank of Japan
KDC	-	Key Development Center
KLSE	-	Kuala Lumpur Stock Exchange
LBP	-	Land Bank of the Philippines
LGU	-	Local Government Unit
LIFRB	-	Land Transportation Franchising and Regulatory Board
MARINA	-	Maritime Industry Authority
MERALCO	-	Manila Electric Company
MICT	-	Manila International Container Terminal
MIGA	-	Multilateral Investment Guarantee Agency
MKSE	-	Makati Stock Exchange
MMTC	-	Metro Manila Transit Corporation
MSE	-	Manila Stock Exchange
MUC	-	Major Urban Center
MWSS		Metropolitan Waterworks and Sewerage Systems
MVDP		Motor Vehicle Development Program
MW		Megawatt
NCSO		National Census and Statistics Office
NEA		National Electrification Administration
NEB		National Electricity Board (Malaysia)
NEDA		National Economic Development Authority
NFA		National Food Authority
NG		National Government

ABBREVIATIONS AND ACRONYMS (cont.)

NGO	-	Non-governmental Organization
NIA	-	National Irrigation Administration
NPA	-	Non-performing Assets
NPC	-	National Power Corporation
NSC	-	National Steel Corporation
NTC	-	National Telecommunications Commission
OD	-	Operational Directive
ODA	-	Official Development Assistance
OECF	-	Overseas Economic Cooperation Fund
OMO	-	Open Market Operations
OPSF	-	Oil Price Stabilization Fund
PAL	-	Philippine Airlines
PASAR	-	Philippine Associated Smelting and Mining Corporation
PCGG	-	Presidential Commission for Good Government
PCO	-	Public Calling Office
PHILPHOS	-	Philippine Phosphate Fertilizer Corporation
PIPP	-	Philippine Infrastructure Privatization Program
PLDT	-	Philippine Long Distance Telephone Company
PNB	-	Philippine National Bank
PNOC	-	Philippine National Oil Company
PPA	-	Philippine Port Authority
PSA	-	Private Sector Assessment
PSC	-	Public Service Commission
PSD	-	Private Sector Development
PSE	-	Philippine Stock Exchange
QR	-	Quantitative Restriction
RR	-	Reserve Requirements
ROR	-	Rate of Return
RSA	-	Revised Securities Act
SBL	-	Single Borrower Limit
SEC	-	Securities and Exchange Commission
SEMIRARA	-	Semirara Coal Corporation
SIPF	-	Securities Investor Protection Fund
SITC	-	Standard Industry Trade Classifications
SMC	-	San Miguel Breweries
SME	-	Small- and Medium-Size Enterprise
SOE	-	State-Owned Enterprise
SRRS	-	Interisland Liner Shipping Rate Rationalization Study
TA	-	Transferred Assets
TCC	-	Traffic Control Center
TNB	-	Tenaga Nasional Berhard (Malaysia)
UNDP	-	United Nations Development Programme
USAID	-	United States Agency for International Development

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Preface

The report was prepared jointly by the World Bank and IFC.

World Bank inputs to the report were task managed by Mr. Yalcin M. Baran, with contributions from Mr. Martin Edmonds, Mr. Aldo Baietti, Ms. Erika Jorgensen, Mr. Sheyam Khemani, Mr. Robert Pardy, Mr. Mark Shacter, Mr. Peter Smith, Mr. Douglas Webb (Bank Staff), Mr. Roger Boner, Mr. Mario Lamberte, Mr. Peter Wallace, and Mr. Bruce Owen (Consultants). Mr. Peter Cordukes, Mr. John Nash, and Mr. Bjorn Wellenius provided peer review for specific chapters; Messrs. Rolando Arrivillaga, Faruq Iqbal, Andrew Stone, and Michael Walton were the peer reviewers for the whole report. An enterprise survey carried out by Access-Asia and the Philippine legal firm, Sycip, Salazar, Hernandez & Gatmaitan also contributed to the report. Ms. Mercedes Pendleton and Ms. Alicia Roaquin assisted in the preparation of the report.

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Mr. Hassan El-Rifai (MIGA) and Mr. Boris Velic (FIAS) also contributed to the report.

The report was discussed with the Government on June 14-15, 1994. The report was cleared by Mr. Vineet Nayyar, Mr. William McCleary (World Bank) and Mr. Dileep Wagle (IFC).

I. A PROFILE OF THE PRIVATE SECTOR

A. Background

1.1 The Philippines is largely a private sector oriented economy, although in many ways (both direct and indirect) the Government plays a key role in shaping business outcomes. The boundary between private and public activity blurred during the Marcos administration. Since 1986, the definition of the boundary has been redefined with more clarity regarding the role of each sector. However, even today the distinction between what is public and what is private is not easy to make. Not only are a number of top corporations publicly-owned, but the Government still owns large shares in "private" companies such as Philippine Airlines (PAL). Other major companies such as San Miguel Corporation have large blocks of shares which were sequestered by the previous administration after Marcos was toppled, but ownership of those companies is not unambiguously clear. In addition, there remains in the Philippines an element of public sector influence over the decision making of some of the larger private companies, and this, coupled with corporate influence at the government level, results in private-public transactions not always being dealt with at an arms-length basis. The granting of franchises, the allocation of loans through public financial institutions and the inconsistent enforcement of regulatory mechanisms each have provided examples of how the more established elements within the business sector continue to give as much priority to the relationship with the government as to the marketplace as a source of growth. This may explain why those private sector groups with large real estate holdings have preferred to expand in the domestic market and, hence, why an "export mentality" prevalent in most Southeast Asian countries has not taken root in the Philippines.

1.2 According to national accounts data, the private sector in 1993 accounted for around 72 percent of fixed investment in the domestic economy, but this share has fluctuated considerably in recent years. As recently as 1988, private businesses accounted for 87 percent of total investment in the Philippines, but this proportion has declined slightly since then because of a drop in private investment. By comparison, the private sector share of total investment in 1990 was 67 percent in Malaysia, 58 percent in Indonesia and 82 percent in Thailand (and on a rising trend in each country).

1.3 Neither real private nor public investment grew significantly over the period 1980-93 (Figure I.1), leading to low investment rates, poor infrastructure and rundown private capital. The expansion in infrastructure investment (mainly by the public sector) slowed down once the debt crisis in 1983 unfolded. Similarly, because a significant share of private investment undertaken during the 1970s involved explicit or implicit government subsidies, the deterioration in public finances in the early 1980s also resulted in reduced public sector support for private investment. As the financing of large and growing public sector deficits became difficult to finance, the previous administrations found it increasingly difficult to provide incentives to selected private firms, such as tax write-offs, directed credit, and foreign exchange access. Although some efficient investments were undertaken during this period, a number of inefficient but very large undertakings were also made under the guise of "crony capitalism".[1] Some of these investments increased private sector capital formation, they also expanded the country's external debt burden, while others only raised the debt level without having any appreciable impact on output. Poor private investment performance also reflects the impact of other policy and infrastructural impediments as well as the conduct of the private sector in trying to protect its market share through various entry barriers rather than by undertaking necessary investments, as in

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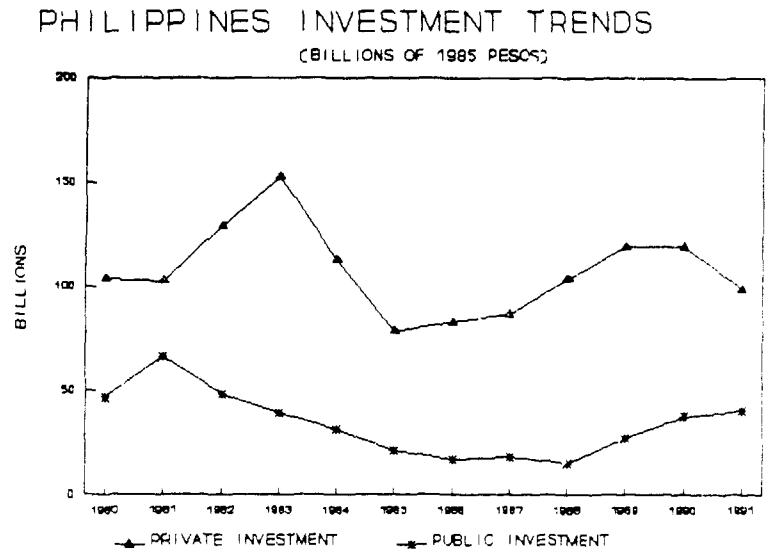
1 Some US$6.[illegible] billion of questionable state loans were made to 419 companies during the Marcos years. The 419 debtor companies were subsequently transferred to the Asset Privatization Trust (APT) to enable their disposition.

telecommunications and transport. It may also reflect the relative attractiveness of financial investments over risky physical investments, given the still high risk-free real T-bill rates (which have come down to 15 percent recently, while real rates have averaged in a range of 5 - 8 percent annually).

Figure I.1



Investment and Savings

1.4 Private investment has risen in the last two years to equal 17.2 percent of GNP in 1993 (see Table I.1). This expansion was fueled mostly by private investments in power and telecommunications. Public investment also rose in the last two years as public current outlays were restrained. The worrisome trend is the declining savings both in the public and private sector alike in 1993. This trend needs to be reversed in the subsequent years for sustained economic growth. In the short-term, the private investment-savings gap has become the binding gap.[2] Household savings (including unincorporated businesses), which in the late 1970s up to the mid-1980s was a major source of national savings, has fallen drastically in recent years, even turning negative in 1993. Increased savings would reduce dependence on foreign savings, which rose from 5.9 percent of GNP during 1993.

[2] Especially since foreign exchange and fiscal constraints are being addressed.

Table I.1: Investment and Savings, 1988-93[a/]

	1988	1989	1990	1991	1992	1993
Gross investment	18.5	22.1	22.4	20.1	21.7	23.6
Public	3.3	4.1	4.9	4.8	5.5	6.4
Private	15.2	18.0	17.5	15.3	16.2	17.2
National savings	17.4	18.7	16.3	17.8	19.8	17.7
Public	0.9	-0.1	-0.1	3.3	2.9	2.3
Private	16.5	18.8	16.4	14.5	16.9	15.4
Foreign savings[b/]	1.1	3.4	6.1	2.3	1.9	5.9
Public saving-investment gap	-2.4	-4.2	-5.0	-1.5	-2.6	-4.1
of which: NG deficit	-2.9	-2.1	3.4	-2.1	-1.1	-1.4
Private saving-investment gap	1.3	0.8	-1.1	-0.8	0.7	-1.8

a/ Investment and savings adjusted from National Income Accounts. Non-monitored corporations are excluded from the public sector; investment in the Comprehensive Agrarian Reform Program is excluded from public investment. Private shares are calculated as residuals.

b/ Foreign savings equal the current account deficit.

Source: NEDA, IMF and World Bank staff estimates.

1.5 Investment performance has also been affected by shifting patterns of **foreign direct investment** (FDI). Following the rise of nationalism in the early 1970s, the framework became more restrictive: Foreign banks had been limited to four until this year, public utilities were mandated to be 60 percent Filipino-owned, and retail trade was closed to foreign direct investment. After 1972, foreign investment was made only with the approval of the Board of Investments (BOI). Moreover, because foreign investors perceived public policy as inconsistent, foreign capital inflows were limited, especially as compared to flows received in neighboring countries. Most foreign investment in the 1970s was from Japan and other countries in the region; the main recipients were vehicle assembly and consumer goods.

1.6 In the 1990s, the stock of foreign investment equaled US$3,303 million, of which US$741 million was in oil and gas, US$431 million was in chemicals and chemical products, US$398 million was in banks and other financial institutions, and US$312 million was in food. In 1991, multinational firms comprised 14 of the top 50, 34 of the top 100, and 115 of the top 500 firms in the country. The Philippines has not attracted significant foreign investment in recent years in comparison with its neighbors. However, there was an increase in FDI inflows after 1987 due to a debt-equity swap program between 1986 and 1988.[3]

[3] The United Nations estimates that 21 percent of FDI flows to the Philippines from 1985-89 came from debt-equity swaps.

1.7 Foreign portfolio investment in the Philippines has also been erratic, reflecting investors' response to its domestic political problems. Foreign direct investment averaged under US$200 million per year in recent years, compared to US$1-4 billion in neighboring countries. From a peak of US$344 million in 1982, foreign equity investment inflows fell to less than US$100 million in 1987-88, before rising to an average US$328 million during 1990-93.

1.8 The limited attractiveness of the Philippines as an investment site coincided with the emergence in Asia of rapid growth in cross-border capital flows. From the mid-1980s onwards, large volumes of both loan and equity capital was transferred from Japan (and later Korea and Taiwan, China) to the emerging economies of East Asia undergoing rapid transformation and growth. The Philippines remained largely isolated from these capital flows (due in large part to civil unrest and external debt problems) and, as a result, its investment performance lagged further behind that of its neighbors. U.S.-based investment actually fell during the mid-1980s; even in 1990, U.S.-based investment was lower than in the late 1970s. While investment from Japan rose, the Philippine share was much lower than that for Malaysia or Thailand. The last major slump in FDI occurred in 1984, when the inflow of new direct investment fell to US$9 million, though FDI inflows have gradually risen since then.

B. The Structure of Philippines' Business

1.9 The private sector in the Philippines is highly segmented. Within the private business sector, a substantial amount of economic activity is accounted for by a relatively small number of firms operating across a range of sectors. According to the latest (1988) census, there were 9,141 establishments in manufacturing in the Philippines. Less than 10 percent of these establishments (822 in total) employed more than 200 people, yet they accounted for 64 percent of total manufacturing employment, and 77 percent of manufacturing value added. Food processing and garment manufacturing firms accounted for the largest share of these firms by number.

1.10 Most firms in manufacturing are small and account for only a fraction of the total value added in the sector. Although the micro and small firms seem to compete with each other, they are not necessarily economically efficient; they have been sustained in part by government policies designed to encourage small enterprises.

1.11 Until recently, most industries have been primarily assemblers of imported parts, a reflection of past import-substituting policies. With few exceptions, protectionism has led to mostly inefficient companies manufacturing generally inferior products at relatively high prices. With their domestic markets protected, and given the existence of an anti-export bias, industries are not encouraged to develop products for export, and therefore limit themselves to the relatively small domestic market. The Philippine manufacturing sector is predominantly oriented toward consumer goods, which represent 53 percent of manufacturing value added. Intermediate goods used as inputs in producing petroleum products account for 25 percent of value added, and capital goods, including electronics, account for 22 percent. Within the capital goods sector, electrical equipment and electronics increased its share of manufactured value added to 9.2 percent. The share of transport equipment and other machinery dropped, however, reflecting a move from capital-intensive, mostly inefficient, industries toward labor-intensive production of electronic components. The Philippines has comparative advantages in the latter in terms of the cost and qualifications of its labor force.

1.12 The manufacturing sector is also heavily concentrated in the national capital region. The degree of regional concentration, however, has declined in the last decade. In 1980, Metro Manila accounted for nearly 45 percent of gross value added in manufacturing; this share fell to 39 percent by 1992. Correspondingly, there were small increases in the shares of southern Tagalog (near Manila) and central Luzon. Although the Government has provided tax incentives for private firms to locate outside the national capital region, there has been only a limited supply response because of the lack of transportation and communication infrastructure in regions away from Metro Manila. It seems that there are still greater benefits to locating near the main centers of demand.

1.13 **Dearth of Medium-size Firms**. Medium-sized firms, numbering 683, comprised only 0.9 percent of the total. In the footwear industry, for example, only 24 firms (about 5 percent) out of 484 registered companies have more than 50 workers. The lack of medium-size firms, which tend to be more labor-intensive than large firms, means a reduced capacity to generate employment. The proliferation of small firms, however, has not led to creation of high-productivity jobs.

1.14 At the end of the 1960s, the formal private sector consisted of (a) relatively advanced, oligopolistic and protected family-based conglomerates operating in agriculture, mining, light processing, food processing and real estate; (b) ethnic Filipino-Chinese companies operating in trade, light manufacturing (e.g., textiles), banking, and finance; and (c) multinational firms, predominantly of U.S. origin, engaged in exporting raw or semi-processed goods to the United States or in selling U.S. brands in the domestic market. These three groups continue to dominate the formal private sector. At present, multinational firms account for about a fourth of GDP, and family-based conglomerates and Filipino-Chinese together account for another one-fourth.

1.15 Between 1972 and 1986, new groups emerged. These included (a) "cronies" of the Marcos regime, whose success was largely dependent on access to political power and patronage; (b) some small and medium-size firms, which developed as a result of government policies; (c) informal entrepreneurs; and (d) export-oriented firms engaged in the export of such manufactured goods as garments and electronics. These new groups have not been not able to grow rapidly as a result of a multitude of entry barriers as discussed in Chapter II.

1.16 The persistence of large family groupings in the private sector has significant implications for capital accumulation, asset acquisition, and investment strategies. Family groupings represent a concentration of wealth based on landed estates dating back to Spanish colonial times. Indeed, despite the emergence of other groups, there has not been a significant change in the concentration of wealth in the country over the past three decades. In 1961, the National Statistics Office estimated that 20 percent of the households received 57 percent of the income; in 1988, the same 20 percent received 54 percent of the income.

1.17 The large family groupings continue to maintain significant investments in agriculture — principally sugar, coconut, and forest products. From this foundation, they have diversified into agricultural processing and food industry products, urban real estate (especially in Manila and Cebu), financial services (banking and insurance), and a range of quasi-public services such as transport, telecommunications, and power distribution. Manufacturing (or, more commonly, assembly) has been a peripheral interest of the family groupings; where interest has developed, it has been focused on textiles, home appliances, and automobile parts. During the Marcos years, some family groupings lost and others prospered. Since 1986, following the reorientation toward the private sector, traditional family groupings have become stronger. The concentration of wealth among a few families allowed for little domestic or foreign competition. There has been a tendency in family-based manufacturing firms

to divert profits to other sectors rather than to reinvest in technological development or other modes of gaining competitive advantage. This is especially evident in the telecommunications sector, but also in some industrial sectors such as in textiles.[4]

1.18 A major problem in the private sector is the continued dominance of the manufacturing sector by a few large firms. Existence of a multitude of entry barriers (see Chapter II) led to inefficient and oligopolistic behavior in which the large firms do not compete vigorously with each other. The focus of the large Philippine companies on high-profit, low-volume, domestic markets rather than competitive, high-volume, global markets has meant that these companies have not grown as fast as their counterparts in other Southeast Asian economies. It is common in the private sector to look to the Government to solve a wide range of problems — from relief from energy costs to protection from foreign competition to suppression of labor agitation. Access to political power is not widely distributed, however, and the beneficiaries of government interventions have tended to be large enterprises and the major family groupings.[5] Recent government actions indicate an easing in this stance, but the overall regulatory framework has encouraged rent-seeking and collusion to limit competition, and has reduced the need to be efficient.

1.19 The cartel-like structure in most sectors is also found in the financial sector. In the past, loans to directors, officers, stockholders, and related interests encouraged priority lending to enterprises that are interconnected, and curtailed credit to unrelated entities.[6] This system depressed the financing of efficient private sector investment. In the 1980s, inappropriate insider loans were responsible for all the bank failures, which reduced access to creditworthy borrowers.

1.20 Returns filed with the SEC provide further insight into the structure of business activity. In 1992, the biggest 1,000 corporations had a total revenue of ₱ 951 billion and manufacturing firms accounted for the largest portion (almost 50 percent), followed by businesses in the wholesale and retail trade, and by the financing, real estate, insurance and business services sectors. Applying a value added-to-turnover factor of 0.4 to 0.6 [7] indicates that these firms accounted for some 28 to 42 percent of GDP in 1992. The top 50 of these corporations account for around one-fifth of GDP. This degree of concentration is comparable with that in Indonesia (where it has been estimated that the largest 400 companies account for about half of GDP) and in Korea (where the largest 1,000 firms account for 63 percent of GDP).[8] However, as discussed below, the performance of Philippine firms has lagged behind that of their East Asian neighbors; and entrenched entry barriers, which sustain rent-seeking behavior, indicate the main problem is not only high concentration ratios but overall policy inconsistencies and discretionary application of rules on private businesses.

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4 Most textile manufacturers did not respond to the enterprise survey undertaken for this report.

5 Bruce Koppel and Manuel F. Montes, Private Goals and Public Means: liberalization, Industrialization and Government-Business Relations in the Philippines, 1950-1990, forthcoming.

6 Edita Tan, "Interlocking Directorates."

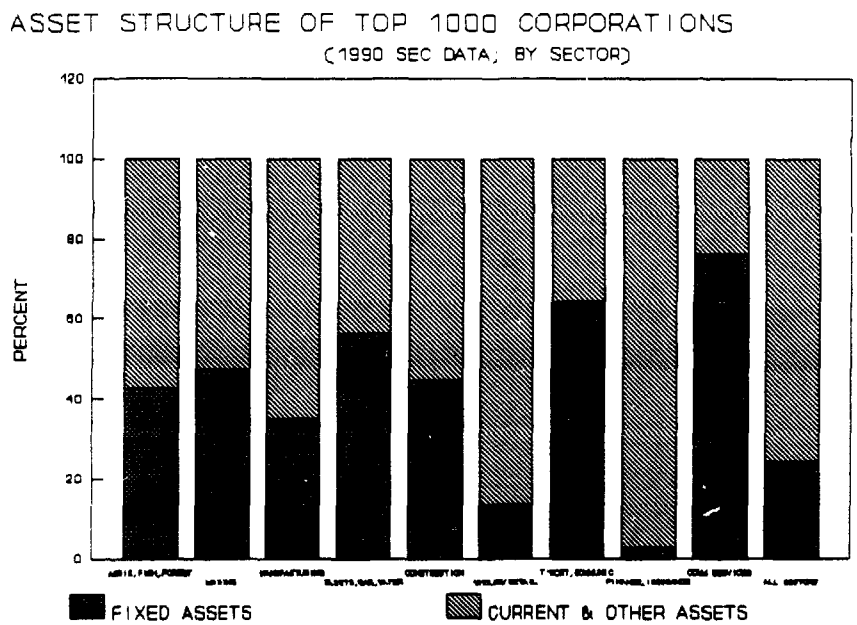
7 A value added to turnover ratio of 0.6 was assumed in the case of the Indonesia PSA; the appropriate value of this ratio varies depending on the activities in which the corporate groups are engaged.

8 Given that about 10,000 enterprises — mostly microenterprises — are created annually and registered with the SEC, and that 1.4 million households operate small business operations, is an indication that the top 1,000 corporations may in fact represent a smaller share of the domestic economy.

1.21 Included in the SEC top 1000 are some 28 Government-owned or controlled corporations, five of which are very large and are presently among the top 25. The largest of these are National Power Corporation (the largest company by assets), PETRON (partially privatized), PNB, PASAR (the largest minerals/metal processing operator), and the National Steel Corporation (which dominates the Philippine iron and steel sector), which is being privatized. In 1992, public corporations accounted for 15 percent of the revenues of the SEC top 1000, but they also accounted for 30 percent of assets and 30 percent of liabilities. These figures indicate that government corporations have a large presence in some key sectors of the economy, such as in power.

1.22 The asset structure of corporations included in the SEC listing provides an indication of the patterns of investment within the business sector in recent years. In terms of total assets, financial sector firms are by far the largest, accounting for half of the SEC top 1000 total assets. Manufacturing sector firms by contrast accounted for only 15 percent of total assets. However, there are substantial differences between firms in different sectors according to the composition of assets. Fixed assets make up only a quarter of the total asset holdings of these 1000 companies, with the balance being classified as "current" or "other". For the business sector as a whole, this indicates that companies may have a strong preference for liquid assets over plant, equipment and other fixed assets. Even in the manufacturing sector, where plant and equipment investment is normally a large component of assets, only one-third of total assets are classified as fixed (see Figure I.2).

Figure I.2



1.23 In 1992, some 110 non-financial corporations had assets exceeding ₱ 1 billion (US$41 million), but more than half of this was accounted for by 19 government corporations (a quarter by NPC alone). Among the private firms, investments of this size provide an indication of the willingness to commit funds and, as Table I.2 indicates, that the sectoral distribution of these large-scale investments has not been even.

1.24 The sectors which have attracted the most large-scale investments have been mining, food processing, beverages, petroleum refining, utilities, transport and communications. In the petroleum refining sector, state-owned PETRON controls the largest operation with a net worth of around US$1 billion in 1992 (and is now being privatized), but private sector firms have also committed substantial funds to their operations (equivalent to around US$1.6 billion in 1990).[9] In the utilities sector also, government agencies such as NPC and the National Electrification Administration (NEA) account for the largest investments, but private operators such as MERALCO have also made very large commitments. In the communications sector, significant private investments have been made in telecommunications (with PLDT being the largest), but in the transport sector, all of the major investments were held by government corporations in 1990 (although a majority shareholding in Philippine Airlines has since been divested). The engineering sector, on the other hand, has not attracted the volume of large-scale and capital intensive investments that are normally associated with efficient operations in this sector. The large textiles sector also reveals a low level of investment. The chemicals sector similarly has attracted only a small number of large-scale investments. With the exception of mining, food processing (which includes sugar) and electrical machinery, few large-scale and capital intensive corporate operations have developed around export activities, while some, such as beverages, have expanded under the shelter of high import protection.

1.25 The SEC top 2,000 includes 342 companies whose ownership includes foreign equity either as sole owner or on a joint venture basis. These foreign-affiliated firms accounted for about one-fourth of total revenue of the top 2,000 companies in 1990, indicating a contribution to GDP in the range of eight to 12 percent. Total assets of the foreign affiliated firms amounted to ₱ 295 billion (US$12.3 billion), more than half of which was in the financial sector, although large holdings also appear in petroleum refining, electrical machinery and chemicals industries. In manufacturing and agriculture, foreign affiliated companies accounted for between one-quarter and one-third of total assets. By contrast, foreign affiliated firms accounted for just five percent of mining sector assets (due partly to foreign ownership restrictions in this sector).

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9 A significant new investment in this sector is Shell's US$667 million STAR refining project, the commercial financing for which was successfully completed in January 1993 with assistance from IFC. This was the largest fund-raising exercise involving the private sector (on a non-guaranteed basis) since the Philippines declared a moratorium on foreign debt payments in 1983.

Table I.2: Distribution of Corporations with more than 1 Billion Pesos in Assets, 1992

(1) Sector	(2) Companies > ₱ billion	(3) Assets held (₱ billion)	(4) Assets held as a percent of total sector assets (%)
Agriculture	1	1.5	15.5
Mining	12	50.7	96.4
Manufacturing:			
Food processing	17	53.6	87.4
Beverages	3	45.4	98.1
Textiles	1	1.6	45.7
Apparel, leather, footwear	0	0	0
Wood products, furniture	1	1.4	28.6
Paper products	1	1.2	46.2
Industrial chemicals	3	4.2	30.2
Other chemicals	5	10.3	50.5
Petroleum refining	5	88.3	99.7
Rubber goods	6	12.2	77.7
Plastic, pottery, china	0	0	0
Glass products	1	3.6	55.4
Cement	6	12.1	69.9
Iron & steel	4	32.2	84.5
Nonferrous	0	0.0	0
Fabricated Metal	2	4.8	80
Machinery	3	3.3	76.7
Electrical Machinery	10	15.2	64.6
Transport Equipment	0	6.3	0
Electricity, gas, water	4	262.1	99.1
Construction	3	4.9	41.5
Wholesale, retail	4	29.6	24.2
Transport, communication	15	127.7	94.4
Community & other services	6	8.8	51.2

Source: SEC, 2000 Top Corporations in the Philippines, 1991 Edition.

1.26 **Small and Medium Scale Enterprises (SMEs).** Due to various constraints, medium-scale enterprises have never grown in number or expanded to any significant degree. This is largely due to the fact that once firms reach a certain size, compliance with business taxes and minimum-wage laws is more likely to be enforced. At the same time, they do not enjoy enough economic power to circumvent these costs (as do the large establishments) that cut into profits. The sector includes 115,000 establishments (and 60,000 microfirms not registered in official statistics), employs more than three-fifths of the manufacturing workforce, and generates more than one-fifth of manufacturing value added and of manufacturing fixed assets. Micro and small-scale firms account for about 98 percent of all establishments, but employ only 41 percent of the workforce and create about 14 percent of value added. By contrast, large-scale establishments (employing more than 200 workers) account for three-

quarters of value added and half of employment in manufacturing, although they represent only 1 percent of all firms (Table I.3).

1.27 Of the limited number, most are concentrated around Metro Manila. Forty percent of the country's industrial firms are located in Metro Manila area and about 23 percent in the nearby central Luzon and southern Tagalog regions.[10] All other regions, including such urbanized growth areas as Cebu, Davao, and Iloilo, accounted for about 40 percent of all SMEs. Larger firms are more concentrated in the Metro Manila area: Over 60 percent of firms with more than 50 employees are in this region. This occurred mainly due to the city's attractiveness as a center of power and therefore essential in terms of lobbying policy makers. Such concentration explains why the rest of the country remained underdeveloped and underscores the need to speed up the Government's plans for decentralization through encouraging the further development of Local Government Units (LGUs).

Table I.3: Employment and Value Added of Manufacturing Establishments (By firm size, 1988)

Number of employees	Number of firms	Percentage of total	Total employees	Percentage of manuf. employment	Value added (Thou. Pesos)	Percentage of manuf. value added
0-10	67,147	88.0	234,428	21.8	4,076	3.0
10-99	7,639	10.0	202,910	18.9	15,610	11.4
100-199	680	0.9	97,670	9.1	14,848	10.9
200 or more	822	1.1	542,309	50.2	102,305	74.7
TOTAL	76,288	100.0	1,077,317	100.0	136,839	100.0

Source: Census of Establishments, 1988, National Census and Statistics Office (NCSO), Manila

1.28 Large firms provide a significant source of manufacturing jobs in the Philippines. But SMEs take the lead in leather and footwear (80 percent); nonmetal mineral industries, excluding cement (75 percent); metallic and nonelectrical machinery (68 percent); paper, printing, and publishing (63 percent); and chemicals, rubber, and plastics (54 percent). About 57 percent of microenterprise employees were in wholesale and retail trade; 18 percent in manufacturing; 21 percent in personal and financial services; and the rest, about 4 percent, in construction, mining, and transport. Food and beverage retailing represented about one-third of cottage employment.[11]

1.29 Government policies have attempted to encourage subcontracting. Promotional policies have included financing programs, such as the Tulong Sa Tao Subcontracting Financing Program, the National Subcontractors' Exchange (SUBCONEX), a registry and placement service for subcontractors. There have also been mandatory local content requirements for cars, motorcycles, trucks, and electronic consumer goods.

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[10] 1983 Census of Establishments.

[11] 1983 Census.

1.30 Subcontracting is usually more important in labor-intensive components or subassembly sectors, such as garments, wood furniture, transport equipment, scientific instruments, electronics, and nonferrous metals. According to 1983 and 1988 census data, subcontracting in the Philippines is most important for small supplier firms, declining as a share of output as establishment size increases. However, medium-size establishments subcontract out a larger share of their work in terms of total cost of production than either smaller or larger firms. The sectors that relied most on subcontracting included garments (19 percent of total costs), printing (7 percent), wood furniture (7.8 percent), nonmetal mineral products (6 percent), wood products (5 percent), fabricated metal products (4 percent), and electronics (4 percent).

1.31 Despite the direct and indirect encouragement given to subcontracting in the Philippines over the past 20 years, it still remains limited to a few subsectors. And although it increased between 1983 and 1988, subcontracting accounts for only a small share of the value of manufacturing output — 2.5 percent in 1988. In Japan, by contrast, purchases of subcontracted supplies account for about 70 percent of total manufacturing costs in the automobile sector.

1.32 **Agribusiness** makes up a key component of private sector activity in the Philippine economy. Broadly defined to include all production, marketing and processing activities linked to food and fiber commodities, agribusiness accounted for about 49 percent of GDP in 1993, made up of primary agricultural value added of 23 percent, agro-industry value added of 13 percent and agribusiness services value added of 13 percent.

1.33 The private sector also includes the small, nonplantation farmers who produce food staples, coconuts, and other agricultural products. In the 1950s and early 1960s, absentee landlords and land tenancy were major constraints to agricultural diversification and efficient land use, but during the periods of rapid economic growth in the 1970s, these farmers prospered. During the early part of the 1980s, however, when price controls tended to favor the urban consumer, increased production did not translate into increases in farmers' incomes, so their ability and incentives to undertake investments declined.

1.34 The sector also comprises a small number of very large conglomerates coexisting with a large number of small farmers and processors. Total business activities (agricultural and non-agricultural) of the top 50 agribusiness groups accounted for 11 percent of Philippine's GDP in 1989, but it is within the agribusiness sector itself that concentration is most evident. Government policies which date back to the 1960s have enabled six conglomerates to control a large part of the agribusiness sector. In 1990, these six groups controlled about 80 percent of the commercial poultry market, 93 percent of the dairy market, 60 percent of the animal feed market, 100 percent of coconut oil processing, 90 percent of banana exporting, and 100 percent of tobacco processing. Expansion and diversification of business activity over the past two decades (at times on the basis of favorable franchise, licensing or financing arrangements with Government) have seen some of these groups extend their interests beyond the agribusiness sector.[12]

1.35 Since 1989, small farmers have been adversely affected by natural disasters, such as droughts, earthquakes, and the eruption of Mt. Pinatubo, in addition to the usual seasonal typhoons and floods. Growth remained stagnant owing to limited scope for production increases in grains and poor market prospects for traditional crops like coconuts and soya. Furthermore, the incomplete

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[12] As an example, in 1992, a tobacco-brewing-banking conglomerate associated with Fortune Tobacco financed 40 percent of the US$369 million paid by the PR Holdings consortium for controlling shares in Philippine Airlines.

implementation of agrarian reform has created uncertainty and deterred private investment, and so has not had the desired effect of increasing agricultural output.

1.36 The main reason for relatively slow growth in the agro-business (particularly processing) sector during the second half of the 1980s has been the limited flow of new investments into the sector. This in turn has resulted mostly from the same series of constraints which have had a negative impact on other aspects of sectoral development (a) the Government's indecisive and slow implementation of the agrarian reform program; (b) poor transport, communications and power infrastructure; (c) high real domestic interest rates and lack of sufficient long-term credit; (d) periodic overvaluation of the domestic currency; (e) trade and investment policies which continue to be biased against agriculture and agro-processing; (f) inadequate market information systems; and (g) law and order problems. Somewhat more specific impediments to effective development of modern agro-processing include irregular (quantity and quality) supply of raw materials, excessive cost of packaging materials (due to high protection on these materials), and high minimum wages compared to successful agro-business centers.

1.37 While agro-industry's share of industrial activity has been declining, it still remains an important part of the Philippine economy. In 1993, agro-industry accounted for 52 percent of manufacturing value added, down from a high of 58 percent in 1986. Food processing dominates agro-industry. Beverage manufacturing, tobacco and wood processing industries are the other main components of agro-industry. Nevertheless, food processing has grown slowly in the Philippines because of limited diversification of its raw material base beyond rice, corn, coconuts, and sugar. Unlike some other countries in the region, the Philippines has largely failed to attract significant investment in processing of non-traditional agricultural crops for domestic consumption as well as for exports.

1.38 The **manufacturing sector** has not performed strongly during the past decade. Total productivity in manufacturing fell. The share of workers in manufacturing has remained at around 11 percent since 1970 — compared to one-fourth to one-third of the total labor force in most other ASEAN countries — while manufacturing's contribution to GDP has similarly remained unchanged at around 25 percent. A recovery in manufacturing output in the second half of the 1980s was accompanied by an improvement in measured productivity, but much of the increase in output was due to increased utilization of existing capacity and not associated with any sustained increase in business fixed investment. The growth of output from manufacturing firms fell to only 0.7 percent in 1993.

1.39 An important indicator of the state of private ownership in the manufacturing sector is the low share of manufacturing workers employed in factories. The 1988 census revealed some 2.2 million employees in manufacturing establishments in the Philippines, but almost two-thirds of these (1.4 million) were employed in the household/unorganized labor sector (i.e., outside of factories). Census data indicate a gradual shift toward factory employment over the past three decades, but the current structure of employment is still very much concentrated in smaller and unorganized establishments. The productivity of labor within the smaller establishments is believed to be lower than in the organized factory units, which not only sustains inefficiencies in the manufacturing sector, but also explains the high share of output coming from a relatively small number of large establishments.

1.40 As external financing became difficult, domestic debt was substituted for foreign debt in the last part of the 1980s. Since 1988, as external debt declined as a share of GDP, domestic debt's share rose (Table 1.4). While part of this increase was attributable to the continued budgetary deficits, persistent large losses of the CBP were also a major factor accounting for the accumulation of domestic debt. Over the period 1990-92, the GOP issued a large amount of Treasury securities to finance CBP's

losses and to assist the CBP in conducting open market operations. Also, the maturity of domestic public debt shortened. In 1983, about one-half of Government securities were in the form of long-term bonds but, by 1992, 95 percent of Government securities were in short-term Treasury bills, mainly 91-day instruments. This change in maturity reflected concerns over domestic inflation, the continued financing needs of the National Government, and the lack of depth of the domestic financial market. Part of the high real interest rate reflects the risk premium, which should decline over time as the ratio of debt to GDP falls. The burden of domestic debt also grew over time. In 1992, interest expense accounted for six percent of GDP and 31 percent of Government expenditures. The impact of interest rate volatility on the Government budget is very substantial. Therefore, the domestic debt situation in the Philippines requires the GOP's serious attention for a coherent debt management strategy.

Table I.4: Total Debt of the Public Sector, Selected Years, 1983-93
(As % of GDP)

	1983	1985	1987	1990	1992	1993 a/
Total debt outstanding	62.5	79.2	90.5	75.6	85.9	97.0
Domestic debt	12.5	17.0	22.2	23.0	37.9	49.0
External debt b/	50.0	62.2	68.3	52.6	48.0	48.0
o/w: NG	20.5	29.3	43.4	46.5	52.5	63.1
Domestic debt	9.2	10.4	20.7	22.3	32.5	43.8
External debt c/	11.3	18.9	22.7	24.2	20.1	19.2
Central Bank	12.0	23.5	19.6	12.6	15.3	15.7
Domestic Debt	0.0	4.2	0.1	0.2	5.0	5.0
External Debt	12.0	19.3	19.5	12.5	10.3	10.7
Other d/	30.0	26.5	27.5	16.5	18.1	18.2

a/ As of mid-September. Data includes ₱ 220 billion of Treasury securities issued to the Central Bank.
b/ Data for 1992 and 1993 are estimates.
c/ IMF.
d/ Residual.

1.41 The financial strength of manufacturing firms has, however, improved in recent years following depressed earnings during the early to mid-1980s. As shown in Table I.5, the most significant improvement in the financial condition of the top 1,000 corporations since 1986 has been in the increase in return on equity despite a significant reduction in leverage. These data indicate that, while balance sheet restructuring has improved the overall capability of Philippine corporations to undertake further investment, depressed domestic market activity until last year coupled with a plethora of disincentives to invest in fixed plant and equipment has been a barrier to resumed investment growth (see Chapter II).

1.42 One significant area of adjustment which occurred within the manufacturing sector over the past two decades has been in the composition of exports. In the early 1970s, about 70 percent of

Philippine manufactured exports came from the food sector but, commencing in the mid-1970s, the Philippines, like many other developing countries, began to shift more into "nontraditional" exports, mostly garments and electrical goods (mainly semiconductor assembly), with low domestic value added. By the mid-1980s, semiconductors accounted for 26 percent and garments 15 percent of Philippine manufactured exports. Now, about three product categories account for a significant share of total exports. Nevertheless, the extent of export diversification achieved by Philippine manufactures has been far less than that of successful exporters like Indonesia, Malaysia and Thailand. This is attributable to low investment and the problems of achieving appreciable cost efficiency. The collapse of Philippine footwear exports during the 1980s (at a time when Indonesia, China, and Thailand were increasing their footwear market share) illustrates the extent of this problem.

Table I.5: Financial Performance of the Manufacturing Sector, 1979-92

Year	Net profit margin (in %)	Return on assets (in %)	Return on equity (in %)	Turnover (ratio)	Leverage (ratio)
1979	3.00	3.15	9.97	1.05	2.17
1980	1.51	1.60	5.61	1.06	2.51
1981	1.12	1.22	3.87	1.09	2.17
1982	n.a.	-0.12	-0.39	n.a.	2.16
1983	n.a.	0.63	2.16	n.a.	2.43
1984	1.26	1.56	6.14	1.24	2.94
1985	0.47	0.59	2.35	1.26	2.98
1986	2.70	3.09	9.84	1.15	2.18
1987	4.07	4.03	13.76	0.99	2.41
1988	5.13	5.73	17.20	1.12	2.00
1989	4.95	5.57	16.03	1.13	1.88
1990	4.44	5.11	14.45	1.15	1.83
1991	4.7	6.0	15.6	1.3	1.0
1992	5.9	6.9	14.5	1.2	1.2

Notes: Net profit margin is after-tax income as percent of gross revenues. Return on assets is after-tax income as percent of total assets. Return on equity is after-tax income as percent of net worth. Turnover is ratio of net sales to total assets. Leverage is ratio of total liabilities to net worth.

Sources: Business Day, 1000 Top Corporations, 1981, 1982; Philippines SEC, Top 1000 Corporations, 1985, 1986, 1990; Mahal Kong Philippines Foundation, Inc. Philippines' Best 1000 Corporations, 1989; World Bank reports.

1.43 Other factors have also limited Philippine exports. First, manufactured exports did not develop backward linkages and have resulted in a high import content of exports. Second, manufacturing is poorly diversified. The continuing overreliance on two products, garments and electronics, makes exports vulnerable to changes in the international markets. Garments are subject to international quotas and electronics are affected by rapidly evolving technology. Also, Philippine export markets are poorly diversified and this might limit future growth. The country's intraregional trade has been the lowest in Southeast Asia, and 75 percent of its exports go to only three industrial markets: the United States (37 percent), Japan (20 percent), and the European Community (17

percent). Most Southeast Asian countries have increased their intraregional trade. For instance, 42 percent of Singapore's exports went to Southeast Asian countries excluding Japan, compared with 7.5 percent for the Philippines in 1991.

1.44 **"Nontraditional" Exporters**. Of the 330 exporters among the top 1,000 companies, 90 percent are controlled by either conglomerates or multinationals. Another group of domestic companies export both labor-intensive ready-to-wear garments and capital-intensive goods. The owners of some of these firms tend to be ethnic Filipinos, and the managers are relatively young, many with degrees from foreign universities. Some are Chinese-Filipinos. There are also many small handicraft exporters, with an annual export volume of about US$100 million. The financing for non-traditional exporters comes from banks and other formal sources, as well as from savings and extended family relationships. Since these firms have to survive in highly competitive, fast-changing international markets, their main impediments to growth — besides the periodic overvaluation of the currency and the overall anti-export bias of the trade and investment regime — are operational problems such as industrial bottlenecks (in particular power blackouts during 1991-93), the still high cost of finance and a slow-moving government bureaucracy.

1.45 Similar to the situation in Indonesia, there are few inter-firm linkages within the industrial sector in the Philippines, and the linkages that exist between exporting firms and the rest of the economy remain limited. Firms that were established within Export Processing Zones (EPZs) or under bonded warehouse arrangements have tended to focus on export markets exclusively and, as a result, few mixed sales businesses have developed. In 1988, of the top 200 exporters (who provided over two-thirds of export sales), virtually all were 100 percent for export.[13] Since the trade policy framework simultaneously affords protection against imports and, at the same time, provides export incentives such as duty exemptions, it resulted in a dualism within industry whereby a number of export-oriented firms coexist with less efficient domestic-oriented firms. The quality and cost of components and services provided by the domestic-oriented firms are in many cases not up to international standards and, for this reason, exporters make relatively few purchases from domestic firms. As a result, the expansion that has taken place among exporting firms over the past decade has not had a significant impact on the business opportunities for other firms.

1.46 While the range of goods being produced in the Philippines gradually expanded during the 1960s (such that textiles, paper, cement, metal products and chemicals joined the traditional industries of wood processing, food and beverages), there has been little change in the overall structure of manufacturing since then (Table I.6). Even with the reform efforts started in the 1980s, there is little evidence of creation of significant new lines of business — unusual for a country located within the dynamic growth region of Southeast Asia. For example, an attempt to introduce upstream petrochemical capabilities into the Philippines was abandoned in 1991 due to legal entanglements. The circumstances surrounding this legal challenge have been cited by some business groups as one factor contributing to the overall caution of foreign business investors. Although the entry of new firms started accelerating toward the end of 1993, the static structure of industrial output until recently indicates that the incentives structure and enabling environment within the Philippines has not been as conducive to the growth of new enterprises or lines of business as took place in other successful Southeast Asian countries. This is the result of several factors, including macroeconomic problems, continuing anti-export bias in the trade and investment regime, crowding out of private investment by large public sector borrowings and, more recently, severe infrastructure limitations.

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[13] In addition, of the top 50 exporters, 20 were majority foreign-owned.

1.47 The Philippine private sector is burdened with cost disadvantages (due to infrastructure inadequacies, high cost of power, labor costs) which make it difficult for them to switch easily from domestic sales to export markets. Development of new export capabilities will depend on timely removal of the anti-export bias of the trade and investment regime. As discussed in Chapter II, a more concerted export-oriented effort on trade and competition policies to lower the costs of doing business in the Philippines will be needed to stimulate investment-led growth by private business, and current Government plans are in this direction.

Table I.6: Distribution of Value-Added Across Manufacturing Subsectors, 1967-93 (share in %)

ISIC codes	Manufacturing subsector	Average 1967-70	Average 1975-80	Average 1985-91	Average 1992-93
311/12	Food manufactures	46.44	43.91	41.50	37.0
313	Beverage manufactures	2.01	2.29	4.22	3.9
314	Tobacco manufactures	2.37	3.16	3.01	2.8
321	Textile manufactures	5.27	5.19	3.89	3.2
322/4	Wearing apparel and footwear	3.92	4.02	4.89	6.2
323	Leather and leather products	0.17	0.12	0.08	0.08
331	Wood and cork products	4.46	3.71	2.12	1.9
332	Furniture and fixtures	1.93	1.49	1.27	1.2
341	Paper and paper products	0.87	1.09	1.12	1.03
342	Printing and publishing	1.18	1.35	1.37	1.6
351/2	Chemicals and chemical products	3.65	7.04	6.44	6.26
353/4	Petroleum and coal products	11.44	10.86	13.83	17.78
355	Rubber products	1.75	1.81	1.45	1.38
356/61-3/69	Non-metallic mineral products	3.07	2.79	2.29	2.74
371/2	Basic metal products	1.15	1.55	2.95	2.24
381	Fabricated metal products	2.72	2.24	2.19	2.42
382	Machinery except electrical	1.53	1.25	1.04	1.24
383	Electrical machinery	1.70	1.77	3.66	4.49
384	Transport equipment	3.21	3.24	0.83	1.22
385/6/980	Miscellaneous manufactures	1.17	1.11	1.84	1.86
	All Manufacturing	100.00	100.00	100.00	100.00

Notes: Derived from constant price value added.
Sources: National Income Accounts, NSCB.

1.48 One important area in which growth has taken place in recent years has been in the equity market as more firms have sought to expand through public listings. The number of listed firms has increased from 130 in 1986 to 186 by mid-1994, and this increase has been accompanied by phenomenal growth in market capitalization from US$2 billion to US$39 billion. The stock market grew by 130 percent in US dollar terms, becoming the best performing stock exchange in 1993. In 1993, initial public offerings (IPOs) of 13 companies reached ₱ 13.7 billion. For the first quarter of 1994, there are already 21 applicants for IPOs filed with the SEC. While the size of the Philippine equity market is still small when compared to the overall domestic economy, as well as to other emerging markets (see section on the capital markets), further growth potential is large. In 1993, the

stock market grew by 154 percent, and large family-owned enterprises have started to go public. Commercial and industrial firms now account for more than 90 percent of the total market capitalization compared to 10 percent six years ago. Recent developments in the number of new listings and total capital raised are shown in Table I.7.

Table I.7: New Equity Listing and Total Capital Raised, 1989-93 (US$ millions)

	1989	1990	1991	1992	1993
Number of new listings	7	9	9	9	13
Total capital raised (US$ millions)	103	351	447	408	493

Source: Manila Stock Exchange.

1.49 Compared with those of its neighbors and countries of a similar size, the Philippine market is small. Also, like many other equity markets in the developing world, the Philippine market is very narrowly based: daily trading value is approximately US$13.5 million, but 85 percent of business by value is accounted for by transactions in only five stocks.

1.50 Most firms are privately owned and want to keep tight corporate control. They are therefore reluctant to provide the information required for registering securities or disclosing material financial information. As a result, they tend to shy away from equity financing. In addition, the beneficial tax treatment of debt and the high real domestic interest rates on government securities have meant that equity offerings are mostly unattractive to investors. With high real domestic interest rates, Philippine firms have generally found it too costly to meet the investor expectations of high returns.

1.51 As a result, the equity market is underdeveloped in terms of both supply and demand (see Chapter II). On the supply side, only a small number of high-grade securities are offered by a small group of listed companies. On the demand side, only a narrow base of investors is actively involved in the stock market. Their limited demand for stocks leads to depressed prices, which in turn limits the incentive for issuers to make public offerings. Although there was a large inflow of foreign funds into domestic equities in 1993, the size of the market is still small compared to other emerging markets (para. 1.48). Moreover, small individual investors have a limited opportunity to participate in primary offerings of popular shares because stock exchange member firms distribute shares among themselves and to preferred clients.

1.52 Recent growth in the volume of funds raised in the Philippine equity market has made it a more important source of investment financing than previously. Nevertheless, the amounts raised are not large, neither in relation to alternative sources of company finance nor relative to the overall size of private sector investment.[14] One reason is that privatization initiatives, which have been used in other countries to stimulate equity market growth, have for the most part bypassed the stock exchanges in the Philippines. The Government will time further privatization of PNB to avoid adversely affecting its share price. The main exception to this was the listing of ₱ 1.8 billion of shares in Philippine National

[14] In 1991, total capital raised on the equities market was equivalent to 6.8 percent of total investment expenditure by the private sector.

Bank (PNB) in 1989. This underscores the need to expedite the introduction of capital market reforms as discussed in Chapter II of the report.

C. The Effect of Government Enterprises and Public Debt on Private Business

1.53 The public sector's direct involvement in the economy increased significantly between 1972 and 1986, with the number of government-owned or controlled corporations (GOCCs) increasing from 75 in 1970 to 301 in 1986. The new GOCCs included corporations nationalized in the early years of martial law, those established by government agencies or subsidiaries created by existing GOCCs, others confiscated from political opponents of the president (sequestered assets), troubled corporations foreclosed by Government financial institutions and those created to advance the political or personal objectives of public officials.

1.54 These GOCCs were engaged in a various activities. More than a third were in finance, housing, and services, and most of the gross value added was in utilities and finance. Their contribution to the overall public sector deficit grew from eight percent in 1975 to 22.5 percent in 1984. Without this burden, the public sector would have had a surplus during this period.[15]

1.55 Also during this period, state-owned banks acquired holdings in a large number of corporations through default. The Development Bank of the Philippines (DBP) and the Philippine National Bank (PNB) became saddled with nonperforming assets, particularly from 1981 to 1983, due mainly to investments by unethical businessmen and the banks' own faulty credit decisions, often dictated by politics. For example, investments that featured overpriced assets were common and created bloated liabilities and a subsequent loss of equity for these banks. The credit compression exposed financial weaknesses in undercapitalized firms. To prevent large scale failures, the Government set up a rehabilitation fund to help financially troubled companies, but this did not prevent many defaults and only increased the DBP's and PNB's nonperforming assets further. By 1986, there were an estimated 399 nonperforming assets on the books of state-owned banks, with an estimated book value of ₱ 132 billion. This figure excludes smaller companies, those with book values of less than ₱ 10 million, whose recoverable value has been estimated at ₱ 24 billion. Thus, the DBP and PNB were in serious technical default when the new administration took power in 1986.

1.56 Virtually all of the provision of infrastructure services (with the main exception of PLDT - telecommunications - and MERALCO - electricity distribution - both of which are private) in the Philippines has in recent decades been publicly owned and operated. Because of this, and the fiscal crisis that accompanied the economic problems of the 1980s, there has been a significant reduction in public spending on infrastructure. The public investment program, which peaked at nearly 11 percent of GDP in 1981 (five percent for infrastructure, the rest for capital transfers to other government corporations), had by 1993 fallen to six percent of GDP (with infrastructure accounting for just over half of the total). During 1988-92, public infrastructure spending has averaged at less than two percent of GDP, far below the Indonesian performance of around five percent. In 1993, even including PLDT's and MERALCO's total capital outlays, Philippine infrastructure expenditures were about three percent of GDP. In recent years, the Government has announced a number of infrastructure spending targets, but a number of problems, including revenue shortfalls, have prevented it from implementing even two-thirds of the planned programs. The Government depends on foreign borrowing (ODA) for

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[15] Manasan and Buenaventura (1985).

the majority (77 percent in 1992) of its infrastructure investment program, but the record of implementation has been poor.

1.57 The expansion of the Government sector in the 1970s led to growth in external borrowings. Over the past decade, these public borrowings have been from official aid agencies. The stock of long-term external debt stood at US$8.8 billion in 1980, of which some 72 percent was public or publicly guaranteed. Over the following decade, public long-term external debt grew rapidly, reaching US$29.1 billion by 1993, with official (multilateral and bilateral) agencies being the principal debt suppliers. Private external debt, on the other hand, declined rapidly after the onset of the external debt crisis in 1983. By 1993, private long-term external debt had declined to US$1.1 billion, or just 3.6 percent of total long-term external Philippine debt.

1.58 The accumulation of public external debt during the 1980s was more rapid than growth in the overall economy and has been one of the major contributing factors to the continuing adverse perception of Philippine country risk. In 1982, just prior to the onset of the external debt crisis, the long-term debt-to-GDP ratio stood at 33 percent, but this ratio climbed rapidly to reach 74 percent in 1987 before declining. By end-1993, the long-term debt-to-GDP ratio was 62 percent, still well above the pre-debt crisis level. The external debt service burden followed a similar pattern, partly because of a large-shift toward variable interest rate debt (although interest rates have fallen since the early 1980s) and an increasing volume of official debt obtained on concessional terms. The ratio of long-term debt service to exports increased from 26 percent in 1983 to 30 percent in 1987, but then contracted to 20 percent at the end of 1993. The reduction in debt service burden has improved international perceptions of Philippine country risk.

1.59 The management of the Philippines' external debt remains a critical factor in mobilizing finance for efficient private sector development. Reducing the debt-to-GDP ratio will be important to securing an enhanced perception of Philippine creditworthiness, which ultimately means reduced internal debt borrowing costs for private investors as well as better access to external equity and securities markets. Controlling the growth of public and publicly-guaranteed debt will remain a priority issue if private external borrowing is not to be further crowded out (see Chapter II).

1.60 The public sector has also been a major participant in domestic capital markets. The issuance of domestic government securities accelerated in the second half of the 1980s as budget deficits persisted and domestic debt substituted for external debt. Government securities outstanding at the end of 1985 were equivalent to US$4.1 billion, but by 1993 these had expanded to US$25.2 billion, with the private sector and semi-government entities accounting for most of this growth. The holding of Government securities by private firms and individuals has been at the expense of investment in productive capital and other financial and nonfinancial assets.

1.61 Deposit money banks (a major source of finance to the domestic economy) also shifted a significant share of their domestic credit toward the public sector during the past decade. In the early 1980s, the deposit money banks allocated 80 to 85 percent of their credits to private sector borrowers, but with the onset of the external debt crisis this share declined (to a low of 68 percent in 1986) and has remained at around 70 to 73 percent in recent years. By March 1994, these banks provided credit to the public sector of about US$3.4 billion equivalent in domestic currency. For the whole banking sector, the increased portfolio allocation toward government paper has followed a similar pattern. Between 1987 and March 1994, the banking sector's holdings of securities (mainly government) rose from US$1.9 billion to US$4.9 billion.

1.62 Part of the Government's extensive borrowing requirements resulted from financing losses incurred by public enterprises. Most stemmed from uneconomic investments and imprudent levels of financial leverage. In 1986, at the end of the Marcos administration, there were some 301 GOCCs, the transfers to which accounted for one-fourth of consolidated public expenditures. The transfers were made to companies such as Manila Electric Company (MERALCO) and Philippine Airlines (PAL) which had been confiscated by the Marcos administration for political reasons and buy-outs (such as that of ESSO) for nationalization objectives. In addition, there were the "nonperforming assets" of Government financial institutions (GFIs) which had previously made "behest loans"[16] to favored private business groups. Fourteen of the larger public corporations have been singled out for closer monitoring by the Government Monitoring and Coordinating Committee (GMCC), and later by the Department of Finance as part of monitoring the reduction in the consolidated public sector deficit.[17] The overall performance of these companies has shown little improvement since the mid-1980s (see Table I.8), and because their overall impact on the fiscal balance is still a concern, all are currently being assessed for privatization by the Government. The overall deficit of the 14 monitored nonfinancial corporations is projected to decline to 0.8 percent of GNP during 1994 from 1.7 percent in 1993. All of this reduction, however, is attributable to sales of companies by the APT and the privatization of PETRON. The deficit of other public enterprises, in particular NPC, is expected to remain unchanged. As a result, the aggregate deficit would rise in 1995 to 1.2 percent of GNP, and then stabilize at this level. To achieve even these targets, the Government plans to undertake a substantial restructuring of NPC (see Chapter II).

Table I.8: Financial Situation and Financing Requirements of Monitored Government Corporations, 1988-93 (Million Pesos)

	1988	1989	1990	1991	1992	1993
Overall surplus (+) deficit (-) a/	1,300	-7,541	-21,327	-10,767	-12,956	-30,144
Government subsidies	1,644	4,546	2,190	3,369	2,296	4,537
Government equity	-2,943	2,078	3,274	2,101	610	5,640
Government lending	4,063	2,174	2,181	4,564	1,330	1,549
Domestic bank credits	-1,224	2,236	7,456	-3,668	3,730	1,986
Other domestic financing	34	-6,094	-47	4,240	-1,726	-5,427

a/ Net of subsidies.

Source: GOCCs.

16 Loans given to Marcos' "cronies" with political motives.

17 These are (i) Export Processing Zone Authority, (ii) Local Water Utilities Administration, (iii) Light Rail Transit Authority, (iv) Metro Manila Transit Corporation, (v) Metropolitan Waterworks and Sewerage Systems (MWSS), (vi) National Development Corporation (a holding company), (vii) National Electrification Administration (NEA), (viii) National Food Authority (NFA), (ix) National Housing Administration, (x) National Irrigation Administration (NIA), (xi) National Power Corporation (NPC), (xii) Philippine National Oil Company (PNOC), (xiii) Philippine National Railways, and (xiv) Philippine Port Authority.

1.63 Privatization was undertaken in 1986 for economic and political reasons. The main economic objective was to reduce the financial burden imposed by GOCCs and nonperforming assets on the public sector finances, and partly to raise the efficiency of the domestic economy. The political objective was to reverse the politically motivated nationalization of particular industries in the 1970s. Initial efforts at privatization started prior to 1986, when DBP was forced to dispose of its nonperforming assets. At about the same time, in view of increasing financial difficulties, the Government began to divest itself of some of the GOCCs.

1.64 The previous administration stated its policy on privatization in Proclamation 50 in 1986. The Proclamation outlined the Government's intention to dispose of GOCCs and nonperforming assets to reduce the size of the Government corporate sector (as well as to remove the poor legacy of the previous administration), financially rehabilitate PNB and DBP, reduce the consolidated public sector deficit, increase government revenues through rehabilitation of GOCCs and nonperforming assets, and fund the Comprehensive Agrarian Reform Program (CARP) from the expected sale proceeds of privatization of GOCCs.

1.65 The Proclamation also defined the institutional framework for privatization. It led to the creation of the Committee on Privatization (COP) tasked to oversee the Philippine privatization program, setting objectives and policies concerning the divestment of public assets, and the Asset Privatization Trust (APT) as the main implementing body.

1.66 The Proclamation was later amended by RA 7181, which extended the life of the COP and APT from December 8, 1991 to August 31, 1992, and added certain provisions on the conduct of privatization. The new law mandated that there shall be no dislocation of labor outside boundaries established by existing laws or collective bargaining agreements; assets shall not revert back to previous owners who were found, through appropriate legal procedures, to have mismanaged or diverted resources from the assets, resulting in loss and/or in bankruptcy; at least 10 percent of the assets, in corporate form, shall first be offered to small domestic investors; and a loss recovery provision shall be a condition of sale for any assets below the transfer price. The law also subjected the sale of strategic industries to presidential approval and spelled out the role of the National Economic Development Authority (NEDA) in determining what constitutes a strategic industry.

1.67 Republic Act No. 7661 further extended the life of the COP and APT until June 30, 1995. The same law confirmed the same conditions in the privatization of non-performing assets in R.A. 7181. The initial privatization program focused mostly on the reduction of nonperforming assets and less on the sale of GOCCs. As of December 1993, the APT and the other disposition entities had sold or liquidated 327 out of 419 transferred assets (nonperforming assets transferred to the APT for disposition) and 81 out of 130 GOCCs targeted for disposition. Total revenues amounted to ₱ 77.8 billion, of which ₱ 38.1 billion came from transferred assets, more than originally estimated.

1.68 COP and APT reports on unsold GOCCs and transferred assets define the future direction of privatization. There are still 92 nonperforming assets, and 49 GOCCs that remain to be privatized. The other 179 GOCCs have been slated for retention, abolition and consolidation. In December 1992, President Ramos signed Executive Order 37 which seeks to take the privatization effort further by speeding up the sale of the remaining GOCCs that have been scheduled for disposition and ordering a review of whether there is a need to retain the remaining 81 GOCCs. In 1993, President Ramos identified seven additional GOCCs for privatization. A discussion of the remaining GOCCs can help to illustrate some of the issues that will have to be addressed.

1.69 The remaining GOCCs have a book value of ₱ 28.3 billion. Four GOCCs that carry substantial foreign debt account for the largest portion. (Table I.9 shows companies that are targeted to be privatized in the near term.) Two of these, the Philippine Associated Smelting and Refining Corporation (PASAR) and the Philippine Phosphate Fertilizer Corporation (PHILPHOS), were part of the Government's attempt to pursue industrialization by investing in projects beyond the means or below the average cost of capital used by the private sector. The Semirara Coal Corporation was created in this way as part of the country's energy development program. Semirara was intended to produce low-grade coal from the country's largest known reserves for the National Power Corporation's Calaca power plant, but the coal turned out to be unsuitable. Another GOCC, the Metro Manila Transit Corporation, was created by the Metro Manila Commission to ease public transportation shortages in metropolitan Manila. Sales of these four GOCCs have been hampered by large foreign debt, and Semirara is barely operating because existing coal users require coal of a higher grade than it produces. Its excessive leverage reduces the financial viability of the mine.

1.70 Legal impediments, primarily injunctions against the sale of assets initiated by former owners, have prevented the sale of four other GOCCs, with a book value of ₱ 5.9 billion, and of about 20 transferred assets. Although Proclamation 50 specifies that "no court of administrative agency shall issue any restraining order or injunction against the Trust in connection with the acquisition, sale, or disposition of assets transferred to it...", privatization undertaken by "disposition entities" does not have the same protection.

Table I.9: Companies to be Privatized in the Near Term

1.	National Steel Corporation
2.	Calinog-Lambunao Sugar Mill
3.	Cellophil Resources
4.	Manila Gas
5.	Nonoc Mining and Industrial Corp.
6.	North Davao Mining Corp.
7.	Land Oil Resources

Source: APT.

1.71 Much progress has been made in disposing of GOCCs and transferred assets, but more needs to be done for privatization to achieve its full potential. Table I.10 shows the status of remaining GOCCs targeted for privatization as of 1993.

Table I.10: Status of Remaining GOCCs Targeted for Privatization

Status	Number of GOCCs	Book value of assets (Millions of Pesos)	Percentage of total
With substantial foreign debt	4	12,559.6	44.4
With legal impediments	4	5,907.0	20.9
For dissolution	6	4,783.3	16.4
For marketing action	22	2,791.7	9.8
Ongoing valuation/private study	11	1,725.4	6.1
Awaiting Commission on Audit (COA) clearance	4	530.9	1.9
Total	51	28,298.0	100.0

Source: COP, APT.

1.72 The implementing guidelines to E.O. 37 contain a broad definition of "privatization", encompassing initiatives other than sale to the private sector:

> "Privatization shall refer to the transfer of government corporations, activities or assets of Government to total, majority or minority private ownership or to private control. It includes sale of shares and physical assets, leasing of assets, management, maintenance and other service contracts or build-operate-transfer (BOT) schemes and other similar arrangements under Republic Act No. 6957."

1.73 This definition of privatization offers considerable flexibility to the agencies responsible for the shares and assets of individual GOCCs. During 1993, the implementing guidelines require that privatization action plans for the 48 GOCCs already identified for privatization by the President be presented to the Committee on Privatization (COP) for approval. Included in this group of companies are the Manila Hotel, PASAR and parts of PNOC. In December 1993, 40 percent of the total shares of PETRON were bought by the Aramco Corporation of Saudi Arabia through a bidding process. Depending on the financial attractiveness of the assets that are brought forward, the divestiture strategy should target increased use of public offerings to develop capital markets and disburse public ownership of the companies being privatized. The IPO of PETRON, covering 20 percent of the firm's shares, planned for July 1994 is a step in the right direction. Another form of encouraging wide dispersion in ownership of public assets for disposition is that approved by the COP for the Metro Manila Transit Corp. (MMTC), which is planned to have a negotiated sale with private organization/cooperative majority owned by former MMTC workers.

1.74 The implementing guidelines also required that the remaining 81 public enterprises and assets be assessed for retention or privatization and, upon approval by the President, a privatization action plan be drawn up for each corporation by the appointed disposition authority. In May 1993, the National Development Company took this process one step further with advertisements notifying privatization opportunities for the National Steel Corporation, PASAR, PHILPHOS, NDC-Guthrie

Plantations, Refractories Corporation of the Philippines, SEMIRARA Coal Corporation, and National Shipping Corporation.

1.75 From 1987 to March 31, 1994, the Philippine Government's privatization program generated ₱ 98 billion cumulative revenues as follows:

- ₱ 41 billion from the sale of transferred assets (TAs);
- ₱ 42 billion from the privatization of GOCCs; and
- ₱ 15 billion the sale of other assets.

This includes the sale of the following big-ticket GOCCs:

Table I.11: Key Privatizations in 1994

	Proceeds from Sale (₱ Billions)	Degree of Privatization (% of total ownership)	Buyer
Petron Corporation	14.8	40	Saudi Arabian Oil Co.
Philippine Airlines, Inc.	10.7	67	PR Holdings, Inc.
Philippine National Bank	4.6	43	Various
Interbank	2.2	100	DBP Consortium
Philseco	2.1	87	Philyards Holdings, Inc.
Narina Properties	1.8	100	Tan Yu Group of Cos.
Phil. Plaza Holdings, Inc.	1.5	100	Allied Kajima
Union Bank of the Philippines	1.3	87	Aboitz, Insular, etc.

Source: COP.

1.76 Some of the most significant privatization transactions during January to March 1994 were the sale of the following (a) 38.7 million government-owned shares in Meralco to SSS and GSIS for ₱ 13.6 billion; (b) 72 percent government-owned shares in PICOP, the only timber and paper product company in the Philippines, to Valderrama Consortium for ₱ 2.4 billion; (c) 87 percent of the sales of stock of Philseco to Philyards Holdings, Inc. for ₱ 2.1 billion; and (d) 19.4 billion Government-owned shares in Oriental Petroleum Minerals Corporation for ₱ 1.5 billion to an international investor.

1.77 Future privatization activities include the additional 20 percent IPO of the shares of stocks on Petron Corporation and the sale of Government-owned shares in National Steel Corporation.

1.78 During 1994-96, the Government expects to receive about ₱ 78 billion (4.5 percent of GNP) in privatization receipts. The Government plans to reduce domestic debt with part of the expected revenues.

1.79 The Government corporations which are to be retained under public control will nevertheless be required to identify specific assets or activities which may be more efficiently handled by the private sector, and to carry out asset sales, leasing, management, service or other arrangements (including BOTs) which will enable private sector efficiency gains to be effectively utilized. These privatization initiatives are potentially important to the development of the Philippines private sector.

II. REMAINING CONSTRAINTS TO PRIVATE SECTOR DEVELOPMENT

A. An Overview

2.1 A number of the constraints to private sector development that were identified in Chapter I have been addressed as part of Government reform initiatives in recent years. Chapter II reviews these initiatives and highlights the remaining obstacles to efficient private sector development and the unfinished reform agenda. The progress achieved in improving the business climate has vastly improved in the last two years: Success in external debt management and macroeconomic stability have enabled the Philippines to move toward voluntary external financing; however, there is still an unfinished agenda of reforms. One of the report's main findings is that the private sector needs to be reformed at the same time that public sector management is strengthened (especially the regulatory agencies), to improve efficiency. Until recently, the main obstacles were largely a heavy external debt, macroeconomic disequilibria, a restrictive foreign exchange regime, and complete isolation from international capital markets. Changes in these areas will help promote more efficient and more dynamic business investment in the coming years, but completing the unfinished agenda of reform initiatives is key. The focus of private sector development for the future should promote greater openness; this should be followed with institutional reforms designed to consolidate the changes, to improve efficiency, and to establish an adequate framework for sustained growth in efficient private sector investment and production.

2.2 An enterprise survey was conducted on small- and medium-scale firms in August/September 1992. The survey covered more than 100 firms in textiles, food processing, software, and wooden furniture in metropolitan Manila, Cebu, and Mindanao. Entrepreneurs pointed to macroeconomic and infrastructure constraints as the most handicapping (Figure II.1). They singled out high real domestic interest rates and the uncertainty of the macroeconomic environment (especially the periodic overvaluation of the exchange rate), despite ongoing policy reforms, as well as policy uncertainty and discretional use of regulations. In infrastructure, the major impediments were electric power, transport, and telecommunications, problems that reflect years of neglect, policy distortions, and strategic conduct by monopolies and oligopolies (as in telecommunications and transport, respectively). The tax burden, legal regulations, and compliance costs were not identified as major obstacles, indicating that many firms are able to circumvent formal rules and practices. Also, security issues were not cited as a key concern because respondents were selected from among enterprises owned by Philippine nationals. Mission findings indicate that security is an important concern to some foreign investors. Firms located in Cebu ranked all constraints much more severely than did firms in Manila or Davao, perhaps because the firms in Cebu are more export-oriented than the respondents in other regions.

2.3 Respondents were concerned that policies were frequently changed and did not provide a sense of stability. Also, although they ranked regulations as less important constraints, they simultaneously complained of bureaucratic red tape. This seeming contradiction could be explained by the fact that firms have found ways to evade the burdens of regulations by participating in informal systems of rules and practices.[18] If this is indeed the case, then the low constraint scores for regulation indicate that the level of constraint imposed by the regulatory regime is mitigated by the ability of some firms to circumvent the formal system. Evidence from other developing countries suggests that, once

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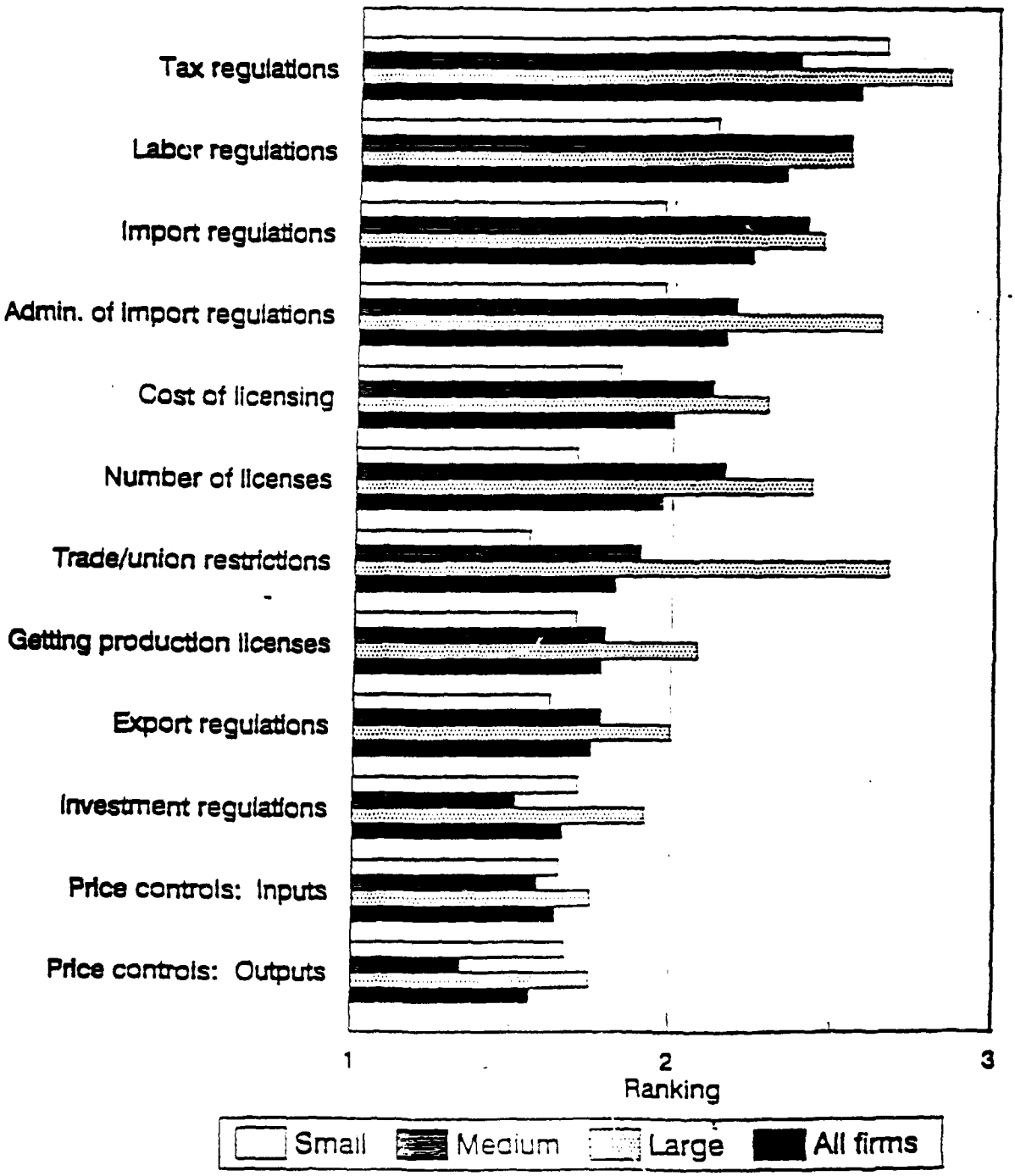
[18] The jeepn[illegible] an example. Because of the long and tedious approval process and the paperwork involved, many of the jeepn[illegible] operators worked without a license, although they were willing to pay the appropriate license fees and various required dues. But when the registration process was simplified, many of them registered and paid the appropriate license fees. This could indicate that front-line government agencies do not seem to be client-oriented, but rather control-oriented to satisfy audit procedures.

Figure II.1: Summary Constraints to Operations and Growth (Average for All firms)



Note: Ranking scale has been truncated from the full 1-5 range to fit the spread of constraints overall.

macroeconomic and policy instability issues are addressed, impediments related to bureaucratic red tape are likely to figure more prominently. As the discussion below also emphasizes, the regulatory burdens are not costless and the reform of arrangements which govern business-to-business and business-to-government transactions will be a priority in coming years. Given the recent fall in domestic inflation and interest rates, and some nominal devaluation that has taken place recently, infrastructure constraints are now likely to emerge as binding constraints to private sector development in the short-term.

2.4 One of the major concerns of local and foreign business groups seeking to expand output and improve efficiency was the acute power shortages that adversely affected activities in most of the country, but especially in Luzon and Mindanao. According to a study prepared by Baring Securities Inc. in early 1993, the power crisis was a major constraint to increased utilization of existing plant capacity, in addition to blocking implementation of new investment plans. Also, a survey undertaken by Business International Philippines Inc., 40 multinational companies pointed to infrastructure deficiency as a key factor in reducing the Philippines' attractiveness as a business destination. Business groups also cite many other issues they regard as problematic. Distortions in financial markets (linked in part to macroeconomic problems) make it difficult to mobilize funds for private investment on a large-scale; administrative weaknesses and regulatory controls are delaying private sector project start-ups; well-defined competition policy is virtually non-existent (although the Government is taking steps to remedy this problem), particularly where franchising arrangements are operating; the scope and depth of the capital markets are still shallow, despite the recent phenomenal growth; and privatization initiatives have thus far been modest. These types of problems reflect unresolved issues surrounding the public-private interface. Their continued presence suggests that even if problems of a more cyclical nature are addressed, a strong and sustained private sector investment response would be unleashed after the reform effort has been fully consolidated. In part, this will require a change in the regulatory and institutional framework that will need to redefine some of the traditional relationships that have existed between business and Government.

B. Macroeconomic Stability and the Business Environment

2.5 The macroeconomic situation in the Philippines in 1994 shows substantial improvements in stability: single digit inflation, some capital repatriation, an increase in foreign portfolio investment, a market-determined exchange rate, the restructuring of commercial external debt, and improved access to international capital markets indicate the positive results that has been achieved in the overall business environment. Nevertheless, among domestic and foreign business groups, the Philippine economy is still thought to have a potential for macroeconomic instability, partly due to historical record, but more fundamentally due to weaknesses in public finances which continue to be a major threat to the business environment. Overcoming the fragility within the macroeconomic balances has been an essential requirement to strengthen recovery of business confidence and can be expected to spur private investment over the next few years, especially now that the authorities plan to introduce a stabilization program with IMF assistance (see paras. 2.20 and 2.25).

2.6 Weaknesses in public finances — evidenced by continuing public sector deficits and the mode of financing these deficits — continue to threaten a sustainable macroeconomic environment, and their origins go back more than a decade. After a period in the 1970s of expenditure-led growth financed by external debt accumulation, the domestic economy decelerated (in the early 1980s). A series of domestic crises coupled with external shocks led to the worst economic contraction in the post-war years, with GDP plunging by 7.3 percent in 1984 and again in 1985. Per capita income fell even faster, at close to 10 percent for both years. Domestic inflation accelerated to 50 percent in 1984 before slowing to 23 percent in 1985. In the second half of 1983, the authorities initiated a stabilization program to reduce

domestic inflation and discourage capital flight. During 1986-88, moderate economic growth took place in response to implementation of economic reforms.

2.7 A series of shocks then hit the economy. In December 1989, an attempted military coup led to a crisis in confidence at home and abroad, and to a period of looser fiscal and monetary management. In July 1990, an earthquake severely damaged infrastructure in central Luzon. This was followed by the Gulf crisis, which sharply raised the cost of oil imports. In November 1990, a typhoon triggered flash floods, killing more than 4,000 people in the Visayas. In June 1991, the eruption of Mount Pinatubo devastated a large area and created a medium-term threat of mud flows. In 1992, American military forces withdrew from the Philippines and their accompanying expenditures ended.

2.8 Macroeconomic management was unable to react effectively to these shocks throughout this period. The most difficult choice appeared to involve adjusting the exchange rate, which would have been useful to restrain import growth. However, this also would have increased public expenditures, especially after the natural disasters (and reveals the problems with regard to policy trade-offs). During the first half of the year, while the current account of the balance of payments continued to deteriorate, the exchange rate was held stable and fiscal policy continued to be expansionary.

2.9 Public borrowing at high nominal and real rates of interest was used to mop up excess liquidity. Domestic inflation fell, as desired, but so did gross domestic investment, which exacerbated the recession. Throughout this period, fiscal decisions became increasingly dominated by debt management concerns, resulting in reduced investment and O&M expenditures and an increasing reliance on short-term fiscal initiatives. It has only been in the past few years that authorities have acted to reverse the growing consolidated public sector deficit and pave the way for more stable public finances.

2.10 Macroeconomic policy has imposed severe constraints on the private sector in the recent past. Financing large public sector requirements to deal with internal and external disequilibria have resulted in high real domestic interest rates, a periodic overvaluation in the exchange rate, volatile domestic inflation, and insufficient infrastructure services. High and volatile domestic interest rates and an overvalued exchange rate have discouraged long-term investment and led to the misallocation of resources to nontradable sectors.

2.11 However, even in the 1980s, macroeconomic stability never deteriorated to the degree witnessed in other highly-indebted middle income countries (especially in Latin America). In the last three decades, domestic inflation has generally remained at single digit rates, with the GDP deflator exceeding 20 percent in only two years (1974 and 1985). Consolidated public sector deficits and current account deficits in the balance of payments have rarely exceeded 5 percent of GDP. The 1980s was a decade in which repeated stabilization efforts coupled with tight aggregate demand management, aimed at containing domestic inflation and emerging balance of payments deficits in the wake of the debt crisis.

2.12 **The Impact of the Public Finance and Foreign Debt Constraints on the Private Sector.** Since 1989, basic prices in the economy, interest rates, domestic inflation, and the exchange rate have been driven by the stabilization efforts of the Government. Rising domestic debt has led to higher real domestic interest rates, which have crowded out private investment. High real domestic interest rates resulting from high levels of debt have also made fiscal adjustment more difficult — by raising interest expenditures, by depressing domestic growth and thus eroding the tax base, and by increasing pressures on spending, in particular on subsidies. The result has been monetary policy subordinated to the cash management needs of the National Treasury.

2.13 The Central Bank has favored a strong peso in the past, and with large foreign liabilities on its balance sheet, it took measures to defend the peso and support its overvaluation in the 1980s. Its attempts to achieve a real devaluation of the exchange rate, however, have been less frequent and far less successful than attempts to support the exchange rate. The recent financial restructuring of the Central Bank was completed in December 1993, but took effect as of July 3, 1993 (see paras. 2.226 and 2.227). The new law stipulated the creation of a new Central Bank called "Bangko Sentral ng Pilipinas" (BSP). As part of the restructuring, the National Government (NG) will pay interest to fund the cash needs of the CB-BOL, which will be liquidating the previous external debts over the next 25 years. The financial restructuring involved shifting most external liabilities and non-performing assets to the CB-BOL[19] and which were replaced by ₱ 220 billion in Government securities bearing interest at market rates. This operation provided the BSP with a strong balance sheet, including capital of ₱ 20 billion, which is to planned to be raised to ₱ 70 billion in 1995 through a further issue of Government securities. As a result, BSP will be profitable even at much lower levels of reserve requirements (RRs). Moreover, the large portfolio of Treasury bills will enable it to conduct open market operations without financial assistance from the NG. These obligations will increase the Government's interest payments to more than 7.5 percent of GNP. The restructuring resulted in a net positive asset and income position, and it should eliminate incentives for the Central Bank to defend the domestic currency at unrealistic levels.

2.14 **Structural Reforms**. The reform steps already taken by the GOP to bring about improved macroeconomic stability, and the strategy being developed, have been documented in Bank studies prepared in late 1992 and early 1993.[20] Interest rates were deregulated in the early 1980s, two major public banks were rehabilitated in the mid-1980s, and the Central Bank was restructured in 1993 (as mentioned above). Together, these actions made interest rates more market-determined. Regarding the exchange rate, deregulation of foreign exchange is now virtually complete, and the exchange rate is market-determined. Although the Central Bank has continually intervened to prop up the value of the domestic currency in the past, this should be less of a problem in the future (see para. 2.13 above). The 1992 Brady deal has strengthened creditworthiness and reduced pressures on the budget. The budget is now supportive of more public infrastructure investment despite institutional problems, although full and timely execution of the budgeted expenditures, especially capital expenditures, depends on revenue performance and strengthened public institutions. Thus, some of the key macroeconomic constraints on the private sector have been addressed.

2.15 However, even though the current macroeconomic situation is no longer a major constraint on private investment, the long history of macroeconomic volatility has fostered a cautious attitude and uncertainty among investors, both domestic and foreign. This caution can only be overcome through time and a consistent track record of prudent fiscal and monetary management — needed to create credibility in government policies.

2.16 **Continuing Issues**. A number of macro policy decisions taken in recent years have been unhelpful to business growth. Cutbacks in public investment and reduced operations and maintenance on public works have helped the authorities to contain its deficit in the short-term, but at a high cost in terms of reduced quality and quantity of services to the private sector. Similarly, the reliance on distortionary taxes to supplement government revenues has also added to the cost of doing business in the Philippines. The temporary nine percent import levy introduced in 1991 increased the cost of inputs to industry. This exacerbated already-low levels of private investment activity as has the Gross Receipt

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[19] The previous Central Bank will continue to exist as the Central Bank Board of Liquidators (CB-BOL).

[20] See The Philippines: An Opening for Sustained Growth, World Bank, April 1993.

Tax (GRT) on financial intermediaries (coupled with high reserve requirements), which has raised the costs of mobilizing funds for private production, investment, and exports.

2.17 The impact of monetary policy on exchange rates in 1992 also adversely affected returns to producers in the industrial and agricultural sectors. While domestic interest rates generally eased throughout 1992 (with the 91-day Treasury bill rate falling from 21.5 percent at end-1991 to 14.8 percent at end-1992), the peso appreciated about 12 percent, impairing the competitiveness of tradables. Large capital inflows (partly in response to high domestic interest rates as compared to international rates) have been the principal factor behind the real peso appreciation. The continued decline in nominal interest rates in 1993, paralleling reduced domestic inflation, has since resulted in a nominal devaluation of the peso, somewhat improving prospects for exporters. However, with an open capital account and a convertible exchange rate, there is a risk of large swings in private capital flows with the attendant impact on appreciating the exchange rate and hence harming export growth.

2.18 From the viewpoint of promoting stronger private investment growth, it is evident that the broad thrust of macro policy should aim at avoiding actions which either impair business competitiveness through distortionary taxes or overvalued exchange rates, or which crowd out private investors through high real domestic interest rates or a large volume of government borrowings. The main requirement is for fiscal policy to shoulder more of the burden of controlling aggregate demand so as to reduce the adverse business impact of tight monetary policy on the exchange rate and on private investment. In short, the focus should be on reducing continued reductions in the consolidated public sector deficit without at the same time impairing business competitiveness. The reduction in the consolidated public sector deficit should be achieved in a sustained and credible way and not through short-term palliative measures.

2.19 To be sustainable, a reduction in the consolidated public sector deficit will need to be achieved by permanently increasing non-distortionary tax revenues and decreasing low priority expenditures. Temporary levies, revenues from the privatization program, and excessive reduction of operation and maintenance spending can all reduce the public sector deficit in the short-term, but cannot yield a lasting improvement in fiscal balances. Although excessive reduction in growth-oriented expenditures — public infrastructure and social services — might be sustained, the resulting reduction in growth will reduce the tax base in the long run and thus undermine fiscal adjustment. Unless the public finance constraint is permanently overcome and the burden of both external and domestic public debt reduced to more sustainable levels, the economic recovery will remain weak and will continue to be vulnerable to exogenous developments, reducing the country's capacity to successfully confront external shocks in the future.

2.20 Strategies for achieving these outcomes form the basis of ongoing discussions between GOP, the Bank, and IMF. To further reduce the consolidated public sector deficit and achieve a better balance between fiscal and monetary policies, with the thrust of adjustment falling more on fiscal policy, this report recommends continued efforts to increase resource mobilization by strengthening the administration and greater reliance on value-added and income taxes instead of by trade and excise taxes and phasing out tax exemptions. The largest scope for improved revenues comes from more effective implementation of existing taxes; weaknesses in collection have resulted in individual and corporate income taxes yielding only about one-half of their measured potential.[21] Public corporations have also been a drain on the

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[21] Said differently, businesses are likely to be better off if they pay their tax obligations rather than bear the cost of being crowded out. At the same time, businesses should reasonably expect the Government to cut back on wasteful expenditure and to promote efficiency in public provision of services.

budget because of recurring financial losses and a failure to pay taxes in full and on a timely basis. Options for reducing these losses include greater efficiency, improved management, and binding budget constraints.

2.21 A number of new measures are under consideration by the Congress and the Administration, the most important of which are listed in Table II.1. The minimum three percent import tariff put in place in April 1994 is to be extended to BOI exemptions by narrowing the sectors covered, reducing the length of tax holidays, and by not renewing exemptions nor granting them for plant expansions. More comprehensive tax reform is also in the works. A new Task Force on Tax and Tariff Reform has been at work since February 1994 to suggest improvements to the tax system and the tariff code. By mid-1994, it is expected to provide recommendations on a modified income tax for corporations and an asset-based minimum corporate tax (similar to one in operation in Mexico), aimed at increasing corporate tax collections above their current level of two percent of GNP, as well as any further revisions to the VAT. By February 1995, the group is to prepare suggestions on individual income tax revisions, tax incentive restructuring, excise tax simplification, and import tariff changes.

2.22 The Government took action to raise new revenues in the last two years. In 1993, VAT withholding was extended to government contractors and suppliers. In 1994, the Congress broadened the tax base for VAT to cover most previously exempted areas, including telecommunications; road freight and other transportation; lease and sale of real property; restaurants; hotels and motels; and books, newspapers, and broadcasting. Also in 1994, a minimum three percent customs charge was applied by administrative action to all zero-rated goods and certain currently exempt items, to be extended over time to goods imported under projects registered with BOI.

2.23 In addition, the Government is taking action to improve tax collection through a number of measures, including the establishment of separate treatment for large taxpayers and strengthening of penalties for non-payment of VAT. The Bureau of Internal Revenue will begin monitoring the tax returns of large taxpayers; the 1000 largest taxpayers in Metro Manila have been notified and issued Taxpayer Identification Numbers.

2.24 On the expenditure side, the options for reform should focus on public employment and on high priority public investment, since close to two-thirds of National Government expenditures represent wage and interest payment obligations. The Government needs to exercise caution in incurring new debt obligations, including contingent liabilities. In effect, the Government will need to resist borrowing commitments in activities which can be financed and undertaken by the private sector. Given that public sector employment has grown at an annual average of 5.6 percent in recent years, this report recommends continued efforts to streamline public spending, with a focus on privatization and a restructuring of public employment. The Government plans to reduce the number of departments to avoid duplication and the size of the civil service. Also, the Government plans to devolve additional functions and personnel to the LGUs to ensure that their responsibilities are raised to the level of funds being made available to them. While discretionary current expenditure is restrained, interest payments should decline as domestic debt is reduced and domestic interest rates fall in line with reduced domestic inflation and a fall in risk premiums (para. 1.40), creating room for increasing capital expenditure prudently. This should allow the Government to provide the infrastructure necessary to support economic growth. Increasing private sector delivery of public services represents a viable means of achieving the same public purpose with fewer public resources.

Table II.1: Revenue Enhancement Measures (billions of Pesos)

Measures to Improve Tax Collections	Status	Estimated Revenue Impact 1993	1994
Executive Branch			
Computerization	On going	0.0	0.0
Investigation and prosecution of tax evasion and smuggling cases	On going		
Tap private sector in disposing goods by BOC/BIR	On going		
Liberalize importation of luxury vehicles	On going	0.1	0.3
Energy conservation and environmental levy	EO 115	2.0	0.0
Re-registration of imported vehicles deficiency taxes	On going	0.1	0.5
Capital gains tax from privatization	Pending in Congress		2.2
Excise tax on bottled water	Pending	0.0	0.0
Moratorium on new tax exemptions and review of current exemptions	Pending	0.0	0.0
Legislative Branch			
Consolidation of trust and special funds with the General Fund	On going	-	-
Structural reforms in VAT	RA 7716	0.0	3.0
Administrative reforms in VAT		2.1	0.0
Excise tax on alcohol	Pending in Congress	0.0	0.0
Excise tax on cigarettes	On going	0.0	2.3
Land conversion tax	Pending	0.0	0.1

Measures to Increase Non-Tax Revenues	Status	Estimated Revenue Impact 1993	1994
Executive Branch			
Adjust fees and charges	On going	1.7	1.4
Accelerate privatization and extend life of APT/COP	RA 7661	0.0	23.9

Other Replacement Measures	Status	Estimated Revenue Impact 1993	1994
Executive Branch			
8% minimum tariff	EO 172	0.0	1.2
Administrative measures	Being implemented		0.7
Increase in registration fees of motor vehicles	Effective on same date as increase in PMVT		0.5
Legislative			
2% affluent consumption tax	Under discussion		0.5
Increase in PMVT	Under discussion		0.1

2.25 **Stabilization Program.** With IMF support, the Government will start implementation of a stabilization program. The program aims at reducing the share of the consolidated public sector deficit (CPSD) and domestic debt to GNP. The CPSD is to be lowered from 2.6 percent of GNP currently to 0.6 percent in 1996, which should enable the domestic debt/GNP ratio to decline to 41 percent. To achieve these objectives, a significant improvement in the savings/investment balance will be necessary, together with an increase in the efficiency of investment. Under the program, the ratio of national savings to GNP would increase by about six percentage points to 24 percent of GNP by 1996, virtually all of which would come from planned public sector fiscal adjustment. The program would continue to reduce domestic inflation, limit the current account deficit of the balance of payments to prudently financeable levels, and rebuild gross international reserves.

2.26 While the large foreign public debt has made new external borrowings difficult for private firms in the past because it had a negative impact on country risk rating, with the completion of the comprehensive commercial bank debt restructuring in December 1992, the Government decided to seek an investment rating from international credit rating agencies. In July 1993, both Moody's and Standard and Poor's gave the Philippines ratings (Ba3 and BB-, respectively), putting the country on a par with Latin American countries, but lower than neighboring Southeast Asian countries. Since then, external borrowing has exceeded US$1 billion (Table II.2). One of the reasons for the increased use of external financing by the private sector is the relatively lower interest rates available in international capital markets.

Table II.2: Philippines — Debt Issuance in International Capital Markets, 1993-March 1994

Date	Issuer	Amount (US$ mil)	Type	Maturity (years)	Spread at Issue	Sovereign Guarantee
Feb. 93	Republic of the Philippines	150.0	Eurobond	3	320	Yes
Jun. 93	Development Bank of the Philippines	175.0	Eurobond	5	310	No
Aug. 93	Philippine Airlines	100.0	Eurobond	3	375	No
Oct. 93	Philippine National Oil Company	90.0	Eurobond	5	265	No
Nov. 93	Philippine National Power Corp.	200.0	Eurobond	7	225	Yes
Nov. 93	Philippine National Bank	150.0	Eurobond	3	220	No
Dec. 93	Subic Power	105.0	Eurobond	15	385	No
Dec. 93	J.G. Summit	260.0	Convertible	10		No
Mar. 94	Philippine National Bank	54.0	Eurobond	3		No
Mar. 94	Filinvest	100.0	Convertible	10		No

Source: Salomon Brothers and Government of the Philippines.

C. Incentive and Investment Regime Constraints

2.27 The emphasis of Philippine industrial policy since the 1950s on high trade protection (to encourage import substitution) and, since the 1970s, on provision of fiscal incentives (to counteract the effects of trade protection and other distortions) had created, by the beginning of the 1980s, a business sector that was high cost and pursued rent-seeking activities. However, especially in the last five years, the trade and investment regimes have become much more liberal and outward-oriented. Foreign exchange regulations have been lifted. Philippine import tariffs and non-tariff restrictions have steadily fallen. Regulations on foreign investment have been relaxed. The policy of promoting specific industrial

sectors has largely been abandoned. The main area of future reform is the successful completion of the reform in trade and in the foreign investment regime as discussed in this report.

2.28 Liberalization of **foreign exchange transactions** in the Philippines took place in August 1992 following partial liberalization in December 1991.[22] The business response to the liberalization initiatives has been positive, both in terms of portfolio capital inflows and reduced transactions costs for exporters. In the past, proceeds from exports and remittances from overseas workers had to be surrendered to authorized agent banks who were entitled to hold the funds for 30 days before conversion into domestic currency. Repatriation abroad was allowed only for certain forms of foreign investment income such as interest and dividend payments. The controls discouraged both trade and investment. Exporters can now hold up to 100 percent of their export earnings in foreign exchange, thereby saving on conversion margins for inputs purchased from abroad. Repatriation of funds by registered foreign investments can also now be made without prior Central Bank approval (before it used to take three to six months). Short-term loans under the dollar-based FCDU credit facility now have a ceiling equal to 100 percent of exporters' L/Cs or expected foreign exchange receipts. The transaction volume in foreign exchange markets has increased significantly since 1991. Exporting firms cite these changes as providing a substantial benefit in facilitating business expansion. Foreign financiers also view forex liberalization as a positive factor in their assessment of country risk. The latest liberalization in this area was the lifting on June 17, 1994, by the Monetary Board of existing restrictions on repayment and repatriation of foreign investments financed by transactions using the debt-to-equity scheme.

2.29 The gradual lowering of import tariff protection will continue through 1995 according to the schedule set out in Executive Order 470 (introduced in July 1991). By the final phase, the Philippines will have a nine-band tariff structure, with items concentrated at 3, 10, 20 and 50 percent tariffs. Capital equipment, initially at an average rate of 30 percent, will face a 20 percent rate if produced domestically and a 10 percent rate if not. Items to remain covered by 50 percent tariffs include rice, vegetable oils, sugar, fruits, alcohol, tobacco and leather goods -- industries wielding political clout.

2.30 Although there was a bias against exportables in general, and agricultural and manufactured exports in particular, there was only marginal growth in the ratio of effective protection rates (EPRs) for agriculture to manufacturing between 1985 and 1992, from 0.28 in 1985, to 0.32 in 1990, to 0.34 in 1992 (Table II.3). (Annex 1 contains tables on the trade regime.)

2.31 In general, however, variances between effective protection rates (EPRs) for exportables and importables have been very wide, between -6.9 percent for exportables and 102.2 percent for importables in 1985, and between -4.1 percent and 74.1 percent in 1992. Thus, some categories of importables carry far higher protection than the average, indicating a bias against exportables and in favor of importables. Delays encountered in the payment of rebates under the export duty drawback scheme reduce benefits to exports and fail to lessen the anti-export bias of the trade regime. Restrictions on potential export industries and the protection provided to inputs and intermediate products increase the bias. For example, the substantial EPRs on imported paper, rubber, leather, and plastic, which could be inputs to food

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22 Only minor restrictions on foreign exchange transactions have been retained: dividends from investments in non-priority sectors under the debt-equity conversion program cannot be repatriated for four years (a restriction that the Government plans to delete soon); muliple exchange rates operate for oil imports because of the forward exchange cover arrangements linked to the OPSF (which will be eliminated as part of the overall deregulation of the oil sector); and foreign exchange to service debts may be purchased from the banking system only for loans approved by the BSP (to assist the monetary authorities in monitoring foreign borrowing). Also, outward investment by residents of over US$1 million requires BSP approval.

exports, penalize downstream industries by increasing costs.[23] The protection levels embodied in E.O. 470 are not expected to achieve sector neutrality or to reduce penalties for exports — imposed by the import tariff regime — by the end of the current trade reform program. Several items that will continue to be taxed at 50 percent are necessary inputs to downstream industries.

2.32 In the Philippines, highly protected capital-intensive upstream industries, such as textiles and paper, have usually obtained high import tariff protection, while downstream industries, such as garments and printing (dominated by smaller firms), have received lower protection. To the extent that inefficient upstream industries dominated by large firms survive behind protectionist policies, they reduce the international competitiveness of downstream SMEs.

Table II.3: Average Effective Protection Rates, 1985, 1990, and 1992 (percent)

Sector	1985	1990	1992 /a
All sectors	49.0	41.8	35.7
Exportables	-6.9	-4.1	-4.1
Importables	102.2	75.1	74.1
Agriculture	20.7	18.2	18.1
Exportables	-6.6	-0.7	-0.7
Importables	82.2	57.1	59.7
Manufacturing	73.3	57.5	53.4
Exportables	-4.4	-1.3	-1.3
Importables	107.3	79.2	77.5
Agricultural EPR / Manufacturing EPR	0.28	0.32	0.34

/a - Projected, based on E.O. 470.
Source: USAID (1991), Erlinda Medalla (1992).

2.33 Although there was a rapid decline in the proportion of restricted items to total items, and of their value to total import value between 1985 and 1988, the value of restricted imports did not decline in relation to total imports between 1988 and 1991. Several of the items that remain restricted are essential to support domestic competition and to encourage export growth. These include second-hand trucks and buses, motor vehicle parts, accessories, passenger cars and jeeps, pesticides, fertilizers, and refined petroleum products. In fact, these items accounted for six percentage points of the 13 percent share in 1991. Although the Government agreed to phase out the remaining QRs in 10 years as part of the Uruguay Round, this report recommends that the remaining QRs on imports be phased out by the end of 1996.

[23] Importable textiles (as inputs to garments and related industries), however, benefitted from EPRs of 262.3 percent in 1985 and 87 percent in 1992.

2.34 It is easier for larger firms to obtain licenses and quotas. Licenses are usually allocated to applicants based on criteria related to scale or previous performance, such as capacity, past imports, and value of assets. These criteria have created a bias in favor of large firms and have discouraged the entry of new firms. SMEs without access to imported raw materials or capital goods are forced to procure them from domestic producers, who generally offer lower quality, or from importers, often at a higher markup than their larger competitors pay for direct imports. An example of a policy that gives a clear advantage to larger enterprises is the restriction on the import of used light commercial vehicles for the transport of merchandise. Conversely, imports of larger commercial vehicles, more likely to be purchased by larger firms, are not restricted.

2.35 Regarding QR elimination, the Government reduced the number of restricted items from 3,000 items in 1980 to 183 items at end-1993. Coverage has been reduced to around five percent in 1993. However, the number of items under QRs increased during 1993 due to the imposition during that year of restrictions on 57 commodity categories, mostly related to grain and livestock products. While only a small number of import items today are subject to administrative restriction, the resulting price distortions impose efficiency costs on some important areas of the domestic economy. Remaining import restrictions kept domestic agricultural prices high, especially for corn, for which the domestic price was more than 50 percent above world levels, thereby hindering the expansion of poultry and other processing industries.

2.36 The Government stated its intention to use administrative orders to lift QRs on processed meats and rescind the administrative component of the QR on coal products. A speedy ratification of the Uruguay Round Agreement of the GATT and aggressive action to eliminate import restrictions on the broad range of agricultural products negotiated for tariffication under the GATT (including all agricultural items except rice) would underscore the Government's commitment on trade liberalization. By end-1996, virtually all QRs will have been eliminated, apart from those needed for reasons of security, health, or safety. The only exceptions will be the QRs on rice and petroleum products, which will be lifted in early 1997; and those under the Motor Vehicle Development Program (MVDP), which will be phased out by end-1998.

2.37 While E.O. 470 is a step in the right direction, it is clearly not sufficient to alter the anti-export bias of the trade regime and hence assist the Philippines in catching up with some other countries that have gone much farther in reducing trade barriers and integrating their economies with world markets. Although the Philippines' current tariff rates are not radically different from some of the other East Asian countries such as Korea, Malaysia, and Thailand, the overall bias of the trade regime is not pro-export. As a result, the "export push" which characterizes those countries is not evident in the Philippines.[24] In some East Asian economies — Hong Kong, Malaysia and Singapore — outward orientation reflected neutral trade policies, since those countries largely or entirely eliminated trade barriers. However, several other economies — notably Korea and China (Taiwan) — selectively supported exports without dramatically cutting import barriers (see "Foundations of East Asian Success", by Peter A. Petri, 1993). Given the fiscal constraints and the decision to join GATT, the latter alternative is not feasible for the Philippines. Hence, drastic reduction in import tariffs would remove the anti-export bias of the trade regime. Some of the countries in Latin America that have been most successful in expanding exports in recent years are Colombia, Chile, Argentina, Cost Rica, and Bolivia. These countries have all achieved high rates of export growth, following implementation of trade reforms. The import tariff range in most of these countries is 5-20 percent. (The exceptions are the top rates in Bolivia and Argentina -- 10 percent and 22 percent, respectively — and Chile's uniform tariff of 11

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[24] East Asian Miracle, World Bank, 1993.

percent for all imports.) All have virtually eliminated import licensing and other non-tariff barriers. Based on the success of these examples, most other countries in Latin America and the Caribbean have introduced or are in the process of introducing similar trade regimes. Improving customs administration should generate fiscal revenues which would be needed to offset the expected decline in revenues as a result of reduced import tariff rates. It may also be noted that the cost of distortions (i.e., high import tariffs) is lost output and employment, which the country can no longer afford. This report recommends accelerating trade liberalization and reducing import tariff rates to a range of 5 to 20 percent, with few rates in between, and striving for revenue neutrality in trade reform by phasing out import tariff exemptions, and strengthening customs.[25] It also recommends phasing out all QRs, except for health considerations, and maintaining the market-determined exchange rate while minimizing Central Bank intervention in foreign exchange markets, except to smooth out high volatility in the exchange rate in line with current policy. This report also recommends introducing net operating loss carry-over and accelerated deprecation over time once public finances stabilize, tax holidays are phased out, and reliance of the tax system shifts from international and excise taxes to VAT and income taxes.[26]

2.38 The Philippines has made important progress in liberalizing the foreign investment regime. As further administrative efficiencies are gained, the process of business registration should not be an issue for most investors. Rules governing foreign direct investment were substantially liberalized with the Foreign Investments Act of 1991. (Annex 2 provides a summary of repealed provisions of the Omnibus Investment Code.) Under the new regime, foreigners can invest up to 100 percent of the capital in an enterprise that is not covered by the negative list simply upon registration with the SEC. If they wish to benefit from the fiscal incentives provided under Book 1 of E.O. 226, they must apply to the Board of Investments (BOI) for approval. Foreigners can own up to 100 percent equity in any enterprise that exports at least 60 percent of its output (rather than the 70 percent cutoff rate under E.O. 226) or in any domestically-oriented enterprise that is not in those sectors included in the negative list. No divestment of foreign majority control is required. (Annex 3 lists investment areas closed to 40 percent foreign equity participation; Annex 4 shows table of nationalized activities and their requirements; and Annex 5 describes citizenship requirements for foreign investment in different activities.) Previously, foreign investors had been required to transfer control to Philippine nationals within 30 years of registration. Corporations with less than 40 percent foreign equity can obtain SEC registration within about nine days; for companies with 41 to 100 percent foreign equity, the processing time is about 24 days. (Annex 6 describes rights provided to foreign investors under the existing laws.)

2.39 The Act does not apply to the banking industry, but in May 1994, a law was passed liberalizing the entry and scope of operations of foreign banks. RA 7721, signed into law in May 1994, allows for entry of up to 10 additional foreign banks and further scope of operation for foreign banks already in the country. The new entrants, six allowed within the next five years and another four upon approval of the President, will be limited to six branches and will require minimum capital of US$7.5 million. No limits were set on setting up subsidiaries in the country or buying into existing domestic banks as long as 70 percent of the assets of the banking sector remain controlled by domestic banks with majority Philippine ownership. Under the new law, a foreign bank may choose one of the following modes of entry (1) by acquiring, purchasing, or owning up to 60 percent of the voting stock of an existing bank; (2) by investing in up to 60 percent of the voting stock of a new banking subsidiary

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25 NEDA proposed in 1994, an acceleration in the reform described in "Guidelines for the Overall Tariff Review" which sets out trade liberalization targets. The proposal, which is under discussion, is to reduce tariffs gradually to two rates: three percent and 10 percent after the last year of EO470. By the year 2000, a uniform tariff of five percent is being targeted. The President has yet to approve the guidelines.

26 The Government has already taken steps to shift reliance of the tax system to the VAT (see para. 2.22).

incorporated under the laws of the Philippines; or (3) by establishing branches with full banking authority. Regarding the last mode of entry, on ten new foreign banks will be given a license within five years of the effectiveness of the law, but each one of them may have up to six branches. The four existing foreign branches may also open up to six additional branches each. The law stipulates that only those among the top 150 foreign banks in the world or the top five banks in their country of origin as of the date of application will be allowed entry (para. 2.223). According to the BSP, 15 foreign banks have already indicated their interest in applying for a bank license, most of which prefer to enter as a branch. The passage of this law should help promote competition within the financial sector generally and improve the level of funds mobilization for private investors (see section on finance).

2.40 Other actions have been taken to improve the environment for foreign investors. Full and immediate repatriation of dividends, profits, and capital from foreign investment was put into place as part of foreign exchange liberalization in 1992. Streamlining of procedures for obtaining work permits and visas for foreigners also occurred in 1992. In 1993, the maximum length of land leases were extended from 25 to 75 years, giving foreign investors greater security of tenure.

2.41 Greater perception of political stability and internal security will likely encourage potential new foreign investors. Most foreign investors decide to undertake investments in a particular country based on an overall assessment of risks and opportunities. In this respect, the timely implementation of reforms suggested in this report should lead to higher foreign investment flows to the country, since the expected benefits should alter the balance between risks and opportunities in the Philippines' favor. Equally important is the need to address the issue of legal restrictions prohibiting foreigners from investing in certain industries and from owning land. Some sectors, such as retail trade, are completely closed to FDI. Furthermore, the dilapidated infrastructure in the Philippines also has constrained foreign investment, while economic stagnation in the past several years has deterred increased FDI flows.

2.42 The first Negative List consists of Lists A, B and C. List A includes areas in which foreign ownership is limited by mandate of the Constitution and specific nationalization laws. List B contains investment areas where foreign ownership is limited for purposes of public health and safety and to protect small and medium-sized domestic market enterprises. List C includes investment areas in which existing enterprises are assumed to meet domestic demand. Under the law, inclusion in List C requires a petition by a Philippine national engaged in the area before public hearings may be held. Among the restricted areas in List A are mass media, licensed professions, cooperatives, utilization of natural resources, public utilities. List B includes manufacture of weapons and explosives, dangerous drugs, small and medium scale domestic market enterprises, and small and medium scale export enterprises which utilize raw materials from depleting natural resources. In contrast to the Transitory Negative List, List C in the first Negative List is empty because no petitions for inclusion in said list had been received as of the August 31, 1993 — the deadline set by the implementing Rules and Regulations of the FIA. With the empty List C, new areas will be effectively opened to foreign investments upon the expiry of the transitory Negative List on October 24, 1994. Legislation amending the Foreign Investments Act to eliminate Negative List C has already been submitted to Congress. The Government also plans to eliminate the restrictions under Negative List B, limiting the entry of medium-size firms and the ban on foreign retail firms in List A. These areas include, among others, travel agencies, tourist lodging services (pension houses and tourist inns), convention and conference organizers, life and non-life insurance business including professional reinsurance services and insurance brokerage.

2.43 The empty List C is considered welcome for the following reasons:

(a) "Adequate capacity" is not a sound basis for excluding foreign investments in a particular sector. A foreign firm would enter if it has something better to offer, and can compete with

the incumbent firms by offering quality products at lower prices which would respond to the consumers, and domestic producers as well.

(b) Restricting entry into an industry on the basis of "adequate capacity" meanwhile, encouragers existing firms with high-cost production techniques to continue operating at the expense of consumers.

2.44 Foreign ownership restrictions on mining firms remain a major constraint to mobilizing needed equity investments in this sector (in contrast to Indonesia where foreign investments in mining have been critical to the development of the sector). As a result, the sector has been contracting due to lack of new investment. With the assistance of foreign mining firms, a Financial and Technical Assistance Agreement (FTAA) policy has been drawn up but as yet no specific projects have been authorized by the Government. Under the proposed FTAA, a wholly foreign-owned firm may engage in mining ventures, as a contractor, but must divest 60 percent of its holdings to local investors within 10 years from the recovery of its pre-operating and property expenses. Foreign firms must therefore judge the risk of an adequate return from divestiture against the revenue sharing arrangements under which the Government takes 60 percent of net revenue and the company receives 40 percent.[27] In the shipping industry also, restrictions on foreign ownership are preventing the growth of adequate shipping to meet inter-island commerce needs. Industry estimates indicate that passenger and cargo vessels will need to double (to around 600) in the coming decade, but mobilizing the capital for this expansion will be more difficult if the majority of equity has to remain local.

2.45 On June 2, 1994, the House of Representatives approved on the third and final reading a bill that proposes five major amendments to the FIA, including the (1) reduction in the minimum equity requirement for foreign-owned domestic and export enterprises which use depleting natural resources from US$500,000 to US$150,000; (2) deletion of the three-year requirement before a domestic market enterprise can change its status to export enterprise; (3) repeal of the entire provision on strategic industries in order to include these in the BOI-IPP (Section 10 of the FIA); (4) deletion of all provisions pertaining to Negative List C (Sections 8-c, 9 and 15 of the FIA). These changes will make the country more attractive to foreign investors. On the other hand, the Senate version which is yet to be discussed by the chamber proposes to modify only the two following major provisions of the FIA (1) repeal of a provision on "strategic industries"; and (2) removal of the three-year requirement before a domestic market enterprise shifts to an export enterprise.

2.46 The Lower House filed a bill in 1993 seeking to liberalize retail trade business. The three major features of the bill include: (a) the retail trade business will be exempted from the FIA; (b) the three levels of capitalization will be a 100 percent foreign ownership for ventures with capitalization of at least US$100 million, a maximum of 51 percent equity participation for ventures with at least US$10 million worth of investment, and a maximum of 49 percent foreign equity participation for capitalization of less than US$10 million; and (c) enterprises partially or wholly owned by foreigners, involving the establishment of a chain of retail stores, are required to have capital of at least US$10 million for every store or branch established in the country.

2.47 The challenge to the Philippines in attracting manufacturing investment from abroad has become tougher with the emergence of southern China and the expected take-off of Viet Nam as the most

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[27] Because FTAA is designed to circumvent constitutional limitations on foreign ownership (at least in the initial phases of a venture), it also carries the risk of a legal challenge. Foreign mining groups are believed to remain cautious about the legal basis of this initiative.

dynamic growth area in Southeast Asia. Foreign investors in Asia (many of whom are ethnic Chinese) see China as an increasingly preferred investment site, and the recent decision by Taiwan (China) to officially allow Taiwanese (China) firms into China indicates that countries such as the Philippines will have to compete much harder in the future to attract foreign direct investment.[28] Addressing infrastructure and capital mobilization issues on a timely basis will remain a priority, as will the need for much greater professionalism on the part of Government officials who deal with business people directly. One issue of importance in coming years will be the need for a coordinated effort from the Export Processing Zone Authority (EPZA) and the Subic Bay Authority in attracting foreign investment.

2.48 As discussed earlier, foreign investors typically are influenced by overall macroeconomic and political stability — areas in which the Philippines has been making good progress recently. Red tape and bureaucracy are still perceived as impeding speedy implementation of projects, particularly at the level of line agencies. However, there are also legal and regulatory impediments which will need to be modified through legal changes. The most important legal constraint is the 40 percent maximum ownership allowed for foreigners in some key sectors. The other restrictions are as follows:

- **Foreign Investment in Land**. It is recommended that the nationality requirements be relaxed to allow noncitizens to lease land in industrial estates or export processing zones, as proposed in a legislation presented to the Congress four years ago. It is also suggested that noncitizens be permitted to lease public lands.

- **Minimum Capitalization**. The minimum capitalization requirements (domestic market enterprises not involved in advanced technology or export companies utilizing raw materials from depleting natural resources must have a minimum paid-in equity of US$500,000 if they are more than 40 percent owned by foreign nationals) should be deleted or reduced substantially to attract smaller foreign investment which can grow over time.

- **Existing Production**. Because List C enumerates areas in which foreign investment need not be encouraged, it discourages competition and a healthy private investment environment. It is recommended that List C be deleted from the Negative List.

- **Import and Wholesale Activities**. The language in List C restricts the "import and wholesale activities not integrated with production or manufacture of goods" to Philippine nationals. Thus, foreign enterprises proposing to engage in import and wholesale activities in the Philippines, through a branch, partnership, or majority-owned subsidiary, must manufacture the products to be distributed. Prospective foreign investors who have expressed a desire to engage in such activities without owning a manufacturing facility have been prevented from doing so. It is recommended that restrictions on import and wholesale activities be removed from the Negative List.

- **Joint Venture**. Once a foreign investor enters into a joint venture with a Philippine national, the Philippine partner has a right of veto with regard to any competing activity by the foreign investor in the domestic market. Anti-competitive restraints of this kind entered

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28 While fewer than 1 percent of people in the Philippines are pure Chinese, Chinese-owned companies account for two-thirds of the sales of the 67 biggest corporations (The Economist, July 18, 1992). Philippine businesses have yet to exploit the overseas Chinese business network to the same extent as other Southeast Asian countries such as Indonesia, Thailand, and Malaysia.

into by a competitor and a potential new entrant are illegal in most market economies. It is proposed that this restriction be deleted from the implementing rules of the FIA.

- **Nationality Restrictions**. Nationality laws are too restrictive for certain classes of business. These include retail trade, construction, shipping, airlines, mining, travel, media, advertising, utilities, and insurance. Foreign investments can be increased if these restrictions and limitations are relaxed to permit foreign investors to own up to 100 percent equity.

2.49 To attract higher levels of FDI, this report recommends the following legal changes:

(a) Phasing out the 40 percent limitation on foreign ownership.

(b) Reducing the minimum capitalization requirements for FDI.

(c) Allowing foreign ownership in sectors — presently closed to 100 percent foreign ownership — such as retail trade.

(d) Eliminating the negative list.

2.50 The **investment response** since the introduction of the For n Investment Act has been generally modest. While the Act itself was an important step to make the lippines more internationally competitive in attracting FDI, the realization of these flows has awaited the resolution of other more binding constraints to investment activity (notably political uncertainty before the May 1992 elections, power supply shortages, capital mobilization difficulties and macroeconomic stability) as well as the factors listed above. Many FDI inflows are accompanied by some type of foreign loans as part of a project financing package, and the reluctance of foreign commercial banks to take on additional Philippine exposure in recent years has been a contributing factor to the muted FDI response. It is for this reason that the recent Brady-type restructuring of foreign commercial bank debt to the public sector and the consequent improved credit rating secured by the Philippines are major positive steps toward regaining the confidence of foreign banks, institutional lenders, and equity investors — an essential step for the resumption of strong FDI growth in the next few years.

Fiscal Incentives

2.51 Fiscal incentives affect relative factor use because of their effects on relative factor prices. Fiscal incentives also influence the flow of resources across different economic activities by changing relative profitability. The Board of Investments (BOI)-administered incentives created biases in market orientation and in intersectoral and geographical distribution of registered activities, thereby adversely affecting resource allocation. (Annex 7 describes BOI incentives.)

2.52 The BOI, which was established in 1968, is charged with responsibility for preparing the annual Investment Priorities Plan (IPP), processing applications for registration of enterprises under the IPP and approving incentives, and periodically monitoring compliance by enterprises. (Annex 8 describes the Investment Priorities Plan.) Since the incentives are given selectively, they serve as an entry barrier. In preparing the IPP the BOI was guided by the concept of "measured capacity", that is, incentives are not given to applicants if the BOI decides that the existing capacity can meet domestic demand. Potential entrants are not prohibited from entering the market, but they will no longer enjoy the fiscal incentives. This is intended to avoid wasteful investment. A study estimated that the fiscal incentives given by the

BOI can increase the rate of return of a pioneer firm by at least 12 percentage points and that of a non-pioneer firm by at least 10 percentage points. These generate larger profits that can be used by BOI-registered firms to defend themselves against new entrants that do not benefit from BOI incentives. In the past, incentives encouraged capital intensive projects in Metro Manila.

2.53 Although some economic activities were added to the IPP list between 1989 and 1992, the number of economic activities included in the IPP list has been declining over the years. (Annex 9 presents a list of preferred economic activities in 1986, 1989, and 1992.) This means that many potential entrants will no longer enjoy the fiscal incentives accorded to the earlier ones, creating a bias against new entrants and favoring incumbents. Fiscal incentives are not believed to have had an appreciable impact on increasing private investment, but have led to higher fiscal expenditures.

2.54 With the approval of the 1994 Investment Priorities Plan, which lists 59 priority areas eligible for BOI incentives, the BOI has already restricted tax and duty free importation of capital equipment and tax holidays to three years instead of five, and excluded expansion projects from eligibility for tax holidays, except for export oriented firms and garment firms exporting under quota.

2.55 The single most important incentive in terms of revenue foregone and, consequently, in terms of benefits to the firms registered with the BOI, is the exemption from paying taxes and duties on imported capital equipment. The Government needs to improve the mechanisms for exemptions and drawback of the duties and taxes on inputs to exports. The BOI-administered tax and duty drawback system was one of several such schemes, none of which was effective. However, the establishment of the One-Stop Action Center for Tax and Duty Exemption/Drawback is helping to streamline the exemption/ drawback system until trade liberalization finally makes some of these incentives unnecessary. This is particularly true for the tax and duty exemptions on capital equipment; this means that if the Government later decides to provide incentives for reasons other than to compensate for trade distortions, it will have to use other types of incentives.

2.56 By reducing the cost of capital for larger enterprises, fiscal incentives for "priority" areas in the Philippines have discriminated against SMEs. Likewise, investment incentives provided by the Government to industries to promote decentralization of economic activities largely benefit large enterprises:

(a) One example is the exemption from income tax granted by the BOI to infant industries. This policy is neutral between enterprises but not within sectors, since the BOI's designation of areas as "pioneer" involves fiscal incentives. The main criteria for designation as pioneer activities are production of goods not previously manufactured in the country and use of new production technologies. A strict application of these criteria can result in a relative disadvantage for SMEs, since large firms are in a better position to implement new technologies and to move into new areas of production.

(b) A comparison of incentives available for increasing the use of labor (deduction of labor expenses) with incentives for the use of capital (tax and duty exemption or tax credit) shows a clear bias in favor of capital-intensive firms. Even the 100 percent eligibility for offset against taxable income of additional labor costs (due to new hiring for a project) that is available to pioneer enterprises cannot compare with incentives for capital investment. In addition, tax relief on labor costs cannot be claimed where the income tax holiday is already claimed. This renders this instrument practically worthless as an incentive for highly labor-intensive production, in which subsidies for capital investments encourage higher capital

intensity. This scheme clearly benefits large and capital-intensive enterprises and discriminates against small and more labor-intensive industries.

(c) The tax credit on domestic capital equipment is intended to place purchases of locally produced capital on the same footing as imports of capital goods. An investor purchasing domestic capital goods receives a tax credit for the amount of the import duty that would normally have been due if the capital goods had been imported. But, in fact, parity is not achieved. A tax credit issued for purchases of locally produced capital goods yields a financial benefit only when the enterprise makes a profit. Because SMEs, for a variety of reasons, have poorer access to imported machinery than large enterprises, they are also less able to claim incentives. Although the tax credits are transferable, this is only possible on a limited scale to suppliers of intermediate materials. SMEs are often supplied by marginal suppliers paying no tax or officially exempted from income tax, so, in practice, the benefit of tax credits is limited for them.

A background paper prepared for this report showed that most firms which benefitted from the incentives were large-scale, capital-intensive and mostly oriented to the protected domestic market as a result of the biases in the design and implementation of fiscal incentives.[29] Annex 10 provides tables which show the biases fiscal incentives create as discussed above. This report recommends phasing out fiscal incentives and dropping the IPP in view of the tight fiscal situation which requires cutting all unnecessary spending, the anti-export bias of the incentives, and the general ineffectiveness of fiscal incentives in encouraging private investment in the presence of trade protection and other binding impediments to efficient private sector growth. Regarding the BOI, this report supports the expeditious and successful completion of the transformation of the entity from a regulatory agency to a promotion agency in line with FIAS' UNDP-financed restructuring program.

2.57 Phasing out fiscal incentives over time will not only help reduce consolidated public sector deficits, but will also remove some of the harmful biases of the current investment incentives regime.

2.58 Heavy regulation of the **petroleum sector** also resulted in price distortions. The Oil Price Stabilization Fund (OPSF) minimized the frequency of domestic price adjustments, but led to large price adjustments in the past. Price increases resulted in popular opposition, delaying adjustments and causing the OPSF to incur deficits at times. In 1993, the authorities took advantage of an OPSF surplus to increase the oil import duty without a corresponding increase in retail prices. However, when the OPSF funds ran out and prices had to be raised by 15 percent in February 1994, widespread public protests forced the authorities to roll back both the price increase and the related tax. Another problem arising from regulation has been that cross-subsidization of prices within the OPSF, which caused a serious disparity between consumer demand and refining capacity, especially for low-priced diesel. During 1994, the authorities plan to adopt an automatic mechanism for adjusting petroleum prices. Domestic prices will be reviewed monthly and will be revised whenever movements in international prices and the exchange rate necessitate an adjustment. This should minimize the need for large and politically difficulty price increases in the future.

2.59 **Labor costs** are a critical determinant of competitiveness for the Philippines. Overall, unit labor costs in the Philippines are low compared with some of its neighbors; the cost of skilled labor, such as foremen, accountants and clerks is still competitive. The legislated minimum wage in the Philippines, at approximately US$5.00 a day (somewhat less outside Metro Manila), is higher than in Indonesia,

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[29] Rosario Manasan, "Fiscal Incentives in the Philippines," background paper for the PSA.

China, and Vietnam. The problem appears to have been political influences on minimum wage legislation until the last few years, which raised the wage floor and compressed wage differentials in the formal sector. This floor erodes the profitability and competitiveness of large firms in the formal sector, which includes foreign-owned firms, and it increases the wage bill for the public sector, where wage levels tend to adjust with changes in the minimum wage. However, the minimum wage does not serve to protect workers because many workers are employed outside the formal sector; as a result, more than two-thirds of all wage earners in industry earn wages below the minimum. Given that the overall productivity of labor is also low, productivity adjusted wages for unskilled labor are even higher than those which do not consider productivity. Alone among its competitors in Southeast Asia, the Philippines faced a significant decline in output per worker during the 1980s. For the period 1980-89, total output per worker declined nine percent for the entire economy and 17 percent for the non-agricultural sector. This report recommends a review of the minimum wage by the Government to ensure that legally mandated increases in minimum wages do not result in slowing down employment growth.

2.60 Legislation in the Philippines is generally pro-labor, in line with the constitutional mandate, although traditional management prerogatives are still recognized and respected, subject to certain limitations. These prerogatives include the employer's right to run the business and to regulate all aspects of employment, such as hiring, work assignments, working methods, time, place, and manner of work, and dismissal of workers, according to his own discretion and judgment. Also, labor relations have improved since the end of the Marcos regime. The number of strikes has dropped steadily, and the loss in worker-days was reduced by more than half in recent years. With regard to labor union organization and labor-management relations, the Philippines is not much different from other ASEAN nations, although union activity and strikes are somewhat more prevalent in the Philippines than in Singapore or Indonesia. Slightly less than one-quarter of the workforce is unionized, but the presence of more than 3,000 unions helps prevent any one union, particularly a radical organization, from fundamentally disrupting the labor scene.

2.61 The Philippines has an attractive labor pool. Its labor force is well over 20 million and growing by four percent a year. There is an abundant supply of skilled workers and managers, and English comprehension is widespread among both skilled and unskilled workers. This particular combination of a large labor supply and a high level of skills and other qualifications is uncommon. The Thai labor force, for example, is comparable in size to that of the Philippines, particularly in unskilled labor, but there is a serious shortage of qualified engineers, technicians, and middle managers — a shortage likely to persist in the immediate future and perhaps beyond. In Malaysia, where the labor force is a little over six million and growing at two percent a year, firms generally have no difficulty hiring unskilled and semi-skilled workers, but skilled workers are in short supply. Indonesia's strength is the size of its workforce — 76 million and growing at three percent a year. Yet, an estimated 70 percent have received only elementary education and familiarity with English is practically nonexistent at lower levels. This has led to a shortage of skilled workers, in particular technicians, engineers, accountants, and managers, at all levels. To maintain its competitive edge in skilled labor, the Philippines needs to focus on improving the quality of education and to encourage further development of management skills training. It is the recommendation of this report to upgrade management training.

2.62 Despite the Philippines' relatively skilled labor force, a number of weaknesses are evident. There is a mismatch between secondary and tertiary education and industry needs; the brightest and most qualified skilled workers often choose better-paying jobs abroad; and the apprenticeship schemes do not adequately prepare trainees. Although the country has a high literacy rate, there is apparent evidence that graduates are either ill-prepared for the careers they had sought to pursue (those from lesser-known universities virtually cannot compete for employment) or are mismatched against the needs of the job market. There is a lack of good technical and vocational schools. Institutions offer two-to-three-year

technician courses in which students learn theory under controlled conditions and then get only one to three months of on-the-job training. The Government limits apprenticeships to six months, hardly long enough to teach trainees all the skills required by an industry. In most countries, multi-year apprenticeship schemes overcome this problem. The Philippine Government appears to be favorably considering a more realistic apprenticeship scheme. This report recommends that the Government adopt such an apprenticeship scheme.

2.63 **Competition policy** remains an area of concern. Reflecting the impact of a multitude of entry barriers in over half of manufacturing subsectors, the top four firms account for more than 70 percent of total sales, but due to the protection and other incentive policies of the past, they generally have not had the same outward efficiency incentives as major firms in the successful exporting economies of Southeast Asia. In a number of highly-publicized cases, firms have been able to use the vagaries of the legal system to ward off competitors. High levels of industrial concentration and protection from foreign competition have combined to create very weak pressures for product or market innovation. The gradual removal of trade and industrial policies is starting to break down the concentrated market structures, but the process could and should be accelerated. More determined enforcement of competition policies, now under consideration by the Government, would also encourage greater competition and create pressures to achieve greater efficiency.

2.64 Lack of competition is also a problem in sectors where state-owned enterprises (SOEs) dominate. Within the manufacturing sector, a few SOEs are extremely large and together they account for 15 percent of manufacturing sector revenues. PASAR, which carries out nonferrous smelting, ranks eighth among corporations; National Steel Corporation (NSC), which operates mainly rolling mills, ranks tenth; while Paper Industries Corporation ranks 39th. PASAR, NSC and PETRON (before it was privatized) all dominate their respective subsectors, and their privileged position has not only reduced competition within each subsector but, more importantly, the passing on of their cost inefficiencies has impaired the competitiveness of private sector operators in downstream activities.

2.65 While cross-ownership patterns between larger corporate groups and private banks provide greater ease of access for loans to established groups for expansion or diversification, it is at the aggregate level that the Philippines' financial sector weaknesses have probably had their greatest impact on limiting the growth of firms and the spread of effective competition. A combination of isolation from international capital markets and large government borrowings on domestic financial markets has meant that the domestic financial sector has not developed the range or volume of credit and equity-related instruments that private firms require in order to respond to emerging opportunities. While initiation in liberalization of the trade and investment regimes have been important precursors for a competitive and cost-efficient business environment, high cost and limited access to credit and crowding out has inhibited the pace at which private firms can mobilize the funds needed to make investments and make more effective competition a reality. Reduced public borrowings and substantive financial sector reform will be important in order to realize the investment needed for greater competition and improved cost efficiency.

2.66 Overcoming these barriers to more effective competition will also have important implications for the pace and direction of future **privatization** activity in the Philippines. As outlined in Chapter I, the privatization program that has been implemented since 1986 has had a mixed record in terms of enabling the Government to disengage from commercial activities, and the stage has now been reached for a broadening of the privatization effort and a shift in the overall strategy of divestiture. (Annex 11 discusses issues faced in the early stages of the privatization in the Philippines.) The financial sector weaknesses have inhibited the pace of privatization to date, and have caused the Government to become overdependent on private placements as a method of divestiture. With the exception of PNB and

the Union Bank, there has been little effective broadening of the ownership base. Overcoming this problem in the case of the very large assets that have been listed for sale will require a more focused strategy based on capital market initiatives in order to secure a broader ownership base and more effective competition (see section F below).

2.67 Additionally, the Government must capitalize on the momentum toward privatization that had been created since 1986, and learn from past experience. Toward this end, it is recommended that the Government enhance the privatization program through the following actions:

- **Define a broader privatization framework**. To broaden the scope of privatization, it is recommended that the Government consider:

  - An expanded privatization policy that covers not only the GOCCs and nonperforming assets that are currently targeted, but all GOCCs and government agencies that perform commercial functions.

  - A policy to restrict future public sector involvement in the economy beyond regulatory and enforcement activities. The immediate implementation of this policy would involve minimizing (a) the purchase of GOCCs or shares therein, or government-owned shares in any entity by other state-owned entities; and (b) existing GOCCs and government agencies from taking on economic functions they are currently not performing.

  - A policy to encourage competition and discourage excessive concentration of market power in any industry by facilitating entry through merger control prior to any privatization.

  - Continue to contract out private sector delivery of public services through BOTs and BOOs.

- **Dispose of the backlog of GOCCs and transferred assets**. The Government should seek an early resolution of all accounts on the books of the APT and other disposition entities as of the end of 1994. APT should be given the sole responsibility for disposing of all GOCCs identified for privatization, under the policy direction of the Committee on Privatization (COP).

- **Expand privatization coverage**. In conjunction with expanding the privatization program, the Government should establish a mechanism for identifying and evaluating privatization options. Under E.O. 37, the administration has already ordered all Department heads to identify activities and assets that would be better controlled by the private sector. E.O. 37 also seeks to speed up the sale of 50 GOCCs and to review 81 remaining GOCCs. It is recommended that the process for identifying and evaluating attractive privatization targets be introduced on a timely basis, and that the Government expedite the sale, liquidation, and privatization of the remaining nonperforming assets and the GOCCs targeted for privatization.

Privatization Strategy Initiatives

2.68 To implement the above mentioned objectives, it is recommended that certain initiatives be undertaken as part of a coherent action plan. The legislation should give COP and APT expanded responsibilities for establishing policy and guidelines for implementing privatization. Specifically, the following actions are recommended:

- Directing the proposed competition agency to review concentration in selected sectors and to drafting regulations designed to encourage competition in these sectors and in the economy as a whole, and reviewing privatizations to limit market power of individual companies.

- Establishing guidelines on the treatment of labor by the new owners of GOCCs and transferred assets.

- Extending the life of COP and the APT from June 30, 1995, as needed. The COP should be directed to develop new guidelines under which APT disposes of GOCCs and nonperforming assets. All sales of these assets should be centralized under APT. The guidelines should make it possible to:

  - Assess the condition of GOCCs and nonperforming assets to determine their liquidation value. The rehabilitation of these assets, particularly the infusion of funds to improve their value, should be discouraged.

  - Expand the options for negotiating the disposition of an asset, while taking account of the asset's condition, its marketability, its realizable value, and the incremental cost to the Government of maintaining it.

  - Establish the conditions under which the assets will be offered for sale on a timely basis. At the end of a certain period, the enterprises should be dissolved and the underlying land and equipment sold as quickly as possible.

  - Ensure proper management and corporate accountability for firms being privatized.

2.69 The Presidential Commission for Good Government (PCGG) controls "surrendered" assets including large blocks of shares in PLDT, San Miguel and numerous other companies, as well as some physical properties. These assets are valued at several billion US dollars. The ownership of these assets should be decided expeditiously by a special court. This report recommends that those assets determined to be Government property should be privatized.

2.70 **Financing and Securities Markets**. The Government should seek to establish creative means by which the securities markets can finance the transfer of Government assets to the private sector. In particular, Section 2(d) of RA 7181, which provides that 10 percent of these assets shall first be offered in corporate form to small investors, including overseas workers, should be complemented by mechanisms that facilitate the entry of small investors into the capital markets.

D. Infrastructure Constraints

2.71 Infrastructure bottlenecks have been one of the key constraints to private sector development: Power outages were the principal deterrent to new investment until the end of 1993. A number of initiatives have already been taken that will expand supply through BOT and BOO schemes, and it is the private sector that has and is expected to play the key role in these initiatives. Beyond these immediate steps, however, there exists a broader range of infrastructure issues such as low telecommunications coverage, high cost of transport and inter-island shipping, dilapidated transport infrastructure, all of which adversely affect private sector development. Infrastructure deficiencies have necessitated increased private provision of those services, hence creating new investment opportunities, as well as pressing constraints on private investment and growth.

2.72 The Philippines is now caught in a downward spiral of poor infrastructure services, low resource mobilization, and cutbacks in maintenance and investment resulting in further deterioration. The costs of starting and running a business have increased over recent years as electricity brownouts and other disruptions have risen. Requiring back-up power generation, or waiting months or years for telephone connections, being unable to place calls, or having to install a dish for communications, makes doing business costly. Time delays and congestion, and frequent interruptions in production activities, add further to the costs of doing business. The wide range of deficiencies and the declining level of services have triggered consumers' resistance to price increases. But without increasing prices and revenues, the utilities cannot improve services and invest in additional capacity.

2.73 The present infrastructure inadequacies can be traced to successive fiscal crises that resulted in a shift in spending priorities toward current expenditures. Budgetary pressures meant that public funds were not allocated either for new capacity additions or for recurrent maintenance expenditures; even where official loan funds were made available from abroad, the public sector had difficulty utilizing them according to plan. Fiscal problems also contributed to a rundown in operations and maintenance activity; a number of government power stations are now running at a fraction of their capacity due to lack of maintenance.

2.74 While public sector funding shortages are superficially viewed as the cause of the infrastructure crisis, a more fundamental issue lies with concentrated industry structures, dominated primarily by public enterprises and private monopolies. During the last decade, the poor economic performance and weak financial outcome of many public enterprises have seriously limited their capacity to maintain and invest in infrastructure systems through internally generated funds. This poor performance can, in turn, be traced to structural factors. These include non-commercial management structures, unclear and often conflicting commercial and social objectives, low capitalization and limited accountability for performance. Price controls, inadequate pricing levels and/or tariff structures as well as difficulties in enforcing revenue collections, further constrain internal revenue generation. As a result, many enterprises have failed both to expand access or to improve quality of services to a growing population. They have also had to increasingly rely on the Government's financial support to sustain their activities. This support, combined with the need to reduce the consolidated public sector deficit, has further diverted already limited financial resources from the priority activities and prevented the Government from undertaking necessary and urgent infrastructure investment.

2.75 In addition, existing and new firms face further disincentives to provide infrastructure and improve the quality of services. These stem from existing industry structures and the regulatory framework which encourage incumbent firms to focus on lucrative market segments, while presenting significant barriers to entry by new firms. Such barriers have arisen, for example, through a bundling

of commercial and regulatory functions into a single organization (e.g., the Philippine Ports Authority), thereby creating considerable impediments to competition in the provision of infrastructure related services. In other instances (e.g., power and telecommunications), natural monopoly elements within the various sectors have been bundled together with contestable businesses, thereby frustrating effective competition in supply and reducing incentives to improve quality. Initiatives such as BOT schemes may provide a temporary remedy for some of the more obvious symptoms, but avoiding a recurrence of these problems may require a more fundamental restructuring of the various regulatory frameworks governing the supply of infrastructure services.

2.76 The extent of the infrastructure problem in the Philippines cannot be overstated. Infrastructure degradation is most noticeable in poor highway maintenance, urban traffic congestion, inefficient seaport cargo handling, intermittent power failures, and chronic underinvestment in telecommunications services, with resulting limited and low quality service. These problems, in turn, raise production costs and lower productivity, which together reduce employment, incomes, and international competitiveness. Difficult communications and inefficient transport reduce responsiveness to clients, lowering demand for Philippine exports. Poor infrastructure also diverts scarce investment funds from productive capital improvements into infrastructure substitutes, and drives foreign investors to other locations which do not have these problems.

2.77 Because of the loss of confidence in public sector infrastructure management, and because of recent trends in privatization, the private and public sectors roles in infrastructure development and management are now being reconsidered. In order to rehabilitate the infrastructure quickly, a strategy has to be formulated based on competitive, self-financing, decentralized, and accountable infrastructure service delivery systems, including an expanded role for the private management of "natural monopolies" with proper public regulation. There is still an important role for the public sector under this strategy, but many of the managerial, institutional, and regulatory problems that contributed to infrastructure degradation must be addressed by involving the private sector on a larger scale.

2.78 Experience in the Philippines shows that the concentration of responsibilities into single institutions has not necessarily had the desired effect. Instead, it has often resulted in poor operational performance in most of these agencies. It has also led these institutions to exploit their monopolistic positions by engaging in rent-seeking behavior, i.e., maximizing the benefits to the owners, managers and employees to the detriment of the public as a whole.

2.79 Thus, this report recommends the following:

- Encouraging and developing efficient ownership and management of infrastructure systems which are fully accountable and autonomous.
- Establishing competitive industry structures to attract new firms and supply infrastructure needs.
- Fostering an effective and transparent regulatory framework.
- Maintaining stable macroeconomic, legal and political environments to generate confidence in the Philippine economy.

Energy

2.80 During 1992-93, capacity was so short that Luzon faced brownouts virtually daily; during the hot months of March-June, these averaged seven hours a day. Mindanao also had severe brownouts which reached nearly 12 hours a day for a few months in 1992 as a result of serious drought conditions. However, because of the Government's policy of encouraging "fast-track" projects, power blackouts were eliminated by the end of 1993.

2.81 In the energy sector, the overriding constraint has been serious shortages in power generating capacity. These shortages put a severe brake on economic growth given that prolonged outages adversely affected industrial and commercial activities. Consequently, unemployment and economic losses averaged an estimated US$600-US$800 million per year during 1992-1993.[30] There are other estimates which put economic losses at about US$2-3 billion a year.[31]

2.82 **Sector Structure**. Shortly after the inauguration of the new administration, the Energy Sector was reorganized to (a) increase the economy's responsiveness to public policy; and (b) strengthen the Government's capacity to improve the sector coordination. The newly created Department of Energy (DOE) became the leading policy body, with the Secretary of Energy becoming the ex-officio chairman of NPC, PNOC, and (unless otherwise agreed) NEA. NPC continued as the main generation and transmission company in the country. Its monopoly over generation was broken by Executive Order (E.O.) 215 in 1987, and an increasing number of private independent producers now seek to sell their output both to the grid and to regulated distribution utilities. PNOC retained its monopoly position in primary fuels. It is also developing generation facilities that are fired by the fuels it produces. Virtually all electricity distribution is provided by private companies. Some 13 are investor-owned; they provide service mainly to urban centers. Distribution elsewhere is provided by 120 member-owned electric cooperatives (they, in turn, obtain their investment funds and technical assistance from NEA, a government-owned corporation). Aside from MERALCO, the distribution utilities are small and relatively weak. Price regulation for all power utilities was assigned to the ERB in 1993.

2.83 **Causes of the Crisis**. The two main causes of the current power shortage situation include:

(a) **Limited Additions to Capacity**. In 1986, NPC had sufficient rated capacity to last until 1991-92. However, only limited capacity was added during 1986-1991. The Bataan nuclear plant — for which about US$2 billion was spent — initially expected to meet demand, was never brought on line due to concerns over safety. As a result, NPC was unable to meet demand in Luzon, especially during the hot months of March through June of last year. Peaking plants, which have low capital costs and high operating costs accounted for virtually all of the limited power capacity that has been added since 1986 to provide a short-term solution to the immediate crisis, given the inability of putting base load plants into operation in a short time. This indicates that future efforts will need to focus on building base load plants to address the expected electricity capacity deficit on a lasting basis.

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30 This is equivalent to a loss of around 1.5 percent of GDP; some business groups estimate economic losses to be even higher.

31 AYC Consultants, Manila, Philippines.

(b) **Aging of Existing Base Load Plants**. The age of NPC's base load thermal capacity averages about 23 years. The youngest base load plant in the Luzon grid is 10 years old. Virtually all base load plants have been maintained poorly. During the power crisis in 1992 and 1993, the NPC delayed taking plants out of service for maintenance, thereby running them at high load factors until they broke down. The condition of some of the larger plants is poor; they run at or substantially below their rated capacity, and their rehabilitation is both expensive and left to chance. On one occasion, a large plant failed within a couple of days of the completion of a rehabilitation program. While some blackouts result from the shortage of rated capacity, the severity of blackouts has been seriously exacerbated as a result of the poor working condition that reduces the plants' reliable capacity. This problem further increases the need to add base load plants in the future.

Investment Requirements

2.84 Investment requirements during 1994-98 for capacity and transmission additions and rehabilitation are conservatively estimated at no less than **US$2 billion annually**, under a very strong assumption that existing plants will perform up to rehabilitated standards. However, it is more likely that the annual investments will need to be raised, since greater capacity will be needed, given the poor condition of existing plants. Together with the need to provide reserve capacity for independent power producers (IPPs) and the old age of existing plants, NPC will need to maintain a reserve capacity of at least 30 percent. The fast growth of IPPs may reduce NPC's need for future capacity additions and investment requirements as well. This would increase investment requirements still further. Thus, during the rest of the decade, the power sector will require at least US$10 billion (assuming modest economic growth rates) to finance generating capacity, and another US$3 billion for transmission. These investments are needed urgently. Any delays will severely constrain future economic growth.

2.85 The worsening of NPC's finances in the past constrained investments. Borrowing to finance expenditures during the 1970s and early 1980s left the company with an exceptionally high 8:1 debt/equity ratio. Consequently, to fund its operations, NPC relied on the National Government, through equity injections, fuel prices subsidies through the OPSF and, most recently, an exemption from payment of duty on oil imports. While public opposition to price adjustments made it difficult to introduce timely rate adjustments, tariffs have generally been maintained in real terms since 1988. Despite large transfers and relatively high tariffs, the company relies on external financing to fund its investments. The Government has indicated its commitment to ensure the financial viability of the NPC. In early 1994, energy pricing was made more flexible with the introduction of a formula that allows the NPC to make regular monthly tariff adjustments to compensate for increases in fuel prices and the cost of electricity purchased from private power producers. A similar formula will be introduced soon to compensate for exchange rate depreciation, which affects debt servicing costs.

2.86 Large investment needs will continue to require financing both from private and official external sources. Private financing, although showing an increasing trend in the last two years, has been constrained in the past as a result of the following reasons (a) commercial lenders do not want to commit funds beyond about US$1 billion a year to both the public and private sector in the Philippines in the short-term (with improved creditworthiness, this amount would likely increase over the years); (b) some credit sources are reaching country risk limits (for example, JEXIM and ADB private financing); and (c) most sources of supplier credit either require government guarantees or are constrained by narrow exposure limits at their unguaranteed windows.

2.87 Moreover, NPC, despite having been recapitalized by the Government, still faces important cash constraints because it has been unable to raise investment capital from domestic capital markets, although it borrowed from international capital markets with a Government guarantee. To recapitalize, NPC could also privatize some of its viable thermal plants either through outright sale or public offering of stocks. The latter, which is actually recapitalization by the private sector, would be preferable since it would improve NPC's financial ratios.

2.88 Reforming the energy sector is a high priority of the new administration; as a result, the Government prepared and approved an Energy Sector Plan (ESP) in January 1993. The ESP recognizes that a coordinated approach to development of the sector requires a framework that emphasizes order and discipline. To that end, the ESP sets out measures in many areas of key concern — particularly sector coordination, regulatory framework, private sector participation, power and oil pricing, environmental management, energy conservation, operational efficiency, and project implementation. Some actions of the ESP have already been implemented, including the establishment in late 1992 of the Department of Energy (DOE). The Government, NPC, and the Bank are engaging in an ongoing dialogue on the implementation of the ESP. As part of that dialogue, the Bank is currently involved in sector work, under which it will seek to agree with the Government on a long-term rational development for the power sector, including an appropriate sector structure and regulatory framework.

2.89 In order to meet demand, the Government has set the following targets (a) adding generation capacity as quickly as possible so as to prevent any blackouts; and (b) doubling generating capacity to 8,000 MW by 1998. The total power additions to the Luzon grid for the period 1994-98 are about 3,000 MW. Introducing expected capacity additions from the IPPs, the capacity is expected to be raised to about 5,670 MW. The Government's strategy is to focus on low-cost generation by greater reliance on combined-cycle, coal, hydro, geothermal and renewable resource-based generation. The Government will continue to rely on greater private sector participation in the development of the sector. Conventional base load supply projects (coal, geothermal, and hydro) require construction times of three to six years, and could not provide relief in the short-term. Therefore, to address the urgent need for additional capacity, the Government has embarked on a "fast-track" generation expansion program that involves the financing, implementation, and operation of several combustion turbine or diesel-engine driven systems. In addition, under the "Electric Power Crisis Act of 1993," the President was given special powers to resolve the power crisis, including facilitating increases in tariffs as and when needed, and speeding up project approvals.

2.90 The scheduled total power additions to the Luzon grid for the period 1994-98 are about 3,000 MW. Including expected actual capacity additions from the IPPs, the capacity is expected to be raised to about 5,670 MW. Due diligence should be applied in preparing the expanded program and in considering the entry of distributors to prevent overcapacity.

2.91 Fifteen contracts have already been signed, and several others are under negotiation with private developers for the construction, financing and operation of power plants using Build-Operate-Transfer (BOT) or Build-Transfer-Operate (BTO) systems. The total power generation contracted by NPC with the private sector amounts to about 2,700 MW, or 70 percent of the present reliable capacity (of this total, some 1,000 MW were brought on line by the end of 1993), and the private sector is expected to develop most new power generation in the future. NPC's Board of Directors has decided that it will rely on the private sector to develop practically all new thermal generation plants; most of them will be built as BOT or BOO projects.

Box II.1: Salient Features of the New BOT Law

RA 7718 amending the four-year old BOT law (RA 6957) introduces flexibility in the following areas which created constraints in the last year:

- **Coverage of the BOT scheme** by providing a clear legal basis for BOT variations such as build-own-operate, build-lease-transfer, build-transfer-operate, contract-add-operate, develop-operate-transfer, rehabilitate-operate-transfer and rehabilitate-own-operate (see Table II.4).

- **Government financing** by allowing Government financing of up to half of project cost through direct budgetary appropriate and official development assistance (ODA) in the case of "projects which would have difficulty in sourcing funds."

- **Rate of return** by defining a reasonable ROR as "that which reflects the prevailing cost of capital in the domestic and international market", except in the case of negotiated contracts where the National Economic and Development Authority will set the ROR, which for "public utility projects which are monopolies" should not exceed 12 percent.

- **Negotiated contracts** by allowing direct negotiations in cases where there is only one qualified bidder.

- **Acceptance of proposals** by authorizing the acceptance of unsolicited proposals on a negotiated basis if projects involve a new concept or technology or are not included in the priority list; do not entail any government guarantee, subsidy of equity; and have been subsequently opened to competitive proposals and no other proposal was received.

- **Contract termination** by allowing a contractor to terminate the contract in the event that government defaults on major obligations subject to reasonable government compensation.

2.92 The Government and NPC have arranged for a substantial amount of new generation under the "fast-track" program. Moreover, NPC is itself developing several large generating facilities. The Philippines has so far signed 35 contracts with the private sector for the construction, financing, operation, and management of power plants, involving a total capacity of about 5,000 MW, compared to total existing generating capacity of around 6,800 MW. This program has had the intended effects, with new generating capacity of 855 MW installed in 1993 and rehabilitation of two power plants adding 560 MW more. Through the BOT/BOO schemes, over 6,000 MW have already been contracted through 1998, over half of the total system capacity of 12,000 MW. By the year 2005, the Government expects that total system resources would reach 24,000 MW, with much of the generating capacity being undertaken by the private sector. This should help the Government begin to focus its attention on the orderly long-term development of the sector, rather than the immediate need to add capacity.

2.93 On May 5, 1994, a law was passed amending the Republic Act No. 6957 — known as the BOT law. The BOT Law Amendments were designed to modify the existing legal framework and to encourage infrastructure development by the private sector, which was not satisfactorily achieved by the previous law. A number of improvements were put in place, resulting in a substantially liberalized version, Republic Act No. 7718 (see Box II.1 for the salient features of the new BOT law).

2.94 The most significant changes introduced by R.A. No. 7718 include the following (see the following table for description of different contractual schemes):

(1) Unsolicited Proposals which contain new concepts or technology viewed as desirable by the GOP may be implemented under the new law. This is seen as one of the landmark provisions, allowing the GOP to harness the creative energies of the private sector.

(2) Government Support may be provided to critical infrastructure projects in a variety of ways under the new law:

- Credit enhancements refer to the provision of GOP risk abatements to projects, essentially, assisting in creating a financeable project.

- Cost-sharing projects with the private sector is another area which has been liberalized. Under the new law, the GOP may provide up to a maximum of half of total project cost.

(3) Market-determined Rates of Return, reflecting the cost of capital in domestic and international markets, will be the guiding principle when determining user charges/tariffs. Under the new law, regulatory risk is also substantially decreased from the private sector's perspective because toll increases are implemented automatically, based on predetermined formulas.

(4) Streamlining of GOP approvals is achieved by identifying the critical bottlenecks in bidding and award procedures and by providing solutions as needed.

(5) The BOT Center is another key initiative of the BOT program, whose establishment will address the need for a one-stop assistance center for both the private and the public sector. This Center will consist of four divisions, namely the (i) Private Sector Unit; (ii) Public Sector Unit; (iii) Training and Conference Management Unit; and (iv) Information and Liaison Unit.

2.95 Even with the active participation of private power producers, the orderly development of the power sector depends on improving the efficiency and effectiveness of NPC, which still owns most of the existing generating capacity and of the transmission network. Current government regulations have caused NPC to follow cumbersome processes with regard to the development of new capacity. Political considerations have prevented it from making timely tariff adjustments, and even from taking plants out of service on schedule for planned maintenance. In short, NPC's management lacks autonomy and cannot operate the company along commercial lines.

2.96 The privatization of NPC will likely take some time and effort. Because of the age and questionable operating condition of most of NPC's plant and equipment, an effort to sell or lease the company's assets is likely to be time consuming. The Government is currently in the process of preparing an action plan to privatize NPC. The Senate passed its version of the privatization study and the Lower House is preparing its version. The DOE plans to present to the President a blueprint of a power sector restructuring by September 1994. NPC needs to define the separation of power generation and transmission function in view of the complexity and vastness of the operations. Currently, there are three privatization studies underway. Ridgehome/Lahmeyer has just completed one, RCG/Hagler has presented its first draft in June (which is being reviewed by NPC), and the NPC in-house study will soon follow.

Table II.4: Different BOT Schemes

Build-Own-and-Operate	• Private sector finances, constructs, owns, operates and maintains facility.
Build-Lease-and-Transfer	• Private sector finances and constructs facility. • Government leases facility for fixed period. • Government owns facility upon expiration of lease.
Build-Transfer-and-Operate	• Government finances project. • Contractor builds facility. • Contractor operates facility on behalf of Government agency.
Contract-Add-Operate	• Private sector leases existing government facility. • Private sector undertakes expansion/improvement. • Private sector operates the project.
Develop-Operate-and-Transfer	• Private sector undertakes project. • Project results in higher property values for adjoining property. • Private sector obtains right to develop property.
Rehabilitate-Operate-and-Transfer	• Private sector rehabilitates, operates, and maintains existing Government facility. • Government retains ownership upon expiration of contract.
Rehabilitate-Own-and-Operate	• Privates sector rehabilitates existing government facility. • Private sector operates facility for indefinite period on the condition that it does not violate the terms of its franchise.

2.97 Since competition is possible in generation, it should be vigorously pursued, and there should be no undue legal restrictions on franchising or other types of private sector entry. Merely removing statutory restrictions, however, will not induce the private sector to participate in the power sector. Private firms should be encouraged and protected by a regulatory and legal framework that allows them to assess and undertake reasonable market risks, and permits them to enter into long-term contractual arrangements with the grid operator, as discussed below. Since 1991, when the term of ERB's commissioners became fixed, thereby giving that organization greater autonomy, its effectiveness has improved.[32] Its further improvement should be strongly encouraged.

2.98 The Government considers that there is a need to review existing ERB regulations on the IPP purchase power agreements with the energy distributors. It currently allows distributors to enter into private power contracts with IPPs at prices higher than the grid rate. Moreover, the distributor has the option to purchase its own requirement from the IPPs at maximum capacity even at a price higher than the grid rate. This can happen when the distributor is also the owner of the IPP. Safeguards would need to be introduced to assure NPC of a market for its existing and planned generating additions.

2.99 In the next two years, NPC should be transformed into a commercially-oriented power utility. In the immediate future, NPC should continue to manage the addition of generation capacity,

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32 The most recent events raise doubts about ERB's level of autonomy, however. For example, it raised the price of oil products in early 1994; but when opposition surfaced, it rolled back the price hikes.

particularly under BOT/BOO arrangements. At the same time, work should begin on corporatizing NPC and giving its management a clear mandate to function along commercial lines. In the medium-term, once the company has had some experience as a commercially oriented utility, the most desirable approach would be for NPC to move toward privatization. (See Box II.2 which describes power privatization in Malaysia as an example. Given that some of these privatization experiences are quite recent, a number of experiences will need to be carefully reviewed to select the best form of privatization for the Philippines.)

2.100 Regarding transmission, there should not be any structural or legal deterrent to multiple party (public and private) ownership of the transmission system. To prevent a disorderly situation from developing, however, the Government should carefully formulate rules, including principles for the establishment of wheeling charges that would govern the use of the grid for transfers of electricity from suppliers to clients. The Government's main responsibility will be to ensure a level playing field for all participants in the sector and the flow-through to the public of the benefits (if any) of private sector efficiency. In the long-term, the Government's responsibilities in load dispatch and system planning should become the core activities through which it ensures the orderly development of the sector.

2.101 To expand investment financing in the energy sector, the Government has sent the Congress two separate bills: One is to exempt the private sector from the payout of an onerous 60 percent royalty on geothermal production for 10 years, and the other is to enable the Government to penalize theft of electricity. If passed and enacted, the former bill would encourage private investment in geothermal production and the latter would improve NPC's financial ability to rehabilitate the existing power infrastructure. This report supports Government efforts for the passage of both bills.

Existing Experience with BOT/BOO

2.102 The Philippines has committed to more capacity additions through BOT/BOO arrangements than all other developing countries combined. The experience so far with such arrangements has been mixed. Several of the existing arrangements involve NPC agreeing to purchase electricity at prices higher than the current grid price. In some instances, these arrangements presumed that a developer would construct a peaking plant and run it at load factors that were more appropriate for base load. The rates of return on equity being sought by the developers have understandably been high, and the Power Purchase Agreements (PPAs) assure the developer of these returns through take-or-pay provisions. In principle, these are justified when developers assume the full project and commercial risks on the power facility (although in the Philippines, they have not). In fact, NPC has assumed the fuel risk and the Government has guaranteed NPC's performance as the purchaser of electricity.

2.103 Within five years, one of the major expenditures of NPC is expected to be purchases from independent producers. NPC has a stated expectation that its tariff, in 1993 constant prices, will increase from US6.2¢/kWh to US8.0¢/kWh in 1997. This would raise the already high retail rate of electricity from about US13¢/kWh, to about US16¢/kWh. Already, the Philippines has Southeast Asia's highest rates for medium voltage industrial and commercial end users and rural consumers, while urban residential rates are second only to Japan, and residential rates average about two to three times the norm of the U.S. The existing high tariffs reflect (a) inefficiencies at the generation level; (b) high distribution losses; (c) high priced investments at both levels; (d) the responsibility of distributors to shoulder costs that are either forgiven or covered by the consumer in other countries of the region; and (e) the high real cost of domestic finance. To address the high cost of power, it is suggested that the regulatory agencies require all power producers, public and private, to raise efficiency and cut costs over the medium-term in order to avoid large tariff increases which would adversely affect the international competitiveness of Philippine industries.

Box II.2: Power Privatization in Malaysia

1. The privatization of the major power utility in Malaysia required a number of legal, institutional, and financial changes. After a decision by the Government to restructure the power sector, the laws and regulations were revised, and a regulator was established. The new management was given time to take control of the electricity company and improve its efficiency. Finally, there was a partial sale (23 percent) of the shares of the company, and the private sector was given incentives to participate in generation.

2. The Malaysian National Electricity Board (NEB) was incorporated as a wholly Government-owned company, Tenaga Nasional Berhard (TNB) under the Companies Act in September, 1990. TNB was issued a license to generate, transmit, and distribute electricity as a monopoly, with no competition envisaged initially. While TNB still remains dominant, there are plans to promote the setting up of independent power producers (IPP) over time, so that there will be competition in generation. Prior to the sale of TNB's shares, the Government enacted a new Electricity Supply Act (1990) that established a Directorate General of Electricity Supply (DGES) to issue licenses for electricity supply (at present the only licensee is TNB), set performance standards, recommend prices, and register and inspect electrical installations.

3. In 1992, TNB was listed on the Kuala Lumpur stock exchange (KLSE), and 685 million shares were sold to private investors, including pension funds, banks, employees, and the public. The Government of Malaysia still holds about 77 percent of TNB's shares, and the Ministry of Finance retained a "golden share," which gives it substantial control over TNB. The sale of TNB's shares increased KLSE's capitalization by US$1.2 billion, and this was the largest-ever offering on the KLSE.

4. Under the regulations, a licensee has to maintain a separate account for each activity, provide information on operating costs, propose prices according to the a price cap formula, be responsible for rural electrification, and maintain standards for generation security, transmission system design, and distribution. TNB's license can be revoked only with ten years' notice. Apart from reporting to DGES, TNB reports on its performance to its Board and management, shareholders, and external lenders.

5. Further to establishing DGES as the regulator, a number of other steps were taken for the corporatization of TNB. A new charter was prepared for TNB, and a new Board of Directors was appointed. Corporate objectives and performance targets were set, and TNB's internal organization, managers and staff were restructured on a corporate basis, and salaries were adjusted to market levels. The management was focused on decentralized decision-making, enhancing efficiency, and making a profit, though increases in tariffs were prohibited before privatization. In addition, TNB were made subject to taxes. At present, TNB is a financially viable power utility that has been partially privatized.

2.104 So far, DOE and NPC have licensed private producers to sell directly to distribution utilities, even wheeling through NPC's network. Because it appears financially stronger than NPC, or because power sold to the retailer can be priced more expensively than to the wholesaler, a few developers prefer to sell to MERALCO directly. However, none of the other distribution utilities have the strength or size of MERALCO, and NPC is required by charter to supply all of them. If the stronger private producers all focus on serving MERALCO, NPC would be relegated to purchasing some power from developers, as well as developing its own generation facilities. Because the scope for having contestable markets is limited, the risks attached to direct contracting for supplies by the distribution utilities appear to offset the advantages of competition. These risks include duplication of investments that would be secured by take-or-pay contracts, and the transfer to NPC's shrinking customer base of the

cost of capacity and spinning reserve required by the total system. At best, this would be a sub-optimal arrangement that will result in high-priced electricity to poorer areas of the country; at worst, it will result in the weakening of NPC's finances, on which private distributors outside the Metro Manila area would continue to rely. Already, NPC in its role as coordinator of privately developed power has agreed to four BOO/BOT projects (with an aggregate capacity of 1,300 MW) that would sell their outputs directly to MERALCO, with at least one of them relying on the NPC network to wheel the electricity. Existing arrangements would need to be honored, however, to foster more orderly sector development in the future. New capacity should be procured by the grid according to a transparent bidding process, and direct sales to distributors should be allowed only if the plant is to be built within the distributor's service area.

2.105 BOOs should be preferable to BOTs, given that BOTs revert back to NPC after a period of time and may lead private developers to run down assets toward the end of their contract times.[33] In practice, wherever BOT arrangements have been used, the most recent power purchase agreements have covered the economic life of the plant, and have carried renewal provisions that enable the developer to continue operating plants that are still in working condition. Thus, the BOT arrangements currently in use show little substantive difference from BOO arrangements. Moreover, most of the privately developed oil-fired plants are expected to be obsolete or too expensive to operate by the time they are due for transfer to the Government. The revised BOT Law has introduced features to encourage BOOs rather than BOTs.

2.106 Environmental Issues. DENR's failure to issue timely environmental clearance certificates for pending projects has led to delays of up to several years for urgently needed additions to capacity. The problem results from cumbersome procedures, and is exacerbated by strained relations between the country's electricity and environmental establishments. NPC perceives these problems as the lack of DENR-EMB inadequate logistics support, overburdened EMB-EIA Group due to centralized processing of all Environmental Impact Study (EIS) of projects nationwide. The EIA Group has not yet been institutionalized, but it is a part of an environmental quality division of EMB. To implement the EIS system, it needs to be institutionally strengthened.The recent Bank Environmental Sector Study ("Toward Improved Management of Environmental Impacts") recommended some procedural changes to the environmental impact system which, if adopted, would substantially improve the dialogue between NPC and DENR. One key feature of these changes is that responsibility for the politically charged issue of social acceptability has been assigned to the cabinet level Council for Sustainable Development. This would put adjudication of this contentious social issue within the jurisdiction of a body with sufficient political strength.

Legal Framework

2.107 Under the law establishing the DOE, the Government has committed itself to a regulatory framework that will encourage the entry of private investors, improve the efficiency of existing public sector institutions (including commercialization and privatization initiatives) and make power pricing decisions more transparent and less susceptible to political pressure. Until the passage of the new BOT law, private ownership of power generating plants (other than by regulated utilities) did not have a clear legal basis in the Philippines. Similarly, constitutional restrictions on foreign ownership limit the circumstances under which external sponsors are able to support energy sector reform initiatives. These legal constraints have not prevented private (including foreign) firms from participating as "temporary BOT contractors" (as defined in the Build-Operate-Transfer Law, Republic Act 6957 of July 1989).

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[33] Most recently, NPC is getting into BOO with the 2x50 MW plant in Mindanao.

2.108 Investments in private power generation have proceeded thus far on the grounds that developers are selling their output, not to the public, but to a Government-controlled organization (the National Power Corporation). Under the BOT Law, amending the Republic Act No. 6957, the private sector may "build-own-and-operate" power generating facilities and can tap ODA facilities up to half of the total project cost.

2.109 These considerations are relevant to the decisions which will be taken later this year regarding the sector structure, private participation and the enhancement of regulatory mechanisms for managing the energy sector in the years ahead. Given that adequate and cost effective supplies of power will be critical to private investment growth, reform of the sector should be guided by the objective of moving to a business-to-business contract system over the current system which involves a mix of some business-to-government contracts coupled with a much larger set of within-government arrangements. Development of a contract system would be facilitated by the conversion of NPC to a publicly-listed company (or companies) with broad-based shareholdings. Responsibility for non-price regulation and management of the sector as a whole would reside within DOE. The barriers are not insurmountable, but their reform will likely take considerable time, involving difficult legislative and judicial processes (particularly those that involve amending the constitution).

Telecommunications

2.110 Weaknesses are also present in the telecommunications sector. High levels of chronic unmet demand and poor quality of service pose a constraint to private sector development, and reflect chronic underinvestment in the past. Several foreign companies have reportedly withheld large investments upon learning that they could not be assured of adequate levels or quality of telecommunication services. Tourism earnings are also affected as a number of resort destinations have no regular telephone connections, thereby limiting vital services such as booking enquiries and credit card verification services. In June 1994, at 1.8 lines per 100 people, the nationwide telephone density was among the lowest in ASEAN countries. Manila has 9.6 lines per 100 people (1991), and waiting lists for service average three to five years.

2.111 The Philippines Long Distance Telephone Company (PLDT) dominates local, long-distance, and international telephone service, providing about 90 percent of the country's 800,000 telephone lines. PLDT was established in 1905 and became a Philippine-controlled company in 1967, when its largest American shareholder, General Telephone and Electric Company (now GTE), sold its 28 percent share to a group of Philippine investors. It is a very profitable domestic company and the largest Philippine stock issue traded in the U.S. stock exchanges. Its stock rose some 30-fold in the past six years and pays high dividends, but its profitability results less from expanding service than from charging high international tariffs and servicing a disproportionately high level of incoming calls from abroad. PLDT's performance has been among the worst in Southeast Asia, owing partly to aging equipment and overloading of services, but more importantly to PLDT's cautious approach toward investment in the past. (Annex 12 describes telecommunications sector performance.)

2.112 In the past, a number of much smaller investor owned-companies provided a range of services, including telephone and public mobile radio. These companies have also been weak performers. They too own aging assets, and have a poor record of investing in either adding to or renewing their systems. In effect, the only entity with a viable investment program in telecommunications assets other than PLDT has been the Government, which in turn lacks a viable operation and maintenance capability.

2.113 With some important exceptions, the structure of the sector has remained essentially unchanged over the past three decades. Nevertheless, there have been some important developments. For example, in 1989, the National Telecommunications Commission (NTC) authorized a second and third competitive international voice gateway, with the goal of creating an incentive for local network investment by affiliates of these new gateway owners. Also, cellular telephone technology has developed new opportunities for competition in the sector. Further, in April 1993, on a technicality, the Government nominated six of the 11 members of the PLDT Board of Directors. Although previous interventions into business sector operations have not generally been successful in the Philippines, the case of recent Government actions in PLDT mean that the company started to focus on increasing neglected investments and improving its efficiency. The lesson is that if the Government is determined to improve the services of a monopolist, it can do so within the existing legal framework and without passing a new law. Firm Government determination and consistent actions are key to creating and maintaining corporate accountability.

2.114 Legislative franchises are generally required to operate public utilities, including telecommunications. In addition, carriers must also be authorized by NTC to install and operate telecommunications systems. NTC decisions can be challenged in the courts. In practice, this legal and regulatory framework has obstructed new entry into the sector in the past, mainly by enabling PLDT to challenge entry based on franchising issues. The company has engaged in lengthy legal battles and has succeeded in blocking new entry into the sector.

2.115 The public sector's inability to regulate the sector adequately and induce a favorable supply response through the creation of contestable markets is part of the reason for the sector's poor performance. Annex 13 describes the Government's role in the telecommunications sector. Despite its intentions, the Government's regulations, especially around the issues of underinvestment and the sector's structure, have not been effective: The Department of Transportation and Communications (DOTC) and NTC have not enforced the requirement for interconnecting telecommunications networks. Thus, NTC's performance in regulating the sector and its major carriers needs to be dramatically improved in several key areas, including (a) carrier obligations to provide service; (b) network interconnection; (c) revenue settlement; (d) tariff review; (e) rate of return monitoring; and (f) carrier transaction monitoring with linked companies. Regulatory reform can only be made effective by improving governance, eliminating the need for legislative franchises, and revising the laws to make the regulatory agencies self-financing.

2.116 The Government has to become more effective at managing the sector's development. For years, it has lacked a policy framework to manage it in an orderly fashion with a plan against which PLDT's performance, as well as others, could be assessed. In 1988-90, the Government convened the National Telecommunications Policy Committee, which discussed at length the key issues that underlay sector policy; and, in 1991, it adopted the National Telephone Development Plan. (See Table II.5 for physical targets in the plan.)

2.117 **Tariffs**. Both the distortions in the current tariff structure and the high international rates tilt incentives against investing in local network facilities. The tariff structure and cross-subsidization between domestic and international tariffs need to be carefully reviewed and reforms introduced to make cross-subsidies unnecessary over time; this would reduce tariffs for international calls and improve incentives for investment in domestic lines, which could be achieved through raising charges for domestic calls without jeopardizing the development of rural telephone infrastructure.

Table II.5: Telecommunications — Summary of Physical Targets

		1992 Status	Target Status	Target Year
1.	Main station density per 100 inhabitants	1.4	3.8 6.2 10.0	1998 2004 2010
2.	Percentage of municipalities with local exchange service	20.6%	50% 75% 100%	2000 2004 2010
3.	Telephone quality of service			
	Monthly trouble rate	18%	10% 5%	1998 2004
	Trouble response within two days	89%	90% 98%	1998 2004
	Service application response within four weeks	65%	94% 98%	1998 2004
	Other standards	N/A	To be set by NTC	
4a.	Percentage of municipalities and cities with access to pubic switched data network (a)	2.5%	31% 46% 52%	1998 2004 2010
4b.	Percentage of municipalities and cities with access to non-switched digital data circuit	12%	41% 51% 57%	1998 2004 2010
5.	Establishment of nationwide maritime communications in accordance with Global Maritime Distress and Safety System (GMDSS)		100%	1999
6.	Percentages of Barangays with public calling office (PCO) service	22%	26% 38% 51%	1998 2004 2010
7.	Cellular mobile telephone service (CMTS) (b)			
	Metro Manila & Cebu	Available	Digital CMTS	1993
	Percentage of municipalities and cities with CMTS service		100% of MUCs 70% of KDCs	2010

(a) Locations for data services correspond to Major Urban Centers (MUCs) and Key Development Centers (KDCs).
(b) PCO services to the barangays could use a mobile technology overlay with fixed subscribers.

Source: National Telephone Development Plan, 1991-2010, Department of Transportation and Communications.

Recent Deregulation Measures

2.118 Reform of the telecommunications sector was initiated in 1987 with the issuance of DOTC Department Circular No. 87-188. This circular contains a broad package of policy statements. However, it was only in the last two years that the Government accelerated the reform process. It issued several policy measures to deregulate the sector in order to improve its efficiency and to bring about a robust supply response through encouraging healthy competition in the sector.

2.119 While the Philippines Long Distance Company (PLDT) remains as the dominant carrier, there are now new entrants in response to the Government's policy to encourage and broaden competition in the industry (see Table II.6 for current telecommunications services and carriers). Prior to the new policy, competition to PLDT consisted essentially of two gateway operators associated with MCI and Cable & Wireless, and small local telephone companies. A cellular phone company, EXTELCOM, subsequently entered the market. However, it was primarily in the last year and a half that developments have responded and several telecommunications companies are now poised to operate gateways, cellular lines and fixed land lines. Among the developments which enhanced competition in the industry are the following:

(a) The interconnection of the facilities of all public communications carriers has been made mandatory by Executive Order No. 59 issued on February 24, 1993.

(b) Entry into the supply of customer premises equipment has been deregulated. Consumers are not obligated to buy their equipment from the supplier of telephone services.

(c) The issuance of E.O. No. 109 in July 1993 to introduce universal access to basic telecommunications services by requiring international gateway operators and providers of services to provide local exchange carrier service in unserved or underserved areas.

(d) The formulation and issuance in November 1992 of Government Policy on Cellular Mobile Telephone Service (CMTS) contained in DOTC Department Circular No. 92-269.

(e) The development and issuance in June 1993 of a Policy on Domestic Satellite Communications contained in DOTC Department Circular No. 93-273.

(f) Pursuant to Executive Order 108 issued on July 12, 1993, the NTC divided the country into 11 major areas to be serviced by various telecommunications companies. The plan requires companies granted gateway and cellular telephone licenses to put up a certain number of fixed lines in the particular region assigned to them. There has likewise been an increasing number of foreign telecommunication companies engaged in various activities in the Philippines [34]

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[34] As of end of 1993, among the telecommunications companies reported to have activities in the Philippines (1) Alcatel, supply of equipment for microwave switching exchange and lines; (2) Cable & Wireless, 40 percent ownership in Eastern Philippine Telecoms, Inc., 40 percent ownership in Oceanic Wireless Network, Inc., and 27 percent ownership of Digital Telecom Philippines, Inc.; (3) Ericsson, supply and installation of cable network and installation of cable network and TACS cellular system; (4) NEC, supply of ESS lines and microwave transmission equipment; (5) Siemens, turnkey supply and part installation of exchanges, gateway switches, joint venture for the manufacture of telephone terminals and components; (6) Telstra, joint venture for satellite and microwave sets, voice and vide network; (7) Sprint, executed a Memorandum of Understanding with Smart Communications, Inc. under which Sprint agreed to provide support to the international requirements of Smart should the latter secure an international gateway license from the NTC; and (8) Singapore Telecom, joint venture with the Ayala Group.

Table II.6: Telecommunications Services and Carriers in the Philippines

Telephone Services		
Local Exchange	Long Distance	
• PLDT • Other PAPTELCO members • Government	National • PLDT • Other carriers	International • PLDT • PhilCom • ETPI

Record Carrier Services	
Domestic	International
• PT&T • RCPI • TELOF	• ETPI • Capwire • Globe Telecom • PhilCom

Other Services			
CMTS	Trunked Repeater	VSAT	Paging Services
• Extelcom • PILTEL	• LBNI • Romasanta • S. Lustre • Omninet • ICC • A. Zaragoza	• LBNI • CRS • ICC • PLDT • Capwire	• Easy Call • Pocketball • Digipage • Satellite Paging, Inc.

Source: National Telecommunications Development Plan, 1991-2010, Department of Transportation and Communications.

2.120 The National Telecommunications Commission (NTC) issued implementing guidelines for each of the above-noted measures. NTC also introduced several initiatives to liberalize the sector. Furthermore, several bills were filed in both the Senate and the House of Representatives seeking to enhance competition and strengthen NTC.

Competition Policies and Sub-sector Market Structure

2.121 **Satellite Services**. In 1989, the NTC granted provisional authorities to five companies to provide either VSAT services or carrier type services despite strong opposition from the incumbents. The DOTC Circular No. 93-273 spelled out the liberalization policy on domestic satellite communications. In particular, Section 3 of the circular states that "Authorizations for the provision of satellite communication services will not be limited to those satellite services provided currently possessing provisional authorities or certificates of public convenience and necessity (CPCN). Any qualified applicant may apply for a CPCN/PA to install, operate and maintain any satellite related services."

2.122 Recently, the private sector formally agreed with the Government to launch a Philippine satellite. It is a privately owned project with the Government acting as a facilitator. Accordingly, "The consortium or corporation will have the exclusive right to provide space segments to Philippine users for their operations within the footprint of the subject satellite for ten (10) years from date of actual operation....." Unlike in Thailand, in which such privilege was given to a single firm, the Philippine project will be carried out by a consortium of 17 firms. Participation in this consortium is open to duly enfranchised telecommunications carriers. Moreover, the consortium will provide satellite space segments in the Philippine satellite to all interested parties on a non-discriminatory way. Further, DOTC is now in the process of defining satellite policy with the intention of opening up this market for more competition. It is envisioned that interested parties will have direct access to international satellite services, thereby ending the monopoly of PHILCOMSAT.

2.123 **Cellular Mobile Telephone Services**. The issuance of DOTC Circular No. 92-269 in 1992, NTC liberalized this sub-sector to expose the two incumbents to greater competition. Since then, seven CMTS operators applied to provide CMTS services, and NTC approved three of them, thus bringing the number of service providers to five.

2.124 **Radio Paging Services**. NTC took action to open up this sector, previously dominated by a monopoly. To date, there are five radio paging service operators.

2.125 **Telephone Services**. PLDT used to be the only operator of an international switching center in the Philippines. Recently, however, the NTC liberalized this sector and approved the applications of four firms to operate their own gateways, thereby bringing the number of players in this sub-sector to five. The national long-distance service is still largely dominated by PLDT which owns and operates an extensive nationwide backbone transmission network. The Government is currently encouraging the development of an alternative backbone. The dominance of PLDT in this sub-sector has been lessened with the issuance of EO 59, mandating interconnections of all public telecommunications mentioned earlier. There are small municipal telephone operators. With the liberalization policy pursued by the Government, Congress approved several medium-size national telephone operators in the last two years. Bell Telecommunications Philippines, Inc., which has foreign partners, is the latest recipient of a franchise to operate on a nationwide basis.

2.126 Clearly, these changes will break the monopoly power of PLDT through increased competition. It may take some time to see the results of the current liberalization in the telecommunications sector because investments have yet to be made and, if they are made, they may need a long lead time. In some sectors, as in the case of the CMTS and international gateways, tangible results have already resulted. It is expected that the sector structure will consolidate over time, and the suggested regulatory framework and competition policies when put in place would ensure healthy competition while allowing the expected consolidation in the sector.

2.127 Additional steps will also be needed to improve the performance of the sector. These should involve:

- *Improving the tariff structure*. Rebalance the tariff structure as described in para. 2.105.
- *Improving the regulation of telecommunications operations and making NTC an autonomous but an accountable agency* with an adequate budget and ability to recruit, train, and retain qualified professional staff. Regulatory strengthening would encourage new investment in the sector.

Transport Sector

2.128 In transport, infrastructural limitations are also very apparent. The limited availability and high cost of services impose serious competitive disadvantages on private businesses, and limit the growth of a dynamic export sector.

2.129 The Philippine transport system is composed of over 700 km of railways, over 160,000 km of roads, about 85 public ports, some 90 municipal ports, over 200 private ports, and six international and more than 80 other public airports. The system is basically bimodal: Road transport and inter-island shipping together account for almost all the national freight and over 95 percent of passenger movements. Domestic air transport is very limited and almost entirely passenger traffic, while railway traffic, both passenger and freight, is negligible.

2.130 **Highways.** Many of the existing roads suffer from a lack of maintenance and only about one-third of the national roads was considered to be in good condition, according to a recent Department of Public Works and Highways (DPWH) survey. It is estimated that over two-fifths of the provincial roads and over half the barangay roads are in such poor condition that they cannot be maintained and have to be rehabilitated or abandoned.

2.131 The quality of the main network is significantly inferior to several Southeast Asian countries: In 1992, the latest year for which comparable data is available, a very low share of main roads in the Philippines were paved (29 percent in the Philippines compared with 60-70 percent in other Southeast Asian countries).

2.132 The primary problem in the highway sector is the neglect of maintenance. The replacement value of the entire Philippine road network is estimated to be US$8 billion. Due to the enormous backlog of reconstruction and maintenance, the cost of rehabilitating the existing network is estimated at US$11.3 billion, which implies that almost half the value of the road network has been lost.[35] This puts the current value of the road network at only US$6.0 billion, or about 12 percent of GNP, as compared with 15 percent of GNP in other Southeast Asian and Pacific countries. The seriousness of the road maintenance problem promises significant benefits from maintenance.

2.133 The sharp decline in road expenditures in real terms during the 1980s, especially for maintenance, contributed to the poor condition of road infrastructure. National Government (NG) expenditure for both road construction and maintenance in constant 1985 prices is estimated to have dropped from ₱ 6.3 billion in 1981 to ₱ 4.5 billion in 1990. Maintenance expenditure for the main arterial network (national roads) is estimated to have decreased from around ₱ 25,400 per km in 1985 prices in 1981 to about ₱ 16,000 per km in 1990. Thus, during the next few years, the Government should emphasize public expenditure for basic road maintenance rather than for new road construction, according to the road management system model proposed in the World Bank's Highway Management Project. The Government should also increase private contracting for road maintenance, which will complement needed reductions in Department of Public Works and Highways (DPWH) staff, and free remaining staff to concentrate on planning improved management.

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35 The basis for the computation of the replacement value of the entire road network is the inventory at end-December 1993 based on assumed average unit cost for existing concrete, asphalt, and gravel roads, and for rehabilitation works.

2.134 Underfunding compounds the maintenance problem as available financial resources are used to carry out the most urgent repairs. Regular and preventive maintenance on relatively good roads is deferred until they too deteriorate to the point they become urgent or need major rehabilitation. The relative share of road construction in GDP fell from 1 percent in 1981 to 0.5 percent in 1990 and the share of maintenance from 0.4 percent to 0.2 percent.

2.135 While overall resources were constrained during the last decade, even the funds available funds may not have been effectively utilized due to poor management practices. In particular, the quality of the construction has often been poor and supervision has not always been adequate.

2.136 The transport industry is predominantly privately owned and most of the trucking and bus companies are small. Companies with less than five vehicles and owner-operators with only one vehicle are estimated to comprise around 75 percent of the trucking industry and large companies with more than 50 trucks about one percent. On paper, the road transportation sector seems highly regulated, and governed by laws, regulations and practices dating back to the 1930s: For example, official authorization or franchise from the LTFRB is needed to provide freight and passenger services. In practice, however, the regulations have not been fully enforced and the industry has been de facto deregulated with costs to shippers reflecting market conditions. Nevertheless, potential restrictions to entry, Government-determined tariffs, and uneven enforcement of the regulations have constrained the development of the road transport industry. The Government has recently taken steps to address some of these regulatory issues.

2.137 By far the most important urban center is Metro Manila. It accounts for 40 percent of total vehicle registrations and the main urban congestion problems. Adding to congestion is poor physical traffic management (location of stops, bus lanes, enforcement of parking regulations, and traffic light phasing). The extent to which there might be scope for using the franchising system to direct more transport to less heavily trafficked roads is not clear, but this could obviously reduce congestion.

2.138 The main cause of congestion is probably the private automobile, which typically has an occupancy of not more than 10 percent of a jeepney and occupies about the same road space. In 1993, 5,000 new cars a month were being added to the Luzon road system. Reducing private car use, and substituting either buses or jeepneys, could probably reduce congestion — but this has proved very difficult in most industrial and developing countries. In this context, it is also suggested that authorities consider allowing the duty-free import of buses, vans, and trucks. It is unclear whether there has been any significant progress in recent years in addressing Manila's urban transport problems. The Philippines Traffic Control Center (TCC) has estimated that congestion costs amount to ₱ 16 billion a year.

2.139 If the TCC congestion cost estimate is accurate, and the population of greater Manila continues to grow at the present high rate, actions to improve traffic flows in the city will probably become the most urgent in the whole transport system. The TCC data should be reviewed and a comprehensive urban transport study carried out. This study should evaluate the economic feasibility of extending the LTR system and of restricting automobile access to central Manila, based on the Singaporean experience.

Table II.7: Priority BOT Projects

	Project Cost (Millions of US$)
Road Projects	
M. Manila Skyway	635.6
North Expressway, Subic/Clark	290.5
Manila-Cavite Expressway	79.1
S. Luzon Expressway Expansion	69.7
	1,074.9
Transport Projects	
Light Rail Transit No. 4	678.4
Light Rail Transit No. 5	279.8
Mainline North Rehabilitation	76.8
NAIA Cargo Terminal	84.8
Manila Grains Terminal	95.5
	1,215.3
Power Projects	
Small Hydro Program	425.4
Mindanao Geothermal	323.1
	748.4
Water Supply Projects	
Bulacan Central Water Supply	37.1
Cavite Water Supply	164.0
	201.1
Tourism Projects	
Panglao Island Tourism Estate	42.7
Samal Island Tourism Estate	44.7
	87.4
Industrial Estate Projects	
PHIVIDEC Expansion	6.6
Batangas City Agro-Industrial Center	83.5
Bacnotan Agro-Industrial Center	50.4
Pavia Agro-Industrial Center	30.2
Davao City Agro-Industrial Center	24.2
Zamboango Agro-Industrial Center	12.2
	207.1
TOTAL	3,534.2

Source: Coordinating Council on the Philippines Assistance Program.

2.140 To respond to the infrastructure inadequacies by involving the private sector, the Government defined a plan as "the Philippine Infrastructure Privatization Program" (PIPP). The PIPP, which is predicated on the need to respond to short-term needs, is a multi-sectoral integrated infrastructure privatization program based on the law RA 6257 as amended by RA 7718. The Coordinating Committee for Philippine Assistance Programs (CCPAP) is the coordinating agency. Given the continuing and expected fiscal constraints on public spending, the PIPP would encourage the private sector to participate in infrastructure development under a variety of privatization schemes covering a wide range of sectors and activities.

2.141 The Government also created a BOT program for non-power infrastructure services based on the experience in the power sector as well as from careful analyses of the lessons learned in BOT projects in other countries. The Government has developed a preliminary estimate of US$13.5 billion over the next five-year period to establish the infrastructure required from transition to higher economic growth. (Table II.7 shows some of the BOT projects.)

2.142 **Maritime.** The maritime transport sector, particularly inter-island shipping, has not played as important a role as expected in the economic integration of the country. It consists of both infrastructure (ports) and operations (shipping). With close to 96 national ports, another 497 municipal ports and 375 privately-owned ports, the Philippines is not faced with a shortage of harbors. Rather, the main problem in public ports is inefficiency and high costs, reflecting administrative practices and regulation by PPA, MARINA, as well as the Bureau of Customs. Restrictive practices, the lack of facilities such as forklifts and cranes, inadequate storage and the mixing of passenger and cargo operations in most domestic ports, hinder the efficient loading and unloading of vessels. PPA's practice of negotiating annual contracts for stevedoring (on-board cargo hauling) and arrastre (land handling) operations with a single operator leads to monopolistic behavior and high prices.

2.143 The PPA has taken several measures to improve the efficiency of port operations. First, it upgraded the facilities in the Port of Manila, Cebu and other major ports with financial assistance from bilateral and multilateral financial institutions. Second, PPA established "one stop shops" (Port Integrated Clearing Offices) in its ports to facilitate the processing of paper work. Third, it awarded the operation and management of the Manila International Container Terminal (MICT) through competitive bidding to a private operator. Fourth, it is formulating standards on cargo handling productivity and efficiency. It is also moving toward modernization of equipment in ports, training of workers, and improvement of procedures in cargo handling operations. Regarding cargo handling, it is now PPA's policy that after the existing contracts expire, awarding cargo handling will be done through public bidding with contract terms ranging from 5 to 10 years depending on the classification of a port, i.e., major, sub-port, etc. Longer contract periods (up to 15 years) will be granted depending on the operator's commitment to acquire modern equipment, among others. Despite these improvements, PPA's role as both regulator and operator of ports is considered to be a key constraint to the development of effective port operations over the long-term. At present, it collects various fees from private ports for which it does not provide services.[36] Thus, this relieves PPA of the pressure to strive for more operational and cost efficiency in its ports. A further problem is the extensive cross-subsidization between ports.[37] This distorts the incentive structure between PPA ports, reduces pressures for cost control in loss making ports, prevents a rationalization of the ports structure and of shipping operations, and may influence investment decisions adversely.

2.144 MARINA is responsible for developing shipping, shipbuilding and repair facilities, setting policies and regulations governing passenger fares, freight rates and route franchises, and coordinating maritime training. Domestic shipping is provided by the private sector operating within the regulatory framework established by MARINA. Scheduled liners account for about half the domestic freight and almost all of the passenger service. The remaining cargo is carried by unscheduled contract carriers

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36 The practice of PPA to get a share of income from arrastre/stevedoring from private ports has been discontinued. Instead, an annual regulatory fixed fee of between ₱ 10,000 to ₱ 20,000 will be collected from private port owners depending on a set of criteria for approval by the PPA Board of Directors.

37 Cross-subsidization between ports exists because of the nature of PPA's franchise. PPA granted a franchise by the National Government to perform public service on a self-sustaining basis.

(trampers) and by own-account vessels. As with the trucking and passenger transport, shipping was highly regulated.

2.145 The inter-island shipping industry consists of liner operators, trampers, tankers, barges (long-distance and lighterage), and industrial or specialized operators. The domestic shipping fleet consists of over 740 vessels of more than 50 gross tons (GT) (100 passenger cargo ships, 200 ferries, 400 cargo ships and 40 tankers) and a large number of smaller vessels and barges. The liner-shipping industry provides virtually all inter-island shipping passenger services, and it accommodates most non-bulk cargoes. Inter-island shipping is dominated by the Conference of Inter-island Shipowners and Operators (CISO), which comprises 17 members owning about 80-85 percent of the country's shipping tonnage and carries about the same percentage of inter-island cargo and passenger traffic.

2.146 Government regulations combined with the oligopolistic structure of the liner operators are thought to have resulted in price and service distortions, protecting the least efficient operators and allowing the more efficient ones to earn a rent. While liner operators have offered discounts below regulatory rates, CISO has now established an effective control mechanism which ensures that the prescribed rates and fares and other conditions of carriage are adhered to. There is also a cabotage law which prohibits foreign shipping companies from competing for national traffic. The Government has now taken steps to address some of the regulatory issues in the transport sector and has recently started to deregulate inter-island shipping. The expected impact from these reforms should be lower prices and better service quality — a sine qua non for improved export performance.

2.147 Aware of the major bottlenecks and inefficiencies in the transport sector, the Government has adopted several measures to improve performance. Deregulation has proceeded to encourage entry and competition on major routes and to liberalize price setting. In particular, in March 1992, the Government issued a Departmental Order (DO) which significantly reduced the barriers to entry/exit in the transport industry by eliminating several cumbersome administrative practices enacted by the Public Service Act of 1936. The Government also allowed for market-determined fares, with the exception of mandatory rates imposed on routes monopolized by a single operator. However, there is a need to reinforce competition in shipping. But, lacking competition rules (and their strict enforcement), price deregulation may actually lead to monopolistic pricing practices in markets where entry is relative costly and/or can be restricted to a small number of participants. The possibility of cartelization and price fixing in liner shipping is strong because of the substantial sunk cost at stake.

2.148 **Aviation.** Domestic aviation is also an important part of transport infrastructure. Most of the countries in the region have good airport facilities. Typically, domestic airlines service inland cities while international carriers service frequently scheduled routes to major cities around the world. The Philippines has more than 80 operational airports, of which half are used by scheduled air carriers, while Manila and Cebu are the two major international cargo centers.

2.149 In 1986, the Government revoked the one-airline policy, paving the way for the entry of other carriers, particularly in domestic operations. Philippines Airlines (PAL) opposed this policy on grounds that new entrants would limit their operations to lucrative routes, putting PAL at a disadvantage because it would have to continue servicing unprofitable routes. PAL eventually abided by the Government's decision and a new airline started competing with PAL in minor routes only. It operates at a higher cost than PAL because it uses smaller aircraft, and PAL dominates the domestic airline industry and operates on all major routes.

2.150 The industry's inefficiency is well known. Service is poor: Flights are canceled without proper notification of passengers, flight delays are common, and there are long lines during peak season.

Airlines continue to operate unprofitable routes for social reasons, passing the additional cost to passengers through higher fares in other routes. Enhanced competition in the sector should help improve service quality in the future. Congress is presently considering the request of All Asia Airlines for a franchise to establish and operate transport services. Most recently, Congress approved a similar franchise for the Aboitiz Air Transport Corp. and Cebu Air.

2.151 It is suggested that the Government study options to determine if further deregulation of airline route franchising would encourage efficiency through greater competition. Investment in airports needs to be increased, including greater opportunities for private investment. In addition, private sector investment in specialty air freight handling equipment, such as cold storage, should be promoted.

E. Regulatory and Legal Constraints

2.152 The current regulatory framework for business in the Philippines is mostly pro-incumbent, given the nature of entry barriers, which has sustained rent-seeking behavior. This behavior is reinforced by the lack of sufficiently clear rules of the game, of enforcement of rules, and of a credible referee. In addition, high transaction costs have deterred the creation of new and viable private firms and have made it difficult for small and medium-size firms to grow to a larger scale. Further, domestic industry is characterized by high concentration. This situation is one of the main causes of the weak supply response to the economic reforms that have been undertaken to date. Although the structure of the economy will likely change as trade is further liberalized, regulatory reform with a view to increasing competition is key to increasing the efficiency of the domestic economy in the next few years.

2.153 Part of the problem is that the regulatory agencies typically lack autonomy from the executive branch, lack the budgetary and other resources necessary to carry out their tasks, and are in a weak political position in relation to the firms they regulate. With these problems, the regulatory agencies can hardly take the necessary steps to resolve market imperfections and control monopolies while sustaining incentives for productive private investment. At the same time, regulatory processes have allowed dominant incumbent firms to curb or limit competition, while failing to create enough confidence in the system to encourage these dominant firms to expand investment.[38]

2.154 In the enterprise survey (see paras. 2.2 and 2.3), all regulatory issues received average constraint scores, a finding seemingly at odds with entrepreneurs' complaints about bureaucratic "red tape". This finding may indicate a phenomenon observed in other developing countries, where firms have found ways to evade the burdens of regulation and the bureaucracy by participating in informal systems of rules and practices. If this were indeed the case, then the survey scores would indicate that the perceived level of constraint imposed by the regulatory regime is mitigated by the ability of the incumbent firms to circumvent the formal system. This outcome could also indicate that regulatory constraints are more onerous to new entrants than to incumbents.

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[38] Most incumbent firms are small by international comparisons, but conduct of some incumbent firms are believed to have been aimed at curbing competition which limits entry of other firms and paradoxically keeps them small (see Box II.3).

(i) Regulatory System for Infrastructure

2.155 The Philippines has recently given the private sector a significant role in developing and operating public utilities. In the power generation sector, in addition to the publicly owned and operated National Power Corporation (NPC), there are private generators which supply power to distributors that are privately owned companies or cooperatives. Telecommunications is virtually private, there is limited public ownership and most Government systems have recently been privatized. The dominant carrier, Philippine Long Distance Telephone Company (PLDT), is controlled by private interests and has share listings on domestic and foreign stock exchanges. New entrants to the sector are all private.

2.156 The regulatory process has created incentives for the dominant firms in infrastructural sectors to deter the entry of new firms in order to limit competition and earn high profits. At the same time, it has not built enough confidence in the system to encourage large-scale investment by the dominant firms to expand services sufficiently. (Annex 14 discusses the regulation of utilities; Annex 15 reviews regulations and competition in infrastructure; and Annex 16 analyzes regulations and competition in natural monopolies in infrastructure.)

2.157 At present, there is substantial scope for liberalizing the rules of entry for private operators in these industries: For example, in infrastructure, the requirements for obtaining a franchise are unnecessarily complex.

2.158 Securing a franchise for operating a public utility is a two-step process. In the first step, Congress or a local legislature must enact an authorizing law, generally tailored to the individual operator, which details the nature of the franchise and the restrictions on transfer and changes of ownership: For example, the franchise holder must be a Philippine citizen, or a domestic corporation or association with at least 60 percent of its capital owned by Philippine citizens. The franchise is never exclusive, has a maximum term of 50 years, and Congress retains the power to amend, alter or repeal it at any time. In the second step, the industry regulatory authority must give its approval, determining if the applicant is financially capable of establishing and operating the service, and if it will promote the public interest. Although the law does not define the criteria for a legislative franchise, those applied by the regulatory authority are generally comprehensive. Thus, there is not likely to be any public benefit in maintaining the two-step process. Instead, Congress could delegate the licensing functions to the regulatory agencies, as it has already done for public land transportation and radio and television broadcasting.

2.159 Once a franchise has been granted, the regulatory agency has the power to set performance standards, determine rates, and define geographic areas of operation. In the telecommunications sector, the regulator can direct an operator to interconnect its network with that of another operator. PLDT, however, as the dominant operator in the market for toll telephone services, has vigorously argued that its competitors do not have the legislative franchise to operate a telecommunications system. The scope for those actions would be eliminated if the practice of issuing specific legislative franchises were ended.

2.160 The regulatory agencies' ability to function is hampered by weakness and inefficiency, characteristics fostered by the political structure: The agencies are quasi-judicial bodies whose decisions can be appealed to the Supreme Court. Also, agency heads are appointed by the President, subject to approval by the Congress, which also controls their budgets. They can be dismissed by the President at any time. (Annex 17 discusses possible causes of regulatory failure in the Philippines.) The weaknesses are clearly reflected in the regulatory system's main characteristics:

- **Lack of sufficient insulation from political processes**.

- **Limited effectiveness**. The Philippine regulatory agencies are often poorly endowed with the equipment, skills, and other resources needed to perform their mandated tasks. Their budgets are limited, salaries are low, and recruitment is not subject to strict criteria.

- **Weakness vis-a-vis those regulated**. The regulatory agencies for infrastructural sectors are appendages of the relevant departments, although the recently-created DOE is separate from NPC. The agency heads rank low in the Government hierarchy and have little access to the top echelons. In contrast, the firms they regulate are owned or controlled by groups that have significant resources and political clout.

- **Nonspecificity of regulations**. The regulatory agencies typically have quite general mandates that leave them a great deal of discretion. The Government has not provided detailed instructions about the content of regulatory rules in order to achieve sectoral goals. For example, there is no fixed rule for setting utility prices.

- **Entry restriction bias**. Public utility regulators do not fully control entry. They can exert control by issuing or canceling operating permits for franchised companies, but franchises are nonexclusive and must be obtained from the Congress or, for local projects, from local governments. This system, because it requires entrants to pass two major hurdles, tends to restrict entry.

2.161 A reform agenda to address the underinvestment in infrastructure should have four main objectives. It should increase the autonomy of regulatory agencies, allow them to issue more specific rules, create conditions for contestable markets, and regulate against anticompetitive practices. Regulatory agencies should be strengthened by improving their technical and human resources and their bureaucratic standing. But, full public sector commitment will be needed to achieve the four main objectives. Also, more equipment and increased training for regulators will bear little fruit as long as decisions are not based on economic fundamentals.

2.162 Two factors are likely to hamper the suggested reforms. First, the weakness of the judiciary could adversely affect implementation: Without effective enforcement, regulatory rules will be useless. Nevertheless, progress can be made in this direction by focusing on simple and transparent rules that are easy to enforce. Second, the reforms are likely to meet with opposition from vested interests. But the present condition of the Philippine public utilities should give sufficient reason for pushing for expeditious reform.

(ii) Competition Policies

2.163 Government policy has played a prominent role in the structure and performance of the domestic economy. While policy has addressed social, economic, and political concerns, it has also fostered the development of industries characterized by high levels of concentration, and poor productivity and growth, in both domestic and international markets.[39] Mostly through interlocking directorates, large incumbent enterprises are often in a position to raise prices through collusion, exclude potential competitors, and engage in rent-seeking through intervention in the political and regulatory processes. Because the economic interests of special interest groups have been accommodated, if not facilitated, by

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[39] Medalla (1990), Panic and Medalla (1990). *The World Bank Basic Economic Report* (1993).

successive administrations,[40] the pursuit of private gain has not produced the public benefits that usually accrue in a market economy through the efficient allocation of resources. Public policy failure has perpetuated existing and introduced new market failures. Lack of an effective competition policy has heightened barriers to entry and has limited competition, which in turn has had an adverse effect on the efficiency of the private sector. The persistent high levels of industry concentration and the lack of a level playing field between large and small firms, coupled with the "missing middle" (the absence of medium-size firms), indicate that substantial successful entry of new medium size enterprises have been blocked until recently. High concentration ratios when coupled with anti-competitive conduct have led to reduced efficiency and inward-orientation of much of the domestic industry (see para. 1.18). (See Annex 18 for a discussion of the current practice of competition policies.)

2.164 Many firms are inefficient, high-cost producers,[41] reflecting the effects of tariff and non-tariff barriers. These barriers insulate domestic firms from foreign competition and the international market, and sustain high concentrations and oligopolistic market behavior, enabling domestic firms to price up to the tariff (even higher in the case of non-tariff barriers) without facing import competition; this, in turn, dampens incentives for firms to be cost-efficient, leading to misallocation of resources in the domestic economy.

2.165 The prevalence of concentrated market structures and tariff protection is a result of rent-seeking behavior by special interest groups and economic stakeholders, many of whom are linked by extensive interlocking corporate directorates,[42] as in the financial sector (studies of the banking system reveal interlocking ownership).[43] For example, one of the largest unibanks has links with three other large commercial banks, and a controlling interest in four smaller thrift and savings banks. In addition, this ownership extends to 40 companies in other sectors. Such concentration of ownership seems to have contributed to the slow growth of the banking sector, and restricted finance available to small and medium-size enterprises (SMEs). Because of their socioeconomic and political importance in a concentrated economy, the special interests are well positioned to influence public policy, and have often been able to block competition.[44] Under their influence, successive governments have created barriers to entry and limited competition through licensing and regulations, ownership controls, granting of special access to resources, and various trade protection measures (see Box II.3 on how lack of competition adversely affects performance).

2.166 There is considerable evidence that large Philippine enterprises engage in anti-competitive conduct. A 1989 survey of SMEs found that 30 percent of respondents in food processing were subjected to exclusionary tactics by incumbent suppliers; in garments and metal-working, the numbers were 34 percent and 25 percent, respectively.[45] However, exclusion is not directed solely to SMEs; large conglomerates also use the tactic to reduce competition from each other. During the Marcos regime, the

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40 SGV-USAID, (1992), "Barriers to Entry," especially Volume 1.

41 SGV-USAID, op. cit.

42 Tan, "Interlocking Directorates: Commercial Banks, Other Financial Institutions and Non-Financial Corporations," 1989.

43 Tan, op. cit.

44 SGV-USAID, op. cit. and citations, and Tan (1991).

45 See "The Philippines: An Opening for Sustained Growth," p. 187.

Romualdez and Lopez groups competed for control of (statutory) MERALCO's monopoly on electric power distribution, and the Jacinto and Elizaldes groups competed for the right to set up a cold-rolling steel mill. These disputes were settled through the political process rather than through commercial competition in the marketplace. In addition, large enterprises have persistently and often with success opposed efforts to promote trade, financial, and market liberalization, and their ability to intervene in political and regulatory processes has been cited to account for the reluctance of foreign investors to invest in the Philippines.[46]

Box II.3: Similar Beginnings, Different Endings: A Tale of Two Companies

1. Public policies significantly affect corporate performance. The relative commercial success of the Far Eastern Textile Ltd. (FETL) Company of Taiwan (China) over the Filipinas Synthetic Fiber Corporation (FILSYN) of the Philippines illustrates this point vividly. Both companies produce synthetic fibers, were established in 1968 and had about the same level of initial capacity, 4,700 metric tons (MT) a year. Similar levels of tariff protection were provided to each.

2. Today, FILSYN's capacity is rated at 37,000 MT. An additional capacity of 4,500 MT is being added under an ongoing modernization project. FILSYN is the sole domestic producer and its capacity even after modernization falls short of meeting domestic demand. Excess demand is met through imports — higher priced, because FILSYN continues to receive tariff protection.

3. In stark contrast, FETL's capacity is currently 400,000 MT, ten times that of FILSYN's. Taiwan (China) removed import tariffs on synthetic fibers several years ago. There are numerous domestic producers of synthetic fibers and they compete with Japanese manufacturers.

4. In 1989, FETL acquired 40 percent of FILSYN and entered into a management/consultancy agreement. The equity infusion enabled FILSYN to reduce its leverage. In addition, through FETL, it is able to procure major raw material inputs at lower prices.

5. Although FETL and FILSYN had common starting points, they performed differently in part because of different government policies: While both imposed tariffs on the import of synthetic fibers, Taiwan (China) imposed no further entry controls. In the Philippines, the Board of Investments (BOI) determined (with advice from incumbent firms) that additional capacity was needed and preferred the expansion of the existing firm. This led to the development of a highly concentrated synthetic fiber industry with no competition.

6. In the Philippines, Government policy was designed to promote import substitution, while in Taiwan (China), because of the limited domestic market, the main objective was to promote exports. The "inward" vs. "outward" policies also had different effects in related sectors. In the Philippines, the high cost of domestically sourced synthetic fibers and textiles impeded the development of a large export-oriented garment industry; in Taiwan (China), the synthetic fiber industry became linked to the textile and garment industries because of the success and stimulus provided by export markets.

7. In Taiwan (China), tariffs on synthetic fibers have been reduced to zero whereas they continue to be maintained at a high level in the Philippines. The domestic 'monopoly' producer in the latter thus has no domestic or external competitive stimulus.

8. The case of FETL vs. FILSYN reminds us of the advice of Michael Porter in his book, The Competitive Advantage of Nations (1990):

> "Few roles of government are more important to the upgrading of an economy than ensuring vigorous domestic rivalry. Rivalry at home is not only uniquely important to fostering innovation, but benefits national industry. In fact, creating a dominant domestic competitor rarely results in international competitive advantage. Firms that do not have to compete at home rarely succeed abroad. Economies of scale are best gained through selling globally, not through dominating the home market." (page 662).

2.167 The Philippines has no mechanism for effectively monitoring anti-competitive conduct, but some remarkable examples of such conduct stand out. In the cement market, the PCIA had regulated entry and marketing arrangements. But in 1987, it delegated its authority over marketing arrangements to a supplier, PHILCEMCOR, which supervised monthly meetings among cement suppliers on pricing

[46] See the description of the political backlash against E.O. 470 in "Barriers to Entry Study," p. 109; see also "The Philippines: An Opening for Sustained Growth," pp. 233-234, 245-254.

and establishing exclusive territories.[47] Even after the PCIA was disbanded in 1987, these monthly meetings, a form of overt collusion, continued. In a similar case, two competing transit operators agreed to allocate bus routes. This agreement was successfully challenged in a private lawsuit. The Supreme Court ultimately ruled to vacate the agreement between the transit companies but did not otherwise impose penalties. In most industrial and in many developing nations, horizontal price-fixing cases such as these would expose the participating executives to criminal prosecution and their companies to heavy fines.

2.168 Although present Philippine competition law is based on U.S. law, a good deal of the practices in the Philippines would not be tolerated in the United States or many other countries. Competition law has been weakly enforced: There is a dearth of private litigation, and only two antitrust cases have been appealed as far as the Supreme Court. Administrative enforcement has been equally weak. Although both the Central Bank and the BOI are authorized to promote competition, their regulatory programs have often served to promote suppliers' interests at the expense of competition and to the detriment of buyers. As a result, there is a public perception that anti-competitive behavior is tolerated.[48]

2.169 Reflecting the impact of entry barriers, the recent trend in market concentration in the Philippines is significant. Between 1983-88, a number of markets became even more concentrated: By 1988, petroleum refining, sewing machines, cells and batteries, transport equipment, motor vehicle parts, motorcycles and bicycles, fruit and vegetable canning, tobacco products, synthetic and treated fabrics, furniture and fixtures, clay products, foundries, steel making, non-ferrous smelting, and photographic and optical equipment had three-firm concentration ratios of nearly 100 percent. Concentration also increased in transport equipment, non-ferrous smelting, grain milling, general hardware, foundries, synthetic resins and plastics, furniture, mattresses, synthetic and coated fabrics, and food manufacturing, processed milk, dairy products (except milk), canning and preserving of fruits and vegetables, vegetable and animal oils and fats, cigarettes, matches, synthetic resins, plastic materials, and manmade fibers, glass and glass products, coffee roasting and processing, fertilizers, pesticides, refrigerators, primary cells and batteries, motorcycles and bicycles, non-ferrous smelting and refining, and adhesives and glues. Ownership of firms is also highly concentrated and only one percent of companies are listed in the SEC.[49]

2.170 All in all, 66 Standard Industry Trade Classification (SITC) lines had concentration ratios of at least 70 percent in 1988, up from 63 in 1983. This suggests that market concentration in the manufacturing sector remains unabated.

2.171 Entry barriers are largely the result of Government policies, programs, statutes, and regulations. For example, in the transport industry, until recently, the capacity-regulating rule for inter-island shipping required very long and highly centralized procedures to acquire a public utility franchise for land transport. In telecommunications, the Government named the dominant firm as the sole international gateway for telephone services, and allowed it to expand services and acquire existing telephone systems until recently. In power, the ownership of power generation was legally separated

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[47] Agreements among competing suppliers to establish exclusive marketing territories prevent competition and thereby allow each supplier to charge a monopoly price over its assigned territory. Suppliers sometimes allege that such agreements reduce freight costs (which can be substantial for cement). Unfortunately, the agreements remove any competitive incentive for suppliers to offer low (cement or freight) prices to buyers.

[48] See Senate bill No. 845, p. 7.

[49] These markets exhibited increases of more than 20 percent in the three-firm concentration ratio.

from the ownership of power distribution, and a Government-owned corporation was designated the sole generator of electric power until recently. Private companies and cooperatives are allowed to distribute this power, provided they obtain a franchise to operate a public utility.

2.172 Entry barriers have been created consciously or unconsciously by Government policies and regulations; however, the reasons for erecting them may differ among industries. For instance, the Government's perception of a natural monopoly is one reason. The development of infant industries is another (Box II.4). Structural entry barriers, on the other hand (for example, economies of scale and cost advantages), are formidable barriers that an incumbent can exploit to discourage new entrants. (Annex 19 shows products covered by various regulations, and Annex 20 provides an overview of some of the manufacturing sectors in which entry barriers are encountered and of actions taken by the last two administrations to lessen them). Other policy-induced barriers to entry include promotion of import substitution and restriction of foreign investment.

2.173 A license is an authorization to engage in or operate a business or commercial activity. For a public utility, however, the license is called a franchise. This is a legal instrument that confers upon existing corporations or entities the right and privilege to use public property for their private business. Under the Commonwealth Act No. 146, also known as the Public Service Act, only the Public Service Commission (PSC) can issue the franchises to utility operators. The Public Service Act was passed not only to protect the public against unreasonable charges and poor or inefficient service, but also to prevent "ruinous competition". Since these objectives are contradictory, the Act has, for the most part, limited competition at the expense of the public interest.

2.174 Currently, the functions of the PSC are carried out by several government agencies: for sea transportation, by the Maritime Industry Authority (MARINA); for land transportation, by the Land Transportation Franchising and Regulatory Board (LTFRB); for air transportation by the Civil Aeronautics Board (CAB); and for telecommunications, by the National Telecommunications Commission (NTC). These agencies are all attached to the Department of Transportation and Communications (DOTC). In the franchise, the agency specifies, among other things, the routes to be served and the services to be provided by the operator. They are also authorized to determine rates and fares. This authority allows these agencies to play a key role in determining the structure of an industry.

2.175 In the Philippines, competition has often been viewed as "ruinous" and therefore undesirable. However, it is only ruinous to the inefficient supplier, and in fact is an effective means of allocating resources and therefore beneficial to society.

2.176 In addition to competition, another important factor in determining efficiency is corporate control. That is, mergers that result in changing the ownership from less efficient to more efficient firms would be welcome. However, mergers that increase market power and reduce competition should be avoided. However, mergers of neither sort are occurring, partly because the Philippines lacks a well-functioning securities market (see the section on the capital markets): Each year between 1987 and 1991, there were fewer than 20 mergers and acquisitions among the more than 220,000 registered corporations.

Reform of Competition Policies

2.177 Competition reforms can be a powerful tool for encouraging economic development. They involve creating domestic institutions to impede or counteract private or regulatory actions that restrain competition. Competition reform, by inhibiting private restraints of trade and encouraging the design of efficient regulations, would increase the efficiency and flexibility of domestic markets and enhance the

Box II.4: Barriers to Entry and the Mobility of Resources

Barriers to entry are broadly defined as factors that enable existing firms to earn excessive profits without the threat of new entrants. These factors usually fall into three categories: economic, strategic, and institutional/regulatory. The interaction between these factors is also important as this can further heighten barriers to entry.

Economic barriers generally include absolute cost advantages and product differentiation. Absolute cost advantages are a "firm-specific characteristic" and can arise because incumbent firms are more experienced in the manufacture of a given product. This experience may take time to acquire or may not be easily replaced by entrants. First-mover advantages, which arise from being the first firm to enter an industry and establish buyer acceptance for its products, would also be a source of absolute cost advantage. One factor that promotes buyer acceptance and repeat purchasing is product differentiation (creation of real or perceived differences between competing products, such as in product design, image, and quality in the mind of purchasers). Product differentiation can be an industry- or a firm-specific characteristic, or both.

Strategic barriers arise from incumbent firms' behavior aimed at raising the costs of entrants. Examples include predatory pricing, foreclosing sources of inputs or distribution channels, maintaining excess capacity, and product differentiation, such as through large advertising outlays. Firms may also employ strategies using institutional arrangements (such as the legal system) and the regulatory process as barriers to new competition. In the Philippines, it has been alleged that two of the largest and most profitable firms, the Philippine Long Distance Telephone Co. (PLDT) and San Miguel Breweries (SMC) have used litigation to delay and increase the costs of entry by new firms.

Institutional and regulatory barriers include tariff and non-tariff barriers to trade, foreign ownership restrictions, quotas, patents, trademarks, and licensing policies. Like many countries, the Philippines has a plethora of these types of barriers. Some are erected to meet social, political, and economic objectives, but most are questionable. The overall "height" of barriers to entry has generally been defined in terms of the magnitude of prices over competitive costs, the magnitude of cost differences between incumbent firms and entrants, or the magnitude of excess profits. Because of the lack of information on individual firms' costs, and differences in accounting conventions, the overall height of barriers to entry is best measured by the length of time it takes firms to start supplying the market. Thus, regulatory approvals, lags, administrative procedures, and solving the economic and technical problems that a firm may face become highly relevant in this measurement. The longer the time it takes to begin supplying the market, the higher are the barriers to entry. And the longer the incumbent firms will enjoy the latitude to charge high prices without facing competitive pressures.

effectiveness of other structural reforms. It can also reinforce trade and other structural reforms. In addition, it can be effective where trade reform is not. Such reforms would also complement the trade liberalization suggested, especially where the latter would not be effective (as in non-tradable sectors such as transport, utilities, retailing and distribution).

2.178 A great deal can be accomplished in the short-term by reducing entry barriers in regulatory and licensing matters, by focusing on the procedural rules. For example, if an applicant for a license to conduct business must wait to enter while appeals are made, a substantial barrier to entry is created. However, if all applications for a license or permit were automatically granted in a short period, this barrier would be eased. Further, even if the agency denied a license, the applicant could nevertheless continue its business during the appeal process.

2.179 Competition policies, like trade liberalization, would serve the goals of efficiency, competitiveness, and economic development, but do so by directly affecting commercial conduct and constraining corporate transactions that lead to inefficiency. By influencing conduct, competition policies expand and reinforce the effects sought by trade liberalization and other structural reforms. By influencing corporate transactions, they preserve the effects sought by other structural reforms. Similarly, competition advocacy reinforces structural reforms by providing an institutional check on government actions that would weaken domestic competition and undermine the effects sought by trade liberalization and other structural reforms.

2.180 Competition reform has been a significant trend worldwide since 1980 and has accelerated since 1988. Many small or emerging market economies have recently adopted new competition laws, including Colombia, the Czech and Slovak Republics, Hungary, Italy, Jamaica, Korea, New Zealand, Poland, the Russian Republic, and Venezuela. In addition, Argentina, Taiwan (China), Turkey, and Zimbabwe are now considering or enacting such laws. In Australia and New Zealand, recent competition reforms were designed to strengthen Common Market initiatives, but in the emerging market economies, they have been used mainly to support domestic industrial restructuring and reinforce domestic market-oriented reforms (in trade, capital markets and other areas).

2.181 The Philippines' competition statutes — modeled after the U.S. Sherman and Clayton Acts — are not enforced because they rely primarily on criminal sanctions and because of a lack of merger control, vague statutory language, and the absence of a central enforcement agency. Two bills presented to the 1992 Congress would strengthen enforcement: The Senate proposal is especially welcome because it would establish a strong, independent, specialized enforcement agency. The need for such an agency, with exclusive authority to enforce the competition law, derives from the weaknesses of the judiciary, which, in the Philippines, as in most nations, ultimately enforces commercial law. The judiciary is plagued by delays, particularly in the lower federal courts, which make it difficult to establish a commercial code of conduct (see section on the legal framework). Strong administrative enforcement could offset many of these weaknesses, provided it is structured to ensure that decisions are made objectively and without undue influence or prejudice. Annex 21 discusses specific aspects and factors that must be included in the recent proposals for reforming competition policies.

2.182 The Philippines does not presently practice **competition advocacy**.[50] In light of the restrictive regulations, however, it would be useful for authorities to develop an institutional mechanism to counter them. Thus, this report recommends the competition agency be empowered to intervene in the regulatory process and provide expert comment on the competitive effects of regulations.

2.183 Even if the Government enforces competition policy, this would not, in itself, bring about tangible results. Instead, the function of the policy is to maintain a demonopolization program over time. The highest level of Government must fully support the policy and the agency charged with carrying out the reforms should protect and continue the progress that would be made. In particular, the agency should be given the right to overturn anticompetitive decisions and rules of other public sector agencies. Annex 22 provides a list of recommendations to implement the reforms.

2.184 In order to encourage the creation and subsequent maintenance of contestable markets, this report recommends that the Philippines adopt an adequate competition law and establish an administrative agency to enforce the law. To be effective, the proposed law should treat violations as part of civil law,

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50 Competition advocacy implies a formal public expert commentary on government policies with respect to their effect on competition.

increase civil penalties, and prohibit market dominance. The agency should be responsible for competition advocacy and empowered to review competition policy and activities of other public agencies. In addition, this report also recommends that private rights of appeal be ensured.

2.185 For the reforms to be lasting and successful, all private sector firms must be persuaded that the efficiency gains for the economy will produce benefits that outweigh the costs of introducing these reforms. In some ways, the oligopolies themselves may be helpful to reform, since they stai . to gain considerably from the increase in commercial activity and economic growth that would result from microeconomic reforms. For a political coalition to succeed, it may need to persuade these powerful economic interests that they will benefit.[51]

2.186 Competition reform would have various effects on the commercial environment. In the short run, merger control and the review of privatization would immediately constrain mergers and privatization in highly concentrated markets. Similarly, legal constraints on inter-corporate relations (cross-ownership and interlocking directorates) would reduce aggregate concentration.

2.187 Also, deregulation could lead to tangible results given the fact that the Philippines still maintains many regulations that are highly restrictive and distortionary. Further, there are many areas in which the competition agency could provide public studies and recommend regulatory reforms.

2.188 The long run effects could be substantial, particularly for the structure of markets and industries: Competition policies would create an environment that encourages specialization and subcontracting and reduces the advantages of affiliation and conglomeration. This environment would give large Philippine conglomerates an incentive to invest.

2.189 The need to increase efficiency needs to be balanced, however, with the need to control monopolization and market dominance by a few players. It is thus recommended that, given the already high concentration ratios in Philippine manufacturing, the proposed competition policy needs to use flexible standards for merger control and to balance the two key objectives of increasing efficiency and controlling market dominance.

2.190 To slow the increase in market concentration, the competition agency should require pre-merger notification and engage in merger control. This would enable the agency to prevent mergers that weaken competition in specific markets. Similarly, the agency should review the proposed privatization of state-owned enterprises and be authorized to block those that reduce competition. Such a policy would help ensure that privatization does not increase the already high level of concentration and market control.

(iii) Corporate Insolvency

2.191 The closing of corporations or partnerships in the event of insolvency is an unavoidable part of a well-functioning market economy. Thus, insolvency laws should allow failing enterprises to be reorganized on behalf of both debtors and creditors, and should provide a speedy and efficient means of liquidating them and disposing of their assets. In this respect, the laws supporting institutional arrangements in the Philippines are unsatisfactory and need to be modernized.

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51 The conglomerates are probably caught in a prisoner's dilemma. Each one benefits directly from protectionist action, but suffers from the protectionism fostered by other interests. Though all would benefit from general reform, no one wants its own sector reformed.

2.192 Jurisdiction over insolvency matters is now divided between the SEC and the regular courts. The SEC is solely responsible for the reorganization of corporations and partnerships unable to meet their current obligations but are solvent, if the balance sheet value of their assets exceeds their liabilities at book values. The regular courts have jurisdiction over the liquidation of insolvent debtors. But in some circumstances, the SEC may appoint a receiver or management committee for an insolvent corporation, resulting in an overlap of authority. In addition, SEC officials are required to deal with complex legal and economic issues without clear legal guidelines, and often without the necessary professional training and experience.

2.193 The reorganization option for a debtor in financial difficulty but not yet insolvent, which is modeled on Chapter 11 of the U.S. Bankruptcy Code, should be revised to include certain elements that application of Chapter 11 in the United States has shown to be necessary. In particular, the courts should be able to appoint a trustee to supervise the reorganization, and, if appropriate, dismiss the management and make new appointments. The debtor should be responsible for preparing the reorganization plan, under strict time limits. The role of the courts should be to give final approval to the plan after it has been approved by the creditors. A more rigorous and explicit regime of this kind will ensure that the reorganization option provides a proper balance between the interests of the debtors and those of the creditors, and will increase the confidence of lenders and suppliers who provide credit to private businesses.

2.194 The Philippine law on bankruptcy, in both its substantive and procedural aspects, must be modernized and made consistent and comprehensive if it is to be an efficient judicial mechanism for debt recovery and the liquidation of insolvent business. A system that promotes the first objective also promotes the second; however, the present Insolvency Law, enacted early this century, does not contain the provisions found in modern bankruptcy statutes, and is therefore not well equipped to address current situations.

2.195 The Philippine bankruptcy law does not provide detailed guidelines, standards, or objectives for reorganization and liquidation. An attempt was made to modernize the laws through provisions in Presidential Decree No. 902-A, which authorized the SEC to appoint a rehabilitation receiver or a management committee to determine whether a bankrupt business should be continued in the best interests of the creditors and other affected parties. This appointment may be made even when a business is technically insolvent, and against the wishes of the creditors. However, the decree did not sufficiently define the standards and limitations for the exercise of such powers, leaving the SEC with broad discretion. A new bankruptcy law should specify precisely when rehabilitation or reorganization can be undertaken, which procedures must be observed, the objectives and parameters of the rehabilitation process, the rights of creditors, and the powers of the rehabilitation receiver or management committee.

2.196 Reform of the Philippine bankruptcy law also calls for an unequivocal policy that should be given precedence in bankruptcy cases: At present, the legal framework does not unambiguously favor debtors or creditors. Instead, the law should specify how the interests of debtors and creditors will be balanced in cases of insolvencies. Although a finding of insolvency usually results in the liquidation of the debtor, the rehabilitation of the debtor seems to be the paramount consideration when a rehabilitation receiver or a management committee is appointed under the Presidential Decree No. 902-A.

2.197 The bankruptcy law should be modernized along with institutional changes. To ensure efficient implementation of the revised law, special courts should be created that have exclusive jurisdiction over all cases involving bankruptcy, insolvency, suspension of payments, rehabilitation, reorganization, and illiquidity. This has several advantages. First, it will facilitate the disposition of cases, and reduce the time and expense involved. Second, judges can be appointed who have the

necessary technical expertise. Third, it will prevent debtors from using the SEC procedures to delay recovery by creditors. With a system of special bankruptcy courts, one person will evaluate a business' financial problems and decide whether to rehabilitate or liquidate.

2.198 Regarding the financial sector, inability to intervene quickly and effectively with failing institutions, even when problems are diagnosed in a timely manner, perpetuated the weakness and inadequate capitalization of the domestic banking system in the past. In most cases, the Central Bank took remedial actions such as recapitalization, and negotiated with bank owners on corrective measures, but often the finances of the institution further worsened during these negotiations, ultimately resulting in failure. Moreover, because the Central Bank did not have the legal power to issue cease and desist orders until the passage of the Central Monetary Act (CMA) last year, some insolvent banks continued to operate, while others were closed; this led to lawsuits from bank owners and directors over inconsistent rules. These lawsuits further challenged the Central Bank's authority to intervene. Many examiners were sued in the aftermath of the bank closures in the 1980s and were personally at risk because the Central Bank did not — by law — financially protect examiners if they were sued by the banks. Under the new Central Bank Act, the Monetary Board may indemnify its members and other officials of the BSP against all costs and expenses reasonably incurred in connection with any civil or criminal action unless courts judge actions of the officials liable for negligence or misconduct.

2.199 One of the most serious challenges to the authority of the banking system's administrators was a Supreme Court case involving the Monetary Board's closure of a savings bank on the grounds of insolvency. In *Banco Filipino Savings & Mortgage Bank v. Court of Appeals*, December 11, 1991, the Supreme Court overturned the action of the Monetary Board stating that the bank was not insolvent at the time of closure, since valuation reserves should not have been deducted from the assets of the bank. Under the new CMA mentioned above, the supervisory powers of the Central Bank were strengthened. As a result, it is expected that the BSP will address insolvency issues expeditiously in the future.

(iv) Legal Framework

2.200 The Philippine judicial system is widely perceived as failing to meet the needs of the private sector. Although the system is generally adequate for a market economy on paper,[52] its ability to render justice and enforce contracts is seriously constrained by the inability of the courts to consistently provide (a) relief against abuses by Government officials or improper administrative actions; (b) prompt determination of the rights of parties to commercial transactions; and (c) reliable and rapid disposal of civil litigation. A well-functioning legal system is essential to resolve disputes quickly and inexpensively, to enforce contracts properly and rapidly, and to ensure fair, transparent, and competitive markets. Although existing firms, especially large ones, find ways to circumvent the existing legal barriers and use them in order to deter new firms from entering, a well-thought-out judicial reform could be an important component of a program to promote efficient private sector development.

2.201 The Constitution provides maximum periods for disposing of cases.[53] Once the parties to a dispute have filed their pleadings, a trial court is required to make a decision within three months, and the Supreme Court within 24 months. In practice, however, these time limits are frequently exceeded; the failings of lawyers, judges, and court personnel have made delay endemic. One reason is the failure to dispose of outstanding cases when a judge retires, resigns, dies, or is transferred or promoted, even

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52 As discussed above, laws for promoting competition and regulating monopolies need to be improved.

53 Article VIII, Section 15.

though delays impose significant costs on the parties to civil litigation. Not only are court proceedings expensive, but delays can affect other business transactions in which financial issues are at stake. Long delays can also be ruinous to the party bearing the financial risk of the disputed contract, and highly advantageous to the party relieved from the obligation to make payment during the trial period. Such delays can dissuade a party with a meritorious claim from pursuing that claim and instead force an unsatisfactory compromise.

2.202 Respondents in the enterprise survey discussed earlier (see paras. 2.2 and 2.3) indicated a high level of dissatisfaction with the legal system. Most strikingly, all respondents said they would not attempt to resolve a legal dispute entirely within the formal system, even though most had previously attempted to do so (Table II.8). The data on the time required to resolve disputes in court as opposed to outside clearly indicate a major source of discontent for the private sector. On average, court cases took more than a year, with some firms still awaiting a decision after a year and a half. In contrast, settlements were reached out of court in less than four months. Asked to explain their preference for resolving future disputes out of court, most firms said that court settlements were too costly, time-consuming, or both. Three firms felt that involvement in formal legal actions would harm their business reputation.

2.203 The ratio of practicing private lawyers to the general population is relatively high and, in the major urban centers, there are significant numbers of law firms to serve the needs of the private sector. In rural areas, however, private lawyers are in short supply. In Palawan, for example, the number of trial courts exceeds the number of practicing lawyers. Most major law firms include partners who obtained academic qualifications or work experience outside the Philippines, frequently in the United States. Law firms are well equipped with computers, libraries, and other facilities, and are fully capable of helping their clients minimize business risks.

2.204 Although the problem of judicial misconduct exists in all systems, the public and members of the legal profession believe that corruption is widespread in Philippine courts. Between January 1991 and June 1992, out of a total of 1,936 judicial positions, eight judges were dismissed for misconduct, two were suspended, 19 were fired, eight were censured, and eight were reprimanded. In the mid-1980s, El Ponente, the official newsletter of the Ateneo Law School, conducted a survey among judges and lawyers. The respondents said that they believed that dishonest judges outnumbered honest ones and that incompetent judges outnumbered competent judges. Similar results have appeared in other Philippine public opinion surveys. When public confidence is weakened or lost, it contributes to a spiral of declining standards among litigants and their lawyers who seek other ways to win cases in what they feel is a capricious environment.[54]

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[54] On August 27, 1992, the Philippine Supreme Court issued a decision in the case of "Philippine Long Distance Telephone Co. v. National Telecommunications Commission et al." (G.R. No. 94374) which revoked the grant to Eastern Telecommunications Philippines, Inc. (Eastern) - a license to operate an international gateway facility in the Philippines. The Supreme Court ruled that Eastern's franchise did not authorize it to engage in telephone services, but merely in record and data services. Eastern was considered as one of PLDT's strongest competitors in the telecommunications industry. But the Supreme Court decision weakened Eastern's bid to challenge PLDT in the market for overseas traffic. On January 28, 1993, two local newspapers reported the findings of a language expert that the decision on the Eastern case may have been prepared for one of the justices by a lawyer working for PLDT. Claiming innocence, the justice resigned from the Supreme Court a few days after the newspaper articles came out. This controversy sparked a discussion on the existence of graft and corruption in the judiciary. The Office of the President expressed concern and indicated that initiative in investigating the matter should be taken by the Supreme Court.

Table II.8: Firms' Experience with the Legal System

	In court	Before decision	Before going to trial
How firms have resolved disputes (percent)	64	9	36
How firms would resolve next dispute (percent)	0	7	93
Months required to resolve previous disputes	13	18	4

Note: Data in the first two rows refer to disputes occurring in the first two-year period prior to the survey.

Source: World Bank, Enterprise Survey.

2.205 The perception that the courts are corrupt continues to erode public confidence in the system. The Government should ask the Supreme Court to review its procedures for handling complaints against judges and court personnel, in order to investigate and dispose of complaints rapidly, fairly, and transparently.

2.206 The Government should articulate its commitment to reforming the judicial system. A strategy could include establishing a standing judicial commission of judges from each level of the system together with the Secretary of Justice or an alternate. The commission would be responsible for judicial training and improving court facilities and resources.

2.207 The Integrated Bar of the Philippines should require its members to comply with the Canons of Professional Ethics. In particular, lawyers should be encouraged to seek reviews of the interlocutory orders of trial courts only when they are satisfied that there is an arguable case for relief. It is suggested that the Integrated Bar actively pursue complaints of professional misconduct by lawyers and judges.

2.208 Complaints of judicial misconduct by lower court judges should be promptly dealt with by a division of the Supreme Court, and the Court should encourage judges against whom complaints have been filed to step down until matters are resolved. When a complaint is upheld, the details of the charge, the name of the judge, and the penalty should be publicized.

2.209 Although arbitration is now used in relatively few disputes,[55] the practice is growing to include compulsory arbitration provisions in important commercial contracts,[56] however, there are two problems with this alternative. The first is the shortage of qualified arbitrators. The second is the inability of arbitrators to enforce their awards if one of the parties does not accept the outcome. The successful party can apply to the courts to enforce it within one month after it is made, but the ease with which the opposing party can delay enforcement by filing motions for relief or taking other procedural steps weakens the benefit of arbitration.

2.210 The use of arbitration for commercial cases complements the other mechanisms for resolving disputes. However, there will always be a significant number of commercial cases that must be dealt with in the courts because the parties do not agree to arbitration. Judges must therefore develop the skills to deal with complex commercial cases.

2.211 Given the courts' heavy workload, it is suggested that the needs of the business community would be most effectively addressed through specialized commercial courts. These courts would have exclusive jurisdiction to deal with commercial matters and would be located in urban centers, where the majority of commercial disputes arise. Initially, pilot courts could be set up in Manila with three to five judges who would handle only commercial law matters. The advantage of this arrangement, which is widely used in many countries, is that it develops a high level of skill among the judges, who would then be able to use flexible procedures to encourage mediation and conciliation or, where that fails, to try cases expeditiously. Another advantage of removing commercial cases from the trial courts is that it frees up those courts so that they can deal more effectively with criminal and other minor civil cases. It is suggested that the pilot commercial courts be given expanded powers to provide rapid and flexible justice. If the courts prove successful in reducing delays and improving judicial performance, consideration could be given to establishing commercial courts in other major urban centers.

F. Financial Sector Constraints

Introduction

2.212 The Philippines financial sector, and in particular the capital markets, have played a limited role in financing the investment requirements of the private sector. The size of the financial system as a share of GDP is small in comparison to the other ASEAN countries. Macroeconomic distortions, particularly the losses of the Central Bank of the Philippines (CBP) until recently, have contributed to the disintermediation of the domestic financial system. Also, the equity market has remained small when compared to other countries in the region despite a sizeable growth in market capitalization in 1993 and the early part of 1994 (see Chapter I). There is a need to strengthen bank supervision, including oversight of public financial institutions. There is also a need to improve the efficiency of the domestic financial system both in terms of mobilizing additional savings and allocating financial resources.

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55 For Government infrastructure contracts, the Department of Public Works and Highways insists on a standard arbitration process.

56 There have been instances in which a major commercial dispute between two Philippine corporations have been referred to arbitration in Hong Kong. Although the costs of sending lawyers and witnesses to Hong Kong are considerable, the benefit can be a fast and reliable resolution.

2.213 Financial market development in the Philippines has lagged behind that of other ASEAN countries, and Philippine banks are smaller in both asset size and capital base than their ASEAN counterparts.[57] In a 1992 ranking of 200 Asian banks by the size of capital,[58] the three largest Philippine commercial banks — all Government-controlled institutions — ranked 52, 80 and 81. By asset size, they ranked 93, 161 and 164. The top three privately-owned commercial banks ranked 110, 111 and 112 in capital strength, and 136, 150 and 163 in asset size. The 18 Philippine commercial banks that rank among the top 200 Asian banks control only 0.9 percent of total Asian bank assets, as compared with 3.9 percent for Thailand, 3.3 percent for Indonesia, and 2.2 percent for Malaysia.

2.214 The level of domestic savings in the Philippines has been among the lowest in Asia relative to the level of economic activity. Savings averaged less than one-fifth of GDP as compared to more than 30 percent in other ASEAN countries. This reflects low levels of financial intermediation: by 1993, the ratio of M3 to GNP had still not recovered to the pre-crisis levels, while the share of bank credit to the private sector in GNP amounted to less than one-third the rate in neighboring countries (see Table II.9). Also, domestic credit to the private sector has fallen in the last decade; this trend needs to be reversed and equity mobilized if private investment is to expand on a sustained basis. To accomplish these goals, incentives must be improved for channeling market-sourced funds (both domestic and foreign) into productive private investment, particularly since infrastructure projects have been earmarked for private investors and the Government is promoting privatization (see Chapter I).

Table II.9: Philippines — Gross Domestic Savings, 1991-93 (as a % of GDP)

	1991	1992	1993	Avg. 1971-80	Avg. 1981-90
Indonesia	35	37	38	22	32
Malaysia	31	36	38	29	33
Singapore	46	47	48	30	43
Thailand	35	35	37	22	27
Philippines	16	15	15	27	22

Source: ADB.

Investment Finance

2.215 Long-term credit for private sector investment projects fell in the past decade, primarily because the uncertain economic and political climate slowed down private investment. At the same time, banks shortened loan maturities in response to the volatility of domestic interest rates. As a result, investments in development and expansion projects, requiring long-term financing, were not undertaken. The short-term loans have been based largely on collateral and not on cash flows, and this has restricted funds for small and medium size businesses.

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57 There are 916 operating financial institutions in the financial system as follows: commercial banks (32), private development banks (37), savings and loan associations (52), savings and mortgage banks (8), and rural banks (787).

58 The Banker, "Top 200 Asian Banks," October 1992.

2.216 In the past, the private sector's long-term financing needs were met by the public development banks; but this source was greatly reduced when both the Philippine National Bank (PNB) and the Development Bank of the Philippines (DBP) became insolvent in 1986. Long-term loans as a share of total banking sector lending fell from 12 percent to 10 percent between 1980 and 1990, reflecting a further reduction of already limited long-term funds. Within the domestic banking system, the main source of long-term lending is currently rollovers of short-term credits, but most long-term funds have been available only through the World Bank, the Asian Development Bank, and Japan under the ASEAN Japan Development Facility and through the OECF and the Export-Import Bank of Japan. To finance private investment on a sustainable basis, long-term domestic funds need to be generated. Recently, macroeconomic stability and liberalization of foreign exchange markets have increased access to foreign exchange financing. The Government successfully sold a US$150 million Eurobond issue in early 1993. It is also highly likely that about 10 of the largest and financially strong firms (both public and private) could sell securities in limited amounts in international capital markets: In 1993, PLDT, PAL, PNB, PNOC and NPC borrowed from these markets. Although foreign exchange financing from abroad is still limited due to the perceived country risk, international lending should increase if political and economic conditions remain favorable.

Role of Government Banks

2.217 The role played by public banks has not encouraged the development of the domestic banking sector in the Philippines. From the early 1970s until 1985, the two largest Government-owned banks, PNB and DBP, accounted for about half the domestic financial system's total assets. Until 1986, PNB held half of all commercial bank assets, and its large government deposits resulted in a lower cost structure than that of other banks. PNB became insolvent in 1986 with large non-performing assets — the result of mismanagement and loans for nonviable projects made at the request of the Marcos administration — which were granted mostly on political grounds.

2.218 In 1986, PNB was restructured under the Economic Recovery Loan (ERL) and 59 percent of its assets were transferred to the Asset Privatization Trust (APT).[59] The Loan also included an institutional strengthening program that entailed reducing staff, consolidating branches, and improving the budgeting and planning processes. This program has worked satisfactorily. In 1989, PNB was partially privatized and 30 percent of its shares were offered to the public. The Government plans an eventual 100 percent divestiture, which this report supports.

2.219 Like PNB, DBP also became insolvent in 1986 and underwent a major financial restructuring. DBP's insolvency resulted from its financing of Marcos' political "cronies" as well as its assuming non-performing loans for failed public and corporate projects between 1982-86.[60] To provide term-finance, DBP was tasked to become a predominantly wholesale bank, providing long-term funds sourced from multilateral and bilateral agencies to domestic financial institutions for on-lending to the private sector. To sustain DBP's wholesale operations, the absorptive capacity of its active conduits has to be expanded. Currently, most of the commercial bank conduits, which are the more active participants under the various wholesale lending programs, have reached their credit ceilings, which are based on DBP's single borrower's limit (SBL). If DBP will pursue its wholesale role, there is a need to address the above constraint. Until the domestic capital market is fully developed and is capable of providing

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59 Economic Recovery Loan (No. 2787-PH).

60 These loans are called "behest" loans (see Chapter I of this report).

adequate financing to the private sector, DBP will need to continue to play a pivotal role in addressing the funding gap in the financial system.

2.220 The Land Bank was created as a conduit for Government funds for agrarian reform, and to make loans for agricultural development projects. LBP has incurred losses in its agrarian credits because of the high cost of lending (high cost of funds, excessive administrative costs, and loan losses) compared to the interest rate charged to small agri-borrowers. Through its commercial banking operations, LBP generates income which offsets the agrarian sector lending losses. Under the FSAL (the Financial Sector Adjustment Loan), LBP was given the role of the apex bank for agricultural credit (this function was transferred from the CBP). LBP will remain publicly-owned and will serve as both a development bank for agriculture and a commercial bank.

2.221 Rural banks comprise 86 percent of the banks in the country, but their total loan portfolios and deposits are only four percent (₱ 15 billion of ₱ 370 billion) and three percent (₱ 13 billion out of ₱ 508 billion), respectively, of the domestic banking system. In Regions I (Ilocos) and IV (Southern Tagalog) alone, there are 104 and 153 rural banks, respectively, with average resources of only ₱ 27 million each. If these banks combine their resources, they will likely raise their efficiency in the delivery of credit, particularly to the countryside, where there is poor access to formal lending channels. This has been done in the past as in the case of 18 rural banks in Central Visayas which merged to form the First Consolidated Rural Bank of Bohol.

Competition in the Banking Sector

2.222 New banks may be established with the BSP's approval. According to the BSP guidelines, qualifications for a banking license include, but are not limited to, compliance with all laws and requirements for capitalization and administration; integrity and responsibility of the organizers and administrators; and their ability to ensure the institution's safety. Despite this open entry policy, bank entry seems restricted. Because of the financial sector's past problems, the BSP prefers banks with a large capital base. However, the limit on the foreign equity investment in domestic banks limits their capital base. Foreign banks, except the four already operating when the sector was closed to new foreign entrants, were de facto precluded from opening new domestic branches. These barriers have contributed to an oligopolistic structure and concentration in the financial system.

2.223 In April 1994, a reform bill (Republic Act 7721) was passed to allow entry of foreign banks (see Table II.10 for a comparison of various bills presented to the legislature). The number of branches that may be established by foreign banks is limited to six, with the possibility of increasing this number to ten upon recommendation of the Monetary Board, subject to the approval of the President as the national interest may require. Also, branch banking is allowed only during the five years following the effectivity of the loan (see para. 2.39). In approving entry applications of foreign banks, the Monetary Board will take into account the following criteria (1) geographic representation of foreign banks; (2) strategic trade and investment relationship between the Philippines and the country of origin of the applicant; (3) the applicant's reputation; (4) reciprocity rights; and (5) the willingness of the applicant to share advanced technology. In order to prevent the dominance of foreign banks in the banking sector, the Monetary Board has been mandated to ensure that at least 70 percent of the resources or assets of the entire Philippine banking system are held at all times by domestic banks which are majority-owned by Filipinos. Although current liberalization is expected to lead to modernization of the sector, further liberalization in the future is desirable. (Table II.10 shows a comparison of various bank reform bills presented to Congress.)

2.224 It is expected that the enactment of RA 7721 would attract the entry of reputable foreign banks which, with large capital base and established track record should contribute to a stronger and more efficient domestic banking system and stimulate further trade flows and foreign investment. In particular, the entry of foreign banks is expected to improve financial intermediation as commercial banks compete with each other for market share through improved quality and broader scope of services, lower interest rates and loans and introduction of technological innovations should further enhance productivity, risk management and competence in the banking system.

Table II.10: Comparison of Bank Reform Bills

HB 8226	SB 1606	RA 7721
	MODE OF ENTRY	
wholly or majority-owned domestic subsidiary acquire up to 70% of existing domestic bank.	up to 60% of locally incorporated subsidiary acquire up to 60% of existing domestic bank.	up to 60% of locally incorporated subsidiary acquire up to 60% of existing domestic bank.
wholly-owned branch.	wholly-owned branch.	wholly-owned branch.
	NUMBER OF BANKS OF ALLOWED **Branch mode**	
no limitation.	maximum of 6 foreign banks + 2 upon approval by the President.	maximum of 6 foreign banks + 4 upon approval by the President (in addition to 4 existing foreign banks).
no limitation.	Subsidiary/acquired bank no limitation.	no limitation.
	NUMBER OF BANK BRANCHES **Branch mode**	
maximum of 6 branches.	maximum of 6 branches.	maximum of 6 branches (for existing foreign banks, present number of branches +6).
full branching capability.	subsidiary/acquired bank full branching capability.	full branching capability.
	LOCATION OF BRANCHES **Branch mode**	
no restriction.	bank to decide location of first 3 branches.	bank to decide location of first 3 branches.
	Monetary Board may decide location of new 3 branches.	Monetary Board will designate location of next 3 branches.
	subsidiary/acquire bank.	
	no restriction.	no restriction.

CAPITALIZATION **Branch Mode**		
PAC of ₱125 million for first 3 branches plus ₱25 million for each additional branch up to 6.	PAC of ₱300 million for first 3 branches plus ₱50 million for each additional branch up to 6.	PAC of ₱210 million for first 3 branches plus ₱35 million for each additional branch up to 6.
some requirements as local bank commercial bank ₱750 million universal bank ₱1.5 billion.	Subsidiary/acquired bank some requirements as local bank-commercial bank ₱750 million universal bank - ₱1.5 billion.	some requirements as local bank-commercial bank-₱750 million universal bank - ₱1.5 billion.
NET DUE TO HEAD OFFICE		
capital = PAC + NDTHO.	capital = PAC + NDTHO.	capital = PAC + NDTHO.
maximum permitted ratio of 5:1 but amounts and ratio may be modified by Monetary Board.	PAC-NDTHO ratio to be set by Monetary Board.	PAC-NDTHO ratio to be set by Monetary Board.
RESTRICTION ON CAPITALIZATION		
	PACNDTHO to be remitted to the country and converted to pesos.	PAC and 15% of NDTHO must be remitted to the country and converted to pesos (except where amounts are invested in productive enterprises or utilized by Philippine companies for export activities).
LIMITATION ON ENTRY PERIOD **Branch mode**		
none.	5 years.	5 years.
	subsidiary/acquired bank.	
none.	none.	
RESTRICTIONS		
Monetary Board to give preference to publicly held foreign banks considering indicators of dispersed ownership, such as levels of single ownership, number of shareholders.	Monetary Board may adopt measures to: • ensure that at all times 60% of assets of the banking system is held by domestic banks. • prevent a dominant market position by one bank or groups with related interests. • secure listing of shares and ensure that at least 10% of shares for public listing be reserved and sold to bank's employees.	Monetary Board may adopt measures to: • ensure that or all 60% of assets of the banking system is held by Filipino banks. • prevent dominant market position by one bank or groups with related interests. • secure public listing of subsidiaries and foreign acquired banks.

CRITERIA FOR APPROVAL BY MONETARY BOARD		
consider geographic representation and strategic trade and investment relationships between the Philippines and the bank's home country.	same.	geographic representation and strategic trade and investment relationship between the Philippines and bank's home country.
reciprocity.	same.	reciprocity rights are enjoyed by Philippine banks in foreign bank's home country.
global reputation for financial innovation and stability.	same.	global reputation for financial innovations and stability.
technology transfer.		willingness to share technology.
		For subsidiary or branch
preference for publicly held banks subsidiary or acquire equity in a domestic bank.	no foreign bank may qualify to set up subsidiary or acquire equity in existing bank unless it is widely-owned and publicly listed in country of origin (except if it is amongst the top 3 banks in its home country).	• only those among top 150 banks in the world or top 5 banks in country origin. • must be widely owned and publicly-listed in home country except where applicant is state-owned bank.

Crowding Out

2.225 Credit to the Philippines' public sector crowded out credit to the private sector during the past decade. In 1983, the share of domestic credit channeled to the private sector equaled 33 percent of GDP; by mid-1994, it had fallen to 27.3 percent. In 1991, the claim of the public sector on domestic financial resources (bank credit to public sector plus the public borrowing through the sale of T-bills) rose to 33 percent of GDP.[61] To expand credit to the private sector, there is also a need to increase the capitalization requirement, to ensure the safety and soundness of the banking system, and to enable banks with branch networks to service a wide client base.

2.226 The insolvency of the Central Bank created a major macroeconomic distortion and resulted in disintermediation of the financial market in the past. Its financial problems have constrained the growth of the banking sector through its imposition of high reserve requirements (RRs) of 24 percent until recently. Those losses averaged about 2.5 percent of GNP during 1986-92. These also stemmed from high debt levels, in particular, the large foreign liabilities assumed during the debt crisis of the early 1980s and improper currency forward and swap transactions (see para. 2.13). These deficits made the Central Bank dependent on the NG to issue Treasury bills to control liquidity, and also necessitate high reserve requirements — 25 percent by 1992 — that aggravated already-high bank intermediation costs. Moreover, the losses tended to grow over time because of depreciation and interest payments on debt issued to fund previous deficits. The growing mismatch between the Central Bank's foreign exchange assets and liabilities led to large deficits that were not dealt with for some time by the Central Bank and

61 1990 Annual Report, "Statistical Bulletin," Central Bank of the Philippines.

the Government. Substantial losses were also incurred in recent years in connection with open market operations (OMOs).

2.227 After a long delay, the Central Monetary Authority Act was passed in June 1993 and became law one month later. The plan consisted of the following features (a) issuance at market rates of Peso 220 billion in Government securities to the CBP. Of this amount, Peso 50 billion will have a maturity of no less than 25 years; (b) placement of a core deposit of Peso 50 billion at market rates by the Government with the BSP to match the maturity of long-term Government securities. The core deposit will have a maturity of no less than 10 years; (c) BSP will contribute 75 percent of its net income after reserves to the Government as a dividend. Any net income over one percent of average total assets will also be declared as an extra dividend for the Government; and (d) the Government services all CBP loans to itself at market interest rates. With the implementation of the above plan, the Philippines now has a financially strengthened Central Bank. This plan satisfies the key objectives of the restructuring, which are to (a) make the Central Bank financially solvent with a positive net worth; (b) facilitate effective monetary policy operations, including appropriate open market operations without resorting to the use of monetary instruments that distort financial intermediation; (c) reduce the financial intermediation cost over time; and (d) have a financial structure that would ensure that BSP will not have to depend on the GOP for budgetary support.

2.228 Government lending programs have been largely ineffective in the past, tying up credit that could have been used to fund efficient private sector initiatives. Most of these programs have been phased out. However, a new program — Magna Carta for Small Enterprises — was introduced in 1992. This program requires all lending institutions lend a predetermined share of their total loan portfolio to small businesses. The requirement demands five percent the first year, and 10 percent the second through fifth years of the program. However, it is virtually impossible for commercial banks to achieve these targets in the short time frame provided under the program. Therefore, they prefer to buy the promissory notes issued by Small Business Guarantee and Finance Corporation, which carry more attractive returns than other investment alternatives allowed under the law. However, at only two-thirds of the yield of the T-bills, this represents an additional cost to commercial banks.[62] Given the unequivocal past failure of such programs, this report recommends that such programs — those lent at subsidized rates — be phased out.

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62 The Government recognized under the medium-term development plan that mandatory credit allocation increases intermediation cost. The current BSP rediscounting facility channeled to export credits of commercial banks provides additional incentives to exporters, but not as a direct credit allocation. Rediscounting of eligible papers of indirect exporters have recently been allowed for cottage/small and medium industries (producers/manufacturers) with supply arrangements with direct exporters.

Table II.11: Revenue Collected from Taxes on the Financial Sector, 1993

Type of Tax	Millions of Pesos	Share of Central Government Revenues (%)
Tax on dealers in securities and lending investors	3,360 /a	1.5 /a
Gross receipts tax on banks and nonbank financial intermediaries	3,980	1.54
Tax on insurance premiums	876	0.03
Documentary stamp tax on financial instruments	5,733 /b	2.22
Transaction tax on sale of shares of stocks	456 /c	0.02

/a 1991 figures.
/b Other documentary stamp taxes are included.
/c A tax rate of 0.25 percent on both listed and unlisted shares of stocks.

Source: Department of Finance.

2.229 **Taxation of Financial Instruments**. Heavy and distortionary taxation of the financial sector retarded its development as it raised the intermediation cost (Table II.11 shows revenue collections). The gross receipts tax (GRT) and documentary stamp tax (DST) on financial transactions account for the largest tax revenues collected. A comparison of real lending rates across selected Southeast Asian countries shows that the Philippines had the highest real domestic lending rates during 1986-91, followed by the Republic of Korea, Taiwan (China) and Thailand. In 1992, the spread between lending and deposit rates in the Philippines was about nine percentage points and this raised the cost of capital even further. Although in line with the recent deceleration in domestic inflation, nominal rates have been falling, but bank spreads have not yet come down appreciably. High real interest rates have led in the past to reduced private investment. The Government plans to replace the GRT and DST on financial transactions with the newly expanded value-added tax (VAT) law. However, the VAT will be levied, assessed, and collected on services rendered by banks, non-bank financial intermediaries, finance companies, and other financial intermediaries performing quasi-banking functions two years after the effectivity of the Act. Since VAT is deductible as an input tax credit by borrowers, the distortion caused by the GRT will thus be removed. Furthermore, the Government plans to review the DST and capital gains tax as part of the ongoing work of the Task Force on Tax and Tariff Reforms (see para. 2.21).

2.230 The Philippines has the highest RRs of all ASEAN countries: RRs in Malaysia, they are 4.25 percent, Singapore 6 percent, Thailand 7 percent, and Korea 8 percent. High RRs (currently at 22 percent) reduce the financial resources that can be channeled to the private sector and increase intermediation costs.[63] Until recently, commercial banks were required to have higher reserves than

[63] The reserve requirement against deposit and deposit substitute liabilities of commercial banks was reduced from 25 percent as of end-1992 to 22 percent effective July 30, 1993. In lieu of the scheduled further reduction in reserve ratio and effective end-1993, banks were allowed to invest two percent of their reserveable deposit and deposit substitute liabilities in Government securities purchased from the BSP in order to increase banks' earnings on reserves and reduce intermediation cost. As monetary conditions may allow, BSP intends to make similar adjustments in the reserve requirements to enable further reductions in lending rates without jeopardizing the price stability objective of the BSP.

thrifts and rural banks in order to offset the cost advantages they enjoyed; however, because the smaller institutions consistently lent at higher rates, the RR was subsequently equalized for all domestic financial intermediaries. RRs are estimated to contribute more than 50 percent to intermediation costs, with commercial banks receiving a below-market interest rate of only four percent on these reserves. The restructuring of the BSP will gradually reduce the need to tax the financial system through high RRs, and the Government has announced a program to gradually lower them. However, under the BSP restructuring program, the RRs are programmed to be reduced only to 12 percent — still a high rate when compared to those in other Southeast Asian countries.

2.231 Since RRs in the Philippines are so large, and the rate of return paid on them is so small, the RRs are effectively an implicit tax on the banking and the real sectors. The GRT and the implicit tax have received considerable attention in discussions of the tax burden on bank intermediation. Removing the GRT over time would reduce the effective tax rate.

Securities Markets

2.232 Private sector development will require stronger regulations, supporting institutions, improved disclosure, and lower tax burdens. The vision for the future is one of rapid development of the corporate bond and equities markets, and a more efficient Government securities market.

2.233 A long-term corporate bond market does not yet exist, but a limited short-term debt (commercial paper) market has started to grow in the last few years. Outstanding commercial paper with maturities of less than one year amounts to some ₱ 7.3 billion, while paper with maturities between one and five years totals ₱ 12.8 billion. Current spreads on successful offerings are 1.5-1.6 percentage points over the Government's 91-day T-bill rate. There is negligible secondary trading of commercial paper. Undoubtedly, uncertainty regarding the future course of domestic inflation is partly responsible for limiting the amount of negotiable private sector debt, given the lack of variable interest rate instruments.

2.234 The presence of the DST may have been a key factor in retarding the development of domestic bond markets. Any negotiable private sector debt instrument is subject to the DST. Because the DST rate is 1/2 of 1 percent on the face value of the instrument, the cost of a debt issue is 1/2 of 1 percent higher than the cost of a bank loan; thus, the domestic bond market has not developed. The DST also acts as an impediment to the development of a secondary market in corporate bonds. To raise revenues, the Government passed a law to increase the DST in December 1994, which took effect in mid-January 1994. This report recommends early phasing-out of the increase, eventually eliminating the DST and replacing the loss in revenues with increases in non-distortionary taxes.

2.235 In the short-term, the need to protect the public revenue base may preclude attempts to reduce the heavy taxes and equalize effective rates on financial instruments. However, some reforms could keep revenues from being reduced, especially if they were introduced in one package. In particular, the following changes merit the Government's consideration.

- Removing the DST on negotiable debt (this would lessen the reliance on short-term financing, and since there is currently little negotiable debt, this change would have virtually no effect on public revenues).

- Removing the GRT, which would reduce the effective tax rate on intermediation (this would result in a revenue loss, estimated at ₱ 3.7 billion in 1991. However, removing the GRT on the financial intermediation cost would have a marginal impact compared with reducing the RRs or increasing remuneration on RRs).

2.236 The revenue loss resulting from these changes were estimated to have been around ₱ 4.3 billion in 1991. This loss could be offset with the following statutory revisions:

- Taxing capital gains on all equity, whether listed or not, and on individual real property at a uniform rate. There is no justification for differential treatment of capital gains of any kind; thus, it is suggested that the final withholding tax on sales of listed equity (1/4 of 1 percent) and on unlisted equity (10 percent for gains under ₱ 100,000 and 20 percent for gains in excess of this amount) be replaced by a single tax on capital gains. It might be argued that this differential tax treatment is necessary for equity market development; however, while it is true it should provide a significant incentive for firms to list in the domestic exchange, it does not seem to have had this effect. (It may well be that the owners of closely held corporations do not want to reveal company-related business information to the tax authorities. This could be overcome if tax compliance was improved.)

- Increasing the final withholding rate on Treasury obligations and deposit accounts. This would significantly lessen arbitrage opportunities, and the adverse impact on intermediation of such an increase would be mitigated to some extent by the removal of the GRT.

2.237 Providing more uniform treatment of capital gains requires equalizing the rate chosen for them and the higher final withholding rate for deposits and Treasury obligations. Further, this new rate needs to be determined in such a way that the resulting revenue gains should offset the revenue losses discussed earlier.

Limited Access to Finance for SMEs

2.238 SMEs suffer from limited access to credit, partly due to the higher transaction costs and the generally greater risk associated with lending to them; as such, they have been discriminated against by the banking sector. Further, microenterprises have always had difficulty obtaining financing: Commercial and thrift banks have argued that the relatively small loans cottage industries would need, along with the perceived risks and the firms' lack of acceptable collateral, make them unacceptable. In addition, they often do not have real estate deeds (other than for homes), which are usually already mortgaged, nor established premises, reputations and track records. Thus, they rely primarily on moneylenders, who charge extremely high interest rates, ranging from three percent to 17 percent or more a month. Consequently, they limit their operations to what can be financed with their own savings and hence they are effectively deterred from expanding and seeking out new business opportunities. Past efforts to address the problem of credit access by SMEs have led to the fragmentation of credit programs and failed to attain their objectives. The number of lending programs has risen recently. There are currently 39 credit programs for agriculture, 13 for the absolute poor, 21 for the salaried and self-employed and 38 for the SMEs. A number of these credit programs are directly managed by non-financial Government agencies, such as the DTI and Department of Social Welfare and Development (DSWD). Monitoring these programs has proven to be difficult in the past. The President created in October 1993 a National Credit Council (NCC) which is mandated to rationalize the use and delivery of the various credit programs. The Council prepared an initial draft implementing guidelines designed to define the roles and responsibilities of the key players such as the implementing Government agencies, the participating financial institutions, borrowers, donor agencies, and policies on guarantees and collaterals. It is recommended that efforts be made to identify sources of funding to be channelled to viable small enterprises that use a market-based approach.

Government and Domestic Securities Markets

2.239 The shift in financing from external to domestic sources has led to a growing market for Government securities. As of December 31, 1993, these amounted to ₱ 682 billion, or 45 percent of GDP. In fact, the public sector has increasingly financed its consolidated deficit through the domestic money market at a rising cost. Treasury bills accounted for 75.2 percent of all outstanding Government securities at the end of 1992.

2.240 A trend toward shorter maturities began to emerge at the same time: About three-fourths of the Government securities had maturities of one year or less, and most paper carries a 91-day maturity. Shortened maturities and the inability of the public sector to manage its cash flows adequately have added to the volatility of domestic interest rates in the recent past.

2.241 Since 1986, the Government has issued Treasury securities using an auction system. Only accredited dealers can compete directly in the auctions, although they may represent their customers when they submit tenders In advanced markets such as those in the United States, investors other than dealers may directly submit bids along with bank deposits or with a letter of credit for U.S. Treasury securities. However, in the Philippines, only the approved dealers are allowed to submit competitive bids, and the minimum bid is fixed at ₱ 1.0 million. The market's efficiency could be improved substantially if the number of participants were increased and the minimum amount required for non-competitive bids was reduced from ₱ 1.0 million to ₱ 200,000. Lowering the amount required would increase the pool of potential buyers of Treasury bills and should likewise put downward pressure on domestic interest rates, which in turn would have a beneficial effect on export growth as lower real domestic interest rates could reduce overvaluation of the currency. Moreover, all non-competitive bids of ₱ 200,000 would be awarded. The recent decision by the auction committee to include both Social Security System (SSS) and Government Service Insurance System (GSIS) as participants in the primary market of Government securities is a step in the right direction. However, participation in the market should also be extended to other potential participants such as private insurance companies and mutual funds in order to widen further the participants in this market. A larger number of qualified participants should increase competition and improve the marketing of these securities.

2.242 The decision of the auction committee on June 14, 1994 to issue a two-year fixed rate Treasury notes starting in July 1994 is a move in the right direction. The Monetary Board is expected to endorse the decision and send to the President for approval. The Bureau of Internal Revenue (BIR) will decide whether the bonds will be discounted up front or pay semi-annual coupon.

2.243 The secondary market for the securities is an over-the-counter one run by accredited Government securities dealers. Secondary market trading in government securities has become more active in recent years (the volume of Treasury bills sold grew to ₱ 600 billion in 1992), but has not reached its potential because of (a) the lack of market makers; (b) the 0.5 percent DST on each transaction, which increases the cost and discourages trading; (c) the capital gains tax; (d) the absence of timely information on Government securities; and (e) the lack of an efficient clearing and settlement system. Capital gains in fixed-income securities are also subject to a regular corporate tax rate of 35 percent, compared with a 0.25 percent tax for capital gains in equities.

2.244 The Philippine domestic securities markets have large potential for development and, with the institutional and regulatory reforms now contemplated, they could fulfill that potential. The obstacles have been discussed for several years, but for the first time in three decades, there are now signs of firm Government commitment to reform.

2.245 In addition to the necessary institutional and regulatory changes that are needed to create a successful market, macroeconomic stability is essential. Then, once the macroeconomic, regulatory and policy constraints to the capital markets are adequately addressed, they should be able to mobilize much needed financing for private sector ventures; also, they should grow to be important instruments for risk management by investors. On the demand side, this will mean that contractual savings institutions and commercial banks will be able to manage their portfolios more efficiently. On the supply side, it will allow both the Government and private firms to improve the management of their balance sheets. And in the process, the markets will provide an avenue for increased capital accumulation for productive purposes and an another investment avenue to provide competition and encourage efficiency in the financial sector. (Annex 23 provides an overview of the status of capital markets in the Philippines.)

2.246 The legal and regulatory framework has not helped develop capital markets, nor has a policy been pursued to create capital markets as part of the privatization of public corporations. In addition, the concentrated and oligopolistic structure of protected domestic industries has reduced the need for private corporations to seek financing for efficiency-enhancing investments. And, because of the risks associated with domestic securities, pension funds and insurance companies have invested heavily in high-yielding T-bills — issued to finance the large consolidated public sector deficits — and have limited their equity investments to a few high-grade securities. This has further constrained the domestic capital market. As the Government T-bill market has grown disproportionately, the corporate bond market has remained virtually nonexistent. Commercial paper issues have grown in recent years but remain relatively small. The taxation of financial instruments has also contributed to distorting the capital markets (paras. 2.234-2.237). The extent to which these markets are underdeveloped can be seen by comparing the depth and trading activity with that in neighboring countries (Table II.12).

Table II.12: Market Capitalization

	Market Capitalization (US$ billion)				Growth Rate (%)		
	1983	1988	1993	1Q 94	83-88	88-93	83-93(x)
Hong Kong	19.5	74.3	385.3	301.3	280	419	18.7
Singapore	15.5	24.2	135.6	119.8	56	459	7.7
Malaysia	22.7	23.3	220.3	174.8	2	845	8.7
Thailand	1.5	8.8	127.6	102.1	492	1349	84.8
Indonesia	0.1	0.2	33.0	31.5	151	n.m.	325.3
Philippines	1.4	4.3	40.3	35.0	208	842	28.0
Korea	4.4	94.2	139.4	143.9	2049	48	30.8
Taiwan	7.6	120.0	195.1	170.2	1479	63	24.7
TOTAL	72.8	349.4	1,276.8	1,078.8	380	265	16.5

n.m. not meaningful figure.
Source: IFC. Salomon Brothers.

2.247 A more important factor that has constrained the growth of the equity market is the preference of family-run companies to maintain close control of business operations and to limit their disclosures of financial performance (the latter being partly for tax reasons). These factors also operate among family-controlled companies in other parts of Southeast Asia, with the result that many companies still rely on retained earnings and borrowings as sources of investment funding; this limits the pace of new capital formation to earnings growth and additional borrowing capacity. In addition, firms are generally reluctant to bring forward public offerings unless there is a reasonable chance of capital gain, which in turn requires buoyant ex ante interest from potential investors.

2.248 Restrictions on foreign participation have constrained a key source of capital. The Foreign Investment Act of June 1991 eased these restrictions; however, share classifications continue to restrict foreign portfolio investment. Because most companies classify their common shares into class A (only Filipino nationals can purchase) and class B (both Filipinos and foreigners can buy) shares (the ratio of one to the other is 60:40), and because Philippine nationals prefer to purchase class B shares, the scope for foreign investors is further limited.

2.249 Although foreign portfolio investment is growing slowly, it still accounted for half of total new share purchases and half the trading activity; also, foreign participation in the domestic capital markets is increasing. It is recommended that authorities consider phasing out the A and B classifications to encourage foreign portfolio investment in the medium-term.

2.250 Demand for securities would also be greatly enhanced by the increased participation of institutional investors, especially the contractual savings institutions. Institutions such as the Social Security System, Government Service Insurance System (GSIS), and insurance companies have been able to mobilize large amounts of long-term resources that could be invested in the capital market.

2.251 On the supply side, there are many opportunities for increasing the market for securities through privatization, macroeconomic reforms, ending the crowding out of the private sector in the financial markets, and addressing tax evasion issues. Also, additional structural adjustment reforms to open up the economy would create incentives for companies to go public, which, in turn, would enable them to grow and compete in foreign markets. Privatization of public enterprises could greatly increase the supply of new issues and thereby help develop the capital markets and attract foreign capital. Reduced domestic interest rates should be one of the key components of any program to encourage the development of a domestic corporate bond market.

2.252 Another way to increase the supply of securities is to make it easier for companies to carry out private placements. At present, only large, established companies with proven track records can access the Philippine capital markets through a public securities offering. Small and young companies can privately place their securities, but the SEC's rules on private placements and limited offerings are not helpful: There are no safe harbor rules that qualify an offering as limited or private. Thus, relaxing and clarifying the rules on private placements could create a market for privately placed securities and give small companies access to funds. Some of these companies, over time, should grow and become qualified to offer their shares to be publicly traded on the stock exchanges. Therefore, it is suggested that the SEC promulgate safe harbor rules on the private placement of securities, define what constitutes a private placement, and eliminate the requirement for a special exemption from the payment of fees.

Legal and Regulatory Framework

2.253 The Revised Securities Act (RSA) of 1982 and Presidential Decree 902A of 1976 are the basic legal foundations of the securities markets. They regulate the distribution of securities, the operation of markets, and the activities of intermediaries in the markets, and they specify the powers and responsibilities of the Philippine Securities and Exchange Commission (SEC). The RSA is based on the U.S. Securities and Exchange Act of 1936. It is basically sound, but market developments have made reforms necessary. The principal limitations of the Act are as follows:

- The SEC has inadequate power over entry and exit of intermediaries in the industry, the rules of self-regulating organizations (such as the stock exchange), and the securities market activities of banks and quasi-banks;
- The SEC's jurisdiction is overly broad and causes it to spread its resources too thinly;
- The SEC can determine the offer price of securities and other matters that should be left to the market;
- Market manipulation and insider trading are not sufficiently well defined, making successful prosecution difficult.

2.254 Other laws relevant to securities markets (such as the Corporation Code, Investment House Act, Financing Company Act, Omnibus Investment Code, and Foreign Investment Act) are also basically sound but require amending to bring them into line with modern practices. Most important, the Corporation Code should better protect the interests of minority shareholders and define the powers of company managers; the Investment House Act should allow underwriting by stockbrokers. The SEC is currently finalizing a draft of a proposed bill to reform the Investment Company Act. It has also initiated work to amend the RSA, the Corporation Code, and the Investment House Act.

2.255 The SEC's own rules urgently need to be consolidated and updated. The last consolidation was in 1986, and it is now very difficult for even the SEC staff to easily determine which rules apply to a particular situation and what precedents exist to help interpret the rules.

2.256 The SEC has not been able to perform its mandate effectively, and its strategic goal is not clear. While the scope of its activities has expanded considerably since 1976, budget constraints and the inadequacy of its organizational structure have not allowed it to adequately regulate the capital markets or enforce regulations. On the other hand, it has issued rules and regulations, in an ad hoc fashion, that have not yet been codified, creating uncertainty for market participants.

2.257 There is considerable overlap among the SEC's departments and divisions, and much duplication of legal and statistical research activity. Interdepartmental coordination seems to be ineffective, and most work is done manually, without a computer. The procedures for monitoring the activities of registrants and securities' issuers are cumbersome and inefficient. Because of outdated data storage and retrieval systems, the SEC's ability to compile and publish timely information on securities, for the benefit of both investors and issuers, has been greatly constrained.

2.258 The SEC lacks the necessary resources and staff to effectively carry out its mandate. The 100 or so financial staff cannot handle the increasing volume of registration and monitoring functions, which now involve scrutinizing more than 30,000 financial statements a year and making more than 3,600

field inspections. Moreover, commissioners seem to be overwhelmed by daily administrative and operational matters, a problem aggravated by budget constraints, which make it difficult to train, attract and retain qualified staff. It is recommended that the SEC:

- Divest its non-regulatory functions and limit its activities to capital market regulation;
- Reorganize to allow more personnel to regulate the capital markets, and to strengthen enforcement;
- Recruit more economists and financial sector experts as well as lawyers with corporate experience;
- Increase self-financing revenues;
- Emphasize self-regulation for the stock exchange.[64]

2.259 The Commission should direct its activities away from voluminous, routine record keeping toward closely-focused market monitoring and targeted enforcement through administrative and legal action. To achieve tangible beneficial results from this reorientation, the management systems, staff skills, and computer support systems will all have to be upgraded. Such a program is planned by the Asian Development Bank (ADB) under a technical assistance program which started in late 1993, as well a USAID-financed program.

2.260 Although the SEC is the principal regulatory authority in the securities markets, several other agencies also have a role. To eliminate duplication, it is suggested that the current system be replaced with one based on regulation by function, with clear cooperative mechanisms between regulatory agencies. Most notably, the SEC should be given clear jurisdiction over the public offering and trading of securities issued by banks, quasi-banks and public utilities. The present division of responsibilities among the SEC, the Ministry of Finance and the Central Bank in this area is anachronistic. Similarly, administration of the Financing Company Act should be made the responsibility of the Central Bank, not the SEC, as the institutions it covers are primarily involved in the provision of credit.[65]

Prudential Regulations

2.261 A major weakness of the securities system in the Philippines is the lack of sound prudential regulations. Three principal aspects are described in the paragraphs that follow.

2.262 **Adequate Capital**. Current regulations require that a broker/dealer have paid-up capital of ₱ 10 million.[66] As a matter of priority, the SEC should instead establish rules that they maintain a minimum adjusted net capital as a share of their assets, in line with other securities' markets.

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64 The SEC as one of the conditions in the license issued to the Philippine Stock Exchange that "it shall set up the corresponding systems and mechanisms necessary for a self-regulatory body."

65 Under the CMA Act, the BSP is supposed to transfer its regulatory powers over finance companies without quasi-banking functions to the SEC within a period of 5 years. The BSP will supervise only those with deposit-taking functions.

66 The paid-up capital requirement has been recently increased from ₱ 3 million.

2.263 **Prudential Supervision**. The system should require record-keeping by stockbrokers in a standard form prescribed by the SEC, frequent reporting of financial positions, immediate reporting of failure to comply with the capital requirements and a program of on-site compliance audits by the SEC.

2.264 **Investor Protection Fund**. The Securities Investor Protection Fund (SIPF) needs to be restructured to fulfill its mandate as the second line of defense against loss to clients from the financial failure of an intermediary. At present, the rules and procedures of the Fund are unclear, its management is not sufficiently professional, and its pool of funds is inadequate. For example, there is no clarity concerning whether the Fund can pay out only after the liquidation of a broker or whether it can compensate a client for loss from fraud or other illegal activity. There has been only one payout. And finally, the total amount available in the Fund is currently ₱ 13 million with a limit on any one payout of a maximum of ₱ 40,000.[67] Both these amounts are inadequate for the size of the domestic market.

Disclosures

2.265 The quality and quantity of information disclosed about public companies are inadequate, which hinder further healthy development of capital markets. Although the accounting profession in the Philippines is developed and a body of accounting rules and auditing practices has been adopted by the professional bodies, the quality of financial information disclosed about public companies is very poor in practice, and the lack of joint ventures with foreign partners as well as of direct foreign borrowing contribute to this problem. Comparisons between companies and between periods for the same company are very difficult to carry out. The accounting profession needs to update its rules and practices to conform with international standards, and to supervise its members in order to improve the uniformity and standards of financial disclosure.

2.266 At the time of an initial public offering of securities, a prospectus must be registered by the SEC and the offer to the public approved. The disclosure requirements are reasonably complete. although a comparison of domestic and international offer documents highlights some areas of concern. Most of the deficiencies are addressed in proposed disclosure requirements contained in a draft listing manual prepared by the two stock exchanges in 1989. These should be implemented as soon as possible by the SEC and the exchanges; the SEC's reluctance to approve the changes before completing the merger of the two exchanges unnecessarily delayed the changes. The audited financial statements included in a prospectus should cover a period ending no longer than six months prior to registration of the prospectus (the current regulations allow for a year). A risk statement should be required specifying the risk factors an investor should take into account when assessing the offer. Profit forecasts should *not* be required in a prospectus and, when they are included, a clear statement of the basis for calculating the forecast should be given (at present they are mandatory for all prospectuses and little or no justification for their magnitude is given).

2.267 The Revised Securities Act requires public companies to produce and distribute an annual report with audited financial statements. The listing rules of the exchanges require companies to lodge with them copies of annual and semi-annual reports. These requirements are generally acceptable but are weakened by the relatively poor quality of the financial reporting and the propensity of companies to include overly optimistic assessments of past and future profitability with insufficient justification. The SEC and the exchanges should monitor the quality of the reports more closely to ensure that they are in line with the spirit of the regulations. More fundamentally, continued effort must be made to improve

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[67] The maximum payout was recently revised from ₱ 10,000.

the professionalism of the accounting and auditing professions and the clarity and completeness of the standards and practices used in preparing financial reports.

2.268 In line with international practice, two forms of continuous disclosure are mandated: that of information about the company and that of the holdings of substantial shareholders in the company. Reform is suggested in both areas. Disclosure to the market of material information about the company is hampered by an unclear definition in the SEC and stock exchange rules of what must be disclosed and by out-of-date procedures that have been unable to prevent many inequities from arising in recent years. The rules should be modified to better specify the parameters of the information to be disclosed, and the procedures should be changed to require simultaneous disclosure to both exchanges in a way that allows release of the information to the general public on a fair and equal basis. The requirement to disclose substantial shareholdings has been widely avoided. To facilitate disclosure, the disclosure threshold should be reduced from the current 10 percent (a very significant holding in the Philippines) to, say, five percent, and disclosure should be enforced on a continuous basis.

Rules on Proxy Solicitations and Tender Offers

2.269 Another weakness in the regulatory system is the lack of clear guidelines for conducting proxy solicitations and tender offers. The RSA provides that the SEC shall prescribe the rules necessary or appropriate to protect investors with regard to the solicitation of proxies or authorizations. The RSA also requires that the SEC provide rules on the information that must be stated in connection with tender offers or invitations or requests for tender offers, and empowers the SEC to promulgate rules on the tender offer process. Only limited rules have been promulgated, leaving participants in a proxy contest or a tender offer without sufficient guidelines. It is, therefore, suggested that more comprehensive rules be promulgated.

Stock Exchanges

2.270 Until recently, the Philippines had two stock exchanges — the Manila Stock Exchange (MSE), founded in 1927, and the Makati Stock Exchange (MKSE), which began operating in 1963. The lack of computer linkage between the two had created a number of problems. Apart from making operations (trading automation, central depository, and so on) more costly, it also resulted in policy differences and variations in enforcement. It further led to different pricing of the same securities, creating opportunity for arbitrage, and hence divided the limited demand and supply. Moreover, since the operations of the two exchanges had not been harmonized, corporations had to deal with dual fees and reporting requirements.

2.271 The President, through the SEC, revoked the licenses of the Makati Stock Exchange (MKSE) and the Manila Stock Exchange (MSE), and allowed the operation of a unified stock exchange, the Philippine Stock Exchange (PSE) in March 1994. The new exchange is now operating. Although there are still two trading floors, both are already electronically linked and one price list for each listed share is posted by the PSE. To send a clear signal to investors that the PSE is determined to guard the integrity of the stock market, it appointed an outsider as president of the new exchange. Upon the commencement of its operations, the PSE began loading stock issues into its own computer system. Finally, on March 25, 1994, all 289 listed issues had been phased into the order routing system. On the PSE's first month of operation, the PSE Board approved the general and trading rules of the PSE.

2.272 To facilitate the turnover of management functions, record and documents from the MSE and MKSE to the PSE, SEC formed ad hoc committee in March 1994. SEC plans to set up a

computerized link with the PSE by 1995 in order to monitor the daily trading activities of the PSE and to take immediate action on any unusual or unexplained stock movements.

2.273 PSE plans to set up an automated central clearing system to more effectively transfer records of ownership of traded stock and give investors easy access to information on listed issues. To broaden the ownership base on listed companies, PSE also plans to set up trading terminals in strategic public areas throughout the Philippines.

Integrity of the Capital Markets

2.274 Although the Philippines has adequate legislation to protect against insider trading, the SEC has not been effective in enforcing the laws, enabling trading abuses to erode investor confidence. Under Section 30 of the RSA, the SEC is responsible for enforcing insider trading rules. Section 30 identifies insiders and precludes them from making unfair use of material information. This provision has been enhanced by a number of SEC rules, and other modifications may be made to Section 30 to penalize insiders who do not purchase or sell a security but merely pass on insider information.

2.275 The RSA also contains anti-fraud provisions that are broad enough to prohibit and penalize any manipulative practice or fraudulent transaction, but the SEC has not used these provisions to prosecute or even make rules regarding manipulators of the stock markets. In addition to its anti-fraud provisions, the RSA also grants certain express rights of action to persons who suffer damages arising from fraudulent acts, but these provisions, too, are not being enforced. The SEC, in close cooperation with the exchanges, should begin to combat fraud and insider trading by strictly enforcing the provisions of the RSA.

2.276 The stock exchange must demonstrate its commitment and capacity to effectively regulate its members. Establishing an effective self-regulatory capacity in the exchanges is vital. Unless confidence in the functioning of the market is substantially enhanced, it is unrealistic to expect a major inflow of foreign institutional portfolio investment in securities. This may impede financial sector development and limit the availability of long-term investment funds for private industry.

2.277 Given the need to build up the necessary skills and commitments to make self-regulation a success, the main emphasis should remain on ensuring that the SEC fulfills its regulatory functions effectively. The capacity of the SEC to undertake its work should be built up quickly. But, the self-regulatory role of the recently merged exchange should be developed at the same time so it can ultimately play its part in a modern securities market.

2.278 The exchanges' listing requirements contribute to a narrow investor base. The main requirements include (a) a minimum authorized capital of ₱ 100 million, with a subscribed capital stock of ₱ 25 million and paid-up capital of ₱ 12.5 million; (b) distribution of 25 percent of the authorized capital through brokers in equal shares; (c) a minimum of 300 shareholders; and (d) the submission of necessary documentation. The requirement for 300 shareholders, in particular, limits broader investor participation by allowing the issuer to distribute shares among employees, relatives and friends. This tends to make shares less available to small investors, especially in the case of blue chip securities such as PLDT or the San Miguel Corporation.

2.279 Stockbrokers. There are 76 active brokers on the Makati Stock Exchange and 59 on the Manila Stock Exchange, but nearly half of the business by value is transacted by only 15 brokers. Securities intermediaries in the Philippines consist of a large group of individual and small incorporated

brokers with relatively limited capital and a small group of large incorporated brokers who have access to large amounts of capital and are increasingly professional and innovative in their operations. The larger brokers find it to their advantage to support many of the modernization proposals for the Philippine market and can usually adapt their operations to a changing environment without great difficulty. The smaller brokers are at a disadvantage, however, and often oppose needed reforms. Their opposition has often been instrumental in holding up essential reforms, for example, the introduction of a comprehensive prudential regulation system.

2.280 **Risk Assessment**. The Philippines has a publicly owned credit rating agency. Its fees are inadequate to enable it to recruit, train and retain good-quality staff. Unsatisfied with the services of this agency, the Bankers Association of the Philippines set up its own credit investigation agency in 1991, called the BAP Credit Bureau Inc. Banks exchange information about borrowers, unpaid checks, canceled credit cards and other relevant credit information. The BAP is planning to extend its services to non-member banks. It is suggested that the institutional capabilities of the existing agencies be strengthened, given that a credible system for rating bonds is a necessary element for a fully functioning capital market.

Conclusions

2.281 The financial sector of the Philippines has not performed as well as its ASEAN neighbors in recent years. The growth of the financial sector has been constrained by economic and political crises in the past decade, directed credit programs, distortionary taxes, large losses of the CBP, and the crowding out of the private sector in financial markets. The financial sector's small size, high real domestic interest rates, intermediation costs, lack of long-term financing, and the oligopolistic structure of the sector, coupled with restricted bank entry, have constrained access to credit, particularly for small and young companies. The GOP should therefore take corrective measures to address these problems to increase long-term domestic resources and credit for private sector investment. To reduce the crowding out of the private sector, the GOP should intensify its efforts to improve its macroeconomic performance, especially on the fiscal side. Until this is accomplished, many of the restrictions, including those on local and foreign bank entry, could be phased out to enhance competition and improve access to finance by the private sector.

2.282 Poor macroeconomic performance, an uncertain political climate, and the lack of market integrity have retarded the development of the Philippines capital market in relation to its neighbors and comparably sized countries. The securities markets have not contributed to financial sector development and economic growth in the way they have in Thailand or Malaysia, for example. There is a need to make concerted efforts to implement the much needed reforms in the structure of the securities market, the regulatory framework, prudential regulations, disclosure requirements, and professionalization of the stock exchanges. The reform programs contemplated under the ADB's proposed program loan for capital market development should promote the equity market.

2.283 If properly implemented, these measures, combined with political and macroeconomic stability, should accelerate development of securities markets and increase the pool of domestic resources for private sector operations and investments, facilitate privatization, and provide financing for infrastructure projects.

III. STRATEGY

A. World Bank Strategy

The Government Program

3.1 Since economic growth is ultimately linked to the success of the private sector, the Government will need to intensify its efforts to carry out economic reforms that will help it develop efficiently. Until now, the Government has introduced some adjustments, but their full potential has yet to be realized: At present, the private sector still has lower investment rates, is less productive and exhibits less export push than in Korea, Malaysia and Thailand (as discussed in Chapter I). Thus, reforms will need to be more comprehensive, introduced as a package, well sequenced, and implemented quickly (see the attachment to the Executive Summary for an outline of the recommended reforms).

3.2 Successive Governments since 1986 have introduced a series of reforms to make the domestic economy more efficient. As a result, major economic distortions have been addressed. These reforms focused on the following:

(a) Macroeconomic stability - In the context of major external shocks, domestic political problems, and a high external debt, authorities intensified efforts to raise revenues — including the recent passage of the law to expand the scope and coverage of the VAT — limit public expenditures, and implement a restrictive monetary policy, and recently reaching an agreement with the IMF on a three-year Extended Program to successfully complete stabilization;

(b) Trade policy - Various reforms reduced the non-tariff barriers on imports and lowered the level and dispersion of import tariffs. The maximum import tariff rate was decreased from 100 percent in the early 1980s to 50 percent. Together with liberalizing the exchange rate, authorities have started to make the incentive regime more favorable for private production and investment;

(c) Liberalization of foreign investment - The Foreign Investment Act, introduced in 1991, relaxed restrictions on foreign investment and opened a number of sectors to FDI. Government actions in 1994 further lessened constraints to FDI;

(d) Privatization - A large number of Government-owned and operated enterprises were privatized. The private sector was allowed to generate electricity through BOT and BOO schemes, and the Congress passed a law to institutionalize the role of the private sector in the power sector;

(e) The financial sector - Interest rates were liberalized, two major public banks were recapitalized, directed and subsidized credits were greatly reduced, the Central Bank was restructured and recapitalized and foreign bank entry was allowed;

(f) Competition policies - The Government began to ease entry into a number of sectors, including telecommunications and inter-island shipping;

(g) Agriculture liberalization - Agricultural monopolies were dismantled, especially in sugar and coconut trading;

(h) Transport regulations - Those pertaining to entry by the domestic private sector were liberalized.

3.3 At the end of 1993, the macroeconomic situation was substantially improved (see para. 2.6). Nevertheless, local and foreign business groups will still need to be assured that macroeconomic conditions will be stable, due to the continued weakness in public finances and the structure of external accounts, despite economic policy reforms. Thus, continued efforts at macroeconomic stabilization are essential to restore business confidence and encourage private investment.

3.4 The political situation today is much more stable than at any time in the recent past. Threats of coups have almost become non-existent; also, the President has built strong political support among the leadership of both the Senate and the House. The improved coordination in policy making between the executive and legislative branches was demonstrated when Congress granted the President emergency powers to deal with the energy crisis, the passage of the laws on foreign bank entry, the BOT and VAT laws mentioned in para. 3.2 above. The Government also appears committed to encouraging competition in markets dominated by monopolies and has required the PLDT to improve its performance and raise its investments and opened the sector to greater competition. These are positive steps, but the change in power relationships is still evolving. Moreover, continued — albeit declining — security/kidnapping problems remain an area of major concern to investors, especially foreigners.

3.5 The next stage of the reform effort must focus on four key areas (a) creating and maintaining an enabling environment in which the private sector can develop; (b) establishing contestable markets and reforming the judiciary; (c) eliminating the anti-export bias of the trade regime and moving the incentives regime toward neutrality between exports and import substitution; and (d) addressing the crowding out of the private sector in the domestic financial markets to enable it to expand and develop. If these reforms are carried out on a timely basis, the Philippines will have an internationally competitive economy, able to attract high levels of foreign investment and, ultimately, achieve sustained economic growth.

3.6 Success in achieving efficient private sector development will depend on good governance — strong leadership, a sense of urgency and a commitment to implement the policies. In addition, remaining entry barriers must be eliminated and trade liberalized further, as these actions will also stimulate the development of small and medium enterprises. However, because of past policy reversals (in part due to external shocks and internal domestic problems), the Government will need to establish a track record that can instill investor confidence. The Philippines must attract foreign direct investment to a much greater extent than most of its neighbors, given its low domestic savings. With these goals realized, the industrial and infrastructure sectors are expected to be the main engines of growth in the next few years, in line with the medium-term development plan.

3.7 To create an enabling environment for the private sector, the Government must continue to promote macroeconomic stability and improve and expand the country's dilapidated infrastructure (much is old, but some has simply not been adequately maintained). In fact, if recommended reforms are not fully implemented, the payoff from the overall adjustments will be greatly reduced. Also, the reforms will need to include measures to vastly improve the country's administrative capacity for effective implementation and enforcement.

3.8 Strengthening regulatory agencies along the lines described in Chapter II is the key element of regulatory reform, especially for infrastructure. Moreover, competition reform, by inhibiting private restraints of trade, should increase the efficiency and flexibility of domestic markets and enhance the effectiveness of other structural reforms.

3.9 In promoting good governance, authorities will need to continue decentralizing various government functions. Until now, they have devolved some responsibilities to the local government level and started transferring some budgetary resources. However, decentralization, if not well managed, can strain local government capacity and could lead to fiscal imbalances, with the National Government (NG) ultimately covering part of the costs. Thus, the NG must adjust the pace and provide technical assistance for effective implementation. (Annex 24 discusses the possible impact of decentralization on private sector development).

3.10 As part of the decentralization efforts of the past two administrations, governors (in Bulacan, Cavite, Cebu, and Negros Occidental) have been able to stimulate local economic growth; and, at present, the Government is converting Subic Bay facilities into an export processing zone with Bank-financial support. If the concept is expanded and the area is turned into a free port, the same model could be applied to a limited number of other ports and this, in turn, could expand trade and provide jobs.

3.11 Incentives, which should be introduced over time, will involve acceleration in trade reform, a phase-out of QRs, a review of the minimum wage, accelerated depreciation, non-operating loss carry-over, and an expedited payment of tax rebates in the export drawback system.

3.12 Future reforms must also address the crowding out of the private sector in financial markets: To achieve this, tax revenues must be increased. In fact, when compared to its neighbors, Philippine taxes are considerably less as a percentage of GDP. Thus, the Government has relied on foreign borrowing to finance its major investments and public external debt was US$29 billion, or 61 percent of GDP in 1993. Moreover, some of the projects for which the Government has borrowed have been inefficient or never used, such as the Bataan Nuclear Power Plan (see para. 2.83).

3.13 In addressing the four broad areas of reform, both the public and private sectors will have to adopt new roles and the traditional relationships between business and Government will need to be redefined. One advantage for the Philippines is that, unlike other countries, it has a small public sector which accounts for less than one-fifth of GDP. Nevertheless, it will have to shrink even more, although this is but one of several issues. Also, the Government will need to continue to address fiscal disequilibria by raising non-distortionary revenues and reducing low-priority expenditures, while it increases infrastructure investments. But, perhaps more importantly, it will have to (a) strengthen its regulatory functions so as to establish and maintain contestable markets and hold the private sector accountable to improve efficiency; (b) assume the role of a neutral arbitrator by creating a level playing field between different private sector firms, foreign and domestic firms and the public and private sector; and (c) continue to minimize its interventions that, in the past, led to macroeconomic and sectoral distortions. Policies and programs to support this process must seek to attract high levels of direct foreign investment into large infrastructure and export-oriented projects, high-priority labor-intensive sectors, and joint ventures with Philippine nationals.

3.14 For its part, the private sector will need to adopt new approaches. In general, it will be called upon to take more risks, invest more in infrastructure and industry than until now, produce more for export and introduce new technology — and in this way, compete more effectively in international markets.

3.15 Obviously, private sector development is not an end in itself; rather, it is needed to stimulate the economy and sustain growth in incomes and employment. Therefore, policies that promote greater competition and contestable markets in the domestic economy will support the overall goals.

3.16 Given that the four areas of reform are tightly interrelated, the next stage must be introduced as a package. For example, even if financing becomes available to ease the crowding out, increased private investment will materialize only if the remaining barriers to entry and efficient production are removed. Similarly, benefits from competition policies cannot be fully realized unless the judicial system is reformed. In the same way, trade liberalization cannot be accelerated and crowding out cannot be ended unless macroeconomic stability is fully restored. Further, contestable domestic markets cannot be created until trade is further liberalized.

3.17 Reform efforts are difficult given expected opposition from vested interests and will likely take time to bear fruit; nevertheless. they have to be intensified and carried out more rapidly. The adjustments will need to be carefully sequenced.

3.18 Although the Government is addressing some elements of this agenda, progress in other areas has been uneven. In trade reform and privatization, it is widely believed that the pace of reform has been slow: For example, continued monopoly privileges for business groups can undermine the credibility of the reform agenda (there are signs now that a new competition law could pass the legislature). In addition, judicial legal reform is long overdue. With regard to foreign direct investment, a positive step was the relaxation of restrictions in 1991 and continued reforms since then, but many still remain. Further, the prudential regulations governing the financial sector need to be strongly enforced as currently envisaged under the recently enacted Central Monetary Act. Because these issues persist, investors are waiting to see whether reforms are implemented before committing significant funds.

3.19 Implementing the needed reforms to ensure greater competition and to develop the institutional and support framework is likely to involve significant political costs, but the gains for the economy as a whole will likely far outweigh them.

3.20 The Bank's overall assessment is that there is now a window of opportunity for the country to achieve sustained economic growth. Authorities have moved to put some reforms into place, begun to open up the economy, and deregulate markets; if they move decisively to sustain these improvements and deepen the structural reforms recommended in this report, the key elements will be in place for strong economic growth.

Past Bank Assistance and Status of the Portfolio

3.21 The most critical part of the World Bank's assistance program has been its macroeconomic analysis, which developed a common position with the Internationai Monetary Fund (IMF) and informed Consultative Group members about the state of the domestic economy and the prospects for growth and balanced development. Also, World Bank reports have helped orchestrate the dialogue and mobilized substantial external aid flows. At present, the Bank is engaged in a number of economic and sector studies that will help define and analyze development issues and formulate lending strategy in key sectors. Reports on managing natural resources and the environment, and on the energy, financial, and education sectors were completed during 1990-93. The last Country Economic Memorandum (CEM) focused on resource mobilization and expenditure allocation, and the recently completed Basic Economic Report (BER) examined key issues in the government, corporate, and household sectors. Other economic

and sector work completed since 1990 has included studies on capital markets, family planning, irrigated agriculture, and fiscal decentralization. The Bank is currently undertaking a study on infrastructure, the power sector and health care, along with a CEM update.

World Bank Strategy

3.22 The Philippines faces challenges in meeting the three major requirements for growth — improved incentives, institutions, and investments. The World Bank can assist in investment lending to expand infrastructure capacity and strengthen the implementing institutions and institutional framework. Already, it has helped the Government finance projects in urban health and nutrition, power transmission and rehabilitation, geothermal projects (Leyte-Cebu and Leyte-Luzon), Subic Bay, tax computerization, and irrigation, as well as in external debt and Central Bank restructuring. For FY95, the Bank plans to appraise the following projects: women's health and safe motherhood, electricity system efficiency, Manila sewerage and water resources development. Further, the Bank may consider helping Government efforts in promoting decentralization, creating trade, building institutions and improving the budgetary systems and customs administration. It would also be useful to explore options to work individually with local governments on relevant private sector development issues.

3.23 In **power**, the Bank plans to be involved in financing generation and transmission as well as ensuring proper implementation of policies conducive to the uninterrupted growth of the sector. In **telecommunications**, the Bank's further involvement will depend on the financing needed to increase telephone coverage, including areas not well covered (such as rural parts of the country). However, the Bank's involvement for the sector hinges on the following (1) solutions should be private; (2) competition in the sector should be enhanced and entry barriers removed; and (3) supply should be expanded and efficiency in investments should be sought. In **industry**, it is anticipated that the Bank will selectively intervene in the areas of pollution and SME development through appropriate lending instruments. Regarding the **institutional framework for private sector development**, an area in which further progress is essential to ensure efficient economic growth, the Bank should also play a key role, including inter alia providing a large dose of technical assistance over a number of years. In **privatization**, the Bank may selectively intervene to ensure orderly implementation of further actions while ensuring an appropriate regulatory framework.

3.24 In **transport**, the Bank's strategy is to build on the progress made under the Highway Management Project, formulate a road network management program and increase expenditure for road maintenance. The Bank is preparing a Maritime Sector project to improve service levels, correct price distortions and increase competition on inter-island shipping and improve efficiency at ports.

3.25 In **agriculture**, production and marketing are mainly private sector activities. Thus, lending would largely concentrate on necessary public infrastructure, improved delivery of credit to small scale farmers and rural enterprises, and upgraded support services including research and extension. It would also promote the participation of beneficiaries through user groups and NGO collaboration. The policy dialogue will continue to press for continued and consistent liberalization of trade for agricultural products; this will involve reducing protection and subsidies. Equally important, uncertainties associated with agrarian reform will need to be eliminated in order to increase investment in agriculture. To enhance international competitiveness in agriculture, the Bank is preparing a project on rural infrastructure. Also, it is supporting national irrigation investment programs that emphasize low-cost communal and run-of-the-river systems, while transferring management responsibilities and O&M costs to user groups.

3.26 In **education and training**, although the Bank has lent significant amounts, a change in approach is now warranted; it should move away from physical construction towards improved quality and greater economies. Also, programs should provide instruction in mathematics, science and technology to improve the technical skills of the labor force.

3.27 Although the Philippines has adequate foreign exchange reserves, the cyclical economic growth pattern, which characterized past decades, does not yet seem to have been eradicated; and, if balance-of-payments problems emerge, the Bank should also be ready to provide BOP assistance.

3.28 **The Economic and Sector Work (ESW) Program.** A strong ESW program is needed to deepen the World Bank's understanding of the factors that constrain private sector development and to support the Bank's sector lending operations. For FY95, studies will be conducted on public expenditures, cooperatives and privatization in agriculture and NGOs. The emphasis will be on cross-sectoral and sector issues such as institutional, legal and regulatory reforms, competition policies, and the overall framework for the private provision of public services. Regarding the former, the ESW will continue to focus on macroeconomic issues and incentives and pay increasing attention to other critical issues, such as competition policies.

3.29 **Bank Interface with the Private Sector.** Although Bank lending will still be geared to the public sector, the objective of its financing activities will be to ease the constraints on private sector development as identified in this report. The Bank will build upon the IFC's established and newly emerging interaction with both the local private sector and prospective foreign investor companies. In addition, the experience of the past few years has shown that the World Bank, the IFC and the Multilateral Investment Guarantee Agency (MIGA) need to work jointly to help the private sector meet some of the financing gaps. The Congress ratified the MIGA convention in November 1993, making the country eligible for MIGA services to investors; exploratory discussions are expected soon.

3.30 The recently completed Brady deal restructured the country's external debt and greatly improved creditworthiness. As a result, the Philippine public sector was able to re-enter international capital markets, as did domestic companies as well. Evidence of improved creditworthiness includes: the GOP's successful US$150 million Eurobond issue at 320 basis points above US Treasuries, which was subscribed in full in February 1993; sizeable private financing packages, including a power project of US$900 million (of which US$250 million is from private sources); PLDT's US$300 million equity offering in 1992; and portfolio investment in 1992 of US$375 million. The most recent price of Philippine debt paper on the secondary market was US80c on the dollar, up from US50c cents two years ago. However, access to foreign markets still seems restricted except for a few of the large companies: It is likely that only about 10 of the largest and most profitable public and private Philippine companies could raise funds from international capital markets. Moreover, the public sector's further access to international capital markets will probably be restricted to limited security offerings. Although access to international capital markets is limited, it is still better than it has been in the recent past; thus, neither public nor private entities should rush imprudently into international capital markets, since this could endanger the country's improved prospects. As a result, Bank instruments to support private sector investments will still be required over the next few years. According to Bank policy, such lending will require Government guarantees.

3.31 The Bank's Board of Directors issued guidelines in April 1992 stating that the institution should finance a private company only if (a) the commercial market cannot provide the required funds; (b) the IFC does not plan to provide the funds; and (c) the policy environment for the sector or operation in question is suitable. In the past, financing for private sector development was channeled through

Government-owned financial institutions (GFIs), with the resources designated for investment financing by a specific company under suitable onlending arrangements. In the future, the Board's criteria will apply to each project at appraisal; thus, in justifying specific projects, evolving market prospects will need to be closely monitored. Where it is established that the market cannot provide the needed funds, the Bank will consider assisting the project. The Bank's strategy should be to provide funds in key sectors that may face capital market imperfections. For large, creditworthy private sector borrowers, ECOs could be used. In each case, the market imperfection should be clearly identified as a precondition for the operation.

3.32 To deal more effectively with private sector development issues, the Bank needs to establish institutional contacts with different private groups. In some countries, this interface is now formally promoted. In the Philippines, the Bank should explore ways to foster this relationship, both through direct contacts as well as through various private sector organizations. This should enable the Bank to better gauge the issues the private sector confronts.

B. IFC Strategy

3.33 The principal message in this report is that the prospect for a resumed private sector investment and growth is good provided that:

- A comprehensive program of infrastructure development (covering power, transport, and telecommunications) is implemented.
- Priority is given to market-based strategies that encourage higher domestic savings, increase equities and securities participation from abroad, and reduce the crowding out of private investment by the public sector.

3.34 The difficulties that private investors (including IFC) have encountered in completing projects in recent years have been mostly due to problems in the above-mentioned areas.[68] Although many large-scale private projects have been able to proceed (including the Hopewell Power project, Shell refinery expansion and several hotel projects), all have involved complex and extended financial negotiations that have been made more difficult by the country's debt burden and limitations on foreign borrowing. The investment opportunities that are opening up to private investors have yet to be matched with an improved environment for market-based mobilization of funds; and, from IFC's perspective, this issue remains central to any strategy for private sector development. In addition, infrastructure constraints continue to depress productive investment across a range of sectors. Notwithstanding the improvements that have taken place in the trade regime, foreign investment policy, and foreign exchange access, there will be few incentives to undertake new private investment until more power, better roads, more cost-effective shipping, and expanded telecommunications services are made available. In these areas as well, IFC has a strong interest in seeing regulatory and administrative improvements that will remove bottlenecks to the private delivery of public services.

3.35 IFC's ability to support the reform process will continue to evolve in response to the constraints and opportunities which are reshaping the business climate for private sector investors. The

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[68] While constraints such as legal vagaries (which led to the abandonment of the Luzon Petrochemical project) and foreign ownership restrictions (which have prevented a satisfactory restructuring of NONOC) have also been important.

most immediate constraint to business development has been the shortage of power generating capacity, but as this constraint is now easing, a pickup in investor interest is anticipated. A related development influencing IFC strategy are ongoing policy reforms which are opening up new areas of activity to private investors both in infrastructure and through privatization. These new reforms are helping to redefine the respective roles of IFC and the Bank and as new initiatives are announced during the course of 1994, IFC will determine the appropriate levels of investment and advisory inputs on a case by case basis. Another major factor shaping IFC's strategy in the Philippines is the prospect of greater funds mobilization by private investors on domestic and international markets. It is anticipated that the Philippines will continue to improve its external financing status during 1994 which in turn will make mobilization by private firms of equity, securitized loans and commercial bank loans from abroad easier to secure. The extent of private sector funds mobilization from abroad (which will influence the volume of IFC-related activity) will depend on government limiting its external borrowing requirements. On domestic markets also, the prospect for increased mobilization of long-term investment capital will depend on limiting the growth of government borrowing and reducing the amount of crowding out that has taken place in recent years. Domestic equity remains a critical constraint for many large-scale projects, and IFC will continue to play an active equity mobilization role.

3.36 In addition to direct investment activity, IFC is also providing fee-based **advisory services**, covering privatization, restructuring, and BOT projects. Projects under preparation, as well as future prospects, include major involvement in private energy schemes, and the industrial sectors. IFC is also working on advisory assignments in the mining sector. IFC will remain active in supporting activities which contribute to increased competitiveness of the industrial sector and create new employment opportunities.

3.37 In the **financial sector**, IFC is supporting a local currency loan guarantee scheme and has equity participation in two Venture Capital Funds. The latter is supporting the growth of capital markets in the Philippines which suffer from a shortage of long-term financing. With it, IFC will help develop the Philippines' nascent venture finance industry and mobilize scarce equity capital for small industrial enterprises that lack access to capital. In addition, IFC is considering participating in the restructuring of commercial banks and is assessing the requirements for creating new investment vehicles (mutual funds, investment companies) for mobilizing equity and loan funds through domestic markets to support large-scale investment activity.

3.38 The past three years have set the scene for a rapid and sustained takeoff of private investment in **infrastructure** in the Philippines. Although IFC has been a MERALCO investor since 1966, and made its first investment in PLDT in 1969, these operations did not kindle the same broadly based investor interest in Philippines as did IFC's support for the Hopewell Navotas power project in 1989. This project demonstrated the willingness of investors to construct and operate a large fixed investment under a limited-term operating agreement, and the willingness of lenders to provide project financing for such investments on a limited recourse basis. IFC's more recent support for the much larger Hopewell Pagbilao power project, and for the "fast track" power projects commissioned to overcome the short-term power crisis in the Philippines, reinforced the view that private investors can provide timely, and low cost solutions for infrastructure needs and that financing for private projects can be arranged. Investors are now active in power, telecommunications, and transportation sectors, although the backlog of needed investments in these key sectors is still large.

3.39 New investment opportunities for private companies are just now emerging, and the Government's eagerness to embrace a private sector approach to management and operation of infrastructure operations has been instrumental in fostering a sound basis for the new activities. The roles

for the IFC and the IBRD in the Philippines are evolving to reflect the new roles that Government and private investors are shaping for themselves in infrastructure sectors.

3.40 IFC, for its part, is seeking to assist on several fronts. First, in line with its broad mandate to assist in the development of the private sector, IFC will be looking for opportunities to use new financing requirements for private infrastructure projects to develop borrowing instruments that will help widen and deepen Philippine capital markets. One of the major benefits from the infrastructure privatization, from IFC's point of view, is in the general development of capital markets, as a means of mobilizing private savings, independently of the more traditional route for the sector of government-guaranteed financing.

3.41 Second, IFC has the expertise to advise on the process of private participation in infrastructure, particularly with a view to ensuring the appropriate allocation of risk between public and private parties. IFC is accumulating a substantial body of knowledge on a broad front on how private participation in infrastructure can be managed, and has an array of models for contractual and regulatory arrangements that fit a number of circumstances. In particular, IFC is in a position to ensure that any continuing government participation in project operations or management (say through so-called golden shares, or board membership) does not pose unnecessary risk for investors or lenders.

3.42 Last, IFC stands ready to consider requests from sponsors to assist in structuring investment projects, and to participate in their financing, particularly for projects that have potential to act, as the Hopewell deal, as catalysts for expanded private sector operation and management of infrastructure sectors. The willingness of the Philippine Government to embrace private sector participation in the delivery of infrastructure services owes a lot to the experience gained through earlier IFC-assisted projects and continuing support from IFC will help to consolidate this progress. IFC does not, however, see its principal financial support for Philippine infrastructure through its own investments but through its role in mobilizing resources through the market. As well as support for the domestic capital market, IFC will expand financing available for Philippine infrastructure through loan syndications, through introducing new lenders, including structures that will have a powerful demonstration effect for international lenders. The extent to which these objectives can be achieved depends, however, on initiatives to improve the climate for private sector funds mobilization and in particular on a reduction in the extent of crowding out due to public borrowing as discussed in this report.

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PHILIPPINES

CLASSIFICATION OF PROVINCES BY GEOGRAPHICAL REGIONS

I ILOCOS
- 1 Ilocos Norte
- 2 Ilocos Sur
- 3 La Union
- 4 Pangasinan

CORDILLERA ADMINISTRATIVE REGION (CAR)
- 5 Abra
- 6 Kalinga-Apayao
- 7 Mountain Province
- 8 Ifugao
- 9 Benguet

II CAGAYAN VALLEY
- 10 Batanes
- 11 Cagayan
- 12 Isabela
- 13 Nueva Vizcaya
- 14 Quirino

III CENTRAL LUZON
- 15 Nueva Ecija
- 16 Tarlac
- 17 Zambales
- 18 Pampanga
- 19 Bulacan
- 20 Bataan

NATIONAL CAPITAL REGION (NCR)

IV SOUTHERN TAGALOG
- 21 Aurora
- 22 Quezon
- 23 Rizal
- 24 Cavite
- 25 Laguna
- 26 Batangas
- 27 Marinduque
- 28 Mindoro Oriental
- 29 Mindoro Occidental
- 30 Romblon
- 31 Palawan

V BICOL
- 32 Camarines Norte
- 33 Camarines Sur
- 34 Catanduanes
- 35 Albay
- 36 Sorsogon
- 37 Masbate

VI WESTERN VISAYAS
- 38 Aklan
- 39 Capiz
- 40 Antique
- 41 Iloilo
- 42 Negros Occidental
- 43 Guimaras

VII CENTRAL VISAYAS
- 44 Cebu
- 45 Negros Oriental
- 46 Bohol
- 47 Siquijor

VIII EASTERN VISAYAS
- 48 Northern Samar
- 49 Western Samar
- 50 Eastern Samar
- 51 Leyte
- 52 Southern Leyte
- 53 Biliran

IX WESTERN MINDANAO
- 54 Zamboanga del Norte
- 55 Zamboanga del Sur
- 56 Basilan
- 57 Sulu
- 58 Tawitawi

X NORTHERN MINDANAO
- 59 Surigao del Norte
- 60 Camiguin
- 61 Agusan del Norte
- 62 Misamis Oriental
- 63 Misamis Occidental
- 64 Bukidnon
- 65 Agusan del Sur

XI SOUTHERN MINDANAO
- 66 Surigao del Sur
- 67 Davao Oriental
- 68 Davao del Norte
- 69 Davao del Sur
- 70 South Cotabato

XII CENTRAL MINDANAO
- 71 Lanao del Norte
- 72 Lanao del Sur
- 73 North Cotabato
- 74 Maguindanao
- 75 Sultan Kudarat

PROVINCE CAPITALS

NATIONAL CAPITAL

PROVINCE BOUNDARIES

REGION BOUNDARIES

INTERNATIONAL BOUNDARIES

KILOMETERS 0 100 200 300

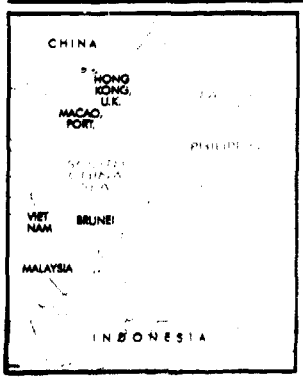
MILES 0 50 100 150 200

LUZON

VISAYAS

MINDANAO

The boundaries, colors, denominations and any other information shown on this map do not imply, on the part of The World Bank Group, any judgment on the legal status of any territory, or any endorsement or acceptance of such boundaries.



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