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Philippines
Growth with Equity: The Remaining Agenda
A World Bank Social and Structural Review

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CURRENCY EQUIVALENTS
(As of May 3, 2000)

Currency Unit	=	Peso
$1.00	=	41.27 pesos
1.00 peso	=	$ 0.024

FISCAL YEAR

January 1–December 31

ABBREVIATIONS AND ACRONYMS

ACEF	Agricultural Competitiveness Enhancement Fund
ADB	Asian Development Bank
AFMA	Agriculture and Fisheries Modernization Act
AFP-RSBS	Armed Forces of the Philippines Retirement and Separation Benefits System
AFTA	ASEAN Free Trade Area
APEC	Asia-Pacific Economic Cooperation
APIS	Annual Poverty Indicator Survey
APT	Asset Privatization Trust
ASEAN	Association of Southeast Asian Nations
B.P.	Batasang Pambansa
BIR	Bureau of Internal Revenue
BOC	Bureau of Customs
BOT	Build-Operate-Transfer
BSP	Bangko Sentral ng Pilipinas
BTr	Bureau of Treasury
CAMELS	Capital Adequacy, Asset Quality, Management, Earnings, Liquidity and Sensitivity
CARP	Comprehensive Agrarian Reform Program
CB-BOL	Central Bank-Board of Liquidators
CEPT	Common Effective Preferential Treatment
CES	Career Executive Service
CESO	Career Executive Service Officer
CMDC	Capital Markets Development Council
COA	Commission on Audit
CSC	Civil Service Commission
CTRP	Comprehensive Tax Reform Program

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CYFP	Children and Youth Foundation of the Philippines
DAR	Department of Agrarian Reform
DBM	Department of Budget and Management
DBP	Development Bank of the Philippines
DND	Department of National Defense
DOH	Department of Health
DOSRI	Directors, Officers, Stockholders and Related Interests
DPWH	Department of Public Works and Highways
DSWD	Department of Social Welfare and Development
EO	Executive Order
EPR	Effective Protection Rate
FDI	Foreign Direct Investments
GAAM	Government Accounting and Auditing Manual
GAAP	Generally Accepted Accounting Principles
GDP	Gross Domestic Product
GNP	Gross National Product
GOCC	Government Owned or Controlled Corporations
GOP	Government of the Philippines
GSIS	Government Service Insurance System
HIGC	Home Insurance and Guarantee Corporation
HPA	Hanoi Plan of Action
HT	High Technology
ICRG	International Country Risk Group
IFAC	International Federation of Accountants
IMF	International Monetary Fund
INTOSAI	International Organization of Supreme Audit
IPOs	Initial Public Offering
IPP	Independent Power Producers
IRA	Internal Revenue Allotment
IT	Information Technology
ITCs	Investment Trust Companies
LBP	Land Bank of the Philippines
LGUs	Local Government Units
LWUA	Local Water Utilities Administration
MAV	Minimum Access Volume
MFIs	Microfinance Institutions
MLT	Medium and Long-Term Loans
MNCs	Multinational Corporations
MTDP	Medium-Term Development Plan
MTPDP	Medium-Term Philippine Development Plan
NAFTA	North American Free Trade Agreement
NAPOCOR	National Power Corporation
NCC	National Credit Council
NDHS	National Demographic and Health Survey
NEA	National Electrification Administration
NEAT	National Education Achievement Test
NFA	National Food Authority
NG	National Government

NGOs	Non-Government Organizations
NHMFC	National Home Mortgage Finance Corporation
NIC	Newly Industrializing Countries
NPC	National Power Corporation
NPLs	Non-Performing Loans
NSCB	National Statistical Coordination Board
NSO	National Statistics Office
OCW	Overseas Contract Workers
ODA	Official Development Assistance
OECD	Overseas Economic Cooperation and Development
OPP	Private Occupational Pension Plans
Pag-IBIG	Home Development Mutual Fund
PAYG	Pay-As-You-Go Systems
PCFC	People's Credit and Finance Corporation
PCIC	Philippine Crop Insurance Corporation
PD	Presidential Decree
PDIC	Philippine Deposit Insurance Corporation
PECC	Pacific Economic Cooperation Council
PEZA	Philippine Export Zone Authority
PHIC	Philippine Health Insurance Corporation
PICPA	Philippine Institute of Chartered Public Accountants
PIDS	Philippine Institute for Development Studies
PMO	Project Management Office
PNB	Philippine National Bank
PPI	Private Provision of Infrastructure
PSE	Philippine Stock Exchange
QRs	Quantitative Restrictions
R&D	Research And Development
RA	Republic Act
RIC	Presidential Retirement Income Commission
SAS	Service Area Scheme
SEC	Securities and Exchange Commission
SSL	Salary Standardization law
SSS	Social Security System
ST	Short-Term
T-bills	Treasury Bills
TFP	Total Factor Productivity
TWG	Technical Working Group
UNDP	United Nations Development Programme
USAID	U.S. Agency for International Development
VAT	Value Added Tax
WTO	World Trade Organization

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FOREWORD

This report has been prepared by a core staff team comprising Bernard Funck (main author), Rajashree Paralkar, Joven Balbosa and based, among others, on valuable contributions by Ceasar Cororaton and Janet Cuenca (sources of growth, impact of trade liberalization), Charles Woodruff (corporate governance), Rick Messick (judiciary); MacDonald Benjamin (financial sector), Cecilia Vales (procurement), Dana Weist (tax administration), Leonora Gonzales and Angelina Ibus (civil society).

The team drew upon a number of background studies, including by Arsenio Balisacan (poverty profile), Mike Alba (incidence of public expenditures), Klaus Deininger et al. (land reform), Aldo Baietti et al., Gilbert Llanto et al. (private provision of infrastructure), Ma. Joy Abrenica (telecommunications), Leonard Early and Sylvie Trosa (budget and performance management), Denis Ives, David Steedman (civil service), Subrahmanya Ramamurthy (budget execution and accounting), Kenneth Dye (audit), Vinay Bhargava et al. and Robert Beschel (anti-corruption).

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The team also received useful input and advice from a number of reviewers within the World Bank, including Masahiro Kawai, Homi Kharas, Sanjay Dhar, Daniela Gressani and Milan Brahmbhatt.

Eduard Bos produced the demographic projections used in this report, and Rosalinda Dacumos helped with the macroeconomic simulations.

The production of the report would not have been possible however without the logistical support of Araceli Tria , Myla Grace de Guzman and Lily Tsang.

EXECUTIVE SUMMARY

1. The following facts command attention:

   (a) Poverty incidence dropped by about 15 percentage points between 1985 and 1997. When growth exceeded 5 percent prior to the Asia crisis, the pace of poverty reduction accelerated to 2 percentage points per year.

   (b) With the share of government corporations in the sales of the top 1000 firms shrinking from close to 20 percent in the mid-1980s to about 6 percent at present, the private sector has been the main engine of growth.

   (c) With export growth accelerating from an average 4 percent in the 1980s to 16 percent in 1990-98, the country doubled its share of world markets.

   (d) The Philippines was among the first countries directly affected by the Asia crisis to regain (and exceed) pre-crisis levels of economic activity.

2. For anyone familiar with the country's history, these are encouraging signs that a new Philippines has begun to emerge.

3. With the Asia crisis receding, the question facing the authorities is how to sustain this achievement and bring back growth to a pace healthy enough to make a serious dent into poverty. The concern is real: the recovery has been hampered by a wider fiscal deficit, slow progress in implementing structural reforms in the last two years, and governance concerns. On financial markets, widening spreads on foreign borrowing and a poor stock market performance are current areas of concern. For the man on the street, the perception is that poverty is no longer declining.

4. This report highlights how much recent achievements in terms of growth and poverty reduction owe to the progress the country has made on a broad front of policy issues, ranging from openness to trade, investment and competition, to education, and from governance and empowerment to financial regulation.

5. But it is also the case that progress has been uneven in many areas, leaving enough of a *remaining agenda* to support growth and poverty reduction efforts over the medium term. The report outlines this agenda, some of the key elements of which are:

   (a) Intensifying trade liberalization and domestic competition.

   (b) Strengthening standards of governance across financial, corporate and public sectors.

   (c) Broadening asset ownership, and the poor's access to tangible assets (e.g., land) and intangible ones (e.g., education).

   (d) Nurturing domestic savings, in the public sector to start with.

6. On that basis, this report envisages that GDP growth would pick up in 2000 from the 3.2 percent recorded in 1999, and again cross the 5 percent threshold, as needed to meet the Government's target for poverty reduction under the medium-term development plan for 1999-2004.

STRUCTURAL TRANSFORMATION

7. Following the crisis of the 1980s, two major factors helped revive growth: (i) the structural reforms undertaken to move from the import substitution industrialization policies of the previous decades to a more balanced development strategy; and (ii) the restoration of orderly relations with the country's creditors following the debt restructuring agreement of 1992.

8. The country's shift from inward to an outward orientation not only permitted a world-class export industry to finally emerge in the Philippines, it also succeeded in making growth more beneficial to the poor by:

(a) Making growth more *labor-intensive*, allowing comparatively modest growth performances to translate into relatively large drops in poverty incidence. This resulted at least as much from changes in the composition of output in favor of more labor-intensive activities (particularly in non-tradable sectors) as from a change in factor intensity within sectors. Employment in construction and services thus opened a main escape route out of poverty, poverty reduction being faster and deeper for those engaged in these sectors.

(b) Forcing a relative *desegmentation of the labor market* under the pressure of competition. The resulting convergence of wages across sectors helped spread the benefits of growth across the economy.

(c) Causing a *redistribution of the national income* in favor of households and consumers, reflecting not only a rising share of labor in the national income but apparently also a redistribution of the previous rents to the consumer as a result of trade liberalization and de-monopolization.

9. This process, however, left a number of issues outstanding. First, what did not improve is *income inequality among families*. The fact that lower income groups also enjoyed unprecedented poverty reduction may have made growing inequality more socially acceptable. But, this may change in a slower growth scenario.

10. Second, a shift in the domestic terms of trade against tradables in the run-up to the Asia crisis—linked in part to the *uneven progress of competition across sectors*—indicates that rigidities persist which stand in the way of sustaining rapid growth. As mounting inflows of foreign savings fueled domestic demand, the related pressure applied differently across the economy, causing prices to rise in sectors less exposed to competition, and factors to shift towards those sectors. Conversely, where international competition limited price adjustments, the same demand pressures caused the current account deficit to expand, leaving the country exposed to volatile market sentiments.

11. An attempt to maintain the country's *self-sufficiency in food* actually exacerbated the problem for the rest of the economy. While other tradables were exposed to higher competition, the effective protection granted to key food items (mainly rice, corn, meat, and sugar) *increased* until 1997. The ultimate result of this policy was to drive up wages to levels considerably higher than in neighboring countries at comparable levels of development. This hindered the capacity of the tradable sector to adjust to the shift from inward to outward orientation and limited its capacity to create jobs in activities where the value added per worker was sufficiently high to make up for high wage costs, i.e. relatively high skilled jobs, such as in electronics. As a result, *industry's contribution to the national output* shrank through the 1990s in contrast to neighboring countries.

12. *Agricultural performance* also remained weak, special protection notwithstanding: not only is agriculture the sector where poverty is highest (over 40 percent of the people engaged in agriculture), but it is also the sector where the pace of poverty reduction has remained the slowest. One can hardly avoid the proposition that the protection granted to the sector in the name of food self-sufficiency actually served to retard a process of structural transformation which would otherwise have benefited the poor, had it been allowed to unfold more freely.

13. To regain the higher growth rates needed for rapid poverty reduction, it will be necessary to amplify the process of structural transformation by which factors of production, particularly labor, shift to higher productivity activities. The word "industrialization" could be used in this context if it encompasses those services which are quickly "industrializing" as a result of the IT revolution, and in which the Philippines is already showing good potential. A key condition will be to restore a more balanced structure of incentives across sectors, including by

(a) *Aligning the pace of trade liberalization across tradables*. While the county forges ahead with cutting down the average tariff to 5 percent by 2004, it is also essential to bring the so-called "sensitive items" into the fold, as indeed contemplated under the Hanoi Plan of Action under AFTA. The devaluation of the peso was actually instrumental in setting that process in motion: as a result of it, the implicit rate of protection dropped in the case of rice from about 80 percent to about 35 percent between 1997 and 1998. It would be important to stay on this trajectory.

Indeed, the pace at which the country is able to bring down its food prices, and thereby enhance labor competitiveness, will have a crucial bearing on its capacity to expand into any internationally competitive, labor-intensive activity in any sector and to seize the opportunities which world trade expansion offers beyond the confines of electronics.

Feeding a growing population will in any case require a different concept of food security than the ideal of food self-sufficiency, which underpins current policies. With cultivated areas constrained and cereal yields sluggish, there is little prospect that the sector could feed 15 to 20 million more mouths by 2010, without putting further pressure on food prices,

further straining household budgets and hampering growth. Trade is a better way of achieving both the objectives of growth and food security.

(b) *Fostering competition in services.* The case of telecommunications vividly illustrates the potential benefits from opening up service sectors to heightened competition. Early gains from the liberalization of the telecommunication industry in the early 1990s—together with the development of an electronic industry—have positioned the country well to participate in the global information revolution (e.g., Internet-based back-office functions, e-commerce). It is now important to consolidate this advance by removing remaining policy bottlenecks in the sector, and, emulating its example, to extend the process to other service sectors, where competition remains stifled (e.g., ports, inter-island shipping).

14. Transforming economic structures is obviously not just a matter of price incentives. Sectoral interventions are also critical in the fields of (i) education and skills development; (ii) population; (iii) urbanization; and (iv) agricultural modernization.

Education and Skills

15. The Philippines might not have benefited as much from the process of structural transformation described above, had it not been for its *long-standing effort in favor of education.* Thanks to this, enrollment in primary education has become almost universal, secondary education has reached the level of "mass education," and even at the tertiary level, enrollment compares to levels found in developed countries. This investment in human capital made it possible for labor to gradually shift towards higher productivity activities and offer sufficient skills to make up for comparatively high wage cost.

16. *Quality and relevance* have, perhaps inevitably, not always kept up with quantitative achievements: dropout rates are stubbornly high, mean achievement scores remain well below target, and in higher and vocational education, low quality state universities and colleges are displacing private institutions. Whereas more than half of the non-poor proceed beyond primary education, only a quarter of the poor do so. The measures proposed to improve the effectiveness and efficiency of education, and its accessibility to all, include: (i) increase the relative allocation for instruction material (as opposed to wages and buildings) and better target investments in basic education to benefit under-served areas and groups; (ii) implement a comprehensive teacher training (both pre- and in-service) and deployment program; and (iii) reverse the haphazard expansion of low quality post-basic public education, wean them from public funding, and develop accreditation systems applicable to both public and private institutions.

Population

17. Curbing population growth would make the task of lifting people out of poverty that much easier. At 95 million by 2010, the population will be 9 million larger than it would have been, had women had as many children as they wished since 1990. For education, for instance, this means attending to 7 million more children and youth than would otherwise have been the case. With such numbers, the ambition of reaching the

poor becomes even more daunting. Conversely, the persistence of this discrepancy between actual and desired maternity points towards the scope for more vigorous population policies, starting with a better *funding of population programs.*

Urbanization

18. If cities are to play host to the process of structural transformation, the country will need to step up its *investment in urban and inter-urban infrastructure* (particularly in the completion of the country's arterial road network). The resources required to bring cities up to par and to operate the related services efficiently extend far beyond the government's own capacity. Hence the need to tap private investment. Whether these materialize—and the cost at which they do—depends in large measure on whether credible regulatory frameworks are established (see below).

Agricultural Modernization

19. Considerable effort will need to go into agriculture to *help the sector adjust to trade liberalization* and seize the opportunities offered by the opening up and expansion of markets along the entire western Pacific Rim to diversify into internationally competitive crops (tree crops, for instance). To see the sector through the transition, there will be a need for a strategic (public and private) investment into land, facilities and infrastructure, as well as for research and extension services to develop and spread alternative farming packages to the farmers. This should be the main thrust of the implementation of the Agriculture and Fisheries Modernization Act.

GOVERNANCE

20. Given the Philippines' open economy and heavy reliance on trade and capital flows, strengthening investor confidence will be vital to sustain a higher growth path. This objective in turn will be best served by undertaking a concerted effort to raise standards of governance in public institutions and the private sector. Much has been achieved since the return to democracy in 1986—ranging from devolution to banking regulation. Yet the remaining agenda is also large.

Raising Standards of Government

21. The Philippines has taken important strides since the people power revolution of 1986 towards stamping out rent seeking and patronage from government. Witnessing this, international surveys report a steady improvement in perceptions of corruption and in the prevalence of the rule of law since the late 1980s. While recognizing this progress, the same surveys also confirm that much remains to be done for a culture of performance and accountability to set in. Indeed, the Philippines' ranking in terms of bureaucratic and judiciary effectiveness is low, while corruption indicators remain uncomfortably high. This report (as well as the 9-point action plan put forward by the World Bank to fight corruption) highlights the need to get some of the basics in place, including:

(a) *A meritocratic civil service.* At present, public employment remains heavily politicized and poorly motivated. By any standard, an extraordinary number of positions at all levels of government remain filled through political appointment. As a result, less than 40 percent of the senior executive positions are currently filled by fully qualified career officers. Even within the career service, appointment and promotion is only loosely linked to merit, and performance evaluation and rewards systems have been debased. Moreover, while the salaries of the rank and file have been adjusted to market levels under the Salary Standardization process, those of senior executives lag behind, creating crippling problems of retention, morale, and perhaps even public morality.

Two priorities emerge. The first one is to professionalize the service. This is one of the objectives of the revised Civil Service Code, which is before Congress. The second is to revamp the pay and grading system with a view to better motivate and retain senior career officers. This would also be the opportunity to initiate a long-term reflection on the proper scope of the civil service code.

(b) *Reliable financial management systems.* In recent years, a number of countries have blazed new trails in using budget reform to improve public service performance. A prerequisite, however, is to create a culture that expects performance and demands accountability. The main issue at present is not so much with the way the budget is put together (which is being improved), but with the way it is spent and accounted for. Sophisticated accounting and monitoring systems do exist, but they are too unwieldy to produce much that is of use in day-to-day management.

Because of these defects, fiscal and department managers are too often left groping in the dark when trying to pilot the execution of the budget, a situation unlikely to foster performance, ... or probity for that matter. Much of the burden in this respect has historically rested on the Commission on Audit. In addition to external audit, it has traditionally performed many accounting and most internal control functions. But, in line with international practices, the Commission is gradually disengaging from non-audit responsibilities, leaving a vacuum where the executive branch needs urgently to step in, with two priorities: bringing accounting in line with international standards and developing internal control.

(c) *A foolproof procurement system.* Although current systems espouse the principles of competition, economy, efficiency and transparency, practices are known to be riddled with fraud and inefficiencies. The heart of the problem is not the lack of rules, but rather an excess of inconsistent ones, which have proliferated over the years, as piecemeal responses to recurring leakage. Much gain could come from (i) consolidating existing rules in a harmonized procurement code; and (ii) developing standardized forms and formats, the use of which would limit discretion, streamline the approval process, and facilitate contract monitoring and audit.

(d) *An effective judiciary.* There is widespread concern, domestically and internationally, that Philippine courts do a poor job of upholding the "rule of law," and thereby debilitate efforts to improve the development policy framework. Laws might, for instance, be more effective at stamping out corruption if courts were more diligent in sanctioning the culprits. On the face of it, the Philippines has a full arsenal of rules and institutions to identify and suppress the syndrome. But comparison with Hongkong indicates why this does not happen: only 1 in 10 prosecuted cases result in a sustained conviction, while the ratio is 8 to 10 in Hong Kong.

Two issues first warrant attention: (i) lengthy delays in resolving civil and criminal cases (the court backlog has increased from about 300,000 to about 650,000 cases between 1992 and 1998); and (ii) unpredictable results when a decision is finally reached. Improving procedures for transparent, merit-based judicial appointments and rooting out corruption in the judiciary would help in both respects.

Devolution and Empowerment

22. With the 1986 revolution, the country has also moved away from the view that the state must or can itself address all the legitimate demands from society, and learned that, in many cases, citizens are often willing to pay or contribute their time and energy to the fulfillment of social needs that they care about. In those cases, the Philippines has learned that it is often best for the state not to abdicate but to focus on providing the enabling environment in which private and local initiatives will flourish.

(a) Although it has caused an uncomfortable accumulation of contingent exposures, there is no question that the option in favor of *private provision of infrastructure* has, on balance, served the country well and will remain irreplaceable for unlocking the growth potential of the economy.

(b) Another important initiative has been to bring government services in closer contact with users and more responsive to their needs, under the devolution of the 1991 *local government* code. Devolution, it was also hoped, would put local government at the forefront of the fight against poverty. How much of that has been achieved is unknown. It is now time for such stocktaking to take place, based on a rigorous data investigation.

(c) In the same spirit, the growing *participation of non-government organizations* (NGOs) in public affairs, although of a different nature and scale, has been one of the greatest successes of the decade.

23. This blooming of civil society initiatives offered a fertile ground for broader approaches to poverty alleviation to emerge. Under these approaches, the poor have come to be seen not merely as recipients/beneficiaries of government programs or policies, but as agents of their own destinies. Through the nineties, a new consensus began to form around the need to *empower the poor*, including by securing the rights of poor communities and individuals and their equitable access to assets.

24. Two of the most important programs to help lower income groups *get access to tangible assets* have been: (i) the National Shelter Program (NSP) of 1986 for *housing*; and (ii) the Comprehensive Agrarian Reform Program (CARP) of 1988. The former unfortunately failed. Although it has involved great expenses (pensioners' money, essentially), there is little evidence that, aside from a few remarkable exceptions (such as the Community Mortgage Program), the NSP made much of an impact on the housing conditions of the poor. There is now growing recognition that: (i) public funding on its own cannot solve housing problems; (ii) to bring in commercial-based financing, low income housing loans need to be at market rates of interest; and (iii) ensuring affordability for the poor could best be achieved through a carefully targeted and transparently budgeted up-front subsidy program. This vision, cast by the Medium-Term Development Plan for Shelter, remains to be acted upon.

25. There is better evidence of success in the case of the *agrarian reform* program. Although its implementation is lagging behind schedule, fresh data presented in this report confirm the intuition that access to land ownership gave the leg up to those who benefited from the program. But what about the many more who did not? It also appears it has become harder for the landless to access land, and that this may be due to the restrictions to the operation of the land market (particularly land rental), which agrarian reform introduced. If further research confirms these preliminary findings, it might be justified to target CARP implementation more toward landless; and to identify which CARP-induced land market restrictions could be relaxed to give a better chance to non-beneficiaries to access land outside of the program. By driving down land prices, food trade liberalization would further help. In the meantime, a more effective collection of existing land taxes would increase the efficiency of land use. In addition, it would be worth piloting mechanisms to fund poor communities directly to purchase CARP land on a mutually agreeable basis to supplement existing compulsory CARP arrangements, and speed up land transfers in areas where landlord resistance is fiercest.

Corporate and Financial Sector Framework

26. The newfound financial resiliency of Philippine banks and corporations in the face of the Asia crisis similarly bears testimony to the progress achieved in the area of corporate and financial sector governance. At the same time, market reactions to a recent spate of stock market scandals and murky corporate maneuvers point to the magnitude of the unfinished agenda, as well as to the urgency of tackling it to restore confidence.

27. Another telltale sign of an underlying problem is the *concentration of ownership* around family-based conglomerates. Not only is it high by regional standards, this concentration also rose in recent years. In the current environment, the limited scope for outside creditors or minority shareholders to discipline corporate insiders also constrains the capacity of firms to raise external finance. To this, ownership concentration and conglomerate structure offer the palliatives of stronger internal control and internal capital markets. The success of this corporate structure potentially poses two major risks to the economy, which the country has begun to address:

(a) Group-based companies might abuse dominant market positions to extract monopoly rents. With the opening up of the economy to trade and

investment, these positions have begun to erode. But further efforts to stimulate competition will be required to put this concern to rest.

(b) Corporate groups might use their *ownership of banks* for connected lending purposes, undermining the stability of the banking system. After a history of banking turbulence often caused by such poor lending practices, vigorous reforms efforts since the late 1980s have made considerable headway toward strengthening the regulation of the sector, in part by elevating the independence and authority of bank regulators.

These reforms proved their worth when the Asia crisis struck. It then appeared that the comparatively better regulated (and also more fragmented) banking industry of the Philippines had been less prone to take on unduly large risk exposures. Furthermore, fresh memories of the 1980s' debt crisis served to cool the appetite for risk of many corporations and banks, while an only recent reentry into international capital markets inhibited the more adventurous from turning to those to circumvent domestic constraints.

Banking regulators will not have the luxury of resting on their laurels. First, recurring abuses of connected lending limits signifies the need for continued supervisory vigilance in this respect. Furthermore, the ongoing consolidation of the banking industry will also (i) relax the constraints which connected lending ceilings had so far been placing on individual exposures; and (ii) increase the scope for oligopolistic behaviors on the part of remaining banks. To obviate the related risk, banking sector consolidation will need to go hand in hand with fresh efforts to improve bank governance; enhance contestability; further strengthen supervision; as well as to ensure prompt resolution of distress cases, should any arise.

28. If the country is to generate the external finance which its corporations need to grow, a more direct effort will be required to tackle, not only the symptoms and side-effects of *corporate and capital market governance* weaknesses, but also their more deep-rooted causes. Such effort should involve, inter alia, reinforcing the protection of minority shareholders and creditors vis-à-vis corporate insiders (i.e., majority shareholders and managers); straightening out the governance and regulation of markets and institutional investors; and elevating the independence and authority of regulators vis-a-vis market participants (particularly that of SEC and PSE), in a similar fashion as was done for the banking industry. An early approval of the proposed Securities Act by Congress, and of effective debt resolution procedures by the Securities and Exchange Commission would considerably improve the formal framework.

29. Little would have been accomplished however unless the rules which are on the books are more deliberately enforced (e.g., integrity of regulatory, accounting and auditing practices; compliance with disclosure requirements). For market participants, this will be the litmus test that the rules of business are indeed changing.

VULNERABILITY \ SUSTAINABILITY

Sources of Vulnerability

30. Resuming growth is one thing. The country just experienced how essential proper financial regulation was in sustaining it. A *lack of savings* also leaves the country more exposed than most to shocks and turbulences. As a nation, the Philippines has one of the lowest domestic savings rates in the region. Thus, any spur of development energy rapidly threatens its external balance.

31. The same goes for low-income groups: taken together, the lower three income deciles of the population do not save. They have therefore little cushion to fall back on in hard times, or capacity, even in good times, to access formal credit markets or makes the most basic investments. As a result, they are the ones who can least afford economic shocks, as research on the impact of the recent crisis confirms.

32. To sustain the level of growth required for rapid poverty reduction, while keeping the country out of future financial troubles, the investment-savings coverage ratio will need to rise over time. A number of factors could contribute to *lifting private savings*: (i) maintaining confidence in the country's banks and currency will remain central; (ii) diversifying savings instruments and broadening the coverage of contractual savings schemes; (iii) bringing down food prices through trade liberalization; (iv) accelerating the decline in the age dependency ratio (through more vigorous population policies). Sustaining faster growth may further induce a virtuous circle of higher private saving.

Fiscal Consolidation

33. One needs to recognize that private saving has a high degree of inertia and that sustained changes tend to materialize only over the long term. For a more immediate impact on aggregate savings, a resumption of fiscal consolidation is needed. After the *fiscal deficit* widened beyond target in 1999 (to 3.6 percent of GNP), government should be steadfast in its resolve to bring the deficit down to 1.9 percent of GNP this year.

34. The main instrument of fiscal consolidation should be *to reverse the recent losses of revenues* (down from 18.5 of GNP in 1997 to 15.2 of GNP in 1999). Anticipating the impact of trade liberalization, the Philippines tax system underwent a fundamental overhaul under the three rounds of the Comprehensive Tax Reform Program in a bid to make taxation more buoyant, remove distortions in incentives, and reduce corruption by streamlining tax provisions, closing loopholes, and generally limiting the room for discretion. This *tax reform* needs to be brought to closure, including by streamlining the many tax incentives, which continue to puncture tax collection efforts.

35. Beyond this, all efforts should turn to *revenue collection.* To start with, the pattern of tax amnesties should be stopped, and the government should distance itself from the various efforts currently afoot in Congress in favor of a new one. Second, the Commission on Audit must be authorized to extend its oversight to the Bureau of Internal Revenue, to help root out allegedly endemic corruption in revenue collection. Third, the

recently decided restructuring of the Bureau from a functional to a client-based organization needs to proceed, and underpin more forceful audit efforts.

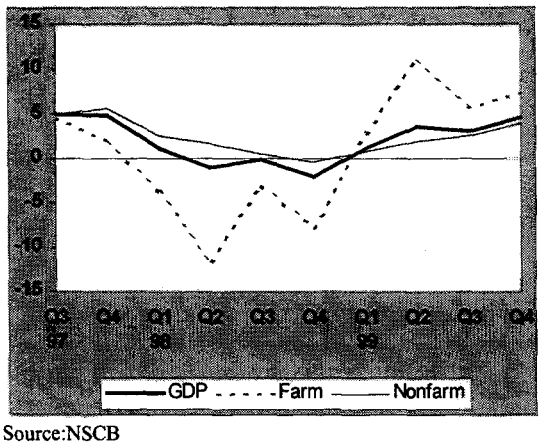
36. The biggest threats to fiscal stability, however, often arise, not from the mainstream of budget operations but from *off-balance sheet risks*, such as the performance guarantees embedded in PPI contracts. Large as those might be, they do not constitute the only form of contingent exposure. There is also a well-established tradition in the Philippines for the government to use off-balance sheet mechanisms to meet social needs (e.g., local water, rural electrification, housing, deposit insurance). These arrangements also create considerable—and in some cases, much less contingent—exposures. Going forward, a more careful use of guarantees and a better monitoring—and pricing—of the risks involved will be in order (e.g., when capitalizing the Home Insurance and Guarantee Corporation).

37. Even if the Philippines succeeds in cutting back its investment/savings gap substantially over this decade, as this report anticipates, the Philippines will continue for some time to come to require *official development assistance* to meet its development priorities. For this assistance to be forthcoming, however, the country will need to restore its record of *aid utilization*, which has deteriorated sharply in recent years.

PROLOGUE

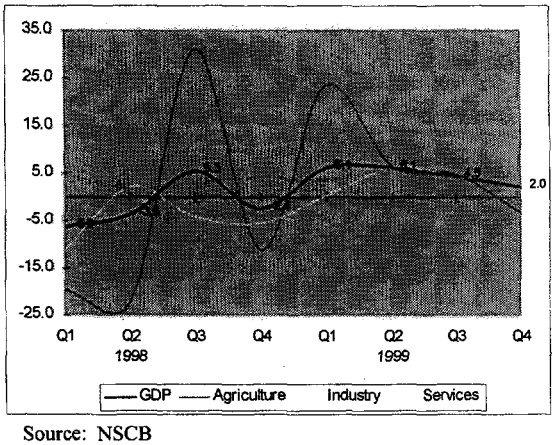
The Philippines was among the first countries directly affected by the Asia crisis to regain (and exceed) the level of activity achieved before the crisis. The pace of the 1999 recovery may have been milder than in other crisis-affected country (3.2 percent GDP growth in 1999), but so was the previous contraction (see Figure 1). Indeed, were it not for the impact of El Niño (which caused rice and corn production to contract by 19 percent and 13 percent in 1998, respectively), the economy would likely have avoided a recession. In fact, GDP shrank somewhat (-0.5 percent in 1998), but growth of nonfarm output remained positive (+1.1 percent in 1998).

Figure 1: FARM AND NON-FARM COMPONENTS OF GDP
(percent year on year)



Source:NSCB

Figure 2: DESEASONALIZED GDP DEVELOPMENTS, 1998-99
(percent, annualized quarterly growth rate)

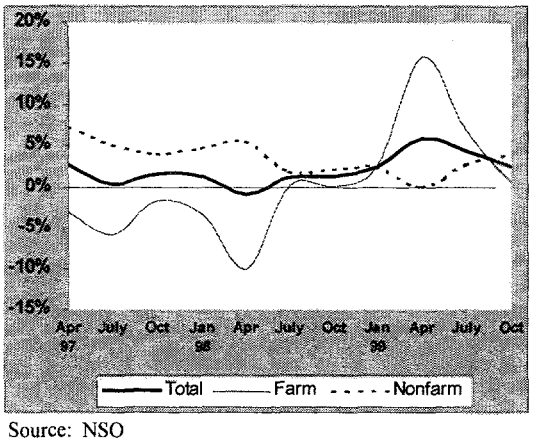


Source: NSCB

Similarly, employment has risen by 4 percent since 1997 (see Figure 3), limiting the social impact of the crisis. Furthermore, Philippines banks have remained capitalized considerably beyond Basle-standards with an average capital adequacy ratio at 17.6 percent.

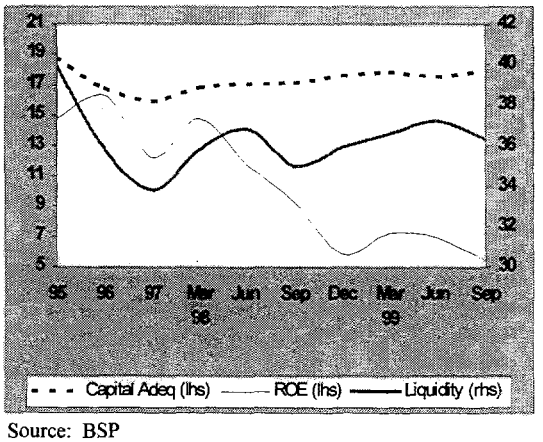
The question now facing the authorities is how to bring back growth to a pace strong enough to make a serious dent into poverty.

Figure 3: GROWTH IN EMPLOYMENT (percent year on year)



Source: NSO

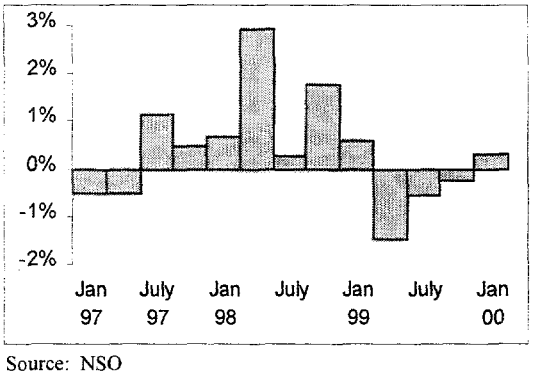
Figure 4: KEY RATIOS OF THE BANKING SYSTEM (percent)



Source: BSP

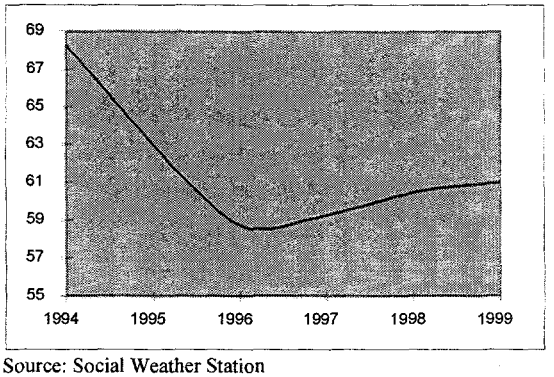
The concern is real. With the technical rebound of agriculture, growth did bounce back in 1999. But nonfarm activity remained sluggish (+2.4 percent in 1999). Furthermore, on a deseasonalized basis, growth has actually been decelerating (see Figure 2), and might already be too slow for unemployment to come down further (see Figure 5). In this context, the public perception is that poverty is not any longer declining (see Figure 6).

Figure 5: UNEMPLOYMENT RATE (percentage point difference, year on year)



Source: NSO

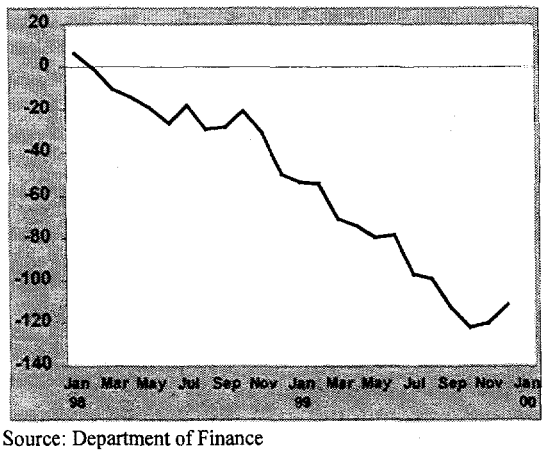
Figure 6: SELF-RATED POVERTY INCIDENCE (percent)



Source: Social Weather Station

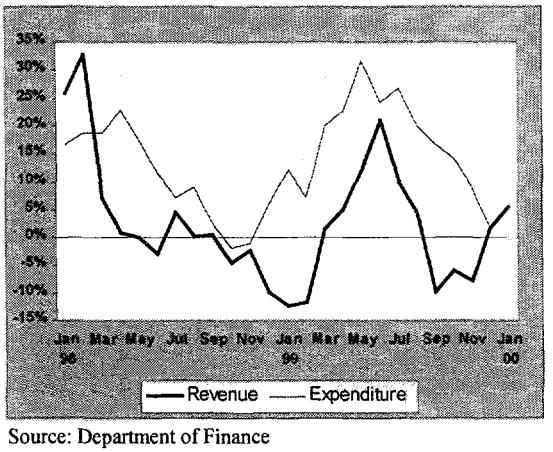
The authorities' attempts at reviving demand have met with only mixed success. Of course, growth might have been weaker, had fiscal and monetary policies not been relaxed. And fiscal expansion may have helped to maintain essential expenditure programs. But, with the fiscal deficit well beyond original targets (from an initial target of 0.6 percent for 1999, the national government deficit widened instead to 3.6 percent of GNP, (see Figure 7), with revenue losses (down from 18.5 of GNP in 1997 to 15.2 of GNP in 1999, (see Figure 8), policy credibility has suffered and the policy of fiscal stimulation has run its course before private demand could gain much momentum. Investment continued to contract and private consumption decelerated in 1999. Concerned to limit pressures on interest rates (see Figure 9), the government is now actively trying to reverse the fiscal trend (see Figure 7 and Figure 8), in the hope of bringing the deficit down to 1.8 percent of GNP this year.

Figure 7: NATIONAL GOVERNMENT CUMULATIVE SURPLUS/DEFICIT
(billions of pesos, 12-months moving sum)



Source: Department of Finance

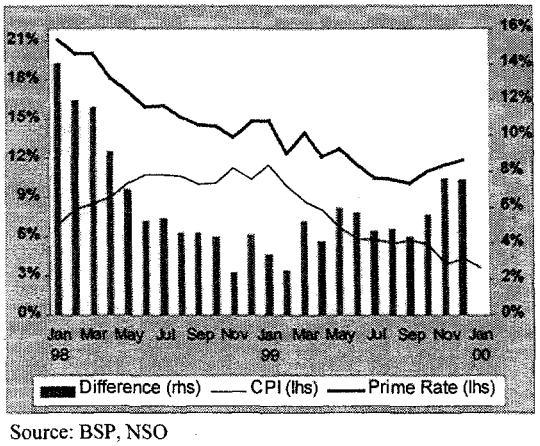
Figure 8: NATIONAL GOVERNMENT REVENUE AND EXPENDITURE
(percent year on year, 3 months moving average)



Source: Department of Finance

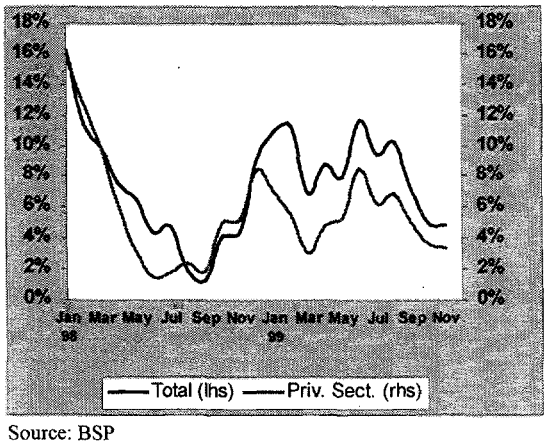
Similarly, a steady relaxation of monetary policy and the ensuing fall in interest rates since the Spring of 1998 (see Figure 9) may have saved banks and corporations from more serious stress, but they have so far breathed little new life into private credit demand (Figure 10). Lower interest rates notwithstanding, the Philippines stock exchange has also had one of the least inspiring performances among major Asian stock markets since they hit bottom in late Summer 1998.

Figure 9: PRIME RATE AND INFLATION
(percent year on year)



Source: BSP, NSO

Figure 10: NET DOMESTIC CREDIT GROWTH (at constant exchange rate, percent year on year)



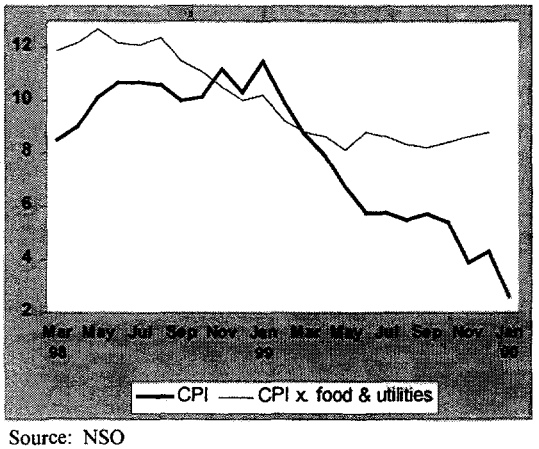
Source: BSP

The combination of an ever widening fiscal deficit, inconsistent structural policy signals, and repeated allegations of cronyism have created a malaise strong enough to blunt the economy's response to the stimulus provided.

Things do not need to be that way. With stronger confidence, there are many reasons to believe that the country could afford to pick up the pace of growth without major immediate financial risk. Weak domestic demand has helped bring down core inflation from 12 to 8 percent between 1998 and 1999 (the impact of the bumper crop

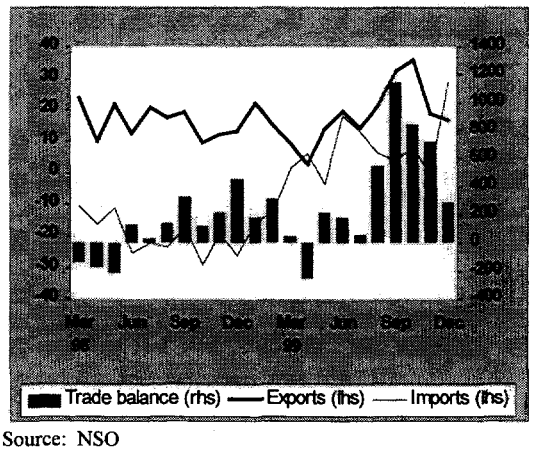
temporarily brought headline rate further down below 3 percent in early 2000, (see Figure 11) and put the country's external accounts in a position of rare strength. Spurred by relentless growth of electronics exports, the trade account swung into surplus (about 5 percent of GDP in 1999) for the first time in 26 years (see Figure 12) and drove the current account to a record surplus. Heavy sovereign borrowing (US$4.4 billion in 1999) to meet the public sector financing requirement have helped boost reserves to historically high levels (about US$15 billion at the end of 1999); though reserve accumulation was at the same time limited by the unprecedented level of unexplained outflows. With subdued demand from other sectors of the economy, the country's external debt remained relatively stable at US$48 billion as of June 1999. Furthermore, most of it (86 percent) is for medium to long-term maturities, while short-term obligations now fall well below the level of external reserves.

Figure 11: CORE AND HEADLINE INFLATION
(percent year on year, 1994=100)



Source: NSO

Figure 12: MERCHANDISE TRADE
(percent year on year in US$ million)



Source: NSO

With the impact of the Asia crisis receding, it is therefore time for policy-makers to train their sights again on the structural challenges of the medium term. The main priority in the view of this report is to set the country on target towards the international objective of reducing absolute poverty by half by 2015. The past decade saw the country make unprecedented progress in that direction. To be able to pick up the pace again, it is useful to reflect on the lessons learned from both recent successes and disappointments. The chapters that follow contribute to this reflection.

1. POVERTY REDUCTION AND ECONOMIC PERFORMANCE

A. INTRODUCTION

1.1 The Philippines' shift since the mid-1980s from inward to outward orientation changed the nature of growth, making it more labor-intensive and more beneficial to the poor. Thanks to a long-standing effort in favor of education, larger numbers were able to contribute to the structural transformation and share in the benefits of growth. A redistribution of the national income in favor of households and a convergence of earnings across sectors further helped spread the benefits of growth. Unfortunately, the period also coincided with a series of shocks—largely exogenous to the structural transformation itself—which limited the duration of the growth years and hence, the full impact on poverty.

1.2 During the run-up to the Asia crisis, moreover, the macroeconomic foundations of growth became more fragile. With the prior appreciation of the currency, the domestic terms of trade increasingly tilted towards nontradables (e.g., real estate, services), while rising food protectionism further hindered the development of sectors more open to international competition. Booming exports notwithstanding, this powerful undertow eventually destabilized the external account, exposing the country to the reversal of market sentiment throughout the region. These developments are discussed in the second section of this chapter.

1.3 As described in the prologue, the country succeeded during 1998-99 in restoring its external financial situation at a much lower social cost than its neighbors more severely affected by the Asia flu. The issue now is how to rekindle growth and put poverty reduction back on track. The final section discusses some of the main challenges involved: (i) containing population growth while dealing with its implications; (ii) resuming faster, labor-intensive, but also better balanced growth; and (iii) managing the rapid urbanization which will necessarily accompany the needed structural transformation[1] of the economy.

B. TRENDS IN GROWTH AND POVERTY REDUCTION

1.4 By all accounts, the policies pursued since the return of democracy have been good to the poor (see Table 1.1). Not only has the number of people living below the poverty line fallen steadily in relation to the population (from 41 percent to 25 percent

[1] "The potential of the concept of structural transformation to unify the study of various aspects of development is demonstrated by the use of such terms as agricultural transformation, industrialization , demographic transition, and urbanization, each of which describes one or more dimensions of the overall transformation process. ... What are the main features of the transformation that affect the ways in which economies grow and that distinguish developed and developing countries? ...

- Engel's law of the declining share of food in consumption
- Lewis' hypothesis of the elastic supply of labor in most developing countries...
- Balassa's "stages of comparative advantage," derived from the Heckscher-Ohlin model
- Kuznets' observation of systematic differences in the level and growth of productivity by sector
- The demographic transition, a set of factors that produces first a rise and then a decline in population growth as per capita income rises"

in Chenery, H., S. Robinson, M. Syrquin, 1986, "Industrialization and Growth," World Bank, Washington DC, page 11.

between 1985 and 1997[2]), but also those who have remained below have moved closer to the threshold (as the evolution of the poverty depth index indicates). Even at the margin, giving greater weight to welfare of the poorest, absolute poverty has become less acute (as the evolution of the severity index shows).

Table 1.1: RECENT EVOLUTION OF POVERTY, 1985-97
(percent)

	INCIDENCE	DEPTH	SEVERITY
1985	40.9	13.2	5.8
1988	34.4	10.1	4.2
1991	34.3	10.6	4.5
1994	32.1	8.7	3.4
1997	25.0	6.4	2.3

Source: Balisacan (1999)

1.5 The resumption of growth (see Table 1.2 and Figure 1.1) obviously played a key role in this accomplishment. Indeed, during the years when growth crossed the 5 percent threshold in a sustained manner for the first time since the 1970s, the country even recorded unprecedented success, with poverty incidence dropping by more than two percentage points a year.

Table 1.2: POVERTY REDUCTION IMPACT OF GROWTH FOR SELECTED COUNTRIES

	PERIOD	PERCENTAGE POINT REDUCTION PER YEAR	GROWTH OF GNP PER CAPITA 1980-94 (percent per year)
Philippines	1985-94	1.0	1.7
China	1987-94	0.7	7.8
Indonesia	1984-96	0.9	6.0
EAP (excl. China)	1987-93	1.6	6.9

Source: Balisacan, Causes of Poverty: Myths, Facts and Policies (1999)

1.6 A number of studies (including Austria, 1998; and IMF, 1999) have shown how much that burst of growth owed to the opening up of the economy, both through

(a) structural reforms—including trade liberalization, privatization, financial sector reform and fiscal consolidation—which will be discussed in the course of this report; as well as

(b) The country's renewed access to foreign savings on regular terms. Through the debt restructuring agreement of 1992, the country succeeded in normalizing relations with its major creditors, and regaining access to international capital markets from which it had been practically shut-off since the debt moratorium of 1982. Important legislative breakthroughs (e.g., Foreign Investment Law of 1996, "BOT" law of 1990, and PEZA

[2] Unless noted otherwise, this report uses the "constant cost-of-basic needs" poverty incidence indicator developed by Professor A. Balisacan, University of the Philippines. This indicator differs from the official poverty incidence indicator developed by the National Statistical Coordination Board (NSCB) in two respects: (i) to provide a measure of *absolute* poverty, the poverty threshold utilized remains constant over time and space (whereas it varies in the case of the official indicator, making it akin to a measure of *relative* poverty); and (ii) poverty incidence is measured based on *consumption* levels, rather than *income* levels (as for the NSCB indicator), which are typically more difficult to measure accurately. It should also be noted that, consistent with international practices, the poverty incidence indicators used in this report refer to the percentage of the *population* living below the poverty threshold, while the practice in the Philippines is often to refer to the percentage of *households* living below that threshold (NSCB publishes both).

law of 1995) opened up the economy to foreign investment, particularly in manufacturing and utilities.

As confidence returned, resident Filipinos began to repatriate their deposits abroad while overseas ones sent back home increasingly large amounts of remittances. In total, inflows of foreign savings (see Table 1.3) swelled from US$5 billion in 1992 to US$16 billion in 1996, before falling back again below US$7 billion in the wake of the Asia crisis.

Table 1.3: INFLOWS OF FOREIGN SAVINGS, 1992-99
(millions of U.S. dollars)

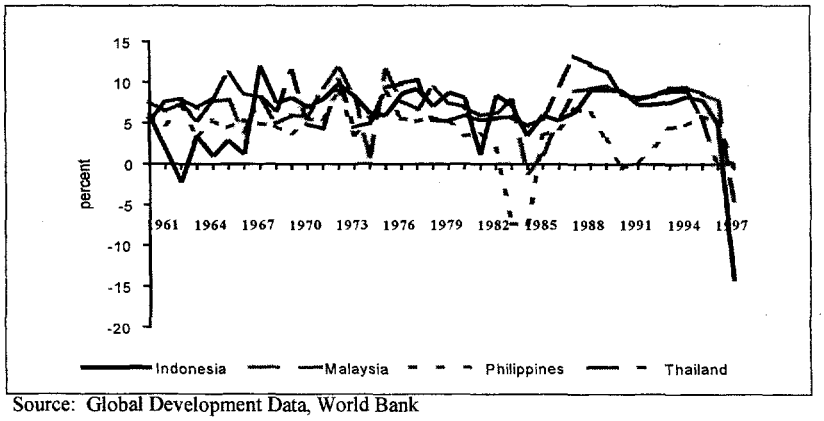
	1992	1993	1994	1995	1996	1997	1998	1999[d/]
REMITTANCES [a/]	2537	2587	3452	4402	4875	6799	5130	6382
OFFICIAL TRANSFERS [b/]	229	187	362	338	338	302	300	259
DIRECT INVESTMENT	675	864	1289	1361	1338	1113	1592	589
PORTFOLIO INVESTMENT	62	-52	269	248	2179	-351	80	254
MLT LOANS DISBURSEMENTS	633	2455	1313	1276	2841	4824	2740	4203
O.W. ODA LOANS[c/]	3301	2950	2392	1978	2250	2437	2196	1866
CHANGE IN THE NFA OF KBS	289	-299	674	564	4214	1188	-1330	-1540
SHORT TERM CAPITAL	660	-148	1002	-56	540	495	-1521	-2856
TOTAL	**5,085**	**5,594**	**8,361**	**8,133**	**16,325**	**14,370**	**6,991**	**7,291**

Sources: BSP SPEI, IFS, Bank estimates
a/ personal income and worker's remittance transfers
b/ to government
c/ from bilateral and multilateral sources gross inflows
d/ first 11-months data from

1.7 Growth cannot be the whole story, though, for

(a) growth rates remained moderate compared to those observed in neighboring countries, and considerably below those recorded by the Philippines itself in the 1960s and 1970s (Figure 1.1);

Figure 1.1: GDP GROWTH RATES IN SELECTED COUNTRIES, 1960-98



Source: Global Development Data, World Bank

(b) the comparative record is even less favorable in terms of GDP per capita (see Table 1.4). Indeed, if national accounts are to be believed,[3] GDP per

[3] There are reasons to believe that national accounts would underestimate the amount of real growth in the economy, particularly due to the use of an old (and unrepresentative) base year (1985, a year of recession and revolution). The bias is likely to grow over time.

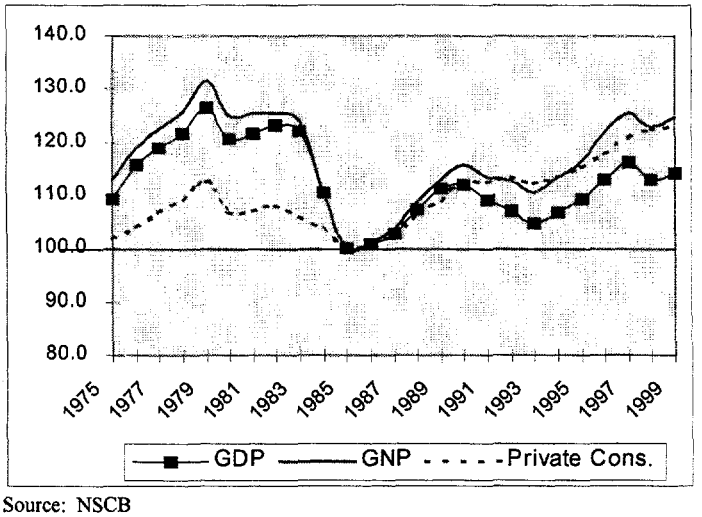
capita would not yet have regained the level the country enjoyed twenty years ago (see Figure 1.2).

Table 1.4: POPULATION AND GDP PER CAPITA IN SELECTED COUNTRIES
(average annual percentage change)

		1961-70	1971-80	1981-90	1991-98[a/]
CHINA	Population	2.0	1.8	1.5	1.1
	Per capita income	*3*	*3.6*	*7.6*	*10.0*
INDONESIA	Population	2.2	2.3	1.8	1.7
	Per capita income	*1.9*	*5.4*	*4.5*	*5.6*
MALAYSIA	Population	2.9	2.4	2.8	2.5
	Per capita income	*3.5*	*5.4*	*3.1*	*5.9*
PHILIPPINES	**Population**	**3.1**	**2.5**	**2.6**	**2.3**
	Per capita income	***1.8***	***3.3***	*-0.8*	***0.8***
THAILAND	Population	3.0	2.7	1.7	1.2
	Per capita income	*5.0*	*4.1*	*6.1*	*5.5*
BANGLADESH	Population	2.6	2.6	2.4	1.6
	Per capita income	*1.4*	*-0.8*	*2.3*	*3.1*
INDIA	Population	2.3	2.3	2.1	1.8
	Per capita income	*2.2*	*0.8*	*3.7*	*3.8*

a/ per capita GDP growth rate is for 1991-97.
Source: Global Development Data, World Bank

Figure 1.2: INCOME AND CONSUMPTION PER CAPITA
(1985 = 100)



Source: NSCB

(c) the previous time the country reached respectable rates by international standards, i.e., in the 1960s and early 1970s (see Figure 1.1 and Table 1.5), a number of authors—including Gustav Ranis[4]—had been struck by the lack of poverty response to it. This time around, despite more moderate growth, poverty reduction achievement stands the comparison with countries like China and Indonesia (see Table 1.2), i.e., those neighboring country whose level of income per capita (at purchasing power parity) was closest to that of the Philippines

[4] Ranis, Gustav and Frances Stewart. 1993. "Rural Non-agricultural Activities in Development: Theory and Application. *Journal of Development Economics* (40): 75-101.

1.8 A rising elasticity of poverty to growth (see Table 1.6) confirms that other factors must have been at play to make growth more pro-poor. The following sections will highlight how much this owes to

(a) A more labor-intensive pattern of growth.

(b) A redistribution of the national income in favor of households.

(c) A convergence of earnings across sectors.

Table 1.5: GROWTH RATES IN SELECTED COUNTRIES
(percent)

	1980-85	1985-90	1990-97	1998
CHINA	9.9	8.8	10.3	7.8
INDONESIA	6.2	6.5	7.6	-14.3
MALAYSIA	5.5	5.5	8.7	-4.8
PHILIPPINES	**-0.1**	**2.7**	**3.1**	**-0.5**
THAILAND	5.4	9.4	7.4	-9.4
KOREA	6.3	9.5	7.4	-5.8
EAP5[a/]	4.7	6.7	6.8	-7.0

a/ all countries in table, except China.
Source: Global Development Data

Table 1.6: ELASTICITY OF POVERTY TO GROWTH
(percent)

	INCIDENCE
1960-85	-0.26
1985-97	-1.57

Source: World Bank Staff

C. SOURCES AND PATTERNS OF GROWTH

From Inward to Outward Orientation

1.9 The shift, which the economy operated in the last two decades, from inward to outward orientation, accounts for a large part for this improved "quality of growth."[5] This shift allowed for a more efficient use of the factors available to the economy and a more labor-intensive pattern of growth. A range of studies have documented how the protectionist policies pursued from the 1950s to the 1970s, if they had initially spurred growth, had done so through an inefficient accumulation of capital (and at the cost of the country becoming increasingly over-indebted). This had resulted in a lower absorption of labor and an overall decline in the productivity of production factors. Table 1.7, which summarizes some of this earlier research,[6] illustrates how inward oriented policies bent the use of factors out of shape, entrenching poverty.

[5] see Austria, M. S. 1998. "Productivity Growth in the Philippines after the Industrial Reforms." PIDS Discussion Paper Series No. 98-26. Makati, Philippines.; Cororaton, C. B., and M.T. Duenas-Caparas. 1998. "Total Factor Productivity: Estimates for the Philippine Economy." Revised final report submitted to the TWG-Productivity Indicators and Monitoring System.; and Cororaton, C.B., and R. Abdula. 1999b. "Productivity of Philippine Manufacturing." PIDS Discussion Paper. Makati, Philippines.

[6] Kawai, H. 1994. "International Comparative Analysis of Economic Growth: Trade Liberalization and Productivity." *The Developing Economies* 32(4): 373-397; Nehru, V., and A. Dhareshwar. 1994. "New Estimates of Total Factor Productivity Growth for Developing and Industrialized Countries." Washington D.C.: World Bank; Bosworth, B., et al. 1995. "Accounting for Differences in Economic Growth." Economic Studies Program, Brookings Institution, Washington, D.C. show similar results. Drysdale, P., and Y. Huang. 1995. "Technological Catch-Up and Economic Growth in East Asia." *Economic Record*, 73(222): 201-211 using a much longer timeframe (1950-90), shows positive TFP growth, probably capturing the impact of the productivity growth during the post-war to 1960 period (also highlighted in Williamson, J. 1969. "Dimensions of Postwar Philippine Economic Progress." *Quarterly Journal of Economics* 83(1): 93-109.).

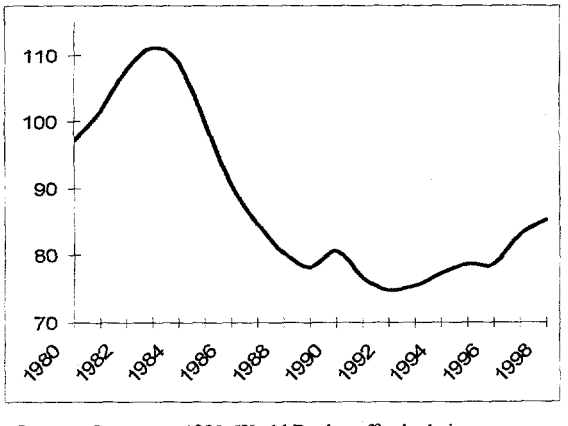
Table 1.7: EVOLUTION OF SOURCES OF GROWTH OVER TIME
(percentage contribution to growth)

	WILLIAMSON (1969)		SANCHEZ (1983)	AUSTRIA & MARTIN (1992)	AUSTRIA (1997)	CORORATON (1999)
FACTORS	1947-55	1955-65	1960-73	1960-87	1960-96	1981-98
LABOR	33	54	52	24	27	37
CAPITAL	9	25	24	87	76	72
LAND	3	5	n.a.	n.a.	n.a.	n.a.
TOTAL FACTOR PRODUCTIVITY	55	15	24	-11	-3	-9
TOTAL	100	100	100	100	100	100
MEMO ITEM						
GDP GROWTH	7.3	4.5	4.6	4.8	3.8	2.2

Source: Austria, Myrna & Martin, Will, Economics Division Working papers, Macroeconomic Instability & Growth in the Phil: A Dynamic Approach. Research School of Pacific Studies, Australian National University, 1992; Cororaton, 1999d.

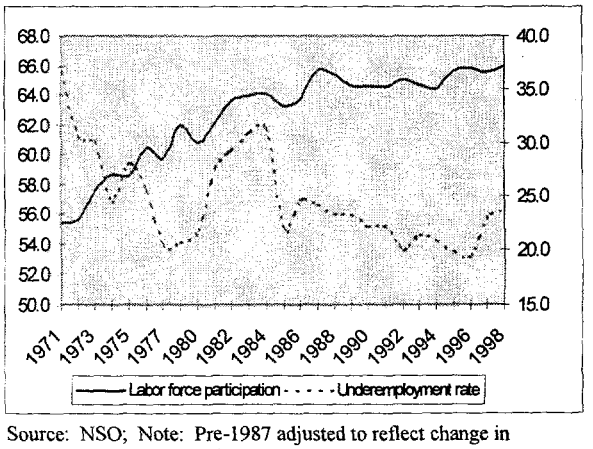
1.10 The subsequent shift to outward orientation policies (see Chapter 3, for a discussion of the policies pursued) brought the economy back in line with developing economies' standards (see Table 1.8 and Table 1.9). As in other developing countries, the accumulation of capital remained the main driver of growth during the period 1980-98, contributing two thirds to the economies' growth rate (in developed countries, growth typically derives much more heavily from total factor productivity). But the economy also mobilized more effectively its most abundant factor, i.e., labor, whose contribution to growth rose in this more outward oriented setting (see Figure 1.3 and Table 1.7). The labor force participation rose from an estimated 55 percent in the mid-1970s to about 65 percent in recent years, while underemployment retreated (see Figure 1.4). While growth increased, it also became more labor intensive than had previously been the case—much to the benefit of the poor whose main asset became in demand. As a result, employment expanded at an annual rate of 2.8 percent between 1980 and 1998 (leading to the creation of 11 million new jobs).

Figure 1.3: CAPITAL/LABOR RATIO
(1985=100)



Source: Cororaton, 1999, World Bank staff calculation

Figure 1.4: LABOR FORCE PARTICIPATION AND UNDEREMPLOYMENT, 1971-99
(percentage of age group, and labor force, resp.)



Source: NSO; Note: Pre-1987 adjusted to reflect change in estimation methodology (recall period)

Table 1.8: SOURCES OF GROWTH: AN INTERNATIONAL COMPARISON
(percent contribution to growth)

REGION	CAPITAL	LABOR	TFP
PHILIPPINES	**72**	**36**	**-9**
DEVELOPING COUNTRIES, 1960-87	65	23	14
AFRICA	73	28	0
EAST ASIA	57	16	28
EUROPE	58	14	28
LATIN AMERICA	67	30	0
SOUTH ASIA	67	20	14
SELECTED DEVELOPED COUNTRIES, 1960-85			
FRANCE	27	-5	78
WEST GERMANY	23	-10	87
JAPAN	36	5	59
UNITED KINGDOM	27	-5	78
UNITED STATES	23	27	50

Source: Lim (1994), Table 1

1.11 This structural transformation has not been smooth, as the closer inspection below of sectoral developments during that sub-period reveals. Twice during the twenty years concerned, the economy embarked upon unsustainable courses. First, as a result of the debt crisis and political turmoil of the 1980s, the economy failed to invest as much as it should have and ran its capital stock to the ground, ...until it was unable to grow at all due, *inter alia*, to power shortages. The abnormally low contribution of capital to growth during the 1980-89 sub-period (see Table 1.9), followed by an abnormally high contribution during the subsequent "reconstruction" period reflects in part the subsequent catch up effect. Second, during the mid-1990s, the country caught a milder strain of the "Asian Flu."

Table 1.9: SOURCES OF GROWTH BY SUB-PERIOD
(percent)

	GROWTH				CONTRIBUTION TO GROWTH		
	Output	Labor	Capital	TFP	Labor	Capital	TFP
1981-89	1.6	3.0	0.5	0.4	49.6	24.1	26.4
1990-98	2.7	2.7	3.7	-0.8	28.6	101.0	-29.6
1980-98	2.1	2.9	2.1	-0.2	36.5	72.2	-8.7

Source: Cororaton (1999d)

Sectoral Trends

1.12 An examination of sectoral trends allows us to better understand the nature of the transformation as it actually took place, highlighting how the shift towards more labor intensive growth resulted at least as much from changes in the composition of output in favor of more labor intensive activities (particularly in non-tradable sectors) as from a change in factor intensity within sectors. It will also help begin to identify the tensions, which mounted in the run-up to the Asia crisis.

Domestic Terms of Trade

1.13 Perhaps one of the most spectacular, and to some extent, unexpected impact of the two decades of trade liberalization policies (see next Chapter) is the impact they have had on the domestic terms of trade (see Figure 1.5). After fluctuating without clear directions during the high inflation years of the 1980s, domestic terms of trade shifted against industry and in favor of services. Essentially, they gradually turned against the sectors where progress was achieved earlier towards freeing up competition.

1.14 As regards tradables, the beginning of trade liberalization dated back to the early 1980s (under the government of Prime Minister Virata). During the 1990s only, the effective rate of protection was cut by half overall (see Table 1.10), with even faster progress in the area of manufacturing. Of course, after decades of import substitution policies, the tradable sectors most sorely needed competition. But there is also a need to balance treatment across sectors, and as this chapter will argue, it would to the detriment of the whole economy to allow agriculture and nontradable sectors to lag behind.

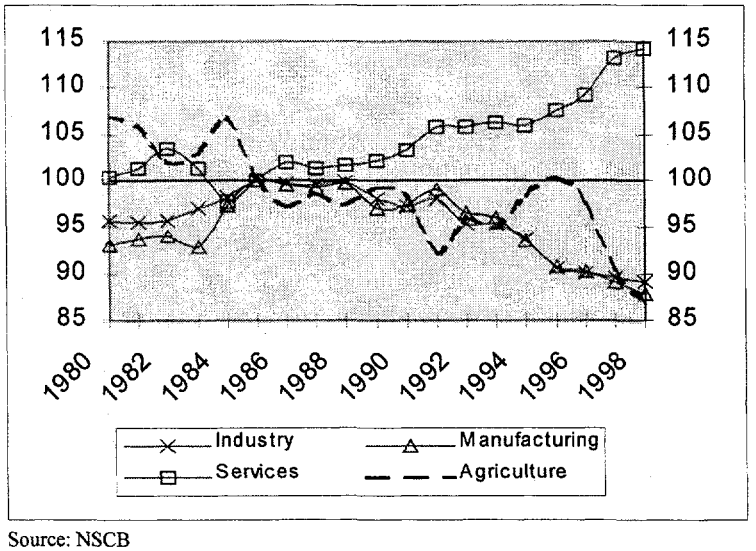
1.15 Progress has indeed been more recent in nontradable areas, where many of the important milestones bear recent dates—e.g., liberalization of inter-island shipping (1996), liberalization of petroleum trade (1997-98), partial liberalization of retail trade (2000); even when in areas where the formal decisions are slightly older (e.g., earlier in the 1990s in the cases of telecommunication and power), their impact on prices is only beginning to be felt.

Table 1.10: EFFECTIVE RATE OF PROTECTION, 1990-2000
(Percent, weighted average)

	1990	1995	1996	1998	2000
AGRICULTURE	26.4	25.6	28.7	25.0	22.5
MANUFACTURING	31.0	23.1	28.2	19.9	14.5
OVERALL	29.4	24.8	25.5	18.7	14.4

Source: Manasan and Pineda (1998)

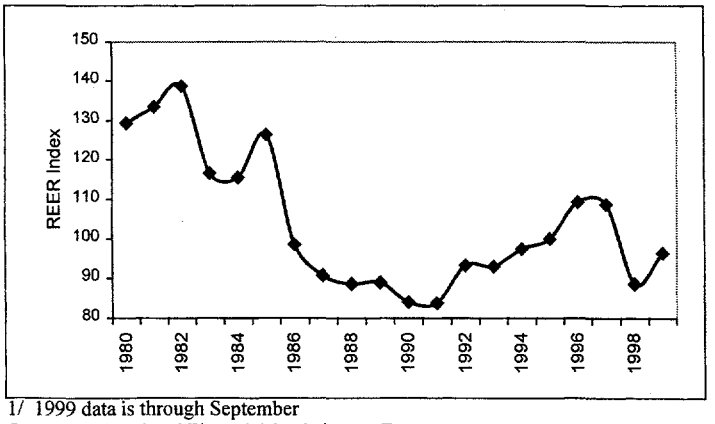
Figure 1.5: SECTORAL PRICE DEVELOPMENTS
(1985=100)



Source: NSCB

1.16 Furthermore, whereas the exchange rate should have been expected to depreciate in parallel with trade liberalization, and relieve some of the competitive pressures on sectors producing tradable goods, the reverse happened during the nineties (see Figure 1.6). At the heart of the matter is the upsurge of foreign capital inflows, which followed the country's re-entry into international capital markets and amplified as emerging markets heated up in the mid-1990s. This inflow of savings fuelled domestic demand pressures throughout the economy. Where competition prevented prices from rising, as in the case of tradables, these pressures led to a growing current account deficit. In contrast, in non tradable sectors where the supply is (almost by definition in an open economy) less elastic, demand pressures translated more readily into price escalation—and all the more readily that in many instances, competition was still insufficient to hold prices in check (as noted above). Non tradable sectors were thus able to turn the terms of trade in their favor.

Figure 1.6: REAL EXCHANGE RATE INDEX[1/]
(1995 =100, increase = appreciation)



1/ 1999 data is through September
Source: International Financial Statistics, IMF

1.17 An attempt to nevertheless maintain the country's self sufficiency in food actually exacerbated the problem for the rest of the economy. While other tradables were exposed to higher competition, the effective protection granted to key food items (mainly rice, corn, meat, and sugar) *increased* until 1997 (see Table 1.11). As a result, from 1995 onward, and for the first time in history, agriculture enjoyed a higher degree of protection than manufacturing (see Chapter 2, Figure 2.2).

Table 1.11: NOMINAL PROTECTION RATES OF MAJOR AGRICULTURAL COMMODITIES (percent)

	1980-84	1985-89	1990-94	1995	1996	1997	1998
RICE	-13	16	19	63	91	82	34
CORN	26	67	76	104	54	96	72
SUGAR	42	154	81	91	93	66	99
COCONUT OIL	-4	7	18	10	5	0	0
PORK	-9	43	31	44	n.a.	n.a.	n.a.
CHICKEN	46	39	74	84	n.a.	n.a.	n.a.

Source: David (1999)

1.18 The ultimate result of this autarky policy was to drive up wages to levels considerably higher than in neighboring countries at comparable levels of development (as measured by GNP at purchasing power parity, see Table 1.12). This affected particularly unskilled labor, as the latter devotes a proportionately larger share of its income to food. Being less subject to competitive pressures, non-tradable sectors were also better able to pass on the related costs to their customers, which in turn further widened intersectoral price differentials.

Table 1.12: WAGE COSTS IN MANUFACTURING

	GNP PER CAPITA AT PPP	MINIMUM WAGE	%	AVERAGE LABOR COST PER WORKER IN MANUFACTURING		AVERAGE VALUE ADDED PER WORKER IN MANUFACTURING	
	($ per year)			($ per year)			
	1998	1995-99		1980-84	1995-99	1980-84	1995-99
PHILIPPINES	3527	1472	41.7	1240	2450	5266	10781
INDONESIA	2423	241	9.9	898	1008	3807	5139
KOREA	13289	3903	29.4	3153	10743	11617	40916
MALAYSIA	7167	...	...	2519	3429	8454	12661
THAILAND	5382	1083	20.1	2305	2705	11072	19946
CHINA	3192	...	...	472	729	3061	2885
VIETNAM	1521	134	8.8	...	711	...	...

Source: World Development Indicators, 2000

Sectoral Composition of Output

1.19 Sectoral performances have essentially mirrored those terms of trade developments. Capital poured in non-tradable sectors (see Table 1.13)—such as construction, services, and utilities—where profitability was rising as a result of the real appreciation. Even San Miguel, the food and beverage giant, went into real estate. Wage competitiveness being less of an issue for non-tradables, labor followed, and the composition of the national output shifted towards more labor-intensive sectors of activity, such as construction and services.

1.20 Unfortunately, the pace at which factors were mobilized into the non-tradable sector overtook that of output growth.[7] Although the quality of the statistics may overstate its magnitude, there seems to be little doubt that factor productivity dropped across non-tradable sectors.

Table 1.13: SOURCES OF SECTORAL GROWTH BY SUB-PERIOD
(percent)

	Growth Rate			
	Output	Labor	Capital	TFP
		TRADABLES		
AGRICULTURE				
1981-89	1.3	1.5	5.0	-3.0
1990-98	0.9	1.1	-2.8	2.9
1981-98	1.1	1.3	1.0	0.0
MINING				
1981-89	1.7	4.6	-6.2	4.4
1990-98	-0.4	-3.7	-11.2	2.1
1981-98	0.7	0.4	-8.7	5.7
MANUFACTURING				
1981-89	1.0	2.6	2.1	-1.2
1990-98	2.4	1.8	2.8	-.0.2
1981-98	1.7	2.2	2.4	-0.7
		NON-TRADABLES		
CONSTRUCTION				
1981-89	-3.8	5.1	11.9	-12.6
1990-98	3.9	6.2	4.8	-1.8
1981-98	...	5.7	8.3	7.0
UTILITIES				
1981-89	3.8	5.3	-2.4	4.3
1990-98	5.1	5.1	0.7	3.0
1981-98	4.4	5.2	-0.8	3.6
TRANSPORT & COMMUNICATION				
1981-89	3.7	4.4	3.5	0.1
1990-98	3.8	6.2	12.1	-6.8
1981-98	3.8	5.3	7.7	-3.4
TRADE				
1981-89	2.7	6.6	12.7	-9.3
1990-98	3.5	3.8	7.8	-3.7
1981-98	3.1	5.2		-6.4
FINANCE & DWELLINGS				
1981-89	2.1	2.4	9.8	-6.5
1990-98	3.7	6.0	8.8	-4.7
1981-98	2.9	4.2	9.3	-5.6
OTHER SERVICES				
1981-89	4.3	4.1	8.2	-1.3
1990-98	3.4	3.9	10.3	-2.6
1981-98	3.8	4.0	9.2	-1.9

Source: Cororaton (1999d)

1.21 There are many reasons for such productivity losses. In some cases, as in transport, this reflects merely the fact that massive investments needed to sustain growth[8] were still under gestation at the close of the period. In others (e.g., housing), they might reflect a need to catch up with demographic or other fundamental trends after a period where growth would have been suppressed. It remains nonetheless telling that the only

[7] Note as a caveat that (i) capital accumulation in sectors, which generate substantial externalities, such as in transport and communications, should not necessarily be expected to generate output in the same sector.

[8] e.g., Manila light rail train, skyway and flyovers, and new air terminal, Mactan bridge, Cagayan Valley and in land – and cellular phone facilities across the country.

non-tradable sector which would have registered productivity gains—utilities—is one where (as will be discussed in Chapter 2) competition heightened through the 1990s.

1.22 Squeezed as they were between wage and competitive pressures, tradables had little option but to improve their productivity performance, or fold (see evolution of total factor productivity in those sectors, in Table 1.13). But the same pressures also constrained their expansion, as well as their capacity to generate jobs (see below).

Export Take-off

1.23 A key feature of this improved productivity performance in tradable sectors is the emergence of a world-class export industry. Whereas total exports had grown at an annual average rate of 4 percent in the 1980s, they surged to a rate of about 16 percent in 1990-98. As a result, their share in GDP nearly tripled from 21 percent in 1980-85 to 57 percent in 1998. Similarly, the country doubled its share of world markets (see Table 1.14).

Table 1.14: EAST ASIAN EXPORT SHARES IN INTERNATIONAL IMPORT MARKETS (percent)

IMPORT MARKET	WORLD				INDUSTRIAL COUNTRIES				UNITED STATES				JAPAN				DEVELOPING ASIA			
EXPORT SOURCE	1985	1990	1995	1998	1985	1990	1995	1998	1985	1990	1995	1998	1985	1990	1995	1998	1985	1990	1995	1998
EAST ASIA	9.3	11.7	16.2	16.0	8.8	9.6	13.3	13.1	15.8	19.0	23.1	22.2	25.5	26.5	34.4	35.3	21.3	28.8	33.1	37.0
CHINA	1.6	2.5	4.5	4.6	1 1	1.7	3.7	4.0	1.2	3.2	6 3	7.2	5.0	5.1	10.7	12.1	5.2	7.7	9.5	10.1
NIES	5.1	6.4	7 6	7.3	5.2	5.5	5.9	5.5	11.6	12.2	11.0	9.3	7.6	11.0	12.3	11.3	10.2	15.2	16.1	18.2
HONG KONG, CHINA	1.2	1.4	1.1	1.1	1.1	1	0.9	0.9	2.5	1.9	1.4	1.1	0.6	0.9	0.8	1.0	3.3	4.6	2.2	2.3
KOREA	1 3	1.7	2.3	2.2	1.4	1.7	1.8	1.6	3.0	3.7	3.2	2.6	3.2	5	5.2	4.5	1 4	2.4	4.3	5.1
SINGAPORE	0 9	1.2	1.8	1.8	0.6	0.9	1.2	1.2	1.2	2	2.5	2:0	1.2	1.5	2.0	1.9	3.2	3.9	4.4	5.7
TAIWAN, CHINA	1.7	2.1	2.5	2.2	1 9	1.9	2.0	1.9	4.9	4.6	3.9	3.6	2.6	3.6	4.3	3.9	2.4	4.3	5.2	5.1
SOUTH EAST ASIA	2.6	2.8	4 0	4.1	2.6	2.4	3.6	3.6	3.1	3.6	5.9	5.7	12.9	10.4	11.4	11.9	5.9	5.9	7.5	8.7
INDONESIA	1.0	0.8	0.9	0.9	1.2	0.8	0.9	0.9	1.4	0.7	1.0	1.0	7.8	5.4	4.2	4.0	0.9	1.1	1 3	1.6
MALAYSIA	0 9	1	1.6	1.6	0.7	0.7	1.3	1.2	0.7	1.1	2.3	2.0	3.3	2.3	3.1	3.3	3.4	3.3	3.8	4 1
PHILIPPINES	**0.3**	**0.3**	**0.4**	**0.6**	**0.3**	**0.3**	**0.4**	**0.6**	**0.6**	**0.7**	**1.0**	**1.3**	**1.0**	**0.9**	**1.0**	**1.7**	**0.5**	**0.3**	**0.5**	**0.9**
THAILAND	0.4	0.7	1.1	1.0	0.3	0.6	1.0	0.9	0.4	1.1	1.5	1.4	0.8	1.8	3.0	2.9	1.0	1.2	1.8	2.1
LATIN AMERICA	5.8	4.5	4.7	5.3	6 2	4.7	5.1	5.7	13.6	13	14.0	16.1	4 7	4	3.4	3.4	2.6	1.8	1.5	1.4
Mexico	1.5	1.2	1.6	2.0	1.9	1.5	2.1	2.7	5.4	6	8.1	10.2	1.4	0.8	0.4	0.5	0.2	0.2	0.2	0.2

Note: 1998 is for first half of 1998.
Source: World Bank staff

1.24 Manufacturing led this export boom. The growth rate of manufactured exports more than doubled from 11 percent in 1985-90 to 26 percent in 1995-97 (Table 1.15). The only other country in the region that came close to such performance was China with 11 percent growth. Outside the region, manufactured export growth was also impressive in Mexico (20 percent), largely due to the North American Free Trade Agreement (NAFTA), but even that growth was lower than the Philippines.

Table 1.15: MANUFACTURING EXPORTS OF SELECTED DEVELOPING COUNTRIES

	VALUE (millions of U.S. dollars)				RATES OF GROWTH (percent per annum)					
	1985	1990	1995	1997	1980 -85	1985 -90	1990 -95	1995 -97	1998	1st sem 99
CHINA	6,049	48,043	132,784	164,209	--	51	23	11		-5
MALAYSIA	8,627	21,772	64,823	68,995	7	20	24	3	-7.7	12
INDONESIA	3,856	11,901	29,019	29,241	-2	25	20	0.4	-10.5	-12
THAILAND	3,658	17,255	46,129	47,190	10	36	22	1	-6.9	1
PHILIPPINES	**3,429**	**5,663**	**13,704**	**21,823**	**-3**	**11**	**19**	**26**	**16.9**	**14**
MEXICO	8,336	13,216	64,822	92,646	9	10	37	20	-	-
EAP	120,084	309,972	719,342	710,452	8	21	18	-1	-	-
	SHARE IN EAP EXPORTS (percent)									
CHINA	5	15	18	23						
MALAYSIA	7	7	9	10						
INDONESIA	3	4	4	4						
THAILAND	3	6	6	7						
Philippines	**3**	**2**	**2**	**3**						

Source: Lall, Albaladejo, and Aldaz (1999); CEM, 1999

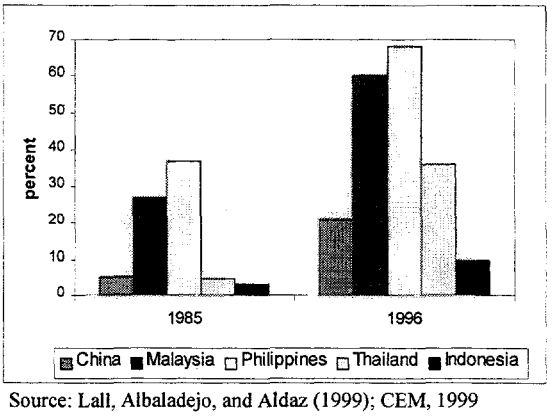
1.25 How could Philippine exports have performed so well in the face of a real appreciation, while they ground to a halt for the same reason in countries like Malaysia, Indonesia, and Thailand? Mainly, because all the expansion that took place came from high-technology sectors where "raw" wage competitiveness is only one of the cost considerations which influence investors' decisions on production location, and less of a critical one than in more labor intensive activities, such as toys, garments or footwear, for instance.

1.26 Indeed, the boom in manufactured exports was on the whole a result of investments by multinational corporations (MNCs) in the electronics industry, particularly in the semi-conductor industry. Fortunately for the Philippines, this was also the fastest growing segment of world trade: high technology (HT) exports increased their share in world exports from 17 percent in 1980 to 28 percent in 1996, growing on average at 12 percent annually between 1980 and 1996. As a result, the share of HT exports in the Philippines manufactured exports almost doubled from 37 percent in 1985 to 68 percent in 1996, higher than its closest competitor in this area, Malaysia (Figure 1.7).

1.27 Where wage competitiveness is paramount, however, Philippine exports performed poorly. Growth performance for garment exports slowed down from 4.5 percent in 1991 to just 0.5 percent in 1998, while that of agricultural exports posted contractions in both periods, -3.4 percent and -14 percent, respectively. Consistent with the poor growth performance, the share of garment exports in total exports also fell from 25 percent in 1991 to just 8 percent in 1998, while that of agricultural exports dropped from 19 to 5 percent over the same period.

1.28 Reflecting both this performance and counter-performance, the Philippines emerged from the 1990s with the most high-tech export structure in the region, and also perhaps in the world.

Figure 1.7: HIGH-TECHNOLOGY EXPORTS IN SELECTED COUNTRIES
(percentage of manufactured exports)



Source: Lall, Albaladejo, and Aldaz (1999); CEM, 1999

1.29 Impressive as it was, export performance was not such as to make up for the missed opportunities of the 1970s and 1980s, when the country missed out on labor-intensive industrialization. Philippines' exports therefore took off from a lower base than, say, China's, Thailand's or Malaysia's. The case is particularly striking when comparing Philippines and Thailand in the mid-1980s. The two countries enjoyed the same share in East Asia's manufacturing exports. But, in just five years, Thailand was able to double its share of East Asia manufacturing trade, and to peg it at about three times that of the Philippines. Similarly, by moving earlier, China was successful in increasing its share in regional exports from 5 percent in 1985 to 23 percent in 1997, followed by Malaysia and Thailand. In contrast, in the case of the Philippines, the recent boom only brought back the country's share to where it was in 1985 (Table 1.15).

1.30 This export performance was not enough either to reverse the process of (relative) desindustrialization, afoot since the early 1980s, and make up for the demise of those import-substituting industries failed to match increased competition, as Indonesia, for instance, managed to do. The latter country was not handicapped, however, by similar currency appreciation, nor by elevated food prices or wage costs (see Table 1.12 and Table1.16). Whereas in most other countries of the region, industry's contribution to the national output continued to expand through the 1990s, (albeit at a slower pace, in countries which experienced rapid currency appreciation), in the Philippines, it shrank (see Table 1.16). In this, the Philippines shared the same experience as Latin America, a region which had to deal with a similar legacy of import substitution industrialization.

Table 1.16: COMPOSITION OF OUTPUT IN SELECTED COUNTRIES, 1992-98
(percentage of GNP)

	AGRICULTURE			INDUSTRY			O.W. MANUFACTURING			SERVICES		
	1980	1990	1998	1980	1990	1998	1980	1990	1998	1980	1990	1998
CHINA	30	27	18	49	42	49	41	38	37	21	31	33
INDONESIA	24	22	20	42	40	45	13	20	25	34	38	35
MALAYSIA	22	19	3	38	40	44	21	26	29	40	41	43
PHILIPPINES	25	22	17	39	35	32	26	25	22	36	43	52
THAILAND	23	12	11	29	39	40	22	26	29	48	48	49
KOREA	15	9	6	40	45	43	28	31	26	45	46	51
LOW AND MIDDLE INCOME COUNTRIES												
EAST ASIA	24	n.a.	15	42	n.a.	45	30	n.a.	32	33	n.a.	41
LATIN AMERICA	10	n.a.	8	40	n.a.	29	28	n.a.	21	50	n.a.	64

Source: World Development Report, 1999; SIMA

Sectoral Employment, Earnings and Poverty Impact

1.31 As we shall see below, this shift of resources during the 1990s towards nontradable sectors eventually found a limit in the unsustainability of the external current account. But while it lasted, the process lifted many people out of poverty. The dynamics of poverty reduction during the 1990s are now clearer. Essentially, labor shifted from agriculture and mining to the more labor-intensive sectors of services and construction (see Table 1.17). As productivity is respectively about twice to five times as large in the sectors where labor moved to than in agriculture, those who made the move also found better income opportunities.

1.32 Indeed, higher competition on goods markets also led to a relative desegmentation of the labor market. Observers had previously noted that the dualistic nature of that market was one of the impediments which prevented the benefits of growth to spread more widely to the population, split as it was between well-guarded high paid jobs in heavily protected, capital intensive industries and an informal sector which hardly paid a living wage.[9] With liberalization however, sectoral earnings began to converge (see Table 1.18). Stripped of their shares of the rents, which trade protection used to generate, industrial wages came down on average (as competitive jobs replaced uncompetitive ones). A sharp drop in the number of workers covered by collective bargaining agreements[10] may have precipitated the phenomenon. Conversely, the draw of the services and construction sectors would have helped lift rural wages.

1.33 This wage convergence helped manufacturing employment expand somewhat despite the odds, although that expansion was limited to jobs where the value added per worker was sufficiently high to make up for high wage costs, i.e. jobs requiring a certain amount of skills (see Table 1.12). In contrast, starting from 1996 onward, agriculture started to shed large amounts of labor (see Table 1.17 and 1.19), notwithstanding the special protection extended to it.

[9] See Lall, D. 1979. "Wages and Employment in the Philippines." World Bank, Washington, D.C.

[10] From 230,000 in 1990 to 68,000 in 1998, despite union membership having risen from 3 to 3.7 million over the same period.

Table 1.17: EMPLOYMENT BY SECTORS, 1980-98
(percentage of total employment)

	1980	1985	1990	1995	1996	1997	1998
AGRICULTURE	51.65	49.31	44.53	43.41	42.83	40.82	39.17
MINING	0.67	0.65	0.63	0.42	0.42	0.47	0.43
MANUFACTURING	10.91	9.67	10.55	10.19	9.92	9.86	9.73
CONSTRUCTION	3.54	3.54	4.38	5.07	5.53	5.91	5.75
UTILITIES	0.34	0.38	0.38	0.44	0.43	0.48	0.51
TRANSPORT AND COMMUNICATION	4.33	4.50	4.85	5.75	6.00	6.29	6.62
TRADE	10.30	13.02	14.56	14.67	14.76	14.93	15.45
FINANCE & DWELLINGS	1.92	1.85	1.87	2.08	2.26	2.48	2.41
OTHER SERVICES	16.35	17.07	18.24	17.95	17.85	18.77	19.92
TOTAL	100.00	100.00	100.00	100.00	100.00	100.00	100.00

Source: Esguerra, et al. (1999); 1999 Philippine Statistical Yearbook for 1998 figures

Table 1.18: COMPENSATIONS BY SECTORS, 1991-97

	1991	1992	1993	1994	1995	1996	1997
AGRICULTURE: average daily wage rate[1/]	38.11	39.87	41.62	42.46	44.91		
INDEX OF COMPENSATION							
MANUFACTURING	103	102	95	87	81	74	71
CONSTRUCTION	120	116	119	123	114		
TRANSPORT & COMMUNICATION	184	197	193	202	216	211	223
TRADE	90	91	95	95	103	95	96
COMMUNITY, SOCIAL SERVICES	142	143	144	143	221	252	257

1/ pesos per day, 1988 base year
Source: Esguerra, et al. (1999)

Table 1.19: EMPLOYMENT BY SECTORS IN SELECTED COUNTRIES
(percentage of economically active population)

	AGRICULTURE			INDUSTRY			SERVICES		
	1980	1990	1998*	1980	1990	1998*	1980	1990	1998*
PHILIPPINES	**51.7**	**44.5**	**39.2**	**15.5**	**15.9**	**16.4**	**32.9**	**39.5**	**44.4**
THAILAND	71.0	64.0	50.3	10.0	14.0	19.7	19.0	22.0	30.0
INDONESIA	59.0	57.0	41.2	12.0	14.0	19.0	29.0	29.0	39.8
MALAYSIA	41.0	27.0	17.3	19.0	23.0	19.0	40.0	50.0	63.7
KOREA	37.0	18.0	13.6	27.0	35.0	33.2	36.0	47.0	53.2

* latest year available
Source: World Development Indicators, World Bank, 1997; Esguerra, et.al (1999)

1.34 Through the 1990s, employment in construction and services thus opened a main escape route out of poverty. Conversely, poverty emerged not so much as a rural issue, but as agriculture issue (Table 1.20 and Table 1.21). Special protection notwithstanding, agriculture remained the sector where poverty is highest (over 40 percent of the people engaged in agriculture are poor, see Table 1.20) and the sector which contributes the most to overall poverty (about two thirds of it, see Table 1.21). It is also the sector where the pace of reduction has remained slowest: between 1985 and 1997, it was twice as slow as in services. Even in rural areas, non-farm employment stands a better chance than farm jobs to lift people out of poverty, confirming

(a) earlier findings[11] that location per se is not a particularly significant determinant of poverty;[12] and

(b) early insights of economic theory[13] that food protection benefits more the landlord than the tiller... the vast majority of which is landless (on this subject, see last two sections of Chapter 2).

1.35 One can hardly avoid a suspicion that the protection granted to the sector in the name of food self-sufficiency actually served to retard a process of structural transformation which would otherwise have benefited the poor, had it been allowed to unfold more freely. Indeed, the next chapter presents the results of simulations indicating how the poor in general would have benefited from more even trade liberalization.

Table 1.20: EVOLUTION OF POVERTY BY SECTOR OF EMPLOYMENT, 1985-97

	1985	1988	1991	1994	1997	1985-97
	(percentage of population)					(percentage change)
AGRICULTURE	57.7	51.2	51.9	49.9	42.3	-17.38
INDUSTRY	32.0	23.8	25.0	22.4	16.8	-29.41
SERVICES	21.8	17.6	16.8	15.1	10.6	-39.77
OTHERS*	21.6	19.5	16.8	17.2	12.1	-37.95
TOTAL	40.9	34.4	34.3	32.1	25.0	-27.33
*Others include unemployed and activities not elsewhere classified.						
Memo item: Rural Population only						
AGRICULTURE	60.0	53.3	55.2	52.5	44.8	-15.95
NON-AGRICULTURE	38.7	31.8	35.7	32.2	23.6	-25.79
TOTAL (RURAL)	53.1	45.7	48.6	45.4	36.9	-19.26

Source: Balisacan (1999)

Table 1.21: SECTORAL PROFILE OF POVERTY, 1997
(percent)

EMPLOYMENT SECTOR OF HOUSEHOLD HEAD	POVERTY INCIDENCE	CONTRIBUTION TO TOTAL POVERTY[a/]
AGRICULTURE	42.3	67.8
MINING	30.0	0.7
MANUFACTURING	13.5	3.8
UTILITY	9.5	0.3
CONSTRUCTION	23.1	7.1
TRADE	13.5	4.7
TRANSPORT	13.7	4.4
FINANCE	3.0	0.2
SERVICES	9.9	4.9

a/ Figures do not add up to 100 because households whose heads were unemployed were excluded.
Source: Balisacan (1999)

[11] Balisacan, A. M. 1999. *Causes of Poverty: Myths, Facts and Policies.* School of Economics, University of the Philippines, Quezon City, Philippines.

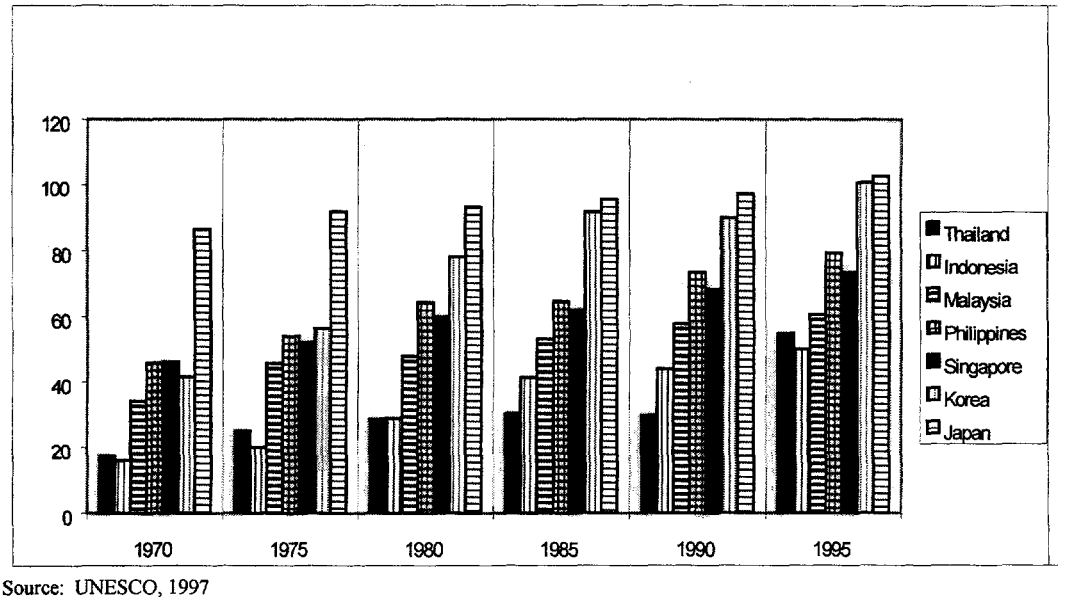
[12] This refers to the direct impact of location on poverty outcome. Location may however have an indirect influence through its impact on other determinants of poverty, such as access and quality of health and education. Note that the figures in Table 1.15 actually understate the contribution of non-farm employment. This is because of the demarcation between rural and urban changes over time. As soon as a rural barangay acquires a minimum of basic infrastructures and services, it is re-classified as urban, leaving the related jobs out of the calculation.

[13] Dating back to David Ricardo.

Skills and Education

1.36 With this structural transformation, the country thus began to realize the benefits of its long-standing effort in favor of education, an effort which the big push in favor of secondary education since the Aquino administration most recently epitomizes.[14] This investment into human capital put the country ahead of its neighbors in terms of secondary and, even tertiary enrollment (see Figure 1.8 and Figure 1.9) and made it possible for labor gradually to shift towards higher productivity activities, as we saw above. Even better, as far as the development of information technology (IT) industries is concerned, at the tertiary level, a higher proportion of population is enrolled in the technical subjects than in either China, Malaysia or Thailand (Table 1.22). As a result, more technical and engineering skills are available in the Philippines than even in countries like Malaysia, where firms often face an acute shortage of skilled workers, and have to rely on expatriate workers (including from the Philippines).

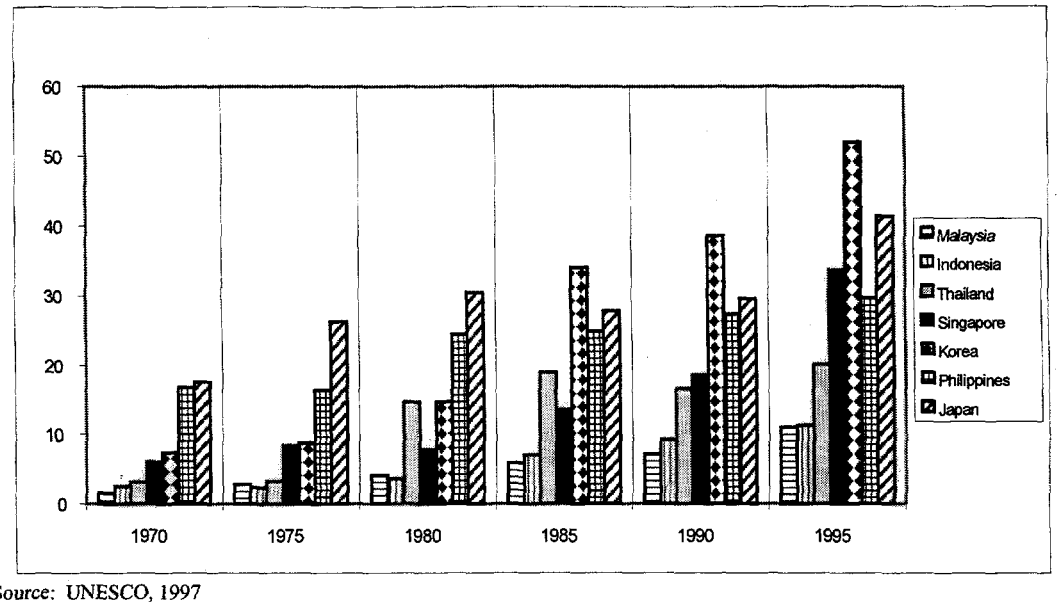
Figure 1.8: GROSS SECONDARY ENROLLMENT RATIOS IN SELECTED ASIAN COUNTRIES
(percentage of age group)



Source: UNESCO, 1997

[14] Although it has been argued that this policy would have merely resulted in crowding out private initiative, recent research (Jimenez, 1999) shows that this "crowding out" effect, while it exists, would actually have been limited: an increase in public school enrollment of, say, 10 pupils would increase additional enrollment of 7 pupils by public and private schools together

Figure 1.9: GROSS TERTIARY ENROLLMENT RATIOS IN SELECTED ASIAN COUNTRIES
(percentage of age group)



Source: UNESCO, 1997

1.37 That investment in education also gave the Philippines an edge in attracting HT activities, when the country opened up more widely to foreign investment in the early 1990s. The facilities offered by the Bureau of Investment (BOI) and the Philippine Export Zone Authority (PEZA)[15] undoubtedly lured many MNCs to the country. But what decided them more often than not to stay and disregard its lack of infrastructure and relatively high wages was the ample supply of relatively skilled and English-speaking workers who could quickly adapt to the HT production methods.

Table 1.22: EDUCATION ENROLLMENTS AT THE TERTIARY LEVEL, SELECTED COUNTRIES

	TOTAL ENROLLMENT IN TECHNICAL SUBJECTS AT THE TERTIARY LEVEL	
	Number	% of population
CHINA	1,238,100	0.101
INDONESIA	447,000	0.226
PHILIPPINES	**373,900**	**0.551**
MALAYSIA	26,100	0.130
THAILAND	108,300	0.186

a/ data is for latest year available
Source: UNESCO, 1997; World Development Indicators, 1999

1.38 Education therefore provided a key underpinning to the poverty reduction process described above. As Table 1.23 shows, the higher the education attainment, the better able the poor were to join in the structural transformation process. Much remains to be done, of course, to make the ideal of equal education opportunity for all a reality (as we shall see in Chapter 4).[16] But recent achievements should be give reason to forge ahead.

[15]As will be noted in Chapter 4, these schemes introduced substantial fiscal incentives, which resulted in a loss in revenue as well as considerable complication of tax administration.

[16] See Asian Development Bank and The World Bank. 1999. "Philippine Education for the 21st Century: The 1998 Philippines Education Sector Study." Manila, Philippines.

Table 1.23: POVERTY AND EDUCATIONAL ATTAINMENT
(percent)

	POVERTY SHARE	POVERTY			CONTRIBUTION TO TOTAL POVERTY		
		Incidence	Depth	Severity	Incidence	Depth	Severity
NO EDUCATION	3.8	46.2	13.8	5.5	7.0	8.1	9.0
ELEM. UNDERGRADUATE	22.8	41.6	11.4	4.4	37.8	40.8	42.9
ELEMENTARY GRADUATE	24.5	31.4	7.8	2.8	30.8	29.9	29.2
HS UNDERGRADUATE	11.5	24.4	5.7	1.9	11.2	10.3	9.5
HIGH SCHOOL GRADUATE	18.6	13.5	2.9	0.9	10.0	8.5	7.5
COLLEGE UNDERGRADUATE	10.5	6.3	1.2	0.3	2.6	1.9	1.5
DEGREE HOLDER	8.2	1.7	0.3	0.1	0.6	0.4	0.3
NOT REPORTED	0.2	3.1	0.0	0.0	0.0	0.0	0.0
TOTAL	100.0	25.0	6.4	2.3	100.0	100.0	100.0

Source: Balisacan (1999) based on the *1997 Family Income and Expenditures Survey.*

Distribution of Income and Consumption

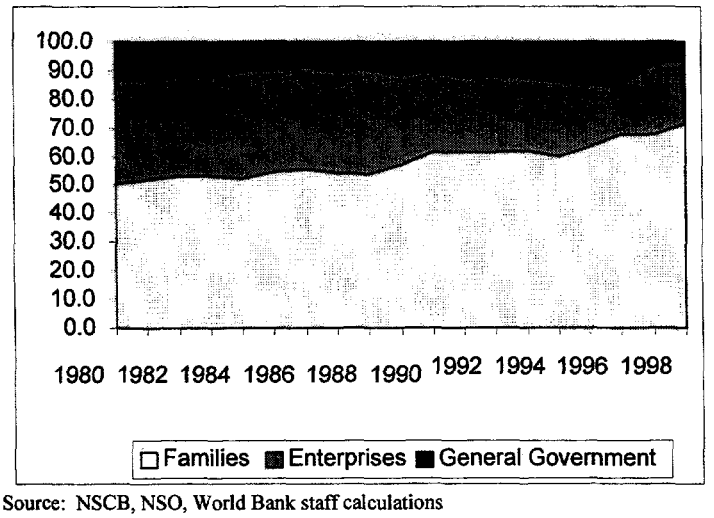
1.39 The shift from inward to outward orientation, also appear to have led to a major redistribution of the national income in favor of families. (see Figure 1.10).[17] Although the data in the area is spotty, this redistribution would have reflected (i) a rising labor share of the national income (as growth became more labor intensive, as seen above) and (ii) a redistribution of the previous monopolist/protectionist rents to society at large.[18] This element of rent redistribution, in particular, may have helped the purchasing power of families (as captured by the Family Income and Expenditure Survey) as it expand faster during the period under review than a cursory look at the national accounts would lead to believe (see Figure 1.11).

1.40 Furthermore, an inflow of overseas remittances served to maintain the expansion of private consumption consistently above that of GDP (see Figure 1.2 above).

[17] The data utilized here is different than the one generated by the national accounts, which lump together "household" and unincorporated enterprises." This category provides an imperfect approximation of developments affecting household *stricto sensu.* First, it covers a broad, but gray area of economic activities having little to do with the economic definition of a "household," ranging from small subsistence farms to sophisticated business enterprises (carried out at the individual, family levels or under the guise of non-corporate partnerships) and to underground economic activities. Second, being often calculated by residual, the related accounts reflect measurement errors affecting the calculation of other items. The analysis above relies instead on the information generated by the Family Income and Expenditure Survey (FIES), and substitutes in the national accounts under the appellation "family income, consumption and savings." The "enterprise" category is calculated by residual so as to encompass both incorporated and unincorporated enterprises. The reader should be aware however of methodological differences between FIES and national account data, and treat the figures presented for "families" and "enterprises" merely as broad order of magnitude.

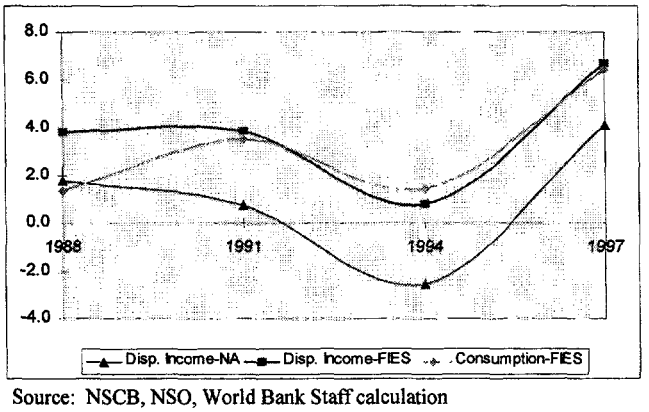
[18] This rent redistribution may help explain why family income (FIES definition) would have expanded faster during the period under review than that of "household and unincorporated enterprises). A gradual "incorporation" of business activities, accompanying the emergence of the underground economy would provide a further explanation.

Figure 1.10 DISTRIBUTION OF THE GROSS NATIONAL DISPOSABLE INCOME
(percentage of total)



Source: NSCB, NSO, World Bank staff calculations

Figure 1.11: POVERTY, DISPOSABLE INCOME, AND FAMILY CONSUMPTION
(average percent change per year)

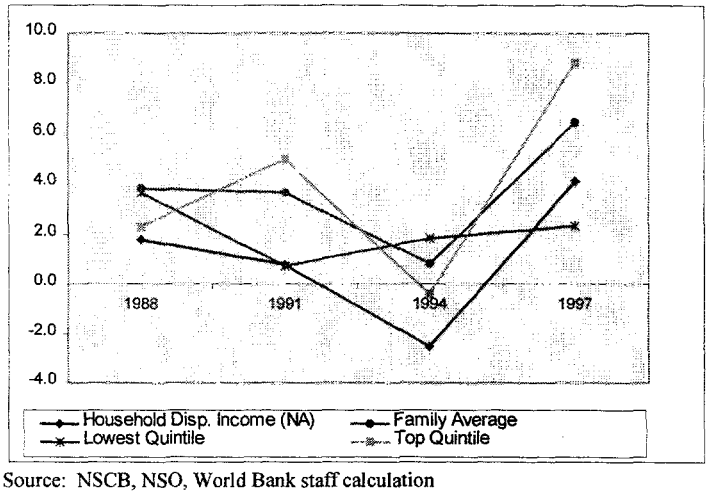


Source: NSCB, NSO, World Bank Staff calculation

1.41 What did not improve however is the distribution of income among families (see Figure 1.12). Until recent years, gains in purchasing power appear to have been evenly shared across families, leaving the distribution of income unchanged. But for reasons, which are yet poorly understood, the benefits from the acceleration of growth in 1994-97 appear to have accrued disproportionately to the higher categories of income. The fact that, in the overall growth, the lowest income categories also experienced unprecedented poverty reduction may have first made this growing inequality more socially acceptable—as it has been in Malaysia, the country which the Philippines came to par with in terms of high income inequality (see Table 1.24).[19] But a slower growth scenario may make distribution issues much more sensitive.

[19] Such levels of inequality are high by international standards, although they are exceeded in Latin America and in the former apartheid countries (Zimbabwe, South Africa).

Figure 1.12: EVOLUTION OF INCOME BY QUINTILE
(average percent change per year)



Source: NSCB, NSO, World Bank staff calculation

Table 1.24: DISTRIBUTION OF INCOME AND CONSUMPTION IN SELECTED COUNTRIES
(percentage of total, unless otherwise indicated)

			INCOME DISTRIBUTION		CONSUMPTION DISTRIBUTION	
		GINI	LOWEST DECILE	HIGHEST DECILE	LOWEST DECILE	HIGHEST DECILE
PHILIPPINES	INCOME	48.9	1.7	39.3	4.4	55.5
	CONSUMPTION	46.2	2.3	36.6	5.4	52.3
INDONESIA	INCOME	36.5	3.6	30.3	8.0	44.9
KOREA	CONSUMPTION	31.6	2.9	24.3	7.5	39.3
MALAYSIA	INCOME	48.5	1.8	37.9	4.5	53.8
THAILAND	CONSUMPTION	41.4	2.8	32.4	6.4	48.4

Source: World Development Indicators, 2000

D. THE ASIA CRISIS AND BEYOND

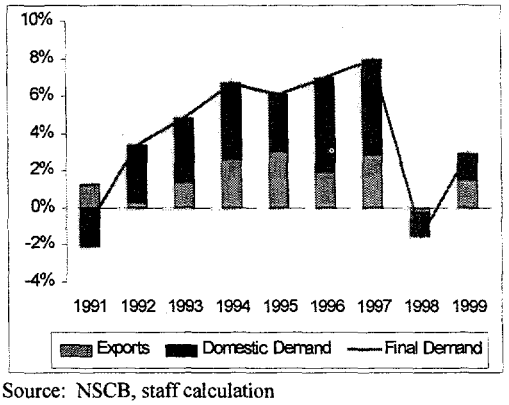
1.42 This growth and poverty reduction pattern—relying heavily as it did on a shift of resources towards nontradables and on foreign rather than domestic savings—was not tenable for ever, however; real appreciation led to unsustainably high macroeconomic imbalances. Whereas demand pressures mounted on the tradable sector, factors moved in the opposite direction—towards the non-tradable sectors where they piled up (see decline in total factor productivity in non-tradable sectors, in Table 1.13) in anticipation of profits which further real appreciation would generate. Investment motives therefore became increasingly precarious and vulnerable to a shift in the underlying macroeconomic parameters. Witness for instance how the forays of an appliance manufacturer such as the Eyco group entry into real estate turned sour shortly after the onset of the crisis, bringing down the entire group.

1.43 The outstanding export performance initially provided a respite (and shielded the Philippines from the brunt of the crisis). Whereas total exports had grown at an annual

average rate of 4 percent in the 1980s, they surged to a rate of about 16 percent in 1990-98. As a result, their share in GDP nearly tripled from 21 percent in 1980-85 to 57 percent in 1998.

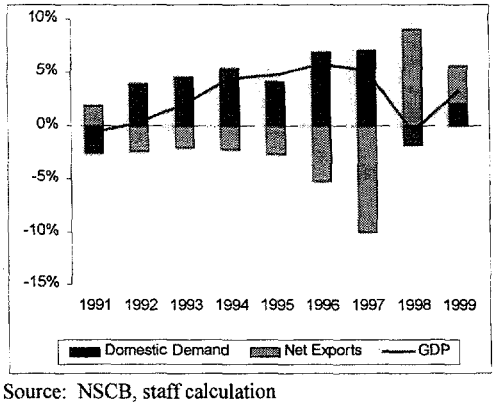
1.44 But export boom notwithstanding, the impulse provided by the external sector ultimately turned negative (see Figure 1.13 and Figure 1.14), as the pace of import growth overtook that of exports. The resulting external imbalances were for a while masked by a surge of overseas remittances (see Table 1.3). By 1997, however, the current account had begun to widen to uncomfortably large levels, exposing the country to the manic-depressive sentiments of international markets.

Figure 1.13: CONTRIBUTIONS TO FINAL DEMAND,
1991-98 (percent)



Source: NSCB, staff calculation

Figure 1.14: CONTRIBUTIONS TO GROSS DOMESTIC PRODUCT
1991-98 (percent)



Source: NSCB, staff calculation

1.45 Luckily for the country, this incipient bout of Asia flu did not become virulent. The later collapse of Gotesco-Orient Bank group after breakneck expansion into real estate and shopping malls financed by connected lending shows that the seeds had been sown, but before the crisis itself stopped the infection from spreading. The main reason is that, thanks in part to comparatively better banking regulation, in part to the country's track record of booms and busts, corporate and banking balance sheets did not generally become as overextended as they did in neighboring countries. Chapters 2 and 3 will return to these points.

1.46 Imbalances remained essentially macroeconomic in nature, and liable therefore to be treated through conventional macroeconomic instruments. A sharp rise in interest rates, against a background of soaring exports, knocked the wind off domestic demand and shifted the current account sharply into surplus. The social impact of the crisis was therefore also more modest than in other affected countries: although the Asia crisis /El Niño episode may have caused poverty incidence to slide back by about 9 percent, two third of that impact may be attributable to the weather phenomenon rather than to financial developments (see Datt and Hoogeveen, 2000).

1.47 As was seen in the prologue, the country succeeded during 1998-99 in restoring its external financial situation at a much lower social cost than its neighbors more severely affected by the Asian crisis.

1.48 The problem now is that the subsequent efforts to revive growth through fiscal and monetary stimulation have been less effective. This is in part because the private sector remains uncertain as to which course the economy is taking next. While the uncertainty persists, poverty reduction is at a standstill. The final section of this chapter will highlight some of the challenges involved in reviving broad-based growth.

E. Lessons and Challenges for the Medium-Term

1.49 If the record of the nineties is any guide, it ought to be possible to reduce poverty incidence from 25 percent of the population on most recent count to 15 percent by the end of this decade. Achieving this would cut down the absolute number of poor by over 4 million, despite current demographics. This would set the country on target towards the international objective of reducing absolute poverty by half by 2015. Meeting this challenge, as will now be argued, will require

(a) containing population growth and dealing with its implications.

(b) resuming faster, labor-intensive, but also better balanced growth.

(c) managing the rapid urbanization, which the needed structural transformation of the economy will necessarily involve.

Coming to Grips with Demographics

1.50 Current rates of demographic expansion hinder the realization of poverty reduction ambitions. Although the country's rate of population growth remains on a secular deceleration path, population would still, on present trend, rise from about 75 million in 1998 to about 95 million in 2010. Although it has come down over the years, the Philippines still has a high fertility rate (3.6) by Asian standards (see Table 1.27). As a result, population growth in the Philippines remains one of the highest in the region.

1.51 Recent National Demographic and Health Survey (NDHS, 1998) data help explain why fertility remains so high: on average, each Filipino woman has one more child than she would desire (Herrin, 1999). Put differently, of the births in the last five years, 27 percent were to mothers who wanted children later and another 18 percent were to mothers who did not wish to have another child at all. Why should it be this way? Essentially because 20 percent of married men want more children than their wives (as the latter perceive it), while 20 percent of married women who do not want to become pregnant are not practicing contraception.

1.52 The consequences of this discrepancy on population trends can hardly be overstated. The population is, in year 2000, five million larger than it would have been, had women had as many children as they wished during the past decade (see Table 1.25). By 2010, it will be 9 million larger because of it.

Table 1.25: DEMOGRAPHIC SCENARIOS
(thousands)

BASELINE PROJECTIONS			
AGE GROUP	**1995**	**2000**	**2010**
5 – 19	25,001	26,711	30,334
20 – 64	33,242	38,573	50,615
65 +	2,428	2,848	4,116
TOTAL POPULATION	70,267	78,602	95,553
SCENARIO 1 (desired fertility rates from 1990 onward)			
AGE GROUP	**1995**	**2000**	**2010**
5 – 19	25,003	24,262	22,968
20 – 64	33,244	38,571	50,614
65 +	2,417	2,836	4,092
TOTAL POPULATION	67,789	73,308	86,544
SCENARIO 2 (desired fertility rate from 2000 onward)			
AGE GROUP	**1995**	**2000**	**2010**
5 – 19	25,001	26,711	28,215
20 – 64	33,242	38,573	50,615
65 +	2,428	2,848	4,116
TOTAL POPULATION	70,267	78,602	91,921

Source: World Bank staff estimates

1.53 These demographic factors frustrated poverty reduction efforts in many different ways. First, at the family level: although perhaps on the high side,[20] available estimates indicate that poverty incidence increases with family size (see Table 1.26). Further research is needed to elucidate the dynamics at play. One of the factors might be that repeated pregnancies[21] lower the participation of women in the labor force, leading to losses of income opportunities and lower living standards for the family as a whole. This may help explain why female labor force participation rate is relatively low compared to other countries in the region, given how relatively well-educated women are (Table 1.27)—even slightly better than Philippine males.

Table 1.26: POVERTY AND FAMILY SIZE
(percent)

	POPULATION SHARE	POVERTY			CONTRIBUTION TO TOTAL POVERTY		
		Incidence	Depth	Severity	Incidence	Depth	Severity
FAMILY SIZE							
1-2	10.4	8.5	1.8	0.6	3.5	2.8	2.5
3-4	32.4	15.8	3.3	1.0	20.4	16.9	14.4
5-6	32.2	28.0	6.9	2.4	36.0	35.0	34.0
7-8	16.9	39.4	11.4	4.5	26.6	30.0	32.7
9 & ABOVE	8.2	41.3	11.8	4.6	13.6	15.2	16.5
NATIONAL	100.0	25.0	6.4	2.3	100.0	100.0	100.0

Source: Balisacan (1999) based on the *1997 Family Income and Expenditures Survey.*

[20] As they ignore economies of scale in consumption.

[21] Awareness and usage of contraceptive methods does not appear to be influenced by the level of income Alba, Michael M. 1999. "Exploring the APIS Data on the Accessibility of Public Services."

Table 1.27: FEMALE EDUCATION, FERTILITY AND LABOR FORCE PARTICIPATION
(percent, unless otherwise indicated)

	PRIMARY ENROLLMENT[a/] (% net)	TERTIARY ENROLLMENT[a/] (% net)	FERTILITY	LABOR FORCE PARTICIPATION 1995
CHINA	101.9	3.9	1.9	72.9
INDONESIA	94.7	8.0	2.7	49.1
KOREA	92.6	46.0	1.6	47.9
PHILIPPINES	**98.0**	**40.7**	**3.6**	**47.3**
THAILAND		22.3	1.9	65.2

a/ latest year available
Source: UNFPA, 1999; World Development Indicators, 1999

1.54 What is clearer however is the sheer magnitude of the challenge to deliver the basic public goods needed to lift people out of poverty under such demographics. Due only to the prevailing discrepancy between desired and actual maternity, there are currently over 2.5 million—and there will be 7 million by 2010—more children and youth of age to go to school than there would otherwise have been! Translate that into teachers, classrooms, desks, chairs, and textbooks and the burden of demands comes in full view.

1.55 Growing population will also pose new challenges. First, feeding it will require a different concept of food security. The ideal food self-sufficiency may have looked plausible in the 1970s when population was half its current level. Already during the last 20 years, rice use has been growing at a faster pace (3.4 percent) than rice output (2.4 percent),[22] leading to higher imports and price pressures. With cultivated areas constrained and cereal yields sluggish, there is little perspective that the sector could feed 15 to 20 million more mouths by 2010. Supply restrictions (including imports) are more likely to end up putting upward pressure on food prices, further straining household budgets (particularly for low-income family for whom food counts most) and dragging down overall economic growth.

1.56 Slowly also, the population will begin to age over the next decade, as the demographic transition unfolds. With this aging will come new challenges. For one, the nature of disease burden will change. The 10 million more people over the age of forty by the year 2010 than in 1995 (on present trends) are likely to put heavier demand on the hospital sector, as well as on the embryonic health insurance system. Second, with two million more people beyond retirement age, old-age poverty and how to prevent it will become a much more vivid issue than it has been so far. These trends will amplify the coming pressures on social programs, already noted in the case of education.

1.57 It is not too late to do something to curtail population pressure. The inherent inertia of population dynamics, notwithstanding, the population simulation shows (see Table 1.25, Scenario 2) that the 2010 population could still be curbed by 3.5 million if fertility rates were brought down to desired levels starting from this year onward.

[22] Of which 1.6 percent reflects higher yields and 0.8 percent due to increase in area harvested.

1.59 Although there has been some recent progress in the use of contraceptives, family planing efforts have largely been neglected. The reluctance on part of the government has forced the country to rely disproportionately on funding from foreign donors (Table 1.28), limiting effectiveness and increasing vulnerability to foreign cutbacks.

Table 1.28: GOVERNMENT AND DONOR SHARE IN FUNDING FOR SELECTED PROGRAMS, 1996
(percent)

SELECTED PROGRAMS	GOP SHARE	DONOR SHARE
POPULATION COMMISSION	63	37
REPRODUCTIVE HEALTH	4	96
STD/HIV/AIDS	18	82
NUTRITION SERVICES – MOTHERS	61	39

Source: UNFPA, 1999

Resuming Faster, Labor-Intensive Growth

1.60 Such rapid population trends put an even greater onus on policymakers to bring back growth to pre-crisis rates. Achieving such growth rates will require amplifying the ongoing process of structural transformation by which factors of production particularly labor, shift to higher productivity activities. The word "industrialization" could be used in this context if it encompasses those services which are quickly "industrializing" as a result of the IT revolution, and in which the Philippines has good potential to expand. Figures 1.15 and 1.16 illustrate how the process could unfold (see also Chapter 2).

1.61 For growth to return to and sustain a 5 percent trend rate during the remainder of the decade (i.e., not counting a cyclical El Niño impact), the baseline scenario envisages that industry should expand to produce 37 percent of the country's value added (the position it had at the beginning of the 1980s) and absorb 20 percent of the labor force. In parallel, agricultural employment would further shrink from about 40 percent now to 34 percent at the end of the decade.

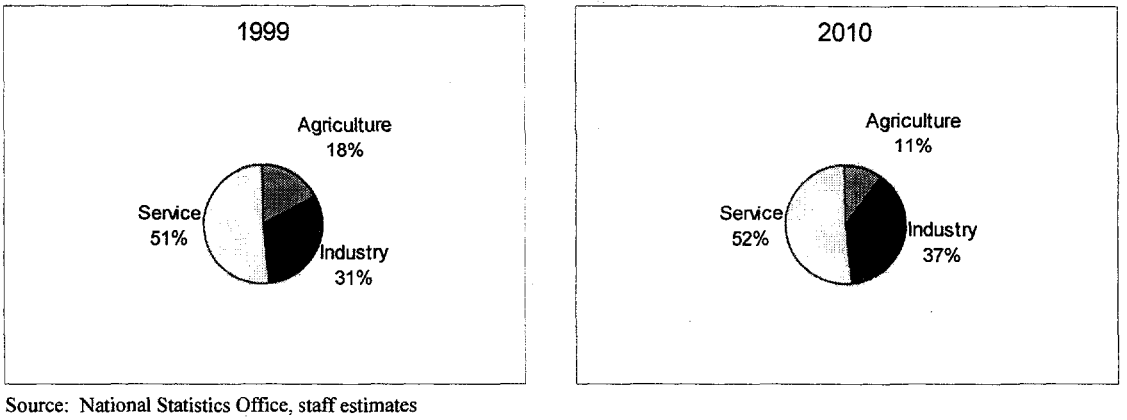
1.62 The resulting growth performance, although not stellar, would constitute a clear improvement on anything the country has known for the last quarter of a century. It would allow average income per capita to grow by a cumulative 27 percent during the decade. Most of the gains would be recorded in industry and services, and, as these sectors expand, those gains would extend to a growing share of the population (see Table 1.29). This process will remain the main escape hatch out of poverty. A reduction in rural underemployment may also boost rural living standards. Still, there are few scenarios under which agricultural earnings could catch up with national averages, short of a more drastic restructuring and downsizing of the sector than envisaged under this scenario.

Table 1.29: GROWTH PROSPECTS
(percent, annual growth rate)

	1998	1999	2000-04	2005-10
GDP	-0.5	3.2	4.6	4.5
O.W. AGRICULTURE	-6.6	6.6	2.6	1.5
INDUSTRY	-1.9	0.5	5.8	7.2
SERVICES	3.5	3.9	4.6	3.2
EMPLOYMENT	0.7	1.3	3.2	2.8
O.W. AGRICULTURE	-3.4	6.3	1.5	1.3
INDUSTRY	-1.0	-1.1	4.2	6.3
SERVICES	5.3	3.5	4.0	2.5
INCOME PER CAPITA 1/	-2.6	0.8	2.4	2.5
PRIVATE CONSUMPTION PER CAPITAL	-0.1	-0.5	2.7	2.3

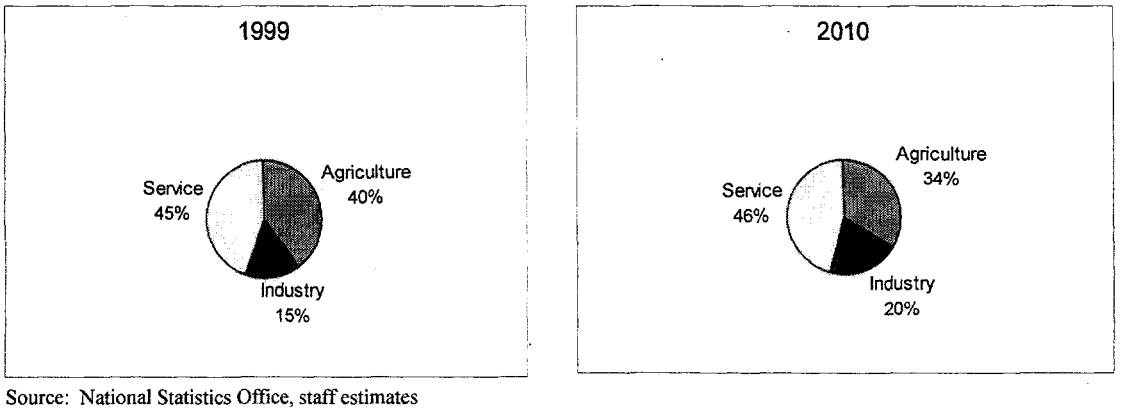
1/ GDP per capita at constant prices
Source: National Statistical Coordination Board, Department of Labor, World Bank Estimates

Figure 1.15: STRUCTURE OF OUTPUT



Source: National Statistics Office, staff estimates

Figure 1.16: STRUCTURE OF EMPLOYMENT



Source: National Statistics Office, staff estimates

1.63 In practice, the pace at which this structural transformation will take place will depend particularly on the following policies:

(a) *Preventing renewed currency overvaluation.* Whatever else happens to capital inflows, the country's heavy reliance on overseas remittances will continue to exert upward pressure on the real exchange rate. Hence the

need to redouble efforts at reducing structural factors of inflation—such as supply bottlenecks (e.g., on food supply) and impediments to competition (e.g., in services)—in order to limit the negative side-effects from these beneficial inflows.

(b) *Broadening trade liberalization.* The pace at which the country is able to bring down its food prices, and thereby enhance labor competitiveness, will have a crucial bearing on its capacity to expand into any internationally competitive, labor-intensive activity, be it in agriculture, industry or services, and to seize the opportunities which world trade expansion offers beyond the confines of electronics. The devaluation of the peso was actually instrumental in setting that process in motion: as a result of it, the implicit rate of protection dropped in the case of rice from about 80 percent to about 34 percent between 1997 and 1998 (see Table 1.11). It would be important to stay on this trajectory. Chapter 2 will outline the remaining trade policy agenda, as well as the difficult transition problems involved.

(c) *Fostering competition in services.* Factor productivity will also need to grow *within each of the sectors.* The discussion above shows how productivity was beginning to improve in tradable sectors under the pressure of competition. The source of the economy-wide counter-performance lies primarily in the non-tradable sectors. If the experience of tradables were any guide, the situation would call for subjecting non-tradables also to a healthy dose of competition (see Chapter 4). Retail trade (recently passed into law), public works, telecommunications, power, ports, shipping should be some of the first targets.

(d) *Strengthening the corporate framework and capital markets.* Weak protection of minority shareholders and creditors, by limiting firms' access to outside finance (both equity and credit) has held back growth and contributed to a concentration of ownership within closely held, family-based conglomerates. As will be discussed in the next two chapters, an early approval of the proposed Securities Act by Congress, and of effective debt resolution procedures by the Securities and Exchange Commission would considerably improve the formal framework. Overtime, there may be grounds to transfer the quasi-judicial functions of SEC to specialized courts. Little would have been accomplished however unless and until the rules which are on the books are more deliberately enforced (e.g., authority and independence of the Security and Exchange Commission, integrity of regulation, accounting and auditing practices; compliance with disclosure requirements; diligence of judicial procedures).

(e) *Reinforcing governance.* A growing body of international evidence documents the importance of good governance for economic growth and poverty reduction. As will be seen in Chapter 4, international surveys report for instance a steady improvement in perceptions of corruption and in the prevalence of the rule of law since the late 1980s; they also indicate

how much remains to be done in order to bring the core machinery of government up to standards.

(f) *Mobilizing domestic savings.* A lack of savings helps to explain why the country as a whole and poorer individuals in particular are so highly exposed to shocks and turbulences (as will be seen in Chapter 5). Both international and national research point toward a virtuous circle between accelerating growth and rising savings rate. The policies outlined above to sustain the level of growth required for rapid poverty reduction should therefore also help improve the country's investment-savings coverage ratio. More direct interventions to bolster confidence in banks and currency, broaden financial markets and instruments, particularly through contractual savings instruments (see Chapter 3), alleviate the burden of food expenditure on lower income budgets (see (a) above and Chapter 2), and resume fiscal consolidation efforts (see Chapter 4) will also be in order.

(g) *Maintaining the country's attractiveness as a production location.* The country still has scope to attract considerably more foreign direct investment. For all its recent successes in the area, the country remains a smaller player in this field (see Table 1.30). With trade liberalization within AFTA, foreign direct investment will become less and less motivated by access to market considerations, and more by production and marketing environment factors (e.g., infrastructure, factor markets). The Philippines will need to redouble its efforts in the area if it wants to benefit from the ensuing industrial consolidation across the region, as well as to position itself for the incipient relocation of service activities from developed to developing countries (see Chapter 2). Improving urban and inter-urban infrastructure is the top priority, as discussed below.

Table 1.30: FOREIGN INVESTMENT INFLOWS TO EAST ASIA

	1980	1985	1990	1993	1994	1995	1996	1997	1998
	FDI INFLOWS–BILL. US DOLLARS								
CHINA	--	1.7	3.5	27.5	33.8	35.8	40.2	44.2	45.5
INDONESIA	0.2	0.3	1.1	2.0	2.1	4.3	6.2	4.7	-0.3
KOREA, REP.	0.0	0.2	0.8	0.6	0.8	1.8	2.3	2.8	5.1
MALAYSIA	0.9	0.7	2.3	5.0	4.3	4.2	5.1	5.1	3.7
PHILIPPINES	**-0.1**	**0.0**	**0.5**	**1.2**	**1.6**	**1.5**	**1.5**	**1.2**	**1.7**
SINGAPORE	1.2	1.0	5.6	4.7	8.6	7.2	7.9	9.7	7.2
THAILAND	0.2	0.2	2.4	1.8	1.4	2.1	2.3	3.7	7.0
TOTAL 7	--	4.1	16.2	42.8	52.6	56.9	65.5	71.5	69.9
CRISIS 5	1.2	1.4	7.2	10.6	10.2	13.8	17.5	17.6	17.2
WORLD	46.3	55.7	203.1	219.4	253.5	328.9	358.9	464.3	643.9
	FDI INFLOWS–PERCENT OF GDP								
CHINA	--	0.5	1.0	6.4	6.2	5.1	4.9	4.9	4.7
INDONESIA	0.2	0.4	1.0	1.3	1.2	2.2	2.7	2.2	-0.4
KOREA, REP.	0.0	0.2	0.3	0.2	0.2	0.4	0.5	0.6	1.7
MALAYSIA	3.8	2.2	5.5	7.8	6.0	4.7	5.1	5.2	5.2
PHILIPPINES	**-0.3**	**0.0**	**1.2**	**2.3**	**2.5**	**2.0**	**1.8**	**1.5**	**2.6**
SINGAPORE	10.5	5.9	14.9	8.0	11.8	8.7	8.0	9.0	8.4
THAILAND	0.6	0.4	2.9	1.4	0.9	1.2	1.3	2.4	2.4
TOTAL 7*	--	1.4	3.8	3.9	4.1	3.5	3.5	3.7	3.5
CRISIS 5*	0.9	0.7	2.2	2.6	2.2	2.1	2.3	2.4	2.3

* Simple Averages
Source: UNCTAD (1999), World Bank data.

Stimulating Agricultural Modernization

1.64 Considerable research and effort will need to go into agriculture to help the sector adjust to trade liberalization and seize the opportunities offered by the opening up and expansion of markets along the entire western Pacific Rim to diversify into internationally competitive crops (tree crops, for instance). To see the sector through the transition, there will be a need for a package of strategic interventions to expand and prioritize strategic public and private investments in the countryside (with innovative cost sharing arrangements), promote improved natural resource management, consistent with increasing smallholder productivity and diversification, and rationalize institutional arrangements and roles (in support of devolution and convergence), as well as for research and extension services to develop and spread alternative farming packages to the farmers. This should be the main thrust of the implementation of the Agriculture and Fisheries Modernization Act.

Improving the Efficiency and Effectiveness of Education.

1.65 As we noted above, under current demographic trends, the country will have about 4 million more children and youth of school age by 2010 than it has now. Whether or not this growing pool of talents is able to drive the country's modernization, will depend on how much the country is able to achieve in improving the relevance of education, and its accessibility to all.

1.66 Four major studies[23] have recently highlighted how quality and relevance had, perhaps inevitably not kept up with quantitative achievements. The school system is

[23] Asian Development Bank and The World Bank. 1999. "Philippine Education for the 21st Century: The 1998 Philippines Education Sector Study." Manila, Philippines; National Committee on Education for All. 1999. "Philippines: Education for All:

succeeding in its most basic mission: the functional literacy rate has risen from 73 percent in 1989 to 84 percent in 1994. But other indicators of effectiveness and efficiency leave considerable room for improvement, as the following figures indicate

(a) Whatever official objectives are stating, the cohort survival rate and dropout rates are stubbornly high (63 percent and 8.8 percent in 1996 and 1997).

(b) The availability of school inputs has dropped (to a point where [] pupils now need to share one textbook).

(c) The improvement in mean achievement scores, despite a steady improvement from 42 percent to 51 percent between 1993 and 1997 in elementary education, and from 39 percent to 49 percent in secondary education between 1995 and 1998, remain way below target.

(d) In higher and vocational education, a proliferation of low quality state universities and colleges is displacing private institutions,[24] with the result that on average less than half the training graduates pass post training skills examination tests.

(e) Accessibility also remains an issue for the poor (as will be documented in Chapter 4).

1.67 It is not possible, in the context of this report, to do full justice to the wealth of ideas, suggestions, and recommendations that these two studies have brought for forward. Let us highlight a few, while inviting the reader to peruse the studies themselves for a more detailed prescription:

(a) Targeting future investments in primary and secondary education benefit underserved areas and groups.

(b) Develop and monitor school performance standards.

(c) Step up and rationalize the procurement of textbooks and other instructional materials so that it becomes financially feasible for all pupils to have textbooks.

(d) Use hardship and performance allowances, in preference to across the board pay raises to elicit performance from the teachers and incite them to serve in difficult areas.

(e) Deconcentrate the management of the school system to school principals and local education boards.

Philippine Assessment Report. " Unicef, October l; Human Development Network and UNDP. Philippine Human Development Report 2000; and "Philippine Agrenda for Educational Reform: the PCER Report" Presidential Commission for Educational Report, Manila 2000.

[24] Four out of the five tertiary, vocational and technical training places are provided by the private sector.

(f) Implement a comprehensive teacher-training program, both pre- and in-service. One particular objective should be to raise the proportion of tertiary level teachers meeting minimum qualification standards from 30 to 70 percent.

(g) Reverse the haphazard expansion of low quality post-basic public education, wean them from public funding and develop accreditation systems applicable to both public and private institutions.

(h) Use the savings to augment current scholarship programs so as to cover within three years, a minimum of 10 percent of the students.

Making Urbanization Work

1.68 Rapid urbanization should be the spatial translation of the transformations in the country's economic structure anticipated above. Whether the latter transformation actually occurs will depend on whether cities are able to play host to the process. If they do, perhaps 15 million more would live in cities by 2010 than today. This is equivalent to adding a new metropolis the size of Metro Manila! Of particular importance will be the growth of secondary towns, if the structural transformation process is to spread beyond the confines of the Manila-Cavite-Southern Tagalog, Cebu-Mactan, and a few other areas where a modicum of infrastructure exists to support industrial activities.

1.69 The consequences of this urbanization can be enormous. On the bright side, urbanization would help ease the pressure on natural resources, although with rural population reaching a plateau of above its current level (at around 43 million), pressure on watersheds, forests, marine, coastal and upland environments would remain heavy.

1.70 But in urban areas, congestion costs (rising crime rates, squatter problems, sanitation, transport problems, infrastructure needs, etc.) may worsen, if not addressed more vigorously than they currently are. Otherwise, urban congestion may reach critical proportions. Unless supported by an expansion of the road system, a rapid rise in car ownership from the current 1 car per 5 families to 1 per 3 families would more than double the number of cars in Metro Manila and potentially choke the metropolis. The same may happen with solid waste. Out of the total 16,400 tons of waste generated by the current urban population, only an estimated 2,600 tons are properly disposed in controlled dumpsites, endangering public health as well as increasing cities' vulnerability to flooding (as garbage piles block waterways). Projections for the next 15 years indicate that an additional 12 million poor people in cities will generate 4,000 more tons of daily waste to collect and dispose of.

1.71 The government has long realized that the investments required to bring cities up to par and to operate the related services efficiently extend far beyond its own capacity. Hence the need to tap private resources. Chapter 2 will stress that the extent to which they will materialize and the cost at which they do depends in large measure on whether credible regulatory frameworks are established, by which all, including the government, are made to abide. Nagging doubts on this score (caused by such things as capricious meddling by the executive or the judiciary with legitimate adjustments in tariffs, a lax/biased enforcement of regulatory requirements, or preferential handling of the related franchises) would seriously undermine urban development prospects.

1.72 With the decentralization of 1991, the country has equipped itself with a framework with which to deal with urbanization. Local governments will have to rise to the challenge if local governments are to live up to the hope that this reform would be a major source of poverty reduction. At this stage, Chapter 2 will argue, the jury is still out on their performances.

F. CONCLUSIONS

1.73 The irony of the situation, which developed during the 1990s, is that, amidst the momentous transformation which made the country aspire—legitimately—to "NIC" status, the contribution of its industry to output actually dropped. It is now time to act in line with this aspiration. Painful as it may have been, the Asia crisis brought some benefits in terms of realignment of incentives between tradable and non tradable sectors, and reduction in the implicit protection provided to key food items (rice, in particular). But private demand has not yet picked up due in part to uncertainties as to which course the country will be taking next.

1.74 Perhaps, the most decisive contribution that the government could make at this stage to reinvigorating private initiative is to act upon stated intentions to further equity, fiscal consolidation, and structural reform and to dispel perceptions that the country's governance framework might be regressing. The discussions above brought out a number of important priorities, including that of:

(a) accelerating the pace of agricultural trade liberalization with the view to aligning agricultural protection with that of manufacturing;

(b) helping the agricultural sector modernize in response to (a);

(c) stimulating competition in the service sector;

(d) investing in urban and inter-urban infrastructure particularly in the completion of the country's arterial road network;

(e) reinforcing efforts in favor of education (particularly with a view toward providing more equitable access to quality education); and,

(f) shedding current inhibitions towards active population policies.

1.75 Acting on those priorities would put the country more strongly on target toward international poverty reduction targets, as well as its own.

2. CHALLENGES FOR THE PRIVATE SECTOR

2.1 Much of the growth and employment needed to lift people out of poverty will continue to be generated by the private sector. The Philippines took that strategic option in the late 1980s. The ensuing deregulation, demonopolization, broadening of private ownership and opening up of the economy has served the country well, as Chapter 1 made clear, and will continue to do so if the country stays on course. The Asia crisis, however, highlighted the risks of private sector-led financial crisis.

2.2 How much growth versus instability, the private sector will actually deliver over the medium term will depend on both constitutive factors of "corporate governance," as well as environmental factors, linked for instance to the competitive framework in which private agents operate. The latter also influences the way in which the benefits of growth are shared across society. How well benefits are shared depends also in part on the distribution of the underlying assets. Hence, the importance of ongoing efforts to expand access to private ownership, particularly through land reform.

2.3 This chapter seeks to identify ways to maximize the upside (broad-based growth), while minimizing the downside (instability). The first section notes that, although the Philippines escaped the worst of the crisis, the country's corporate sector exhibits many of the same vulnerabilities as in some of its neighbors, and some of the same symptoms: limited recourse to equity finance, concentration of ownership, and ownership of banks by corporations. This section puts forward a few suggestions on how to move towards a system of corporate governance based on international best practices.

2.4 Although massive transfers of land during the last decade have already expanded private ownership of productive assets, simply continuing with existing arrangements may not be the best way to achieve the program's objectives, and most probably not within the established timeframe. Novel ideas could be entertained to reinforce the impact of the program and expedite its implementation, as discussed in the second section.

2.5 Although trade barriers have fallen in the last ten years, serious distortions remain, particularly in the food sector, which cripple the country's poverty reduction ambitions. Although it has already begun to benefit from earlier liberalization, more is required to enable the country to take full advantage of the upcoming delocalization of service activities. In both areas, the Philippines should take advantage of ongoing concerted regional efforts to position itself to make full use of its resources and talents to reap the rewards of globalization, as well as of its recent advances in the information technology (IT) sector. The final section addresses this set of issues.

A. Strengthening Corporate Governance

The Role of Corporate Governance

2.6 The Asia crisis has highlighted how important a country's corporate governance framework was for stability. In the strictest sense, the objective of corporate governance is to solve an agency problem by compelling corporate insiders to behave in a way which is consistent with the interests of outside investors, including minority shareholders and creditors.[25] When outside investors can impose good governance on corporate managers, external financing is more readily available from a wide variety of sources (both equity and credit) at competitive costs.

2.7 But when outside investors cannot impose good governance, risks arise that insiders (managers and controlling shareholders) might attempt to: (i) expropriate the returns rightfully due to minority shareholders; or, (ii) frustrate efforts by creditors to recover their investment following involuntary or willful default by a borrower. Sources of financing are likely to be fewer and the cost of financing is likely to be higher to compensate for the additional risks associated with weak governance (unless directed credits are available from government owned financial institutions).[26] Also, when the agency problem cannot be otherwise resolved, ownership and control of corporations tends to be concentrated in the hands of insider shareholders that are also active in the management of their corporations.[27] The result is to constrain the growth of corporations or to skew their financing structure towards the source of funding which is most readily available. Many neighboring countries experienced the latter problem (witness the high leverage of Korea's chaebols and other Asian corporations, and the role this played in the outbreak of the Asia crisis. As will be seen below, the Philippines is more affected by the former.

Structure of the Corporate Sector

2.8 The Philippines' corporate sector is highly concentrated. According to a 1997 survey, 757 of the 1,000 largest corporations (ranked by sales) were Philippine-owned and 216 of these-belonged to only 39 corporate groups (see Table 2.1).[28] The total sales of these 216 group-owned companies accounted for 51 percent of the total sales of the largest Philippine-owned corporations. The same study also found that in 1997, among publicly listed non-financial companies, one dominant shareholder controlled on average 41 percent of the equity, while the top 5 shareholders have majority control of 3 out of every four listed company. The figure actually underestimated the phenomenon as less than 10 percent of the 1,000 largest corporations are listed on the Philippine Stock Exchange. Furthermore, those that are listed seldom make available to the public more

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[25] Shleifer, Andrei and Robert W. Vishny. 1996. *A Survey of Corporate Governance*. NBER Working Paper 5554, p. 2.

[26] La Porta Raphael, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert W. Vishny. 1999. Investor Protection: Origins, Consequences, Reform. Financial Sector Discussion Paper No. 1. Washington, D.C.: World Bank, pp. 1-3.

[27] Ibid., pp. 11-13.

[28] Saldaña, Cesar G. 1999. *Philippine Corporate Governance Environment and Policy and their Impact on Corporate Performance and Finance*. Manila: Asian Development Bank.

than the minimum number of shares prescribed by listing requirements (10 to 20 percent of total shares outstanding).[29]

Table 2.1: GROWTH AND FINANCIAL PERFORMANCE OF TOP 1000 CORPORATIONS BY CORPORATE CONTROL STRUCTURE

	1988	1996	1997	GROWTH RATE (1988-97)
A. GROUP MEMBER SECTOR				
SHARE OF SALES (PERCENT)	27.6	37.1	34.0	
FINANCIAL RATIOS (PERCENT)				
Leverage	57	42	51	49
Return on Equity	21.9	15.0	8.8	15.8
Return on Assets	9.5	8.6	4.3	8.0
Net Profit Margin	10.7	18.5	11.5	12.3
NO. OF NON-FINANCIAL COMPANIES	110	211	216	159
B. INDEPENDENT SUBSECTOR				
SHARE OF SALES (PERCENT)	54.7	55.4	60.0	
FINANCIAL RATIOS (PERCENT)				
Leverage	72	61	68	61
Return on Equity	19.9	15.4	3.3	15.8
Return on Assets	5.6	6.1	1.0	6.1
Net Profit Margin	3.9	6.1	1.0	5.0
NO. OF NON-FINANCIAL COMPANIES	759	664	666	715
C. GOVERNMENT-OWNED SUBSECTOR				
PERCENT OF CORPORATE SECTOR SALES	17.7	7.5	6.0	
FINANCIAL RATIOS (PERCENT)				
Leverage	73	58	67	65
Return on Equity	5.9	5.4	2.3	5.7
Return on Assets	1.6	2.3	0.8	2.1
Net Profit Margin	5.8	15.4	6.2	10.1
NO. OF NON-FINANCIAL COMPANIES	30	23	14	24

Source: Saldaña, C. G. 1999.

2.9 Such high level of ownership concentration *at the firm level* found in the Philippines is not necessarily uncommon. In a study of ownership concentration in 45 countries,[30] La Porta et al. found that, on average, the three largest shareholders own 46 percent of the shares of the largest corporations in the countries surveyed. The number is higher for the Philippines (57 percent of the shares), which is equal to Brazil, and less than the levels of concentration found in Sri Lanka, Colombia, Egypt, Indonesia, Italy, Mexico, Turkey, Austria and Greece. For other East Asian countries, excluding the Philippines, Taiwan (China) and Indonesia, ownership concentration is also quite high with the three largest shareholders owning, on average, 47.5 percent of the largest corporations.[31]

2.10 Among Asian countries, however, only Indonesia exceeds the Philippines' degree of ownership concentration *across firms* (see Table 2.2).

[29] Ibid.

[30] Ibid.

[31] La Porta R., F. Lopez-de-Silanes, A. Shleifer and R. W. Vishny. 1999. "Investor Protection: Origins, Consequences, Reform." Financial Sector Discussion Paper No. 1. Washington, D.C.: World Bank. conclude: "dispersed ownership of large corporations is simply a myth. Even in the United States, the average for the 10 most valuable companies is 20 percent. The only countries where the three largest shareholders own, on average, less than 30 percent of the largest 10 corporations are Australia, United Kingdom, the United States, Sweden, Japan, Taiwan and Korea." Ibid. pp. 1145-1146.

Table 2.2: OWNERSHIP CONCENTRATION AND LEGAL FRAMEWORKS

	CONCENTRATION OF OWNERSHIP CONTROL AMONG TOP 15 FAMILIES (PERCENT)	EFFICIENCY OF JUDICIAL SYSTEM INDEX	RULE OF LAW INDEX	CORRUPTION INDEX
JAPAN	2.8	10.00	8.98	8.52
TAIWAN	20.1	6.75	8.52	6.85
MALAYSIA	28.3	9.00	6.78	7.38
SINGAPORE	29.9	10.00	8.57	8.22
HONG KONG	34.4	10.00	8.22	8.52
KOREA	38.4	6.00	5.35	5.30
THAILAND	53.5	3.25	6.25	5.18
PHILIPPINES	**55.1**	**4.75**	**2.73**	**2.92**
INDONESIA	61.7	2.50	3.98	2.15

Note: All three indexes rank from 1(worst) to 10(best). Countries are ranked by degree of ownership concentration. The efficiency of judicial system index assesses the efficiency and integrity of the legal environment as it affects businesses, particularly foreign firms.
Source: Claessens, Djankov, and Lang (1999); La Porta et al. (1998 and 1999).

Sources of Ownership Concentration

2.11 The structure of the corporate sector, as it exists today, was shaped by two sets of converging forces:

(a) history: the roots of today's concentration can often be traced back to the concentration of land ownership during the colonial period, whose wealth served as a basis for large land holding families to found the country's first industrial and commercial corporations. In the post independence period economic development policies promoting import substitution industries created a new group of family-owned industrial companies as family-owned trading companies shifted to manufacturing in order to take advantage of government incentives, including protection from imports and subsidized credit.

(b) the existing corporate governance framework. As in other parts of Asia,[32] however, a weak protection of shareholder rights has exacerbated this legacy of ownership concentration (see Table 2.2 and Table 2.4). To quote La Porta et al., "there are at least two reasons why ownership in such countries should be concentrated. First, large or even dominant shareholders that monitor the managers might need to own more capital, *ceteris paribus*, to exercise their control rights and thus avoid being expropriated by the managers. Second, when they are poorly protected, small investors might be willing to buy corporate shares only at such low prices that make it unattractive for corporations to issue new shares to the public. Such low demand for corporate shares by minority investors

[32] In many advanced market economies, outside shareholders are protected from insider self-dealing by an array of legislation, including company laws, securities laws, accounting laws and auditing laws. These laws and regulations are vigorously enforced by regulators and public prosecutors and penalties are severe enough to act as deterrents. In enforcing these laws and regulations, an honest and efficient judiciary and/or regulatory agency plays an essential role. There are also other private means of enforcing shareholder rights. Outside shareholders can also launch civil actions against directors and auditors who have failed to perform their duties with due care and diligence. Also, the market for corporate control can be a powerful force which compels insiders in widely held corporations to work on behalf of its outside shareholders or risk losing their jobs when shareholders vote in favor of a merger or takeover by another corporation.

would indirectly stimulate ownership concentration."[33] Thus, "with poor investor protection, ownership concentration becomes a substitute for legal protection."[34]

2.12 Reflecting the impact of these converging forces, 39 family-owned corporate groups owned 216 of the 1,000 largest corporations, representing about one third of the sales of those large corporations.[35] These conglomerates exhibit many characteristics similar to the Korean *chaebols* and Japanese *zaibatsus*: they are family owned; have diversified sectoral interests; include a bank among their component firms (or ITCs, in the case of *chaebols*); very few are publicly traded on the stock exchange; according to some researchers, they receive preferential treatment from government and some of their directors are politically influential.[36]

2.13 The influence and strength of conglomerates has even increased in recent years, as that of government corporations diminished with privatization. The number of top 1,000 firms they control has doubled since 1988, and the latter's market share had expanded by a third (see Table 2.1). They also appear to have weathered the crisis better than "independent firms." On the one hand, being able to rely on internal financial markets to raise equity (including through cross-ownership arrangements), members of conglomerates were also less leveraged than their "independent" counterparts. This, and a diversification of activities, helped them maintain better return on equity when the crisis hit (see Table 2.1).

2.14 The concentration of ownership around family-based conglomerates is nevertheless giving rise to three main concerns:

(a) *Market power*: As Table 2.1 indicates, group members operate, on average, with higher profit margins. Do these arise from monopolistic behaviors, from the nature of the activities they undertake, or from superior efficiency? Table 2.3 does show that in a number of sectors (such as food, tobacco, and beverage, coconut oil, glass, paper, inter-island shipping, pipelines), group-based companies command dominant market positions, which they may be tempted to abuse.

Fortunately, that position is being eroded. With trade liberalization and the opening up of the economy to foreign investment, new firms have emerged which to challenge the former champions of inward orientation have replaced those favoring protectionism and an inward orientation. In particular, foreign and multi-national corporations have come in to upset the status quo by establishing with new green-field operations (e.g., petroleum product distribution) or by buying out the holdings of

[33] La Porta R., F. Lopez-de-Silanes, A. Shleifer and R. W. Vishny. 1998. "Investor Law and Finance." *The Journal of Political Economy* 6 (106). December 1998.

[34] Ibid. (denoting p. 1145 again).

[35] Saldaña, C. G. 1999. "Philippine Corporate Governance Environment and Policy and their Impact on Corporate Performance and Finance." Manila: Asian Development Bank.

[36] Tan, Edita A. 1993. "Interlocking Directorates Commercial Banks, Other Financial Institutions and Non-financial Corporations." Philippine Review of Economics and Business, Volume XXX, 1993. p. 6.

Philippine investors in sectors which badly needed restructuring, such as cement.

(b) *Corporate ownership of banks:* High ownership concentration and the ownership linkages between corporations and banks had also led to a significant concentration in lending with the top 100 corporate borrowers in the Philippines accounting for 30 percent of the outstanding loans of the banking system.[37] As long as banks are so intimately linked to conglomerates, there will a fear that some of that lending be done on the strength of corporate links, rather than on the merit of the activities being financed.

(c) *Constraints to growth.* The main concern, however, is that however efficient conglomerates might be, their success constitutes essentially a second-best solution to the agency problem (outlined at the outset of this discussion) in the presence of a weak corporate governance system. By limiting the scope for external corporate control, these weaknesses also limit the capacity of (raise the cost to) firms to raise external finance and expand in areas where they can compete. Conversely, practices such as cross-holdings of equity,[38] interlocking directorates of banks and corporations and pyramid holding structures, quite common in the Philippines, are effective barriers to hostile takeovers and help prevent productive assets from coming into the hands of those best positioned to managed them most efficiently.[39]

Legal Protection of Shareholders

2.15 The main problem is not so much that the design of the corporate governance framework would be intellectually flawed. Although (as will be seen below) this framework should still be strengthened, a recent study of shareholder protection in 49 countries[40] gave the Philippines, (which is grouped with 21 French-origin civil law countries) a score of three out of a possible seven points, which is at the high end of its group which had an average score of only 2.33. In East Asia, the Philippines scored higher than Indonesia, Thailand and South Korea, the same as Taiwan, but lower than Hong Kong, Malaysia, Singapore and Japan.

[37] Lim, C. H., and C. Woodruff. 1998. "Managing Corporate Distress in the Philippines: Some Policy Recommendations." International Monetary Fund Working Paper (Draft). Washington, D.C. September 1998.

[38] Cross-holdings occur when firms within a family controlled group hold shares in each other, often as a defense against hostile takeovers.

[39] Leechor, C. 1999. "Reviving the Market for Corporate Control." Viewpoint Note No. 191. Washington, D.C.: World Bank. p. 1.

[40] Ibid. p.1131.

Table 2.3: MARKET SHARE OF GROUPS OF COMPANIES IN SELECTED INDUSTRIES, 1991-97 (percent)

SUBSECTOR AND INDUSTRY	% SHARE OF GROUPS		% POINT DIFFERENCE	% SHARE OF LEADING COMPANY		% POINT DIFFERENCE
	1991 a/	1997 b/	1991-97	1991 a/	1997	1991-97
FOOD & OTHER FOOD PRODUCTS SUBSECTOR						
Alcoholic Beverages, Malt Liquor	94.1	89.5	**-4.6**	58.7	70.2	**11.5**
Chocolate, other Food Products	55.6	69.1	**13.5**	45.3	64.4	**19.1**
Meat & Vegetable Oil	57.1	56.4	**-0.7**	50 7	19.6	**-31.1**
Flour Milling & Animal Feeds	52.4	35.1	**-17.3**	52.4	19.6	**-32.8**
Milk & Dairy Products	38.0	51 8	**13.8**	32.1	19.8	**-12.3**
Coconut Oil	33.4	31.3	**-2.1**	25.5	34.3	**8.8**
Sub-Total (above industries)	72 2	64.5	**-7.7**	51.9	55.2	**3.3**
Sub-Total for the Subsector	**67.3**	**63.0**	**-4.3**	**48.1**	**51.9**	**3.8**
ELECTRICITY, GAS AND WATER SUBSECTOR						
Gen. & distribution of electicity	44.8	38.7	**-6.1**	43.2	38.4	**-4.8**
Sub-Total for the Subsector	**44.8**	**38.7**	**-6.1**	**43.2**	**38.4**	**-4.8**
TRANS, STORAGE AND COMM. SUBSECTOR						
Telecommunication	85.0	80.3	**-4.7**	76.0	64.5	**-11.5**
Inter-island water transport	14.5	29.7	**15.2**	11.2	29.7	**18.5**
Pipelines	59.0	96.5	**37.5**	59.0	96.3	**37.3**
Sub-Total (above industries)	62.1	76.9	**14.8**	88.9	38.2	**-50.7**
Sub-Total for the Subsector	**61.7**	**71.6**	**9.9**	**84.3**	**35.5**	**-48.8**
WHOLESALE AND RETAIL SUBSECTOR						
Retail Selling in Supermarkets	66.8	45.7	**-21.1**	31.1	21 5	**-9.6**
Passenger Motor Vehicle Retailing	47.0	45.6	**-1.4**	27.1	24.4	**-2.7**
Construction Materials	31.2	51.9	**20.7**	27.9	35.3	**7.4**
Medicinal, Pharmaceutical Prod.	55.3	13.5	**-41.8**	26.0	13.5	**-12.5**
Sub-Total (above industries)	57.6	41.5	**-16.1**	28.8	31.3	**2.5**
Sub-Total for the Subsector	**37.6**	**26.8**	**-10.8**	**14.8**	**18.7**	**3.9**
FINANCIAL INTERMEDIATION SUBSECTOR						
Fin. Holding & Investment Co.	52.7	65.4	**12.7**	27.3	24 9	**-2.4**
Financing Companies	6.6	15.2	**8.6**	2.7	23.2	**20.5**
Sub-Total (above industries)	18.2	61.7	**43.5**	8 8	42.8	**34.0**
Sub-Total for the Subsector	**37.8**	**40.2**	**2.4**	**1.2**	**6.7**	**5.5**
REAL ESTATE AND BUSINESS SECTOR						
Real Estate	60.4	41.3	**-19.1**	20.4	14.3	**-6.1**
Real Estate Renting	52.0	81.0	**29.0**	45.7	54.4	**8.7**
Architectural Eng'r Services	36.6	12.1	**-24.5**	36.6	12.1	**-24.5**
Sub-Total (above industries)	58.2	40.2	**-18.0**	25.2	16.7	**-8.5**
Sub-Total for the Subsector	**56.9**	**45.4**	**-11.5**	**20.3**	**16.8**	**-3.5**
MOTOR VEHICLES SUBSECTOR						
Motor Vehicles	29.4	47.9	18.5	29.4	25.0	**-4.4**
Motorcycles	24.4	31.2	**6.8**	24.4	31.2	**6.8**
Parts and Accessories	8.5	20.9	**12.4**	8.5	11.3	**2.8**
Shipbuilding	78.1	38.5	**-39.6**	78.1	38.5	**-39.6**
Sub-Total (above industries)	27 4	40.1	**12.7**	27.4	40.4	**13.0**
Sub-Total for the Subsector	**28.0**	**39.0**	**11.0**	**25.6**	**39.8**	**14.2**
CONSTRUCTION SUBSECTOR						
General Engineering	48.6	37.7	**-10.9**	20.8	17.8	**-3.0**
Sub-Total for the Subsector	**48.6**	**35.1**	**-13.5**	**20.8**	**17.8**	**-3.0**
CONSTRUCTION MATERIALS SUBSECTOR						
Cement	53.7	56.9	**3.2**	14.7	36.3	**21.6**
Glass Products	87.2	8.1	**-79.1**	87.2	57.3	**-29.9**
Ceramic & Other Concrete Prod.	15.7	13.8	**-1.9**	15.7	28.6	**12.9**
Sub-Total (above industries)	52.9	58.5	**5.6**	28.3	41.8	**13.5**
Sub-Total for the Subsector	**24.5**	**31.6**	**7.1**	**12.3**	**21.2**	**8.9**
HOTELS AND RESTAURANTS SUBSECTOR						
Rest., Cafes, & Fast Food Centers	41.6	51.4	**9.8**	41.6	51.4	**9.8**
Sub-Total for the Subsector	**28.8**	**11.3**	**-17.5**	**25.0**	**24.1**	**-0.9**
MINING AND QUARRYING SUBSECTOR						
Gold Mining	83.2	97.7	**14.5**	53.5	64.6	**11.1**
Sub-Total for the Subsector	**70.8**	**76.6**	**5.8**	**21.8**	**44.6**	**22.8**
TEXTILE, WOOD & PAPER PRODUCTS SUBSECTOR						
Paper Products	9.7	15.8	**6.1**	7.3	64.6	**57.3**
Sub-Total for the Subsector	**11.5**	**15.0**	**3.5**	**4.8**	**10.7**	**5.9**
OTHER COM., SOCIAL AND PERSONAL SERV. SUBSECTOR						
Radio and TV Broadcasting	49.6	57.8	**8.2**	49.6	57.8	**8.2**
Sub-Total for the Subsector	**49.6**	**23.9**	**-25.7**	**49.6**	**23.9**	**-25.7**
ELECTRICAL MATERIALS SUBSECTOR						
Insulated Wires & Cables	54.0	40.4	**-13.6**	54.0	40.4	**-13.6**
Electrical Transformers	98.8	78.9	**-19.9**	98 8	41.9	**-56.9**
Sub-Total (above industries)	30 0	11.9	**-18.1**	30.0	9.7	**-20.3**
Sub-Total for the Subsector	**5.3**	**3.4**	**-1.9**	**4.2**	**3.3**	**-0.9**
AGRICULTURE, HUNTING AND FORESTRY SUBSECTOR						
Hog Farming	64.5	52.1	**-12.4**	64.5	33.3	**-31.2**
Sub-Total for the Subsector	**38.0**	**52.1**	**14.1**	**14.8**	**52.1**	**37.3**
PETROCHEMICALS SUBSECTOR						
Organic Chemicals	6.2	32 4	**26.2**	6.2	23.5	**17.3**
Sub-Total for the Subsector	**16.2**	**9.1**	**-7.1**	**0.8**	**0.7**	**-0.1**
METAL PRODUCTS SUBSECTOR c/						
Forge, Packaging Oth Fab. Metal	4.3	16 9	**12.6**	4.3	11.2	**6.9**
Sub-Total for the Subsector	**2.6**	**6.0**	**3.4**	**2.6**	**0.1**	**-2.6**
Aggregate Group for Subsectors A to Q	54.5	**39.5**	**-15.0**	39 6	**32.0**	**-7.6**
AGGREGATE GROUP OF COS. FOR ALL SUBSECTORS AND INDUSTRIES	**41.1**	**31.9**	**-9.2**	**21.9**	**20.5**	**-1.4**

a/ 37 groups in 1991 b/ 29 groups c/ 1988 figures in place of 1991

Sources of basic data: SEC-Business World Annual Survey of Top 1000 Corporations (1991); PSE databank and Annual Reports of Companies; Saldana (1999)

2.16 Similarly, according to another study, "the country already has reasonable corporate laws, although they are not perfect, particularly with respect to potential self dealing. The Corporation Code includes many familiar minority-protection measures such as cumulative voting, appraisal rights, inspection rights and audit requirements, as well as standard fiduciary duties binding directors. The Code, in addition, grants the Securities and Exchange Commission (SEC) rule making power for code implementation in general and protection against insider abuses in particular. These Code provisions are further supported by basically sound accounting and audit rules and securities-law disclosure requirements."[41] The study also found that "the legal framework for remedial recourse is also largely in place, providing both for public remedies (although fines available at present are tiny) and for civil damages liability (sometimes multiplied), stockholder derivative suits, class actions and recovery of attorney fees."[42]

2.17 In practice, however, two factors undermine the effectiveness of the legal framework. For one, "the presence of large shareholders in most Philippine companies precludes the effectiveness of U.S.-style legal provisions that are designed to prevent expropriation of resources of minority shareholders and creditors. Specifically the Corporation Code does not adequately deal with conflicts of interest by large shareholders on minority shareholders."[43] Existing legislation should therefore be strengthened by: (i) requiring independent directors especially in listed corporations; (ii) protecting the staff of regulatory agencies from legal harassment; (iii) prohibiting of interest on the part of members of the stock exchange vis-a-vis listed firms; and, (iv) restricting the application of pre-emptive rights by majority owners in order to allow minority stockholders to dispose of their shares at the best available price. The proposed new securities law should go some way in that direction.

2.18 "In principle, a strong system of legal enforcement could substitute for weak rules since active and well functioning courts can step in and rescue investors abuses by management."[44] This is where the main weakness of the Philippines lies. Table 2.2 shows the overall performance of the Philippines in terms of enforcement is the worst of all of the countries included in the survey. Its average score for the 6 variables is 4.49 out of a possible 10, compared to the average score of 7.19 for all countries surveyed and 7.41 for the other East Asian countries. The Philippines ranks at or very near the bottom in almost every category. While the country reviews its legal framework to adjust it to the realities of high ownership concentration and weak judiciary protection, considerable early gains could thus be obtained "simply" by enforcing more diligently what provisions are already in place.

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[41] Fogarty, Kevin S. 1999. "Corporate Governance in the Philippines: An Assessment of Needed Reform Efforts." USAID. p. 2.

[42] Ibid.(denoting p. 2. again).

[43] Saldaña, C. G. 1999. "Philippine Corporate Governance Environment and Policy and their Impact on Corporate Performance and Finance." Manila: Asian Development Bank.

[44] La Porta R., F. Lopez-de-Silanes, A. Shleifer and R. W. Vishny. 1999. "Investor Protection: Origins, Consequences, Reform." Financial Sector Discussion Paper No. 1. Washington, D.C.: World Bank. p. 1140.

Table 2.4: VARIABLES AFFECTING THE ENFORCEMENT OF INVESTOR RIGHTS[45]

VARIABLE	AVERAGE SCORE (OUT OF 10 POINTS) FOR 49 COUNTRIES	SCORE FOR THE PHILIPPINES	AVERAGE SCORE FOR 8 OTHER EAST ASIAN COUNTRIES	RANKING OF PHILIPPINES OUT OF 49
1. EFFICIENCY OF JUDICIAL SYSTEM	7.67	4.75	7.19	48
2. RULE OF LAW	6.85	2.73	7.08	46
3. ABSENCE OF CORRUPTION	6.90	2.92	6.52	48
4. LOW RISK OF EXPROPRIATION/NATIONALIZATION	8.05	5.22	8.40	49
5. LOW RISK OF CONTRACT REPUDIATION	7.58	4.80	8.45	48
6. ACCOUNTING STANDARDS	6.09	6.5	6.84	20 (out of 43)
AVERAGE SCORE	7.19	4.49	7.41	

Source: La Porta et.al. (1998)

Accounting and Disclosure

2.19 The only category where the country ranks better is on accounting standards. But enforcement is again the issue. While statutory accounting guidelines in the Philippines are sound, the accounting profession is well established, and companies listed on the stock exchange are subject to disclosure requirements, there is little capacity to enforce accounting guidelines and disclosure requirements. "In practice, auditors choose from a wide range of disclosure style and reporting standards, for example local GAAP, International Accounting Standards or U.S. GAAP. Penalties for poor conduct of audits by independent auditors and the mechanism for imposing them are weak. In spite of the many well-known cases of poor quality of audited financial statements that caused losses for investors, SEC and PICPA (Philippine Institute of Chartered Public Accountants) have not publicly sanctioned any auditor in the past."[46] Furthermore, many companies prepare different financial statements for different end users.[47] Similarly, whatever the quality of disclosure requirements might be, the sanctions for non compliance are so puny that some companies prefer to pay the related fines as a matter of course rather than disclose their financial condition.

Impact on Corporate Finance

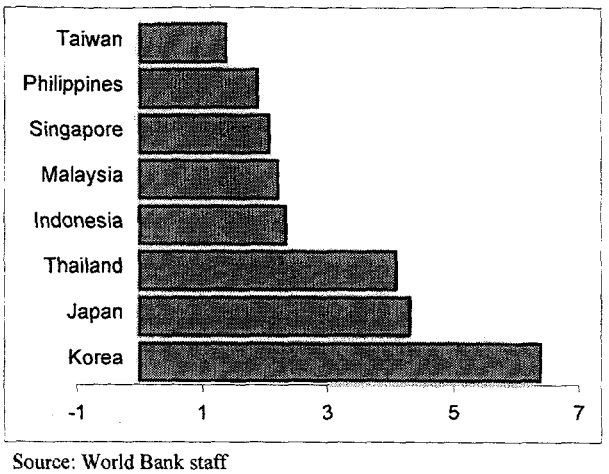
2.20 Flaws of the same nature in corporate governance ultimately brought down many Asian corporations. Limited in their recourse to equity finance, they went on a borrowing spree to finance their expansion. As long as growth was going, high gearing ratios generated even better profit rates to their shareholders. Such ratios, unfortunately, exposed them dangerously to the eventual downturn.

[45] Ibid. p. 1143.

[46] Saldaña, C. G. 1999. "Philippine Corporate Governance Environment and Policy and their Impact on Corporate Performance and Finance." Manila: Asian Development Bank.

[47] The statements provided to the Bureau of Internal Revenue, the Securities and Exchange Commission (SEC) and outside shareholders may be quite different from those shown to insiders including the controlling shareholder, or those accompanying an application for a bank loan.

Figure 2.1: CORPORATE LEVERAGE IN SELECTED COUNTRIES
(1997 debt equity ratio)



Source: World Bank staff

2.21 Why did Philippine corporations not meet the same fate? As it happened, they generally entered the Asia crisis with some of the lowest corporate leverage in Asia (see Figure 2.1). There are essentially six reasons for that:

(a) A history of boom-and-bust made one-way bets on growth less plausible.

(b) Philippine banks were better regulated (the central bank even tightened restrictions in real estate lending and foreign exchange exposures and raised capitalization requirement during the run-up to the crisis, (see Chapter 3).

(c) The Philippines' banking sector is also more fragmented than elsewhere (see Chapter 3), which limits the capacity of any single bank to marshal resource: to any one corporation (even within the same group).

(d) Borrowing abroad only recently became a feasible alternative, only after the debt restructuring agreement of 1992 ushered the country back into international capital markets. Even then, Philippines corporations had less time than their peers to develop a brand name and a track record with international investors.

(e) Lower domestic savings.

(f) Creditors' rights are not better enforced than those of minority shareholders. This is the next topic.

Protection of Creditors

2.22 In an international survey of creditor protection frameworks, the Philippines comes out at the bottom: it obtains a score of zero, while the 21 French-origin civil law countries, as a group, have an average score of 1.58 (see Table 2.5). In East Asia, the Philippines scores lower than all other countries included in the survey. In contrast, Hong Kong, Malaysia and Singapore, and even Indonesia, for instance, score a full 4.0 (maximum).

Table 2.5: MEASURES FOR PROTECTING CREDITOR RIGHTS[48]

MEASURE FOR CREDITOR PROTECTION	AVAILABILITY OF MEASURE IN THE PHILIPPINES	NUMBER OF COUNTRIES WITH MEASURE	NUMBER OF COUNTRIES WITHOUT MEASURE
1. SECURED CREDITORS PROTECTED FROM AUTOMATIC STAYS OF FORECLOSURE.	No	27	24
2. SECURED CREDITORS PAID FIRST	No	42	9
3. CREDITOR CONSENT REQUIRED FOR REORGANIZATION OF DISTRESSED COMPANIES.	No	30	21
4. CREDITORS EMPOWERED TO CHANGE MANAGEMENT OF COMPANIES UNDER REORGANIZATION.	No	25	26
5. AVAILABILITY OF AT LEAST 3 OF THE 4 PROTECTIVE MEASURES	No	21	30

Source: Saldana (1999)

2.23 In contrast to the evolution of best practices internationally, the Philippines' legal framework has evolved in a way that has weakened creditor protection. Absent is the threat of civil action by creditors against independent auditors or company directors who are negligent in carrying out their duties. There is no duty of care compelling corporate directors to: (i) protect the interests of creditors when a corporation defaults on its obligations; or (ii) require the company to cease trading when it becomes apparent that the company is insolvent.

Box 2.1: EXAMPLES OF BEST PRACTICES IN CREDITOR PROTECTION

Many advanced market economies also offer creditors a wide range of instruments and numerous means for imposing corporate governance. When insiders fail to honor the terms of their agreements with secured creditors, they face foreclosure actions and possibly liquidation. Most jurisdictions recognize secured creditors as investors whose claims are senior to those of shareholders. When a corporation is in default to its creditors, best practice requires that the directors of the corporation exercise their duty of care on behalf of the creditors rather than the shareholders. Also in may jurisdictions, directors are personally liable for additional creditor losses which are likely to occur when a corporation continues to trade after it has become insolvent. When creditors suffer losses because auditors fail to carry out their work in accordance with normal auditing standards, the latter may be liable through civil actions for such losses as well as for punitive damages. Even unsecured creditors can quickly obtain court judgements compelling corporate insiders to pay the debts in question. Again, such outcomes depend on judicial systems that are honest and efficient.

Most modern bankruptcy laws provide for rehabilitation as well as the liquidation of distressed corporations. To enable implementation of a corporate rehabilitation program, it may be necessary for courts to intervene and prevent one or more secured creditors from exercising their contractual rights to seize and sell the assets of the debtor corporation in order to recover their claims. However, when this happens, best practice calls for the courts to ensure that secured creditors can be compensated for any losses resulting from a stay of foreclosure. Bankruptcy cases are often handled by specialized courts that have the capacity to deal with complex business and financial issues.

2.24 Furthermore, creditors can be deprived of their right to foreclose and when stays are imposed on creditors which are not accompanied by specific measures to protect their security interests. The decree (PD 902-A)[49] which transferred responsibility for dealing with distressed companies from the courts to the SEC has a strong bias towards the goal

[48] Ibid. p. 1137.

[49] A 1909 law (Act 1956) dealing with cases of corporate insolvency does require that two-thirds of the creditors representing at least three-fifths of the claims must approve: (i) any agreement allowing a suspension of debt service payments by a distressed but still solvent corporation; or (ii) any plan for distributing the proceeds from the liquidation of an insolvent corporation. However, the law did not empower the court to stay foreclosure actions by secured creditors. Therefore, following a rash of corporate failures starting in 1979, Act 1956 was replaced in 1981 by Presidential Decree 902-A.

of preserving the business of a distressed company and hence the investment of shareholders. Under that decree, a distressed company can petition the SEC for permission to suspend payments to its creditors, or if it has more than a temporary liquidity problem, it can petition for rehabilitation. In either case, any foreclosure action by secured creditors can be stayed for extended periods of time. Absent are the principle that corporate insolvency extinguishes the rights and claims of shareholders. In fact, under PD 902-A, the SEC can: (i) allow an insolvent company to continue to trade even if this means further losses for creditors; and, (ii) impose a suspension of payments without the consent of a majority of creditors-without any provision for protecting secured creditors from losses which might occur due to the erosion in the value of their collateral over the period that a stay of foreclosure is in effect.

2.25 Furthermore, debt reduction procedures can be exceedingly long and fruitless. Fogarty reviewed 86 cases filed from the beginning of 1995 through September 1999 (see Table 2.6). During that period, it took, on average, well over one year for the SEC to reach a decision...if a decision was ever reached. For over one-third of the cases there has been no decision, even though these cases have been with the SEC for an average of 580 days. Among the 106 filings since 1982, there have only been two reported cases of companies being successfully rehabilitated.[50]

Table 2.6: DURATION OF DEBT SUSPENSION PROCEDURES

DECISION	NUMBER OF CASES	NUMBER OF DAYS[a/]
CASE DISMISSED OR DENIED	35	419
PETITION VOLUNTARILY WITHDRAWN	11	181
REPAYMENT/REHABILITATION PLAN APPROVED	10	517
NONE (DECISION PENDING)	30	580

a/ average time for a decision in decided cases and average time pending for undecided cases.
Source: Fogarty, Kevin S. (1999)

2.26 The situation can become self-defeating. As it may take six to eight years or even longer if the debtor decides to fight the action all the way to the Supreme Court, most creditors are secured.[51] This, in turn, blunts the interest of creditors for the going concern value of the corporation.[52] Thus, in the event of default, when seniority of claims becomes an important consideration, creditors have an incentive to rush to realize their securities at any cost. In reaction, PD 902-A turns the normal order of seniority upside down by subordinating the claims of all creditors secured or unsecured, to the goal of preserving the interests of the shareholders. Predated checks have therefore developed as

[50] To make matters worse, realizing that assets can be difficult, property foreclosed under mortgages cannot be seized by a creditor but must be sold at public auctions with the proceeds of the sale going to the creditor. However, before an auction can be held, the debtor is given up to one year to settle the claim. When a sale takes place and there is a shortfall, the creditor may try to recover it by filing a complaint with the court. While movable property foreclosed under a pledge must also be offered for sale at auction, in the event it remains unsold after two auctions, it may be seized by the creditor in exchange for an acquittance for the entire claim. If a pledged object is sold for less than the creditor's claim, the creditor has no right to file a complaint to recover the shortfall. Given the delays associated with TROs and the restrictions on foreclosures, debts are often settled "dacion pago" where the debtor settles his debt by simply handing over title to real property to the creditor.

[51] Regala, T. D. 1999. "Report on the Philippines." Manila: Asian Development Bank. p. 15.

[52] "As a rule, creditors in the Philippines do not lend money without a security. Hence it is not unusual if almost all the creditors of a given corporation are secured. If we require these creditors to meet and vote they, almost without fail, will reject the moratorium proposed by the corporation for the simple reason that a postponement of their recovery will greatly increase their risk of losing their money." See Concepcion, L. 1999. "Corporate Rehabilitation: The Philippine Experience." Presentation to seminar on Corporate Rehabilitation by Associate Commissioner of Securities and Exchange Commission. Mimeo. Manila, Philippines. p. 10.

an alternative form of security, as they are protected by criminal rather than civil law. Unfortunately, related cases are now clogging criminal courts (see Chapter 4).

2.27 To cap it all, the process lacks transparency and is highly susceptible to influence peddling. In applying debt resolution procedures, the SEC has wide discretionary powers, but lacks clear rules and time bound procedures. As a result, debtors use the threat of petitioning the SEC as a means of forcing creditors to accept generous terms for debt restructuring while avoiding necessary real restructuring and changes in management. This further undermines the possibility for creditors to impose good governance on their borrowers.

2.28 The SEC has begun to address these problems. In December, 1999, it adopted "Rules of Procedure on Corporate Recovery." The first merit of these rules is to fill a damaging vacuum. They leave in place however a system which is essentially regulator-led. For example, while the rules provide that a rehabilitation plan cannot be approved if rejected by either the secured or unsecured creditors, there is no provision for voting by creditors the hearings on the plan. Also while the rules allow the SEC to override the rejection of a plan by creditors, they provide no guidance as to the circumstances under which a decision by creditors could be considered manifestly unreasonable. While interim receivers are subject to conflict of interest rules, professional conduct rules, minimum qualification requirements and strict reporting requirements, as well as scrutiny and oversight by the SEC, the same cannot be said of members of management committees. The three-man committees, which can be appointed to monitor the management of the debtor company, will include one representative of the secured creditors, one representative of the unsecured creditors and one representative of the debtor. Thus two members have a conflict of interest with the debtor and the third has a conflict of interest with the creditors. Finally, the rules still do not require adequate protection of the interests of secured creditors. Experience with these new rules is likely to show the benefit of evolving further towards a creditors-led process and a more protection of secured creditors.

Reforming Corporate Governance

2.29 By hindering firms' access to outside finance be it equity or credit, these factors have held back corporate start-up and expansion, and growth more generally.

2.30 The international experience is then, barring crisis situations, changes in corporate governance do take time. Not only because the resulting reordering of wealth may meet resistance, but also because, as Black notes,[53] a culture of compliance among accountants, lawyers and company managers is a precondition for effective investor protection. Such a culture takes time to develop, as it requires a myriad of converging actions. The discussions above highlighted the importance of a few of them, including:

(a) *Reforming debt resolution procedures*. Further improve the recent guidelines for suspension of payments (refer to World Bank. 1999. *Philippines: The Challenge of Economic Recovery-Country Economic Memorandum*. Washington, D.C.).

[53] Black, Bernard S. 1999. The Legal and Institutional Preconditions for Strong Stock Markets: The Non-triviality of Securities Law." Stanford School of Law, Stanford, California. p. 26.

For the long term, the government envisages that a high level task force would be established under the Capital Markets Development Council to examine alternative approaches for dealing with distressed or insolvent corporations, including the possibility to remove responsibility for suspension of payments from the SEC.

(b) Strengthening the legal and administrative framework for corporate governance. A high level task force, under the Capital Markets Development Council, should be established to review and evaluate: (i) all of the existing studies concerning the performance of the current legal and institutional framework for corporate governance in the Philippines; (ii) alternative approaches and institutional arrangements for dealing with corporate governance which have been adopted in other countries, including but not necessarily limited to, Canada, the United Kingdom, Australia, Singapore, Malaysia and Hong Kong; and (iii) new and innovative measures to address the excesses and market failures of the last few years which might be more readily applicable to the Philippines.

(c) *Guaranteeing the independence and integrity of the Security and Exchange Commission* (including by routing out any semblance of conflict of interest among its officers).

(d) *Disentangling banks and corporations.* Ongoing efforts to strengthen bank regulations (e.g., measures to strengthen disclosure of lending to connected parties and place limits on such lending as well as limits on the lending to a single corporate group and to increase banks' statutory minimum capital, forcing some family owned groups to divest their banks) will undoubtedly help. In the longer term, however, the Philippines might be well served by simply prohibiting non-financial corporations from owning banks (as in the case, for instance, in the USA).

(e) *Mandating public sector institutional investors to act as "vigilant outsiders" and to uphold minority shareholder rights.* At the moment, minority shareholders lack a champion, while public pension funds too often get enmeshed in inside corporate maneuvers. Pensioners, and the public at large, would be better served if these funds limited themselves to passive investments, but performed their "passive" duties with utmost diligence.

(f) *Broadening financial disclosure requirements, and charge punitive fines for non-compliance.*

(g) *Challenging PICPA to more forcefully uphold professional and ethic standards within its membership.*

(h) *Educating directors.*[54] This will be the primary mission of the newly created Institute of Corporate Directors.[55]

(i) *Strengthening the legal framework.* Passage of the proposed Securities Act (which has been languishing in Congress since 1995) will be a major step forward. Next, a task force should be established under the Capital Markets Development Council (the Council) to review the Company Code, Philippine Stock Exchange (PSE) rules and other laws and regulations affecting corporate governance, including possible changes to the existing legal and institutional framework for corporate governance. The Task Force might draw inspiration from international best practices in corporate governance,[56] including regarding the rights of minority shareholders, disclosure of actions by the board and large shareholders, external control on large shareholders, reporting standards, range of assets eligible as security, and corporate disclosure.

2.31 Changes in the operating environment will also make a difference. The judicial reforms discussed in Chapter 4 are obviously key. But opening up sectors of the domestic markets to domestic and foreign competition (as discussed below), where the businesses of the family owned groups are concentrated, will also help disentangle pyramid holding and conglomerate structures by forcing the owners of a group to focus on core activities and divest non-core businesses.

B. Broadening Access to Land

2.32 Concerns about ownership concentration go beyond, and actually predate the discussion about corporate structure. As noted above, they find their historical roots in the concentration of land ownership in colonial times, and the subsequent efforts, spanning over an entire century, to broaden access to land.[57] The process, however, only came into its own in the last quarter of a century. First steps were taken under Presidential Decree (PD) 27 from 1972. The process subsequently expanded vastly under Republic Act (RA) 6657 from 1988, also known as the Comprehensive Agrarian Reform Program (CARP). The latter program resolved to solve once and for all a problem, which had been festering for too long by organizing the transfer of the full ownership of eight

[54] Fogarty, Kevin S. 1999. "Corporate Governance in the Philippines: An Assessment of Needed Reform Efforts." USAID, notes: "It would be an achievement simply to make board members aware that there is a duty of due care (which should at least imply attending meetings now and again) and one of loyalty to the corporation as a whole rather than to any particular shareholder or individual."

[55] A project of the Center for Corporate Governance of the Foundation for Community-Building in the Asia-Pacific, Inc, it held its inaugural meeting in September 1999.

[56] Including (i) alternative approaches and institutional arrangements for dealing with corporate governance which have been adopted in other countries, including but not necessarily limited to, Canada, the United Kingdom, Australia, Singapore, Malaysia and Hong Kong; and (ii) new and innovative measures to address the excesses and market failures of the last few years which might be more readily applicable to the Philippines.

[57] The first systematic attempt at land redistribution, undertaken by the US colonial government in 1903, involved the purchase of about 166,000 has from the Catholic Church. It was followed by the 1933 Rice Share Tenancy Act which limited share rent to 50 percent and imposed a ceiling of 10 percent per annum on credit extended by the landlord and two major pieces of Agrarian Reform legislation under the Magsaysay administration, namely the 1954 Agricultural Tenancy Act and the 1955 Land Reform Act. The former aimed to improve the situation of tenants by limiting share rent to 30 percent, further reducing the interest ceiling to 8-1-percent, and improving the enforcement of existing legislation. The latter was to provide for expropriation of large estates, but in practice remained rather ineffective.

million hectares (has.) of land over a 10-year period.[58] Table 2.7 provides a comparative indication of the orders of magnitude involved.

Table 2.7: SIZE AND CHARACTERISTICS OF DIFFERENT LAND REFORMS

COUNTRY	AREA		BENEFICIARY HOUSEHOLDS	AREA PER		TIME PERIOD
	TOTAL AREA (1000 HAS)	% OF ARABLE LAND	NUMBER (1000S)	% OF RURAL HOUSEHOLDS	HOUSEHOLD (HAS.)	
ASIA						
JAPAN	2,000	33.3%	4,300	60.9%	0.47	1946-49
SOUTH KOREA	577	27.3%	1,646	45.5%	0.35	1948-58
TAIWAN	235	26.9%	383	62.5%	0.61	1949-53
PHILIPPINES						
PRE-CARP	1,092	10.8%	1,511	24.2%	0.72	1940-85
UNDER CARP	4,300	N.A.	N.A.	N.A.	N.A.	1988-97
AFRICA						
EGYPT	390	15.4%	438	10.0%	0.89	1952-78
KENYA	403	1.6%	34	1.6%	11.85	1961-70
ZIMBABWE	2,371	11.9%	40	3.1%	59.28	1980-87
CENTRAL AMERICA						
EL SALVADOR	401	27.9%	95	16.8%	4.22	1932-89
MEXICO	13,375	13.5%	3,044	67.5%	4.39	1915-76
NICARAGUA	3,186	47.1%	172	56.7%	18.52	1978-87
SOUTH AMERICA						
BOLIVIA	9,792	32.3%	237	47.5%	41.32	1953-70
BRASIL	13,100	11.3%	266	5.4%	49.32	1964-94
CHILE	9,517	60.1%	58	12.7%	164.09	1973
PERU	8,599	28.1%	375	30.8%	22.93	1969-79

Source: Deininger et al. 2000

2.33 More than ten years after the promulgation of CARP, one must recognize that, despite the magnitude of accomplishments, progress lags behind target. As illustrated in Table 2.7, the Department of Agrarian Reform (DAR) has, during the 1972-97 period, covered only about 2.5 million hectares, or less than 60 percent of the targeted area. Even under the optimistic assumption that the pace of land redistribution achieved between 1972 and 1997—i.e., the redistribution of about 100,000 has. per year—can be maintained, it would take 17 years to accomplish the stated target.

2.34 Furthermore, although few disagree with the need for land reform in principle, the extent and modalities under which such reform is supposed to take place are becoming

[58] PD 27 consisted of two key provisions, the applicability of which is limited to rice and corn lands. First, it called for a land ownership ceiling of 7 has and the mandatory sale of all land that is owned in excess of this limit to tenants. Second, it outlawed share tenancy and mandated the conversion of tenants on landholdings below 7 has to leaseholders with a rent ceiling of 25 percent of crop revenue after appropriate deductions for inputs. The 1988 CARP expanded the scope of land reform in two respects. First, land reform is no longer limited to rice and corn land but is expected to cover the whole country, with implementation expected to occur in three main phases over the subsequent 10 years. Second, with everybody owning less than 3 has of land eligible, the range of potential beneficiaries was considerably expanded to include, at least in principle, the landless. Finally, full land ownership was granted to all the beneficiaries who benefited from the earlier land reform under PD 27. Implementation of the land reform legislation under CARP was expected to proceed in three distinct steps over a total period of 10 years. A first phase aimed to complete coverage of tenanted rice and corn lands, transfer ownership to these areas, and include in addition lands that were voluntarily offered, alienable public lands, and holdings with a size above 50 hectares. This phase was expected to last 4 years. A second phase, to cover agricultural holdings between 24 and 50 hectares, was expected to be implemented during the subsequent 3 years. Finally, a third phase with an expected duration of 3-4 years would aim to encompass all lands between 5 and 24 has. In addition, to allow recovery of the fixed investments made, an initial exemption of 10 years was granted to agri-business operations and plantations. Little detail was given concerning how to proceed following the expiration of this exemption in the hope that, once the remainder of land reform has been dealt with, appropriate mechanisms could be found.

increasingly controversial. First, questions have been raised as to whether the approach may not be too centralized to allow active participation by beneficiary communities, proper accountability, and adequate provision of complementary services that are necessary to realize the full productive potential of land reform projects. There is also a concern that—by reducing access to land through rental and share-cropping—current land reform legislation may actually reduce access to land for the poor. Finally, a lack of a sustainable source of financing makes the program dependent on political lobbying and congressional appropriations that are not always guided by the needs of the poorest.

Table 2.8: LAND DISTRIBUTION UNDER CARP STATUS BY LAND TYPE AND MODE OF COVERAGE, 1972-97
(hectares)

LAND TYPE	TARGET	ACCOMPLISHMENT	% ACCOMPLISHED	BALANCE
DEPARTMENT OF AGRARIAN REFORM				
TENANTED RICE/CORN	579,520	500,643	86.39	78,877
VOLUNTARY OFFER-TO-SELL	396,684	265,744	66.99	130,940
VOLUNTARY LAND TRANSFER	284,742	276,307	97.04	8,435
GOVT. FINANCING INSTITUTION-OWNED	229,796	148,900	64.80	80,896
COMPULSORY ACQUISITION: >50 HAS.	456,588	74,687	16.36	381,901
COMPULSORY ACQUISITION: >24-50 HAS.	312,355	6,251	2.00	306,104
COMPULSORY ACQUISITION: >5-24 HAS.	736,420	20,483	2.78	715,937
KILUSANG KABUHAYAN AT KAUNLARAN LANDS	657,843	606,347	92.17	51,496
SETTLEMENTS	662,727	662,727	100.00	0
TOTAL DAR	4,316,675	2,562,089	59.35	1,754,586
DEPARTMENT OF ENVIRONMENT AND NATURAL RESOURCES				
PUBLIC ALIENABLE & DISPOSABLE LANDS	2,502,000	927,734	37.08	1,574,266
INTEGRATED SOCIAL FORESTRY AREAS	1,269,411	832,651	65.59	436,760
TOTAL DENR	3,771,411	1,760,385	46.68	2,011,026
TOTAL CARP	**8,088,086**	**4,322,474**	**53.44**	**3,765,612**

Source: Garilao (1997)

2.35 Unfortunately, until recently, a lack of systematic monitoring and evaluation of program implementation has prevented the program to be refined and improved based on experience gained, to ensure that it achieved its development objectives. Data are finally now coming out to permit such an assessment.[59]

2.36 Preliminary research results[60] reinforce the view that land reform has had a significant impact on improving the beneficiaries' well being (see Table 2.8). Despite having been selected from the poorer segments of society, per capita consumption of beneficiaries from the 1972 land reform in 1998 (the only time when information on this was collected) was 45 percent higher than that of non-beneficiaries. Econometric estimates using a number of different indicators confirm this notion: children of land reform beneficiaries have accumulated human capital faster than those from non-beneficiaries. Rates of physical asset accumulation by land reform beneficiaries were significantly higher than those by non-beneficiaries, both in the period immediately

[59] This refers to a unique data-set covering five villages in Central Luzon and Iloilo that represent the rice and corn environments which were the main focus of the 1972 land reforms. One of the villages in each province (Maragol in Central Luzon and Pandon in Iloilo) represents favorable agroclimatic environments with irrigated rice production. Two further villages in less favorable environments combine reliance on rain-fed production with supplemental irrigation during the dry season. The fifth village (Signe) is located in mountainous and marginal environment.

[60] Deininger, K., F. Lara Jr., M. Maertens, and A. Quisumbing. 2000. "Agrarian Reform in the Philippines: Past Impact and Future Challenges." Mimeo. Washington, D.C: World Bank.

following land reform as well as during 1988-98. While rice yields obtained by beneficiaries in 1985 (the first time when information is available) were not different from those of non-beneficiaries, the data suggest that, in the longer term, land reform beneficiaries were able to improve their productivity more than non-beneficiaries—enabling them to harvest 1,400 kg. per has. more in 1998. All of these suggest that land reform had a positive impact on beneficiaries' livelihood.

Table 2.9: IMPACT OF LAND REFORM ON BENEFICIARIES
(Beneficiaries compared to reference group)

	INDICATOR
ADDITIONAL SCHOOLING (YEARS)	0.60 - 0.83
ADDITIONAL INCOME (US$)	73 – 92
ADDITIONAL ASSET ACCUMULATION (US$)	996 – 1526
INCREASE IN RICE YIELDS 85-98 (KG/HA)	565 – 638
ADDITIONAL PROFITS 85-98 (US$)	80 – 102

Source: Deininger et.al.(2000)

2.37 However, while, by their very nature, both sets of land reform have favored people who were already cultivating at least some land, the first phase was better targeted towards the poor than the second one. In addition to focusing on larger households (with more available family labor) who were less educated and had lower non-land asset endowments, the first phase of land reform provided land access to a large number of previously landless. The lack of any obvious targeting during the second phase suggests that either access to land through regular land markets has become more restricted than it was earlier, or that as it became more difficult to find "CARP-able" areas, DAR officials may have been less able to target land to the most deserving beneficiaries.

2.38 Furthermore, the restrictions on land rental needed to implement CARP may actually have restricted the capacity of the poorest to access land in such a way that welfare losses from malfunctioning land markets would outweigh the gains from land reform to those who benefited. Research results indeed suggest that the functioning of land markets may have worsened considerably between 1985 and 1998 and that CARP related land reform legislation and the associated attenuation of land ownership rights decreased land owners' ability and willingness to rent out land to the landless, thereby reducing access to land for the vast majority of poor who did not benefit from the land reform program. In part as a result, the probability of a landless person accessing land may have decreased by more than 60 percent between these two dates.

2.39 The implications in terms of welfare are important. To start with, the number of landless farmers exceeds by far the number of CARP beneficiaries. Data from 1998 Annual Poverty Indicator Survey indicate that, of the households who have at least one member working in agriculture, 68 percent do not have access to land other than their residence, while only about 3 percent received land through CARP. Furthermore, the welfare losses to the landless might be quite high. Comparing consumption levels between landless with and without land in 1998 indicates that the income lost due to inability to access land may be significant—up to 30 percent of total household income.

2.40 If these preliminary findings are confirmed by further research,

(a) A shift in CARP implementation toward better targeting the landless would be warranted.

(b) A systematic effort should be undertaken to identify and relax those land market restrictions, which are not strictly essential to (a). This would create opportunities for the poor to access land through a rental arrangement of their choice and at the same time greatly increase agricultural productivity, by bringing areas under cultivation which are currently fallow and not rented out due to fear of land loss.

2.41 In the meantime,

(a) *effective collection of existing land taxes* (which are currently poorly enforced due to landlord resistance) might provide a more powerful incentive to increase the efficiency of land use than any threat of bureaucratic intervention and/or expropriation. This might involve a prohibition of further land tax amnesty by local governments and a mandatory update of land assessed values (for tax purposes). Since the one-time cost of such exercise is likely to exceed the capacity of many LGUs, financial assistance may need to be secured from the national government or from donors.

(b) directly *funding poor communities to purchase CARP land on a mutually agreeable basis* could usefully supplement the existing compulsory CARP arrangements. Such program could help speed up land reform implementation, particularly in areas where landlord resistance is likely to be fierce. Even better, such program might also provide an effective mechanism to target land reform toward the landless, and to enhance the its poverty impact. Implementing an approach of this nature in the context of the pilots for "community-managed land reform," which the Philippine Government is currently planning, would provide the learning experience needed before proceeding on a broader scale.

(c) progress towards *agricultural trade liberalization* (see next section) would help reduce the price of land in general, make land more easily accessible to all, and also ease the financial burden of land acquisition under CARP.

C. Opening Up and Leveling the Playing Field

Trade Liberalization in the 1990s

2.42 The environment itself in which private firms and farms operate has changed dramatically over the last decade under the combined influence of trade liberalization and heightened domestic competition. As noted in Chapter 1, tariff reform and import liberalization were used in tandem over the last two decades to shift the economy from an inward to an outward orientation. Following a first wave of trade policy reform starting in the early 1980s, a second one began in the mid 1990s[61] with tariff walls falling in the manufacturing sector, quantitative restrictions in the agricultural sector being replaced by

[61] The first wave of Tariff Reform was implemented in 1981 to 1985 (Manasan & Pineda, 1999). As a result of this initiative, the average Effective Protection Rates (EPR) declined and the bias against primary agriculture and exportables was reduced. The second wave came in the mid 90s, with Executive Order No. 264 (July 22, 1995), adopting the policy of a unitary tariff of 5% by 2004, for industrial and non-sensitive agricultural products.

tariffs,[62] and reduction in the level and dispersion of tariffs. The end objective of the recent generation of reform is to bring tariffs to five percent across all sectors by the year 2004, except for sensitive agricultural commodities.[63]

2.43 The tariff reform initiatives of the Philippine government have been pursued mainly on a unilateral basis. President Joseph Estrada himself expressed his support for such approach most clearly when he said:

"*...The greatest benefits of liberalization are enjoyed by those economies that undertake it, whether others follow suit or not. Without acceptance of this notion, APEC would have bogged down. Its members would have been preoccupied with minimizing the beneficial fall-outs of unilateral liberalization to "free riders" instead of maximizing the benefits for themselves, regardless of such fall-outs.*"[64]

2.44 Commitments to the World Trade Organization (WTO) also provided some push to the reforms, in particular, with regard to tariffication of agricultural commodities formerly protected by quantitative restrictions.

2.45 As a result of the reforms, there has been a substantial reduction in the effective protection rate[65] (EPR) across sectors (see Chapter 1, Table 1.10 and Table 2.9). Notably also, while neighboring countries slowed down their pace of tariff reduction in response to the Asia crisis, the Philippines kept up its own (see Table 2.11)—in keeping with the principles enunciated by President Estrada hereabove.

Table 2.10: EVOLUTION OF EFFECTIVE RATES OF PROTECTION
(1990 to 2000)

	BEFORE TARIFFICATION	WITH TARIFFICATION		UNDER 1998 EOs	
	1990	1995	1996	1998	2000
NO. OF TARIFF LINES	6,193	5,538	5,721	5,627	5,566
EFFECTIVE RATE OF PROTECTION					
WEIGHTED AVERAGE (PERCENT)	29.4	24.8	25.5	18.7	14.4
STANDARD DEVIATION	22.1	23.0	26.1	20.8	18.0
COEFFICIENT OF VARIATION	75.0	92.0	102.0	111.0	125.0

Source: Manasan & Pineda, (1999)

[62] Quantitative Restrictions (QRs) of so-called sensitive agricultural commodities was replaced by high tariff in March 1996, by virtue of RA No. 8178.

[63] Such as, rice, corn, sugar, selected vegetables (i.e., garlic, onion), poultry, livestock, and meat products (see Department of Agriculture. 1998. "Rules and Regulations for the Implementation of the Agricultural MAV." MAV Management Committee. Quezon City, Philippines.).

[64] Speech delivered by Pres. Joseph Estrada during the 13th General Assembly of the Pacific Economic Cooperation Council (PECC) in Manila, October 21, 1999.

[65] EPR or Effective Protection Rate measures the extent to which the protection system increases an industry's domestic value added above its free trade value. The higher the EPR, the more protected is a given commodity (see Manasan & Pineda 1999 for a detailed discussion).

Table 2.11: AVERAGE MFN RATES OF SELECTED ECONOMIES
(percent)

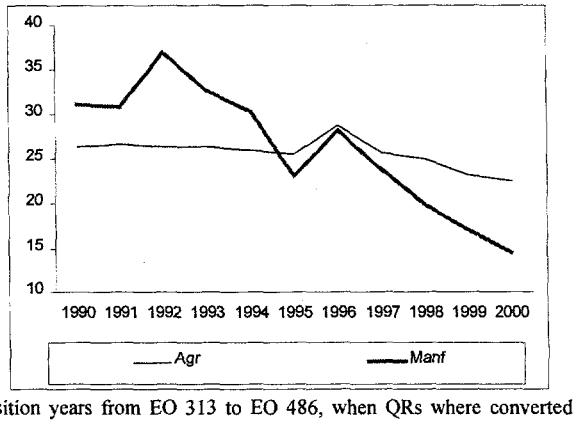
COUNTRY	1993	1996	1997	1998	1999
INDONESIA	17.00	13.14	11.76	11.76	13.5
MALAYSIA	12.80	9.00	7.8	9.3	9.45
PHILIPPINES	23.50	15.55	13.43	10.69	9.98
THAILAND	37.80	17.00	18.36	N.A.	16.97

Source: APEC Individual Action Plan

2.46 Disaggregating the sectors would reveal, however, that the pace of tariff reduction was much faster in manufacturing compared to the agriculture subsector (see Figure 2.2). The enactment of high tariffs in place of the QRs for sensitive items actually pulled up the average tariff in the agricultural sector (Manasan and Pineda, 1999 and David, 1999).

2.47 The high tariff walls for sensitive commodities in agriculture slowed the momentum of reform in the agricultural sector.[66] As a result, a switchover in effective protection structure occurred. Agriculture, which used to be less protected, has overtaken the manufacturing sector in degrees of effective protection (see Figure 2.2).

Figure 2.2: EFFECTIVE PROTECTION RATES FOR MANUFACTURING AND AGRICULTURE
(percent)



Note: 1995 to 1996 are transition years from EO 313 to EO 486, when QRs where converted to tariffs for sensitive agricultural commodities.
Source: Manasan & Pineda (1999)

Economic impact of trade reforms

2.48 An analysis on the impact of tariff reforms carried out for the period 1995 to 2000 was made by Cororaton and Cuenca (1999).[67] Their results indicated that trade reforms had benefited the economy. Household income rose faster as a result while employment improved. In addition, they also observed that the lower income group benefited more from the trade reform than the upper income group (see Table 2.10).

[66] The Minimum Access Volume (MAV) scheme was put in place to ensure a specific level of market access in the event that a country "over-tarrifies." Under EO 313, the government imposed lower duty (i.e., in-quota rate) for imports falling within the MAV and higher duty (i.e., out-quota rate) for imports in excess of the MAV. However, while it served as a compromise between protectionist and liberal camps, it also presented some opportunities for rent seeking activities among market players who are able to corner MAV allocations (see David, 1999).

[67] The analysis was done with the use of a 50-sector computable general equilibrium model of the Philippine economy using 1994 economic data (see Cororaton and Cuenca, 1999 for more details).

2.49 One should however point out that there are some sectors, which are negatively affected in the reform, process. Cororaton and Cuenca (1999) showed clearly the loss of jobs in the agriculture sector during the transition.[68] Their simulations also found that a more aggressive tariff reduction, particularly as concerns "sensitive" items would have been even more beneficial to the economy (see Table 2.11).

2.50 These gains did not come without pain, though. According to the simulations presented below, trade liberalization would have eliminated close to 200,000 jobs to create 500,000 new ones. Interestingly enough, it does not seem that the pain would have been much higher, had agricultural tariff reform been pursued much more aggressively. It appears that even agricultural employment would have fared better, as the cost of rural labor would have been reduced as a result (see Table 2.10 and 2.11). This is not entirely surprising if one considers that a full two third of the households who have at least one member engaged in agriculture are actually landless.

Table 2.12: IMPACT OF TARIFF REFORMS
(Baseline Scenario: Tariff reduction based on present tariff schedules)

	CUMULATIVE CHANGE 1995 TO 2000 (W/O 1996)
CHANGE IN GROSS INCOME OF HOUSEHOLDS	(PERCENT)
HH1 (lowest income group)	4.9
HH2	2.6
HH3	2.7
HH4	2.7
HH5	3.1
CHANGE IN LABOR INCOME OF HOUSEHOLDS	
HH1	4.1
HH2	3.9
HH3	3.7
HH4	3.6
HH5	2.8
CHANGE IN EMPLOYMENT	(THOUSANDS)
Agriculture (including fishery & forestry)	-30.1
Industry (including construction & utilities)	156.0
Service (EXCLUDING GOVERNMENT SERVICE)	146.0
TOTAL (EXCLUDING GOVERNMENT SERVICE)	271.9

Note: 1996 data was excluded due to the technical change from QRs to tariff for sensitive agriculture commodities
Source: Cororaton and Cuenca (1999)

[68] Tan, E. 1999. "Measuring Poverty in Education." In A. M. Balisacan, ed., *Causes of Poverty: Myths, Facts and Policies.* and Medalla, E. 1998. "Trade and Industrial Policy Beyond 2000: An Assessment of the Philippine Economy." PIDS Discussion Paper Series No. 98-05. Makati, Philippines. May 1998, share these findings.

Table 2.13: IMPACT OF TARIFF REFORMS
(Aggressive Scenario: target 5 percent tariff across all sectors in year 2000)

	CUMULATIVE CHANGE 1995 TO 2000 (W/O 1996)
CHANGE IN GROSS INCOME OF HOUSEHOLDS	(PERCENT)
HH1 (lowest income group)	5.3
HH2	2.7
HH3	2.8
HH4	2.9
HH5	3.3
CHANGE IN LABOR INCOME OF HOUSEHOLDS	
HH1	4.4
HH2	4.2
HH3	4.1
HH4	3.9
HH5	3.1
CHANGE IN EMPLOYMENT	(THOUSANDS)
Agriculture (including fishery & forestry)	-17.1
Industry (including construction & utilities)	218.4
Service (EXCLUDING GOVERNMENT SERVICE)	160.5
TOTAL (EXCLUDING GOVERNMENT SERVICE)	362.8

Source: Cororaton and Cuenca (1999)

Remaining Distortions in the Agriculture Sector

2.51 Thus far, the Philippine government has achieved much in leveling the economic playing field and promoting competition. But, remaining distortions in the agriculture sector must be addressed to achieve greater benefit from trade liberalization. There are four major reasons for moving forward with tariff reforms in agriculture.

(a) First, current tariffs stifle the development of downstream activities. Protecting sugar means high input prices for the food and beverage industry, such as, processed fruits, chocolate and sugars confectioneries, carbonated drinks and juices. Similarly, protecting corn results in high feed prices for the hog and poultry industry, areas where the country has great exports potential (David, 1999).

(b) Second, current protection diverts agricultural production away from exports (as happened during most of the 1990s, see Figure 2.3). Conversely, Figure 2.3 also shows how exports can react, as they did in 1998, to a reduction in the implicit protection provided to "sensitive items" since the depreciation of the peso (see Chapter 1, Table 1.11). Pursuing tariff reform in agriculture makes the country better positioned, for instance, to capture the benefits provided by a rapidly liberalizing China market.[69]

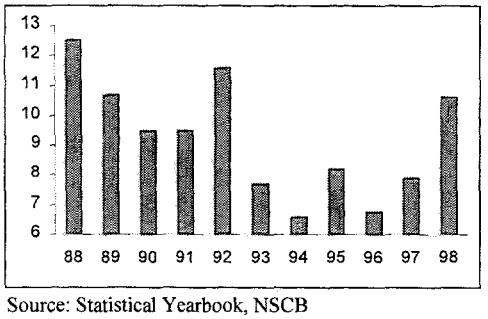
(c) Third, Philippine rice prices are higher compared to some Asian countries (see Figure 2.4). This situation erodes the competitiveness of labor vis-à-vis other Asian countries.[70]

[69] With China's entry into the WTO, we should expect a wider potential for Philippine exports to reach the 1.2 billion Chinese market.

[70] see World Bank. 1997. "Philippines: Managing Global Integration." Washington, D.C.

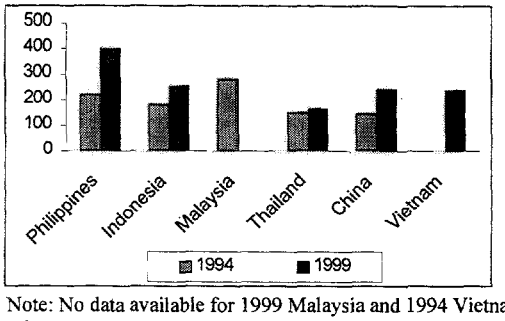
(d) And finally, this imposition falls disproportionately on the poor, who devote a larger portion of their income to food expenditure (see Table 2.12), and weighs down the wage competitiveness of unskilled labor. As the poor are, in general, net buyers of food, they should also generally benefit from the reduction in food price which trade liberalization would bring about.

Figure 2.3: AGRICULTURAL EXPORTS
(percentage of agricultural value added)



Source: Statistical Yearbook, NSCB

Figure 2.4: PRICE OF RICE IN SELECTED COUNTRIES
(US$ per metric ton)



Note: No data available for 1999 Malaysia and 1994 Vietnam rice prices
Source: World Bank

Table 2.14: SHARE OF FOOD IN CONSUMPTION BY DECILE
(percentage of total consumption expenditures)

PER CAPITA EXPENDITURE DECILE	
FIRST (POOREST)	68.0
SECOND	64.6
THIRD	62.3
FOURTH	59.8
FIFTH	58.2
SIXTH	55.6
SEVENTH	52.3
EIGHTH	48.4
NINTH	43.5
TENTH (RICHEST)	28.6

Source: Balisacan (1999); Family Income and Expenditure Survey (1997)

2.52 There will clearly be winners and losers as the economy moves towards a more liberal environment. Lowering import barriers for rice, corn, and sugar, for example, could be a wrenching process. Farmers who have grown accustomed to planting only rice and corn may find it hard to compete as imported rice/corn come in cheaper and in greater quantity. Indeed, some studies have pointed out that further tariff reduction for sensitive agricultural commodities may cause an initial dip in production before sustainable growth could be realized (Cororaton,1999; Tan,1997; Medalla, 1998). However, this is not to say that obstacles in the transition are enough reason for reforms to stall. On the contrary, policies to smoothen the transition and provide safety nets to vulnerable sectors should be carried out as soon as possible, without disrupting the momentum of tariff reforms. The resources in support of the smooth transition would come from the Agricultural Competitiveness Enhancement Fund (ACEF) under R.A. No. 8178; and the Agriculture and Fisheries Modernization Act (R.A. 8435). Both laws are

envisioned to provide more resources towards agricultural modernization and cushion the negative impact of tariff reforms.

Role of AFTA and the next wave of trade reform

2.53 The next wave of tariff reform is likely to take place in a regional context. Two recent developments within the ASEAN Free Trade Area (AFTA) merit closer attention in this respect:

(a) the acceleration of the target year to achieve free trade within ASEAN, moving it five years earlier than planned, from 2015 to 2010;

(b) the expansion of commodities to be covered under the Common Effective Preferential Treatment (CEPT)[71] to include all sensitive items including rice as envisioned under the Hanoi Plan of Action (HPA).[72] As an example of the resolve of ASEAN member countries to lower tariffs, Thailand has already declared lowering tariffs (to 20 percent) on rice and open cross-border trading.[73]

2.54 Drawing inspiration and support from the AFTA initiatives, the Philippines may find it to its advantage to pursue further trade liberalization[74]. McKibbin and Stoeckel (1999) find, for instance, that further unilateral trade reform initiatives in the Philippines will be beneficial for the economy. Real investment is expected to rise, while consumption would get a boost as consumers anticipate the gains of the removal of protection, and real GDP would be over 3 percent above baseline by 2010 given a more efficient resource allocation.

Services, Next Frontier in Globalization

2.55 Technological innovation, especially in telecommunications and information processing, is expanding significantly the scope for service tradability. The quality of the existing telecommunications infrastructure is at the heart of the information revolution. A recent OECD study lists three criteria for developing countries to capture new markets for such long-distance services. Such services need to: (i) be information-intensive, and by implication, relatively labor-intensive; (ii) require limited direct contact with customers; and (iii) not involve manipulation of physical objects.[75]

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[71] New commitments under the Common Effective Preferential Treatment (CEPT) cover highly sensitive agricultural commodities, like rice for the Philippines.

[72] The HPA is the first in a series of plans of action building up to the realization of the goals of the ASEAN Vision 2020, adopted during the Second ASEAN Informal Summit, in Kuala Lumpur on 15 December 1997. The HPA has a six-year time frame covering the period 1999 to 2004.

[73] Philippine tariff on rice at present is 50 percent. Import allocation is however dictated by NFA (National Food Authority), the sole rice importer.

[74] The tariff reduction program of the country gets added support from the individual action plan committed by the country to the APEC. This bolsters the country's resolve to follow the tariff reduction schedule it set for itself towards the target unitary rate of 5 percent in 2004.

[75] See Wallace, P. 1999. "The Philippines as A Regional Center for Shared Services." Speech at CFO Magazine/Citibank Conference, October 28, 1999. and Overseas Economic Cooperation and Development (OECD). 1999. "Global Trade Analysis Programme (GTAP)." August 1999.

2.56 With early gains from the liberalization of the telecommunication industry in the early 1990s,[76] and a labor force known for its English language proficiency, the Philippines is poised to capture the opportunities presented by the global information revolution (see Abrenica, 1998; Abrenica and Warren, 1999). Industry watchers already took note of the Philippines' fast becoming an attractive spot for back-office functions and a strategic e-commerce hub for multinational corporations in the region (Jardine Collier, 1999; Wallace, 1999).[77] Success in this regard should be seen as an enticement for other sectors of the economy to follow suit in the path of deregulation and heightened competition, such as port services, inter-island shipping, aviation, and retail trade.

2.57 Much of these early success in attracting service industries can be attributed to the improvement of telecommunication after the liberalization of the sector in the 1990s. But, as the impact of the early generation of reforms in the telecommunication industry ran its course, it is now time to re-assess the gains and find solutions to policy bottlenecks that constrain the industry. Abrenica (1998) cited three main concerns: (i) failure by telecommunication carriers to meet roll-out obligations under the Service Area Scheme (SAS); (ii) continued fending-off of competition by the dominant carriers; and (iii) inefficiencies in pricing policies, i.e., cross subsidies which encourage under-usage of long distance network while encouraging excessive usage of local network. The first two concerns point toward the need for a more resolute enforcement of regulations. As to the latter, it is one which the emerging competition in long distance services may bring to a head.

2.58 Opening up the telecommunications industry, and the consequent increase in market activity, will create new and complex regulatory problems. The key therefore is to provide regulators with up to date and accurate information to function more effectively. A proactive regulator is needed during this time where rapid changes in the industry will accelerate the infrastructure needed in information technology and help the country capture the opportunities presented by the information revolution.

D. CONCLUSIONS

2.59 For reasons linked to the legacy of the past and the prevailing framework on corporate governance and land tenure, the ownership of both corporations and land is exceedingly concentrated. The insecurity of "outsiders"—be they minority shareholders, unconnected creditors, sharecroppers or landless farmers—has retarded development. Recently however, land reform and the opening up of the economy to foreign and domestic competition have begun to change the former status quo. Similarly, trade liberalization has removed rent opportunities. Progress, although rapid, remains uneven.

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[76] A breakthrough was reached in the early 1990s with the promulgation of the Universal Telephone Service Policy which served as the basis for the Service Area Scheme (SAS). With the entry of more players, an investment surge ensued during the period 1994 to 1997, which greatly benefited consumers. As a result, telephone penetration jumped from less than 1 percent at the beginning of the decade to about 9.5 percent in 1998. There was also a marked improvement in the industry's productivity, as incumbent carriers streamlined operations to meet competition (Abrenica 1998).

[77] Collier Jardine Bulletin. 1999. "The Philippines: A Growing Regional Service Center." listed a number of multinational companies that have utilized the Philippines for their backroom operations in the region, as follows: Citibank's Corporate Technology Support, AOL's internet service center, Bechtel's engineering blueprints and design, Caltex' corporate back office, Barnes & Noble internet service center, SPI Technologies data processing center, among others.

2.60 Addressing remaining constraints would make the private sector better able to become the engine of faster, more sustainable and widely shared growth. The chapter highlighted the importance of:

(a) Strengthening the protection of minority shareholders and creditors. This would put corporate finance on a sounder footing and ease access for all, particularly those smaller, independent firms not connected by business interests, to financial resources. First priorities are to: (i) adopt the proposed revised securities act as well as even-handed, and prompt procedures for disposing of suspension of payment filings; (ii) enhance the independence and integrity of the SEC and PSE and (iii) begin to enforce more forcefully existing provisions for disclosure and accounting. It would also help if public pension funds turned themselves into passive investors and champions of minority shareholder rights. A reflection should finally be initiated on evolving debt resolution proceedings towards international best practices, expanding the range of available securities, and eventually also on disentangling banks from corporations.

(b) Supplementing the land reform program with measures to facilitate the access of the landless to land, including by relaxing restrictions inhibiting land markets, enforcing land taxes, and using land tax proceeds to fund land acquisition by poor communities on a mutually agreed basis.

(c) Bringing the pace of agricultural trade liberalization in line with the one ongoing for manufactures and reinforcing competition in the services sectors. The latter is essential if the Philippines wishes to strengthen its hand as potentially one of the primary beneficiaries of the upcoming wave of Internet-based globalization of service activities.

3. FINANCE FOR DEVELOPMENT

A. INTRODUCTION

3.1 The Philippine banking system weathered the regional crisis relatively well, avoiding major failures or a systemic crisis. This is explained in part by relatively strong pre-crisis capital positions and portfolio quality among Philippine banks compared to several neighboring countries: lower corporate leverage at the onset of the crisis, less overheated real estate markets, and strong export growth and remittance flows. Nevertheless, the banking system has been weakened by the downturn.

3.2 The authorities have responded by initiating a significant reform program in 1998 to strengthen prudential regulation, improve the incentive framework and enhance strategies for prompt corrective actions and failure resolution. This program represents a new phase in a long process of stabilization, restructuring and strengthening of the banking system that began more than a decade ago. Notwithstanding the major progress made to date and the resilience displayed by the banking system, further reforms and progress (in areas such as consolidation of banks, increasing efficiency and technology, improving governance and transparency, strengthening prudential regulation and supervision, and rationalizing financial sector taxation) will be needed to realize the vision of a modern, robust and internationally competitive banking system.

3.3 An important dimension of the recent crisis was the over-reliance on foreign savings as opposed to domestic ones, and excessive dependence by enterprises on short-term bank debt as opposed to long-term debt and equity finance. This suggests that structural reforms to support the development of robust and transparent capital markets and promote long-term domestic savings may be warranted. Over the medium term, such reforms would reduce pressures on the banking system, lengthen the maturity of debts, provide more equity-based financing for enterprises and reduce incentives for speculative investment in real estate. More developed capital markets, including efficient housing finance and well-functioning contractual savings institutions, could also contribute importantly to fiscal sustainability and labor market flexibility. Taken together, these reforms would play a critical role in spurring economic growth and reducing poverty (see Box 3.1).

3.4 This chapter first provides a brief overview of the financial system and highlights key historical trends that help to explain the current status of the sector. Proceeding from there, the chapter characterizes the origins and impact of the crisis and assesses the measures taken to address it. On this basis, it charts out key challenges for the future development of the financial system.

Box 3.1: WHY DOES FINANCE MATTER?

Financial markets play an essential role in the efficient functioning of the real sector. In particular, they facilitate pooling of savings and more efficient allocation of these savings to potential investments, as banks and other financial players acquire specialized skills and information in evaluating the risks and returns of alternative investments, and reduce the costs of intermediation. When operating effectively, financial markets ensure that resources are directed to their most productive use, thereby maximizing opportunities for economic growth.

The savings, credit and insurance instruments that allow households and companies to trade across time and across states of nature also make it possible for them to cope better with risks, by pooling and sharing them with others. Access to savings and credit enables households to smoothen consumption patterns over time, increasing their welfare. There is also an important nexus between risk management and resource allocation, as risk-averse entrepreneurs will choose unduly low-risk/low-return investments if they are unable to borrow or insure sufficiently against contingencies.

The depth and efficiency of financial markets have a major impact on the poor. This impact occurs through both direct and indirect channels. In particular, liberalized, but well supervised, financial markets encourage greater competition and the expansion of formal financial services directly to smaller enterprises and poorer households (e.g., through working capital, mortgage loans, credit cards and small denomination savings instruments). Although a large share of Philippine households operates beyond the formal financial frontier, developing deep and efficient financial markets also results in major indirect welfare gains for the poor (and in times of crisis, reduced welfare losses) through economic growth, employment, and reduced economic volatility.[a] Since financial crises are closely correlated with macroeconomic crises, and since these particularly affect the poor through wage declines and unemployment increases, the indirect impact on the poor of reforms that promote sound and efficient banks and non-bank financial markets should not be underestimated.

a/ See Levine (1994) who reviewed linkages between financial depth and economic growth, and Hausmann and Gavin (1996), on linkages between macroeconomic volatility, financial depth and economic growth.

B. OVERVIEW OF THE FINANCIAL SECTOR

3.5 Even more than in the rest of the region (see Figure 3.1), Philippine banks have traditionally taken the lion's share in mobilizing the country's savings. Their total assets represented 101 percent of GDP, and 82 percent of the total assets of the financial system at the end of 1999. In contrast, those of the second largest segment of the financial system, the contractual savings sector (public and private pension funds, pre-need plans and life insurance companies) amounted to only about 20 percent of GDP.

3.6 As was noted in Chapter 2, large, domestically-owned corporate groups control most major banks in the system, and, like the corporate sector, the banking system is relatively highly concentrated: the largest six banks control close to 60 percent of banking system assets. The other 40 percent of assets, however, are highly fragmented across the remaining 47 universal and commercial banks, 117 thrift banks, and about 830 rural banks.[78] Foreign commercial banks account for around 10 percent of banking system assets. Off-balance sheet activities, including trusts and contingent accounts of banks, amount to over 40 percent of banking system assets, with trusts engaging in significant quasi-banking activities.

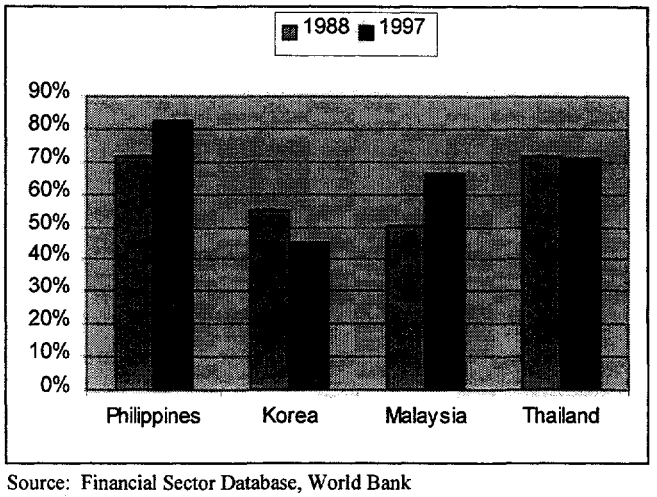
3.7 As a result of banks' dominance of financial intermediation, most corporate finance is obtained through the banking system. Since most household financial savings are placed with banks for fairly short maturity accounts and instruments, bank lending is

[78] The banking system is largely private, with public holdings limited to two development banks, one Islamic investment bank, and a 30 percent share in the Philippine National Bank (PNB) which is being divested.

also generally fairly short-term. Borrowers are therefore relatively exposed (and sensitive) to interest rate risks

3.8 For longer maturities, savings are channeled primarily into contractual savings vehicles (direct investment in equities and debt instruments by the general public remains fairly limited). Public pension funds[79] and mobilized over 60 percent of contractual savings as of December 1998. Life insurers account for the next largest share,[80] followed by private occupational pension plans (OPPs) offered through a large number of Philippine corporations and pre-need plans offered through around 70 pre-need companies. In a bid to generate the longer term lending resources needed to finance social overhead investment (e.g., housing, local utilities), successive governments have created a range of public non-banking institutions, such as NHMFC, LWUA, Pag-IBIG or NEA, backed by either contractual savings schemes and/or by foreign assistance. Unfortunately, the financial record of these institutions has been poor (see Chapter 4).

Figure 3.1: RATIO OF DEPOSIT MONEY BANK ASSETS TO TOTAL FINANCIAL ASSETS
(percent)



Source: Financial Sector Database, World Bank

3.9 Capital markets cater primarily to Government's domestic borrowing requirements. At this point in the financial sector's development, they are still a secondary source of finance for private Philippine corporations (see Table 3.1),[81] in part reflecting the difficulty of raising finance from inadequately protected investors (see Chapter 2).

[79] Comprising the Social Security System (SSS), the Government Service Insurance System (GSIS), the Home Development Mutual Fund (Pag-IBIG), and the Armed Forces of the Philippines Retirement and Separation Benefits System (AFP-RSBS).

[80] The private insurance industry comprises 27 life insurance companies, 97 non-life insurance companies, 4 reinsurers and one composite insurer. Life insurance accounted for 56 percent of the total net premiums written while non-life insurance amounted to 41 percent and reinsurance to 3 percent. Public insurers include the Home Insurance and Guaranty Corporation, Philippine Crop Insurance Corporation, Philippine Deposit Insurance Corporation and Philippine Health Insurance Corporation.

[81] Domestic capital markets comprise markets for equities, government securities and other domestic debt. Equities are traded on the Philippine Stock Exchange (PSE), which has around 180 member firms and 220 listed companies. On the debt side, Government securities are the backbone of the Philippine debt market. While Government owned or controlled corporations (GOCCs) also issue both domestic and external bonds, the private domestic bond market is limited, although trade in commercial paper was fairly active prior to the crisis. Mutual funds are a fairly recent innovation and their total asset value is relatively small. There are only a few local government units (LGUs) issuing municipal bonds, due to high transaction costs and market perceptions of risk.

Table 3.1: FINANCIAL DEPTH AND INDEBTEDNESS IN SELECTED EAST ASIAN COUNTRIES
(percentage of gross domestic product)

	INDONESIA	KOREA	MALAYSIA	THAILAND	**PHILIPPINES**
DOMESTIC CREDIT PROVIDED BY THE BANKING SECTOR	58	84	162	160	**64**
STOCK MARKET CAPITALIZATION	22	38	150	23	**54**
BOND ISSUES OUTSTANDING	5	6	12	9	**14**
PUBLIC DEBT	26	9	17	14	**31**

Source: World Development Report, 1999; World Development Indicators, 1999; Bank Staff; latest data available

C. THE LEGACY OF EARLY FINANCIAL REFORMS

3.10 The Philippine financial system confronted the Asia crisis better equipped than many of its neighbors. First, it benefited from the fruits of the decade-long financial restructuring, which had followed the debacle of the Marcos regime (see Box 3.2). During 1985-95, the Government embarked upon a major program of financial sector restructuring that resulted in the following key reforms:

(a) Restructuring of the central bank, with bad assets assigned to a Central Bank Board of Liquidators and establishment of a new central bank (Bangko Sentral ng Pilipinas) in 1993, with powers to pursue independent monetary and exchange rate policy and to regulate the banking system.

(b) Recapitalization of the Philippine Deposit Insurance Corporation (PDIC) and vesting it with the authority to act as the receiver for all banks under liquidation.

(c) Restructuring the balance sheets of the Development Bank of the Philippines (DBP) and the Philippine National Bank (PNB), which together had accounted for around 50 percent of banking system assets, by transferring their non-performing assets to an Asset Privatization Trust. Government also revised their charters in the late 1980s to rationalize access to special privileges and funds, and started a gradual process of privatization of PNB and conversion of DBP into a wholesale lender.

(d) Increasing minimum capital requirements for banks on four separate occasions during 1986-94, while lifting a moratorium on new banks after 1989, permitting the entry of 10 foreign banks in 1994, and relaxing branching restrictions.

(e) Gradual reduction in selective credit control programs, and related simplification of central bank discounts to a unified rate for all preferential lending programs.[82]

[82] Although the Agri-Agra requirement that 25 percent of bank lending be to agriculture, agrarian reform or qualifying exemptions remains in effect.

(f) Deregulation of the foreign exchange market, opening of the capital account and encouragement of foreign currency deposit units, particularly as a vehicle for capturing remittances from overseas Filipinos.

(g) Strengthening of prudential regulations, including requiring a minimum 10 percent tier 1 capital adequacy ratio, improving the application of generally accepted accounting principles to Philippine banks, tightening of regulations and disclosures governing asset classification and loan loss provisioning, and a limited relaxation of banking secrecy related to connected lending.

(h) Upgrading banking supervision by enhancing skills, and introducing a CAMELS[83] rating system for banks.

Box 3.2: THE PHILIPPINES' 1980S CRISIS

Heavy external borrowing and inefficient allocation of these resources during the 1970s, coupled with high global interest rates and political instability in the early 1980s, contributed to the Philippines being unable to service the principal balance of its external debt by 1983. Following the 1983 debt moratorium, domestic liquidity decreased by some seven-percentage points of GNP and bank credit to the private sector declined by nearly 20 percent in three years. With the political turmoil and macroeconomic instability of the mid-late 1980s, and with increased financial liberalization in a weakly regulated environment, private banks were experiencing severe liquidity and solvency problems. In addition, the financing of large public deficits primarily through domestic borrowing (reflecting the scarcity of external financing from private sources following the debt crisis), resulted in sharp increases in domestic debt and real interest rates, and further stress on the financial system. Years of politically influenced credit allocations also eroded the capital of the Philippine National Bank (PNB) and the Development Bank of the Philippines (DBP), both of which had to be restructured. Finally, the financial position of the Central Bank itself deteriorated to the point of requiring major restructuring, as it was forced to assume the foreign currency liabilities of a number of public and private enterprises. The financial situation was so degraded that, during the 1981-87 period only, the Government closed 3 commercial banks, 32 thrift banks, and 108 rural banks, and additional 500 rural banks participated in a massive rehabilitation program.

3.11 On the capital markets side, key reforms included the establishment of the Bureau of Treasury under the Department of Finance and the regularization of issuances of T-bills and longer-term government bonds; as well as the passage of a Securities Act defining the powers of the Securities and Exchange Commission (SEC) and registration, reporting, disclosure and other requirements for securities issuers and traders; and the integration of the Manila and Makati Stock Exchanges.[84]

3.12 Taken together, these banking sector reforms, combined with improved macroeconomic performance, contributed to a significantly improved financial sector performance going into the regional crisis. Banks were capitalized at an average of 17 percent, commercial bank non-performing loans (NPLs) had been reduced from over 20 percent at the beginning of the decade to below 3 percent.

[83] Capital adequacy, Asset quality, Management Earnings, Liquidity and Sensitivity to market risks.

[84] Associated with these developments was the establishment of infrastructure supporting securities trading, including the Philippine Central Depository Inc. (PCD) and the Securities Clearing Corporation of the Philippines (SCCP), as well as the Securities Investors Protection Fund and the Securities Trading Guarantee Fund, which were created respectively to protect investors from failure of intermediaries and that of trade settlement.

D. THE ASIA CRISIS AND ITS AFTERMATH

Emerging Stresses

3.13 New sources of weakness developed during the decade however, which the Asia crisis exacerbated. As discussed in Chapter 1 and 5, Philippines vulnerability stemmed from an appreciating real exchange rate, high current account deficits, and low domestic savings. With the constraints in domestic capital markets, a legacy of inflation and debt moratorium, and an economy still in process of liberalization, deregulation and increasing transparency, portfolio flows were overwhelmingly of a short-term nature, although direct investment in key export industries was also rising rapidly in the 1990s. Finally, bank credit to the private sector, which rose by more than 35 percent per year on average during 1993-95 and at 50 percent in 1996 (the fastest in the region). It is difficult for even the best banks to sustain such a rapid expansion in risk assets.

Impact on the Banking System

3.14 Although the authorities had started, since the beginning of that year, to take steps to tackle this growing bubble (tightening in domestic credit, quasi-prohibition of foreign exchange exposure, and restrictions on real estate lending), the impact on the Philippines of the Thai crisis of July 1997 was nonetheless immediate. After losing one-quarter of its reserves in eight days, the BSP indicated it would allow the peso to float. As the crisis spread to Korea and Indonesia, successive withdrawals of funds by foreign and domestic investors, and purchases of foreign exchange by domestic companies for hedging purposes, drove the peso to a low of PhP 46 per US1 dollar in January 1998. The PSE index plunged to a low of 1,100 within one year from a pre-crisis high of 3,500. The risk premium on Philippine Government debt over comparable US Treasuries rose from 250 basis points to over 800bps by late 1998. In the domestic market, treasury bill rates rose from under 10 percent in July 1997 to over 20 percent in January 1998, while prime rates reached 26-30 percent before a concerted effort by the BSP and the Bankers' Association began to bring down interest rates. Growth in bank credit to the private sector fell to 15 percent in end-1997 and 8.4 percent in end-1998 and declined through most of the first half of 1999 in spite of more expansionary fiscal and monetary policy.

3.15 Overall, while the banking system underwent significant stress, the problems did not become systemic and the system remains solvent (with an average capital adequacy ratio of over 17 percent) and fairly liquid since Spring 1998, as the central bank cut back reserve requirements, while banks were tightening lending criteria, shifting out of risk assets and taking measures to boost their capital. Non-performing loans in the banking system did rise five-fold from 3 percent in July 1997 to almost 15 percent of commercial bank loans two years later,[85] but this ratio remained below the rates in other countries affected by the crisis (Table 3.2 shows the levels reached in neighboring countries *before* transfer of bad loans to specialized debt resolution agencies) and has since began to recede (to 13.4 percent in January 2000). Bank capitalization has remained high (with a capital adequacy ratio of 17.5 percent as at the end of 1999, compared to a statutory minimum of 10 percent). Banks have also constituted substantially larger loan loss

[85] Not only due to the continuing stress but also reflecting the tighter definition of NPLs as of April 1998 to include loans that exceed three months rather than six months in arrears.

reserves to meet the increased classified assets, although coverage of reserves to classified assets has declined from around 40 percent to 25 percent. There has therefore not been a need for either a government-funded recapitalization of banks or for a central asset management company to handle bad debts.

Table 3.2: NPLs and Financial Restructuring in Selected East Asian Countries

	INDONESIA	KOREA	MALAYSIA	THAILAND	PHILIPPINES
Government Liquidity support	$21.7 bn (17.6% of GDP)	$23.3 bn (5% of GDP)	$9.2 bn (13% of GDP)	$24.1 bn (20% of GDP)	$300m (0.4% of GDP)
NPL/total loans %a	31.4 (9/99)	17.9 (5/99)	19.4 (5/99)	47.1 (7/99)	13.4 (1/00)
NPL/total loans after transfers to asset management cos. %	12.4	11.3	12.4	47.1	14.5
Bank closures	66 out of 237	None	None	1 of 15	1 comm. Bk. 8 thrifts, 45 rural banks
Closure of other financial institutions	N.A.	117	None	57 of 91	N.A.
Mergers of financial institutions	4 of 7 state banks to merge	11 of 26 absorbed by other banks	58 to be merged into unspecified number by Dec. 2000	3 banks and 12 finance companies	Voluntary mergers under way for several banks.
Public funds for recapitalization	$27.6 billion	Government injected $36bn into 9 commercial banks; 5 out of 6 major banks now 90% state-controlled	Danamodal injected $1.6bn into 10 institutions	Plan in place; government injected $8.9bn into private banks and $11.7bn into public banks	No public funds for recapitalizati on.

Source: World Bank staff

Second Wave of Banking Reforms

3.16 In a preventive move, the Philippine authorities embarked nonetheless on a second wave of measures to strengthen the banking sector. The thrusts of this program has been to:

(a) *Strengthen the prudential framework.* Higher minimum capital requirements and tighter provisioning requirements are encouraging the consolidation of banks, and stricter qualification and competency criteria have been put in place for granting new banking licenses (in fact, at present branching and new bank licensing have been curtailed in order to encourage consolidation of the system). There has been stronger enforcement of existing rules backed by tougher penalties for noncompliance, as regulations have been issued mandating prompt

corrective actions to address weak or critically undercapitalized banks. Strengthened disclosure requirements have been issued regarding bank ownership and control, lending to directors, officers, stockholders and related interests (DOSRI), NPLs and banks' overall financial position to facilitate greater public oversight of banking institutions. Measures are also being taken to accredit banks' external auditors and to ensure that they promptly inform BSP of any material shortcomings in banks' performance.

(b) *Reinforce the intervention and resolution strategy.* BSP has stepped up its program of inspection and remedial action against weaker banks. Thus far, one commercial bank out of 54, eight out of 117 thrifts and 45 out of 830 rural banks have been placed under receivership, fortunately for a total of less than 2 percent of banking system assets.[86] The monetary authorities are encouraging consolidations, mergers and buyouts in the system as the preferred solution for weaker banks.

The Central Bank is also developing early warning mechanisms for early detection of stress among banks, and legislation is also pending before the Congress that would codify several reforms under an amended General Banking Act and New Central Bank Act (aimed also at enhancing competition, strengthening bank supervision and further enshrining the independence of the central bank), and revisions to the PDIC Charter are to be proposed soon that would strengthen its powers to implement prompt failure resolutions.

(c) *Introduce laws, regulations and institution-building measures to enhance the supervisory, enforcement and resolution* powers of BSP and the PDIC. Legislative proposals have been prepared for congressional consideration, *inter alia*, to ensure adequate legal protection for banking supervisors in the conduct of their work.

(d) *Reduce intermediation costs and regulatory arbitrage.* Measures undertaken to address this include better remuneration of mandatory reserves, and subjecting interest payments on foreign currency deposits to withholding income tax (although the rate of that tax remains lower than for Peso deposits).

(e) *Strengthen government owned or controlled banks.* In particular, the Government is seeking to divest its stake in the Philippine National Bank to a strategic investor that can infuse the requisite capital, skills and technology. A diagnostic review and audit of PNB is being conducted with a view to prepare an action plan for its disposition to a strategic private investor.

3.17 Taken together, these measures would go a long way towards ensuring greater robustness, transparency and efficiency of the banking system.

[86] In addition, one thrift (Prime Bank) declared a bank holiday in early June following liquidity and other problems that prompted a run on deposits. The bank remains on a self-declared holiday as of December 1999, as a solution has been delayed.

Stalemate in Non-Banking Intermediation

3.18 Reforms have been substantially slower on the non-bank side. A revised Securities Regulation and Enforcement Act that would codify several regulatory, reporting disclosure and sound governance requirements for securities issuers and traders has languished in Congress since 1997, in spite of its certification as high priority legislation. Proposed changes to the Investment Companies Act have met a similar fate. While the Philippine Stock Exchange now oversees equities transactions as a self-regulatory organization, its capacity in this regard remains to be proven, as is evidenced by the difficulties it has faced in managing the large risks to closure of transactions posed by extremely volatile shares and the questions of transparency that have persisted around subsequent investigations of the share price's movements.

3.19 On the debt side, the regional crisis set back plans to lengthen maturities and develop a benchmark yield curve for government securities, which have been under way since 1994 (see 3.3). Commercial paper issuances have fallen sharply, while corporate bond issues have been fairly limited for some time. Secondary trading in all forms of debt instruments is extremely limited. While there is a liquid market for 91-day Treasury bills, the yield curve on Government paper has remained based on primary auction yields rather than secondary market trading. Moreover, policy-driven rejections of bids in the primary market for under-subscribed T-bills have led to increasing market concerns regarding the value of the 91-day T-bill rate as a market benchmark for pricing bank loans.

3.20 Equity markets have also suffered. Following a significant downturn during the crisis, with the benchmark PSE index falling by more than 60 percent from pre-crisis highs have only recovered half of the losses after September 1998. Initial public offerings (IPOs) came to a virtual standstill. In the important area of mortgage finance, efforts at broad-based reforms appear to have stalled (see below).

Table 3.3: VOLUME OF GOVERNMENT SECURITIES: 1990-97
(billions of Philippine pesos)

TENOR	1991	1992	1993	1994	1995	1996	1997
91-DAY	112.6	77.3	103.9	10.0	83.3	60.1	57.5
182-DAY	94.3	72.7	103.2	103.2	84.6	81.9	63.3
364-DAY	67.7	72.0	98.9	86.1	88.4	116.5	85.4
FLOATING RATE TREASURY NOTES	7.8	23.8	64.8	36.3			
2 YEAR BONDS				5.0	23.4	35.5	28.4
5 YEAR BONDS					21.0	19.7	7.5
7 YEAR BONDS						19.6	5.3
10 YEAR BONDS						2.0	10.3
20 YEAR BONDS							2.0
TOTAL, ALL SECURITIES	282.3	245.9	370.7	330.6	300.7	335.3	259.7

Source: Financial Sector Database, World Bank

3.21 The challenge over the next two to three years will be to put in place the legal, regulatory, institutional and tax measures required to fulfil the unfinished agenda.

E. KEY CHALLENGES FOR THE FUTURE

3.22 The regional crisis has highlighted the vulnerability of growth and poverty reduction objectives to capital flow shocks. Given an environment of globally integrating capital markets and the dominance of the banking system in intermediating financial flows within the Philippines, raising banking standards towards international best practices is among the most important policy responses the Philippines can adopt in response to the crisis. While gradual economic recovery and a manageable level of financial stress may reduce the sense of urgency of reforms, the strength of the recovery will depend critically on the reforms instituted in the macroeconomic, corporate and financial sectors. Moreover, with neighboring countries undertaking structural reforms, it will be important to ensure that the Philippines keeps ahead of the pace in promoting a sound and competitive banking sector, and accelerates reforms in non-bank finance.

Strengthening the Banking Sector

3.23 The considerable advances in banking system reforms since the 1980s, together with BSP's judicious management of monetary and exchange rate policy, contributed to the banking system's relatively robust performance during the crisis. The banking system reform program launched in 1998 promises to reinforce the sector.

3.24 However, the consolidation of the banking sector which this program anticipates in itself will create new challenges. While they may reduce the number of family-based banks, it will also (i) relax the constraints which connected lending ceilings had so far been placed on individual exposures; and (ii) increase the scope for oligopolistic behaviors. Indeed, these considerations might constitute a powerful motivation behind the current drive for size among commercial banks. To obviate the related risk, banking sector consolidation will need to go hand in hand with parallel efforts to improve bank governance; enhance contestability, further strengthen prudential supervision, and ensure prompt resolution of distress cases, as follows:

(a) *Improving bank governance*. A key concern is the inability of outsiders (creditors, depositors and even minority shareholders) to monitor the actions of bank management and majority shareholders. The closely held nature of banks by individuals, families and industrial groups had reduced transparency and increased the scope for insider lending, which has been a major cause of bank failures in the Philippines.[87]

To overcome governance deficiencies, the Government could require that more capital be raised from the market, promote the representation of more outside shareholders on the boards, institute the proposed "fit and proper" standards for directors and officers in the new banking law, require increased information disclosure to market participants (as BSP is proposing to put into effect for all banks from December 1999), and encourage the development of a whole set of ancillary financial institutions and related services (e.g., credit bureaus and rating agencies).

[87] Moreover, limitations of existing disclosure requirements on beneficial owners have been highlighted with the recent change in control of a major bank, constraining BSP's ability to monitor adherence to prudential standards.

Over time, prohibiting non-financial corporations from owning banks (as is the case for instance in Korea or the United States) would warrant serious consideration.

(b) *Enhancing banking efficiency and contestability.* A fairly open banking system, such as that of the Philippines in the 1990s, would be expected to encourage efficiency, and indeed, during 1992-97, the overheads of Philippine banks declined from 6.5 percent to 3.8 percent of assets. But the system remains in practice over-banked. This is evident from multiple branches in both urban and semi-urban communities that contribute to high overheads. As a result, overhead remained more than twice as high as in Malaysia and substantially larger than in Thailand, Korea, or Indonesia (see Table 3.4). Net interest margins during the same period were also substantially higher in the Philippines than in all the other crisis countries except Indonesia (see Table 3.5).[88] Increased consolidation and rationalization of banks, together with technology-driven cost reductions, should help not only to build resilience but also improve efficiency, provided that contestability is maintained through further exposure to international competition.

Table 3.4: OVERHEAD COSTS OF BANKS: 1992-97
(percent)

	1992	1993	1994	1995	1996	1997
PHILIPPINES	**6.6**	**5.3**	**3.9**	**4.7**	**4.4**	**3.8**
INDONESIA	3.1	3.0	2.9	2.8	2.6	2.7
KOREA	2.7	2.7	2.6	2.6	2.5	2.3
MALAYSIA		1.8	1.5	1.6	1.4	1.3
THAILAND	2.1	1.9	2.1	1.9	1.9	2.4
HONG KONG		1.8	2.0	1.9	2.5	3.8
SINGAPORE	1.5	1.5	1.4	1.3	0.9	0.9

Source: Financial Sector Database, World Bank

Table 3.5: NET INTEREST MARGINS OF BANKS: 1992-97
(percent)

	1992	1993	1994	1995	1996	1997
PHILIPPINES	**3.3**	**5.3**	**4.4**	**3.8**	**3.5**	**2.9**
INDONESIA	4.3	4.2	4.2	4.2	4.1	4.6
KOREA	2.8	2.6	2.3	2.2	2.2	1.9
MALAYSIA		2.5	2.2	2.7	2.7	2.7
THAILAND	3.3	3.0	3.4	3.1	2.9	2.6
HONG KONG		1.7	1.9	2.3	3.0	2.9
SINGAPORE	2.0	2.0	2.3	2.2	2.5	2.3

Source: Financial Sector Database, World Bank

(c) *Further strengthening prudential supervision.* Bank supervision has improved in recent years, as the BSP has moved to increase training, add examiners and increase the use of computers; develop early warning systems; introduce a CAMELS rating system; focus more on assessment of key risks and risk management procedures; and intensify supervisory

[88] See the financial sector database constructed by Beck, Thorsten, Asli Demirguc-Kunt and Ross Levine. 1999. "Financial Sector Database." Washington D.C.: World Bank.

inspections. The principal areas requiring further initiatives include continued skills upgrading, (e.g., in such areas as regulation of derivatives); enhancing off-site monitoring through computerization and strengthened analysis of data; improving supervisors' access to needed depositor information to prevent fraud and abuse of prudential requirements,[89] and prompt corrective actions against weak banks.

(d) *Ensuring prompt failure resolution.* Perhaps the key area in which more determined action is required on the part of BSP is in ensuring prompt failure resolution. Whereas due process for bank shareholders is warranted, regulatory forbearance towards undercapitalized banks can provide inappropriate incentives to the market, adversely affecting depositors and hold back sound banks by not allowing weak banks to fail.[90] Thus,

(i) requiring advance collateral for BSP overdrafts facilities;

(ii) fully implementing prompt corrective action guidelines (especially against critically undercapitalized banks);

(iii) not permitting banks to go on self-declared holidays, which engender uncertainty in the banking system, promptly transferring failed banks to the PDIC for receivership; and,

(iv) permitting the PDIC to avail of a broader range of tools for rehabilitation and receivership (e.g., purchase and assumption) and quicker, less costly liquidations (e.g., asset pooling, etc.)

would be essential to instill appropriate incentives and build confidence in the system.

[89] Fears of depositor reaction have prevented regulators from having the sort of access to depositor information considered a routine requirement for effective supervision elsewhere. The rationale for allowing supervisory access to account information is precisely to ensure that the banking system be run on a safe and sound basis for the benefit of all depositors.

[90] The example of Orient Bank, a systemically insignificant and recently licensed commercial bank, provides a case in point. Orient unilaterally declared a "holiday" in February 1998, being unable to pay depositors in the face of a 75 percent NPL ratio, apparently stemming from excessive insider lending. Despite the need for prompt action to conserve the value of the bank's remaining assets for the benefit of the depositors and PDIC resources, Orient was allowed to remain in this unorthodox limbo for about eight months. Best practice in the face of a bank declaring a holiday would have called for the immediate appointment of a receiver, or at least of a conservator.

Box 3.3: PROMOTING RURAL AND MICRO FINANCE

Addressing the policy and institutional impediments in the rural and micro finance markets will have significant direct benefits on poorer communities in rural and urban areas and draw them more fully into the formal financial system. With total resources of P168 billion as of March 1998, the Land Bank of the Philippines (LBP) is the main wholesaler of funds for agricultural and rural credit. These funds are channeled primarily through rural banks and cooperatives to small farmers, fishermen, and non-farm rural enterprises. The rural banks and cooperatives have consistently been weak due to limited capital and highly concentrated risks, and LBP is encouraging a process of consolidation among cooperative lenders. The key challenge for rural finance is to ensure that small farmers have access to financial services, which can only be achieved on a sustainable basis if the provision of financial services is a viable proposition for rural financial intermediaries. While most LBP lending for agriculture is on commercial terms, it has come under considerable political pressure to provide loans to agrarian reform beneficiaries at subsidized rates of interest that do not cover operating costs, let alone loan loss provisions. Not surprisingly, agrarian reform loans have declined from one-third to one-tenth of LBP's portfolio during the past five years. It is therefore essential to reconsider the subsidized, directed credit policy as it has sharply curtailed agrarian reform beneficiaries' access to financial services.

Microenterprise credit is provided by a variety of formal, semi-formal and informal financial intermediaries, including rural banks, cooperatives, credit unions, an estimated 500 credit granting NGOs and over 7000 registered pawnshops. Leading non-bank providers of micro finance have begun to establish performance benchmarks as a precursor to establishing a self-regulatory status for the industry. The Government has also established a People's Credit and Finance Corporation (PCFC) to wholesale resources to credit-granting NGOs that follow the Grameen Bank model of providing micro finance. PCFC had resources amounting to P349.9 million as of March 1998. In the past, there have been numerous lines of directed credit at subsidized rates. However, following the signature of a Social Pact on Credit in 1993 and the subsequent creation of a National Credit Council, measures have been taken to rationalize government-based credit and guarantee programs and encourage greater private participation in credit delivery. In addition to breaking the perceived link between micro finance and welfare/interest subsidies, important policy thrusts have been to encourage active networking among MFIs, development of performance standards, linkages between formal and informal sectors, and mobilizing local resources for micro finance. At this point, the key challenge is to upgrade the institutional capacity of financial intermediaries serving this market segment, since most MFIs have limited outreach and fall below proposed performance standards in terms of outreach, portfolio at risk, and financial self-sufficiency. In this regard, GOP has sought USAID support since 1997 for a Credit Policy Improvement Program.

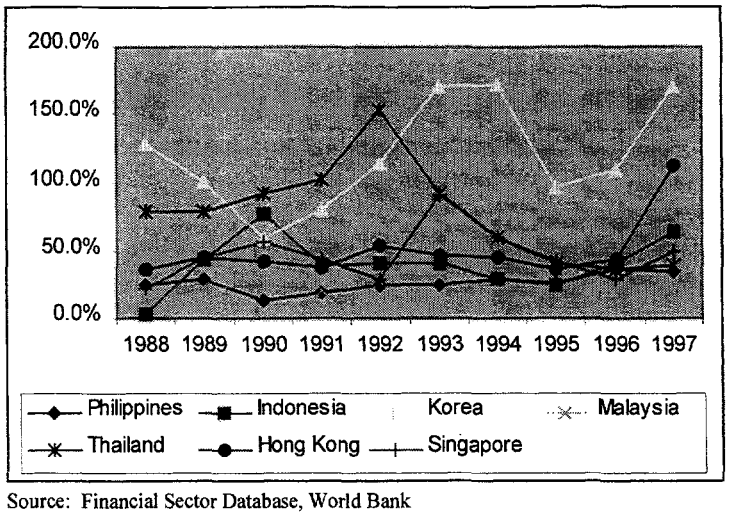
Broadening Capital Markets

3.25 While banks may dominate the scene for some time, capital markets are perhaps the area of the financial system where the potential for growth is most significant, Realizing this potential will require continued reforms in the governance of corporations, markets as well as contractual savings institutions.

Corporate governance

3.26 As seen in Chapter 2, a weak protection of outside investors currently limits the capacity of firms to raise external finance. Capital markets are most affected. Being less well able than banks to monitor their exposures and ensure that corporate insiders do not expropriate them from their legitimate returns, bond and equity investors tend to shy away from the risk involved, or come in at a price. Thus, of the 5000 top corporations in the Philippines, only 222 are publicly listed, resulting in one of the poorest turnover rates in the region (Figure 3.2). Chapter 2 put forward a number of suggestions to ameliorate this situation, ranging from legal reforms to better information disclosure by issuers of debt and equity instruments.

Figure 3.2: STOCK MARKET TURNOVER
(percentage of GDP)



Source: Financial Sector Database, World Bank

Market governance

3.27 While several measures have been taken to upgrade the SEC, with support from the ADB and USAID, further institutional strengthening is essential.[91] The PSE in particular has not yet managed entirely to shake allegations of insider trading and other wrongdoing. The latter have dampened further investor interest and held back the development of non-bank sources of finance. A new Securities Regulation Act under consideration by the legislature would ensure increased transparency of regulations, accountability for regulators, and minimized room for discretionary manipulation and/or fraud. On the equity market side, the immediate challenge is to address governance concerns related to the operations of the Philippine Stock Exchange and improve the surveillance of brokers and dealers.

Governance of contractual savings institutions

3.28 As seen above, the latter institutions, particularly public investment funds are the main investment conduits to capital markets, with the ongoing, gradual drift towards Pay-As-You-Go (PAYG) systems in all three public funds (respectively for government, private sector employees, and the armed forces).[92] These actuarial deficits have one common reason (in addition to generous benefits in the case of the GSIS and AFP-RSBS and relatively low collection efficiency in the case of the SSS): low realized returns for the funds, reflecting both the impact of politically driven investments (see next section) and also more generally that of insufficient attractiveness of capital markets to minority investors.

[91] As an example of this, the SEC is now equipped with a stock watch system linked to the market surveillance system of the PSE, designed to enable the SEC to monitor and detect potential malpractice in the market.

[92] For example, despite a fairly high assets-to-expenditure ratio for SSS in 1997 (590 percent), its fund will be depleted by 2026 unless pre-emptive reforms are undertaken. And the potential costs of delaying reforms are substantial: for example, in the case of SSS, just to maintain benefits at current levels in the absence of reforms, the total contribution rate would have to rise from the 8.4 percent to 12.8 percent in 2020, 16 percent in 2040 and 28 percent in 2060. The viability of the AFP-RSBS has also recently come into question, in spite of annual budget appropriations designed to allow it to build up a self-standing reserve fund.

3.29 This situation has unfortunate social consequences. Low returns complicate the collection of social security contributions, leaving three quarters of the population outside the reach of this critical safety net.

3.30 The Government has now established a Presidential Retirement Income Commission (RIC) to review policies across the contractual savings system, and recommend a policy about the desired combined level of earnings replacement and benefit distribution across the various mandated pension programs, as well as a comprehensive program of legal, regulatory, institutional and fiscal reforms to enhance the contractual savings system. Within the first and second pillars of the system, measures are required to improve incentives and administrative procedures so as to promote increased compliance and collections particularly at SSS and Pag-IBIG, together with improved investment management for all public pension funds with a view to assuring that investments are prudent, liquid, and earn market rates of return.[93]

3.31 The latter point is particularly important. In a bid to boost returns, the public pension institutions have increasingly sought to reap the majority premiums which accompany controlling positions in corporations. In doing so however they have opened themselves to a risk of collusion between public and selected private interests. To avoid even the appearance of it, it would be preferable to move towards outside management of pension funds investments, as provided for an important legislation passed just before the crisis in 1997, and gradually restrict public pension funds' own portfolio to passive investments. The point was made in Chapter 2 that in that position, the public pension funds should turn themselves into vigilant champions of minority investors' rights.

Revamping housing finance

3.32 Whereas the housing sector should provide important investment opportunities for contractual savings institutions, it is one of the areas where pensioners' contributions have been ventured at a cost. The low income housing finance system of target-driven, subsidized lending program through a government financial institution (the National Home Mortgage Finance Corporation) launched under the National Shelter Program of 1986 proved unable to service and recover the portfolio of 200,000 loans that it built up nationwide, leading to the insolvency of the corporation.

3.33 Following that episode, there is now wider recognition that the public funders could not afford to provide the resources needed to address housing backlogs, and that relying exclusively on directed lending would be unsustainable. There is also wider recognition that previous arrangements have thwarted the potential for commercial-based financing.

3.34 The alternative being contemplated is to bring down the walls that channel public pension investments toward housing finance funding and let both supply (including

[93] Complementary measures are also warranted in the related areas of insurance and pre-needs plans. Key challenges in the area of life insurance include increasing competition in the industry by shifting from fairly rigid premium and product controls to a system of solvency monitoring and strictly enforced capital requirements, as well as leveling the playing field with regard to taxation relative to other forms of contractual savings. Moreover, both private and public pension plan benefits are predominantly paid out in the form of lump sums, due to the underdeveloped annuity market. Measures to promote an annuity market could result in improved risk and resource allocations and help to preclude premature disposition of assets by retirees. With regard to pre-need plans, improved disclosure, stricter solvency standards and increased supervision are warranted to protect consumers and develop the industry. A Task Force established by GOP to advise the RIC on voluntary contractual savings is reviewing these issues.

pension funds and other contractual savings institutions) and demand (including from commercial banks) meet freely on de-segmented markets. Asset-based security would be instrumental in helping both sides meet. To draw in private sector funding to the market, it now better recognized that (i) low income housing loans needed to be at market rates of interest; and, (ii) ensuring affordability for the poor could be achieved through a carefully targeted and transparently budgeted up-front subsidy program.[94]

3.35 This is the vision embodied in the Medium-Term Philippine Development Plan for Shelter (MTPDP-S). It would seem to recommend itself over any attempt to resurrect directed lending under another guise.

Rationalizing Financial Sector Taxation

3.36 Finally, there is a need to streamline financial sector taxation. As things stand, piecemeal incentives provided to certain institutions (e.g., lower reserve requirements for thrift banks) or instruments (e.g., lower liquidity requirements for foreign currency deposit units) have resulted to fairly distortionary set of taxes, including a 5 percent gross receipts tax and cascading documentary stamp taxes. Moreover, the uneven nature of reserve requirements and taxes across institutions and products (i) induces bankers and investors to pay excessive attention to regulatory or tax arbitrage; (ii) discourages secondary market trading; and, (iii) introduces distortions across different types of instruments, issuers and investors.[95] By eliminating tax arbitrage loopholes and increasing the efficiency of tax collection, it should be possible to achieve revenue neutrality while reducing or eliminating unwanted taxes.

3.37 Reforming the taxation of financial intermediation is part of the business, which the third round of the Comprehensive Tax Reform left unfinished. A tax package is currently being finalized which would involve the documentary stamp and gross revenue tax being replaced by a VAT-like charge based on banks' profits and salaries. In addition, allowing deductibility of realistic loan-loss provisions would encourage banks to recognize the true quality of their portfolio as early as possible. A package of that nature would deserve early consideration.

F. CONCLUSIONS

3.38 Following a history of banking crisis, the banking sector has emerged relatively unscathed from the Asia crisis. The chapter noted how much this owed to vigorous reform efforts to disentangle banking from policy-political interference, to strengthen the regulation of the sector, and to elevate the independence and authority of the regulators themselves. To generate the long-term finance which the economy needs to grow, a similar effort is now required to shore up capital markets and contractual savings schemes. The chapter highlighted in particular the priority there is to:

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[94] Although the pension funds obliged NHMFC to suspend further lending in 1996 and to focus exclusively on improving collections, there has been no measurable increase in its collection efficiency in the past 2-1/2 years. This suggests those potential loan losses for NHMFC and its pension fund creditors may be substantial. Thus, measures are urgently required to collect or dispose these assets and wind down the corporation.

[95] See World Bank 1997. "Housing Finance: Reforming Public Provision and Promoting Private Participation." Washington, D.C. for a discussion of tax-related impediments to asset securitisation.

(a) straighten out the governance and regulation of markets and institutional investors;

(b) put housing finance on a commercial basis ensuring affordability for the poor could be achieved through a carefully targeted and transparently budgeted up-front subsidy program;

(c) strengthen the independence and authority or regulators vis-a-vis market participants (particularly that of SEC and PSE).

3.39 The various authorities involved in looking after the health of the banking sector will not have either the luxury of resting on their laurels. First, they still need to see through the ongoing "second wave of banking reforms, including the

(a) update and strengthening of the central bank and general banking legislation.

(b) privatization of the Philippine National Bank to a strategic investor capable of putting a final end to the history of recurrent governance problems this bank has been through since its creation at the beginning of the previous century.

3.40 Banking reform will not end there, though. A successful implementation of this wave of reform reforms will in turn give rise to new challenges. While the anticipated consolidation of the banking industry may reduce the number of family-based banks, it will also (i) relax the constraints which connected lending ceilings had so far been placing on individual exposures; and (ii) increase the scope for oligopolistic behaviors. To obviate the related risk, banking sector consolidation will need to go hand in hand with fresh efforts to

(a) improve bank governance;

(b) enhance contestability;

(c) further strengthen prudential supervision; and,

(d) ensure prompt resolution of any distress cases.

4. THE BUSINESS OF GOVERNMENT

A. INTRODUCTION

4.1 Government can make a powerful contribution to growth and equity objectives outlined in the previous chapter in at least three different ways. The first one is to ensure that basic services are delivered, not necessarily by the state itself, but delivered nonetheless so as to reach the poor. The country has taken a number of initiatives in this respect during the 1990s that will hold it in good stead. It has, for instance, increasingly sought to harness private initiative to global development objectives, launched new efforts to guide programs towards poverty reduction objectives, and decentralized its operations to bring public services closer to the citizens. The second section below seeks to identify which lessons have been learned for the future. It brings to the fore the fact that, whereas scarcity of resources should put a premium on the quality of governance, the country still lags behind many of its peers in this area.

4.2 One of the reasons is that, despite the progress accomplished since the people power revolution of 1986, the state still needs to complete its transition from a culture of rents and patronage to one of performance and accountability. The section outlines how actions in the areas of administrative organization, civil service, budget, procurement and financial management may help this come about, and how a more effective repression of fraud and corruption could reinforce their impact.

4.3 A second key contribution that government can make to growth and equity is by providing "good justice," ensuring thereby that individuals, firms and communities can equally depend on the law—rather than on rank, connections and personal obligations—for guidance and protection. It is heartening in this respect that the new Chief Justice of the Supreme Court has resolved to tackle the common perception that justice in the Philippines is slow and capricious. The third section examines where some of the bottlenecks lie and where early action might be warranted.

4.4 The next chapter will elaborate on a third key role for the government, which is to provide macroeconomic stability. It will suffice at this stage to stress how much depends on keeping fiscal house in order. Recent revenue slippage shows that it is still early for the country to lift its guard. The final section of this chapter will outline ways to get revenues back on track.

B. PROVIDING PUBLIC GOODS

4.5 A comparison between public expenditure in the Philippines against a few benchmark countries does reveal a first bottleneck. The bottleneck does not mainly arise however from differences in the level or functional composition of expenditures (see Table 4.1). The latter are, by and large, comparable across the sample. If anything, the

comparison brings to light a number of favorable features including the relatively lower level of the country's commitments to military programs.[96]

Table 4.1: GOVERNMENT EXPENDITURES BY FUNCTION IN SELECTED COUNTRIES (percentage of GDP)

PARTICULARS	PHILIPPINES		KOREA		MALAYSIA		INDONESIA		THAILAND	
	1995	1996	1995	1996	1995	1996	1995	1996	1995	1996
ECONOMIC SERVICES	3.84	4.17	3.67	4.77	4.26	4.79	3.11	3.46	4.63	4.9
AGRI/ FORESTRY/FISHERY	1.24	1.35	1.66	1.47	1.14	1.05	1.38	1.83	1.79	1.7
FUEL AND ENERGY	0.18	0.05	0.12	0.17	0	0	0.08	0.1	0.08	0.05
ROADS, TRANSPORTATION AND COMMUNICATION	2.14	2.32	1.27	2.2	1.92	2.26	1.12	1.07	2.14	2.35
MINING, MANUFACTURING AND CONSTRUCTION	0.01	0.01	0.4	0.54	0	0	0.22	0.2	0.08	0.08
OTHERS	0.27	0.44	0.32	0.39	1.2	1.48	0.31	0.26	0.54	0.72
SOCIAL	4.21	4.75	5.94	7.72	8.53	9.31	5.63	5.72	6.06	6.16
EDUCATION	3.23	3.59	3.62	4.32	4.85	5	1.33	1.32	3.47	3.41
HEALTH	0.44	0.63	0.12	0.15	1.27	1.39	0.38	0.37	1.26	1.27
SOCIAL SECURITY AND WELFARE	0.36	0.41	1.75	2.69	1.42	1.54	0.91	1.06	0.58	0.61
HOUSING AND COMMUNITY AMENITIES	0.18	0.12	0.45	0.56	0.99	1.38	3.01	2.97	0.75	0.87
DEFENSE	1.44	1.59	3.16	3.59	2.8	2.44	1.05	1.07	2.24	2.05
GENERAL PUBLIC SERVICES	1.36	1.12	0.82	1.13	2.94	2.28	1.04	2.31	0.72	0.91
OTHERS	6.84	6.38	4.1	4.86	7.17	7.56	2.89	2.08	2.25	2.18
TOTAL	17.69	18.01	17.69	22.07	25.7	26.38	13.72	14.64	15.9	16.2

Source: Government Finance Statistics (1998)

4.6 It is when looking at the composition of expenditure that the burden of misguided policies comes out more clearly. One reflection of this is the unusually (until recently) high debt service burden which the government has to shoulder. As was already noted in the previous chapter, this represents the legacy of past profligacy, which led to the debt crisis of the 1980s. Although much has been accomplished to reduce this burden to manageable level, it remains nevertheless uncommonly heavy on current generations. This point will be further discussed in the final section.

4.7 A second observation is that the country's budget is saddled with a much heavier wage bill than other countries in the sample. The size of its payroll, however, although perhaps on the high side, does not appear out of line with the levels observed in other countries (see Table 4.2 and Table 4.3). To the contrary, after expanding quickly during the Marcos years (from 1.5 percent to 2.4 percent of the population between 1970 and 1985, see Table 4.4), successor administrations have had a fair measure of success in bringing it back under control and down to 1.9 percent of the population in 1997. The national government, in particular, managed to cut back its payroll from 1.8 to 1.2 percent of the population over the period. Moreover, employment within the Executive Branch of government has actually been shrinking in absolute terms.

[96] Military expenditures may however be rising in the future if and when the implementation of the Armed Forces of the Philippines Modernization Act of 1995, suspended in 1998 due to fiscal difficulties, resumes (see IMF, 1999).

Table 4.2: GOVERNMENT EXPENDITURES BY NATURE IN SELECTED COUNTRIES
(percentage of GDP)

PARTICULARS	PHILIPPINES		KOREA			MALAYSIA			INDONESIA			THAILAND		
	1995	1996	1995	1996	1997	1995	1996	1997	1995	1996	1997	1995	1996	1997
TOTAL EXPENDITURE & NET LENDING	**15.48**	**15.79**	**20.19**	**21.51**	**23.21**	**22.57**	**22.96**	**20.67**	**18.37**	**18.61**	**19.42**	**15.74**	**16.37**	**18.96**
TOTAL EXPENDITURE	**14.68**	**14.64**	**17.71**	**18.62**	**18.77**	**22.36**	**21.97**	**20.15**	**18.17**	**18.56**	**19.37**	**15.75**	**16.16**	**18.68**
CURRENT EXPENDITURE	**7.93**	**8.66**	**14.17**	**14.41**	**14.70**	**17.59**	**17.92**	**15.52**	**14.43**	**15.09**	**15.32**	**10.31**	**10.35**	**10.99**
Expenditure on Goods and Services	4.02	4.40	4.96	4.97	5.02	9.94	9.87	8.36	8.06	8.45	9.28	8.95	8.98	9.43
Wages and Salaries	1.95	2.39	2.44	2.40	2.40	5.86	6.35	5.26	5.75	6.23	7.14	5.32	5.15	5.43
Employer Contribution						0.09	0.08	0.07						
Other Purch. of Goods and Services	2.07	2.01	2.52	2.57	2.63	4.00	3.44	3.03	2.31	2.21	2.14	3.63	3.83	4.00
Interest Payments	1.57	1.21	0.55	0.50	0.54	3.01	2.75	2.41	3.81	3.52	3.22	0.33	0.22	0.32
Subsidies and Current Transfers	2.34	3.06	8.65	8.94	9.14	4.64	5.31	4.74	2.56	3.12	2.83	1.03	1.15	1.24
Subsidies		0.56	0.35	0.38	0.25	2.47	3.07	2.61	0.38	0.58	0.49	0.15	0.17	0.19
Transf. to Other Lev.Nat.Gov't.	1.46	1.46	5.00	5.24	5.48	0.69	0.62	0.61	2.18	2.08	2.33	0.14	0.13	0.13
Transf. to Nonprofit.Inst and Household	0.88	1.04	3.24	3.26	3.34	1.49	1.61	1.52				0.74	0.84	0.91
Transfers Abroad		0.00	0.06	0.07	0.08							0.01	0.01	0.01
Others										0.46				
CAPITAL EXPENDITURE	**6.75**	**5.97**	**3.54**	**4.21**	**4.06**	**5.07**	**4.15**	**4.63**	**3.74**	**3.46**	**4.04**	**5.44**	**5.81**	**7.69**
Acquis. of Fixed Cap. Assets	4.97	4.28	1.07	1.32	1.52				2.79	2.62	3.27	4.88	5.10	6.93
Equity									0.24	0.09	0.07			
Purchases of Stocks			0.09	0.08	0.07							0.00		0.00
Purch. of Land and Intangible Assets			0.34	0.54	0.37				0.00	0.13	0.11	0.00	0.00	
Capital Transfers	1.78	1.70	2.04	2.27	2.10	0.23	0.23	0.19	0.70	0.61	0.60	0.55	0.72	0.76
Domestic	1.78	1.70	2.04	2.27	2.10	0.23	0.23	0.19				0.55	0.72	0.76
To Other Levels of Nat. Govt.	1.62	1.59	1.53	1.61	1.59	0.07	0.06	0.05	0.70	0.61	0.60	0.13	0.42	0.49
Abroad			0.00	0.00	0.00									
LENDING MINUS REPAYMENTS	0.80	1.16	2.48	2.88	4.45	0.20	0.99	0.52	0.20	0.05	0.06	-0.01	0.21	0.28

Source: Government Finance Statistics, IMF

Table 4.3: SIZE OF THE CIVIL SERVICE IN SELECTED COUNTRIES
(percentage of total population)

ASIA			LATIN AMERICA			OECD		
COUNTRY	YEAR	%	COUNTRY	YEAR	%	COUNTRY	YEAR	%
PHILIPPINES	**1997**	**1.9**	ARGENTINA	1990	6.4	AUSTRALIA	Not given	10.6
INDONESIA	1998	2.0	BOLIVIA	1985	0.3	CANADA	Not given	9.0
KOREA	1997	2.0	CHILE	1985	2.5	DENMARK	Not given	14.9
MALAYSIA	1998	4.2	URUGUAY	1990	8.7	FRANCE	Not given	8.9
THAILAND	1998	2.7	VENEZUELA	1990	6.6	GERMANY	Not given	6.9
			ECUADOR	1991	3.3	JAPAN	Not given	3.9
CHINA	1998	2.9	COSTA	1986	5.3	SWEDEN	Not given	16.8
SINGAPORE	1989	2.2	RICA	1987	3.0	UK	Not given	9.3
VIETNAM	1996	1.7	JAMAICA			USA	Not given	6.8

Source: Civil Service Reform in the Philippines, Steedman, D., and S. Howes, World Bank staff.

Table 4.4: EVOLUTION OF THE CIVIL SERVICE, 1970-97
(thousands)

	1970	1975	1980	1985	1990	1995	1996	1997
NATIONAL GOVERNMENT	437	411	840	990	903	854	894	914
o.w. Teachers						388	414	432
Uniformed police						99	117	121
Others						367	363	361
o.w. Executive Branch						*318*	*312*	*311*
GOVERNMENT CORPORATIONS		41	112	132	128	120	112	97
LOCAL GOVERNMENT	94	81	145	198	227	354	354	368
TOTAL	531	533	1097	1320	1258	1328	1360	1379

(percentage of population)

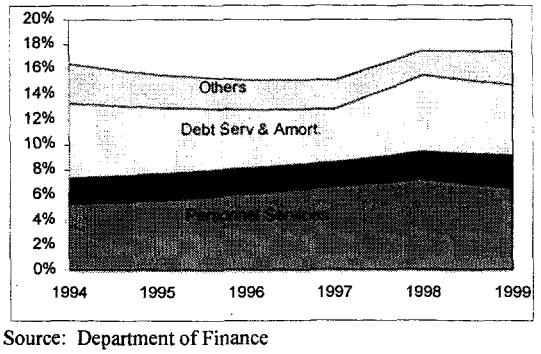
	1970	1975	1980	1985	1990	1995	1996	1997
NATIONAL GOVERNMENT	1.19	0.98	1.75	1.83	1.49	1.24	1.24	1.24
o.w. Teachers						0.57	0.58	0.59
Uniformed police						0.14	0.16	0.16
Others						0.53	0.50	0.49
o.w. Executive Branch						*0.46*	*0.43*	*0.42*
GOVERNMENT CORPORATIONS	-	0.10	0.23	0.24	0.21	0.17	0.16	0.13
LOCAL GOVERNMENT	0.26	0.19	0.30	0.37	0.37	0.52	0.49	0.50
TOTAL	1.45	1.27	2.28	2.44	2.07	1.94	1.89	1.88

Source: Civil Service Commission

4.8 The size of the wage bill may well reflect instead the price that the government pays to agricultural trade protectionism. The first chapter showed how the latter translated into a higher level of wages, than observed in other countries of the region. The latter weighs down the government, in just the same way as it weighs down the tradable sector.

4.9 The net result, however, is that O&M and public investment are being underfunded. Taken together, they rarely managed to account for much more than 6.5 percent of GNP in 1994-97 (see Figure 4.1), compared to a range of 7 to 11 percent for countries in the sample. This situation cannot but damage the long-term development prospects of the country.

Figure 4.1: EVOLUTION OF NATIONAL GOVERNMENT EXPENDITURES,[97] 1994-99
(percentage of GNP)



Source: Department of Finance

[97] Plus amortization of foreign debt.

4.10 Does the country then achieve as much poverty incidence as it could out of the limited resources at its disposal? The reader will need to await an upcoming poverty assessment for a complete answer to this question. Early indications are, however, that the record is mixed. Take for instance the much-vaunted progress in expanding access to education (see Chapter 1). A more careful look at the numbers shows how this progress varies across categories of the population: whereas more than half of the non-poor proceed beyond primary education, only a quarter of the poor do so (see Table 4.5). Worse, a full 15 percent of the poor do not attend school or drop out before reaching any grade (a situation which affect only 7 percent of the non-poor).

Table 4.5: ACCESS TO EDUCATION, 1998
(highest education attainment, percent)

LEVEL	POOR	NON-POOR
DID NOT EVER ATTEND SCHOOL	11.1	4.1
NO GRADE COMPLETED	4.0	2.5
PRE-SCHOOL	1.7	1.7
GRADES I-III	21.3	11.3
GRADES IV-VI	34.5	24.3
SUB-TOTAL	72.6	43.9
SECONDARY	23.4	31.7
POST-SECONDARY	0.4	1.8
COLLEGE	3.7	22.4
GRADUATE	0.0	0.3
TOTAL	100.0	100.0

Source: M. Alba (1999)

Table 4.6: ACCESS TO HEALTH, 1998
(percent)

HEALTH FACILITY	POOR	NON-POOR
VISITED A HEALTH FACILITY	16.5	20.2
TYPES OF HEALTH FACILITIES VISITED:		
PUBLIC	13.2	9.8
BARANGAY HEALTH STATION	3.6	1.9
RURAL HEALTH UNIT/HEALTH CENTER	6.5	3.9
GOVERNMENT HOSPITAL	3.1	4.0
PRIVATE	3.7	10.9
PRIVATE HOSPITAL	1.0	4.1
PRIVATE CLINIC	2.4	6.6
OTHERS	0.3	0.2

Source: M. Alba (1999)

4.11 Access is one thing, quality is another. Recent research shows that, on that score also, the poor can get short-changed, and indicates the extent to which this shortcoming contributes to poverty. "The poor performance in the National Education Achievement Test (NEAT) raised the poverty incidence by 64 percent. The proportion of students failing the NEAT is extremely high in the more remote and poorer regions. In Region 12, as much as 80.7 percent of the students failed to obtain 50 percent correct answers."[98]

4.12 In contrast, there is *prima facie* evidence that the health sector would do a better job of reaching the poor. Indeed, access to health care does not appear to vary widely between poor and non-poor (see Table 4.6). This seems to be largely due to how effective the public sector is in reaching lower income groups. Quality again is a different matter: as Table 4.7 shows the differences in health status across income groups are unacceptably high. Furthermore, as will be seen below (see para 4.36), there are concerns that health services to the poor might have deteriorated since health was devolved to local government.

[98] Tan, E. 1999. "Measuring Poverty in Education." In A. M. Balisacan, ed., *Causes of Poverty: Myths, Facts and Policies.*

Table 4.7: SELECTED HEALTH INDICATORS BY LEVEL OF INCOME, 1998

	QUINTILES					
INDICATOR	LOWEST	SECOND	MIDDLE	FOURTH	HIGHEST	TOTAL
HEALTH STATUS (PER THOUSAND)						
INFANT MORTALITY	48.8	39.2	33.7	24.9	20.9	36.0
UNDER 5 MORTALITY	79.8	60.5	49.7	33.4	29.2	54.9
HEALTH SERVICE (PERCENT)						
IMMUNIZATION COVERAGE						
MEASLES	67.6	77.1	83.4	84.3	92.2	78.9
DIPHTHERIA POLIO TETANUS 3	66.8	80.3	84.2	91.2	92.7	80.9
ALL	59.8	72.5	76.3	79.6	86.5	72.8
NONE	16.4	8.7	3.6	2.4	1.0	7.7
MEDICAL TREATMENT OF ILLNESSES						
TREATMENT OF DIARRHEA						
PREVALENCE	8.8	7.7	7.7	6.2	4.9	7.4
ORAL REHYDRATION THERAPY USE	74.7	64.4	78.8	77.4	...	73.7
SEEN MEDICALLY	43.0	37.9	48.8	55.4	...	43.9
% SEEN IN A PUBLIC FACILITY	35.2	26.8	23.9	13.3	...	25.0
TREATMENT OF ACUTE RESPIRATORY INFECTION						
PREVALENCE	15.3	13.4	13.6	12.6	9.1	13.3
SEEN MEDICALLY	47.3	55.0	62.9	67.5	74.2	57.9
% SEEN IN A PUBLIC FACILITY	37.1	36.6	30.4	18.9	10.7	30.3

Source: Demographic and Health Survey, NSO
Note: ... indicates that the related figure us not statistically significant.

4.13 A key theme for the rest of this chapter will therefore be to identify ways for the government to contribute more fully, within its resources, to growth and equity.

The Quality of Institutions

4.14 With resources constrained as they are, it is all the more important to deploy them with the highest possible degree of efficiency and effectiveness. Hence the importance of improving the "quality of government." A look at the country's international ratings on this score indicates that the country still has to go some way to compare to the performances of Malaysia, or even Thailand (see Table 4.8).

Table 4.8: QUALITY OF INSTITUTIONS IN VARIOUS COUNTRIES

	GOVERNMENT INEFFECTIVENESS	CIVIL LIBERTIES	FREEDOM OF PRESS	PROTECTION OF PROPERTY RIGHTS	CORRUPTION IN GOVERNMENT
	Scale of 0 to 100 (0 is most effective)	Scale of 1 to 7 (1 is most free)	Scale of 0 to 100 (0 is most free)	Scale of 1 to 5 (1 is most secure)	Scale of 0 to 10 (0 is most corrupt)
	3rd Quarter 1998	1998	1998	1998	Dec-99
BRAZIL	50	4	32	3	4.1
INDONESIA	88	5	77	3	1.7
KOREA REP	46	2	28	1	3.8
MALAYSIA	30	5	61	2	
PHILIPPINES	**67**	**3**	**30**	**2**	**3.6**
SOUTH AFRICA	85	2	28	3	5.0
THAILAND	53	3	31	2	3.2

Source: ICRG, Standard and Poors/DRI., Transparency International

4.15 This section will discuss the challenges of bringing the quality of Philippine institutions up to par, and particularly some of the issues involved in (i) improving service delivery and marshalling resources towards poverty alleviation; (ii) developing a meritocratic and motivated civil service, while (iii) containing the payroll; (iv) strengthening performance and accountability in the use of public monies; and, (v) suppressing fraud and corruption.

Redirecting Public Services

4.16 Major changes have already taken place through the 1990s in the way public services are organized and delivered to the population. These changes arose out of a disillusion for the centralized, state-centered approach of the Marcos era, and a desire to decentralize initiatives and engage society more broadly and more actively in the process of development. Some of the main initiatives have involved: (i) the privatization of commercial corporations and the entry of the private sector into the infrastructure sector; (ii) the engagement of non-government organizations in the development effort; and, (iii) the devolution of powers to local governments and deconcentration of the national one.

4.17 This process will still take many years to unfold. This section will take stock of some of the major achievements and problems as well as outline the unfinished agenda in the areas concerned. One of the outstanding challenges remains to adjust the arrangements at the center of government in response to the new demands emerging from this process, thereby weeding out obsolete offices and establishing capacities where new needs have arisen (e.g., in the area of economic regulation).

Mobilizing private initiative

4.18 After the failure of the Marcos policies, the Philippines has moved away from the view that the state must or can itself address all the legitimate demands from society, and learned that, in many cases, citizens are often quite willing to pay or contribute their time and energy to the fulfillment of social needs that they particularly care about. Opportunities for mobilizing private initiatives abound, ranging from the production of electricity to the care of street children. In those cases, the Philippines has learned that it

is often best for the state, not to abdicate, but to focus on providing the enabling environment in which private initiatives will bloom and serve the common good.

Private participation in infrastructure

4.19 The *benefits* which the country has earned from the entry of the private investment in public infrastructure[99] (as well the issues this policy faces) are well documented.[100] Suffice to recall that:

(a) in the telecommunication sector, the number of telephone lines has expanded from 1 per 100 to 9 per 100 population between 1990 and 1998, and brought such productivity gains as to raise the number of lines per employee from 35:1 to 98:1 between 1990 and 1996;

(b) in the power sector, the Independent Power Producers (IPP) have augmented total capacity by 5,533 MW and private distributors have added another 518 MW of capacity;

(c) in the water sector, the private concessionaires which took over Manila's water and sewerage systems have undertaken to expand the coverage of the piped water system to 98 and 94 percent of the population in service areas West and East, respectively, by the end of the decade (from about 80 percent in 1997), and that of the sewerage system to 20 and 50 percent respectively in each of the service areas (from about 6 percent in 1997). They have already markedly cut down leakages and raised productivity;

(d) the privatization of the Philippines Airlines and the opening up of the air to new private carriers gave rise to a doubling of the international air traffic between 1990 and 1998;

(e) in the rest of the transport, private investors are involved in the construction of 630 km of roads outside of Manila, that of the new metro line of Manila as well as of a new terminal at its international airport; and,

(f) 316,000 new jobs have been created in the 57 private industrial zones built during the 1990s under the auspices of the Philippine Economize Zone Authority (PEZA).

4.20 Furthermore, the BOT and related models initially designed for infrastructure services are now expanding to more traditional administrative services, such as the modernization of the Land Transport Office and the computerization of the Civil Registry. To be sure, all has not been successful: in the roads and water sector, for

[99] The process was set in motion in the early 1990s with the passage of Proclamation No. 50 and the establishment of the Committee on Privatization for the disposal of major public industrial and infrastructure enterprises. Further progress was made in 1993 when the GOP achieved a major milestone in this regard with the passage of the BOT law. This law which pioneered PPI in the Philippines and to some extent in the region, rationalized BOT schemes through a transparent and competitive process for involving the private sector in infrastructure. While the law principally emanated from the need to overcome extreme power shortages in the country, it was also extended to the other infrastructure sectors including, transport, water and sanitation.

[100] Llanto, G. 1999. "Government Policy, Regulatory and Institutional Framework for Private Participation in Infrastructure." September 17, 1999.

example, private sector involvement has remained limited to large flagship projects, and little if any progress has been achieved in other sectors, such as ports and railways.

4.21 Overall, however, private provision has served the country well and will remain an irreplaceable tool for unlocking the growth potential of the economy. The difficulties which other countries of the region (e.g., Indonesia, Pakistan) have experienced with their own IPPs in the wake of the Asia crisis should also serve as a timely reminder of the need to be alert of the sometimes hidden risk such arrangements involve. Of particular concern is the accumulation of contingent exposures, arising from the government shouldering some of the risks involved in private projects.

Table 4.9: SELECTED CONTINGENT EXPOSURES [a/]
(end-1998, except where mentioned)

	OUTSTANDING	
	BILLIONS OF PHIL. PESOS	BILLIONS OF US DOLLARS
1. GOCC DEBT GUARANTEED OR ONLENT BY THE NATIONAL GOVERNMENT	379.3	9.48
2. NON-BANK FINANCIAL INSTITUTIONS		
2.1 FUNDING SCHEMES		
NHMFC[d/]	39.7	0.99
LWUA[d/]	4.5	0.11
NEA	14.5	0.36
NDC[d/]	5.6	0.14
2.2 GUARANTEE SCHEMES		
HIGC	36.3	0.91
PIDC	300.0	7.5
3. BOT AND RELATED PPI ARRANGEMENTS[/]		
EXCLUDING CONTRACTUAL BUYOUT CLAUSES WITH IPPS	59.7	1.5
CONTRACTUAL BUYOUT CLAUSES WITH IPPS	316.0	7.9
MEMO ITEMS		
NON FINANCIAL PUBLIC SECTOR DEBT	2,167.2	54.2
NATIONAL GOVERNMENT DEBT (INCLUDING CB-BOL)[c]	1,421.1	35.5

a/ Figures cannot be added up due to possible double counting
b/ Net present value at 10 percent discount rate
c/ Excluding onlent or contingent or guaranteed liabilities that have not been assumed
d/ As of end 1998
Source: Department of Finance, Llanto et al.(1999)

4.22 In the power sector, for instance, the government (via NPC) was made to take on virtually all risks with the exception of construction costs and some risks associated with the efficiency of operation and availability. These may have been the best terms available given the situation prevailing at the time and under the assumption that the National Power Corporation (NPC) would remain a monopoly, able to pass on its cost to its consumers. However, the situation has drastically changed. There is competition now even in power generation, and this leaves the NPC dangerously exposed. Table 4.9 indicates how much total contingent exposure may already have been incurred during the past decade (close to US$10 billion in the power sector only, including the present value of buyout clauses in IPP contracts).

4.23 The magnitudes—and the risks—involved are quite considerable, but they should not mislead. By their very nature, BOTs lessen government exposure, as they allowed to shift some of the risks to private parties. That government did not always succeed to shift as much of them as it may have thought or wished does not alter the fact that its level of exposure is less than would have been the case, had it undertaken the related investment itself. It is now important to avoid that these risks actually materialize, and be particularly careful not to trigger the contractual buy-out clauses inadvertently during the

restructuring and privatization of NPC (e.g., by unwittingly giving ground to IPP sponsors to invoke them).

4.24 How can the government stimulate private provision of infrastructure, without getting itself overly exposed? In part, by changing itself in the process. This can be achieved in two ways. The first one involves competition and regulation. The situation of the power sector illustrates graphically how the success of a PPI strategy rests not only on "passively" opening the door to private involvement and competition, but also on "actively" revamping government structures and practices accordingly: in this case, building up credible power markets and regulatory arrangements. Private investors would indeed be much less keen for performance guarantees if they operated in an environment where the rules of the game are clear, stable and independently administered.

4.25 The strategy being contemplated to restructure NPC rests on that premise, as it emphasizes developing competitive, efficient and well-regulated power markets, before proceeding to privatize the generation capacities. Absent this, investors in privatized assets are likely to insist either on similar forms of enhancements as current IPPs have, or on oligopolistic arrangements (e.g., through cross-ownership of generation and distribution) to safeguard their profits. Either the government, or the consumer, would pay. This is one of the key issues at stake in the current debates over the Electricity Restructuring Bill. Similar issues of competition and regulation also affect, *pari passu* almost all sectors of infrastructure, including ports, aviation, water, solid waste management, roads, telecommunications, etc.

4.26 The second change required is for the government to become much more careful in managing its contingent exposures. Hence the need to first develop transparent and suitably restrictive guidelines on the use of sovereign guarantees for PPI projects. As noted, the prejudicial question should always be whether such guarantees are needed at all. There exist nowadays a growing number of best practice templates, based on a dosage of privatization, competition and regulation, which obviate the need of such enhancements entirely. Even when they are still required, such enhancements can be much more judiciously targeted than was the case ten years ago. The second one would be to develop accounting rules to account for: (i) BOT and related transactions in government books; and (ii) performance guarantees as contingent liabilities when they are extended, and actual liabilities in case they are called, drawing inspiration from the methodological work currently under way within international professional organizations, such as the International Federation of Accountants (IFAC).

4.27 This being said, Table 4.9 reminds us also that the contingent exposures do not arise only, or even mainly, from PPI contracts. There is a well-established tradition in the Philippines for the state to devise mechanisms to leverage its meager resources to meet social needs. This is done through the operation of specialized non-bank financial institutions, providing either funding [e.g., Local Water Utilities Administration (LWUA), National Electrification Authority (NEA), National Home Mortgage and Finance Corporation (NHMFC)] or guarantees [e.g., Home Insurance and Guarantee Corporation (HIGC)] to direct financial resources toward such important social purposes as water systems, rural electrification, and housing development.

4.28 These arrangements also create considerable—and to some extent, much less contingent—exposures, also. The funding institutions, in particular, have a poor record of collection performance. NHMFC, for instance, had to be bailed out twice in the last decade, before it was barred from new lending activity in 1996. Even HIGC—which charges for its guarantees—has not been free of liquidity problems. This is something policy makers will want to keep in mind when they consider whether to increase its guarantee capacity by PhP1 trillion. They will also want to consider to what extent those mechanisms steer, supplement or supplant private initiative (see related policy discussions in Chapter 3).

Civil society participation

4.29 The participation of non-government organizations (NGOs) in public affairs, although of a different nature and scale, has been one of the greatest successes of the decade. These NGOs have evolved from social welfare and relief agencies, to more progressive social movements, to church-based activist groups, to business groups and corporations involved in social development. With no more than 16 percent of the household population (Alba 1999) declaring to be enrolled in non-governmental and people's organizations, civil society participation undoubtedly still has considerable room for expansion. But a strong start has been made.

4.30 The people's power revolution in 1986 created the momentum for the unprecedented recognition and engagement of the NGOs as partners of the government in carrying out development and reform programs. Let us only mention by way of illustration two NGOs which greatly expanded their reach to poor communities in this new environment:[101]

(a) The Philippine Rural Reconstruction Movement (PRRM) is currently supporting 30,000 people in almost 500 villages across 20 provinces in the country. PRRM provides services to these people in the areas of sustainable agriculture, economic development, environment and natural resources management, health, disaster management, small-scale infrastructure and renewable energy and capacity building of people's organizations.

(b) The Philippines Business for Social Progress (PBSP), on the other hand, traces its roots to a group of business corporations as an expression of their social responsibility in the midst of widespread social unrest in the 70s. Today, the PBSP boasts of 170 member-companies who have committed 1 percent of net income before taxes to social responsibility. Since its inception, PBSP has since assisted underprivileged sectors such as the landless farmers, fisherfolk, rural workers, urban poor and indigenous cultural communities. For the past 30 years, PBSP has mobilized over P1.5 billion that funded 42,000 projects of 2,500 partner organizations. These projects benefited two million families in 65

[101] The reader interested to know more on the topic may want to refer to Alegre, A. G. 1996. Trends and Traditions, Challenges and Choices: A Strategic Study of Philippine NGOs. Ateneo Center for Social Policy and Public Affairs. 1996; Alegre, A. G. Civil Society Resource Organizations and Development in Southeast Asia. The Philippines Country Report. The Synergos Institute. 19-. David, K. C. Intra-Civil Society Relations: A Synoptic Paper. 19-.; as well to an ADB report entitled "Study of NGOs in Nine Asian Countries: Philippines Country Report," 1997.

provinces. Its programs include capacity building, technology management, enterprise development, environmental protection, local governance and corporate citizenship.

4.31 Both NGOs assist underprivileged sectors such as small farmers, fishers, landless farmers, agricultural and rural workers, urban poor and indigenous cultural communities. They are supporting these sectors not only to better access basic services but also to develop their capacities in making choices and creating opportunities for sustained development.

Empowering the poor

4.32 This blooming of civil society initiative offered a fertile ground for broader approaches to poverty alleviation to emerge. Under these approaches, the poor came to be seen not merely as recipients/beneficiaries of government programs or policies, but as agents of their own destinies. Through the nineties, a new consensus therefore began to form and solidify around the need

(a) to secure

(i) equitable access to assets, be they tangible (particularly, agricultural land, housing) or intangible (e.g., human capital);

(ii) access to a productive livelihood, hence the role of micro-finance;

(iii) the rights of poor communities (e.g., fishing rights, indigenous peoples' ancestral domain) and individuals, including to personal security and integrity (e.g., against sexual harassment, rape and pedophilia); and,

(b) to empower the poor through social mobilization. A Community-Based Minimum Basic Needs Monitoring System has been developed to that effect to involve the communities themselves in the identification of basic needs requirements.

And, for a while, this new approach came to be known as the "Social Reform Agenda," aptly reflecting the societal nature of the transformation being sought.

4.33 A hallmark of this process was the passage of the Social Reform and Poverty Alleviation Act of December 1997 and the subsequent creation in July 1998 of a National Anti-Poverty Commission (NAPC) to monitor and coordinate the country's fight against poverty. In keeping with the spirit of empowerment, the Commission is made of representatives of the major departments involved in the poverty reduction, as well as of the most affected sectors of society: farmers, fisherfolk, urban poor, formal and informal labor, women, youth and students, children, senior citizens, persons with disabilities, victims of disasters and calamities, cooperatives and NGOs.

4.34 The recent years have also seen a number of important building blocks being laid towards better directing programs and resources towards poverty reduction. An Annual Poverty Indicators Survey, now in its second edition, is providing provincial level

information on the multiple facets of income and non-income poverty as well as, for the first time, feedback on the incidence of major government programs. Furthermore, a special coding system had been devised to track down how well government resources were directed to clearly specified poverty reduction objectives. This system has since been abandoned, in part due to the lack of demand for the (very useful) information it generated, but could be resurrected if demand would revive.

4.35 On many fronts, this empowerment agenda remains obviously unfinished. But instruments and institutional frameworks have been put in place in which it can come to fruition. It is now up to the players involved to rise to the occasion.

Decentralization

4.36 Another important strand of the strategy to improve service delivery (the first two being to look for partnerships with private initiative and to mobilize civil society participation, particularly on the part of the poor themselves) has been to bring government services in closer contact with users. The devolution of responsibilities to local governments under the 1991 Local Government Code was a landmark in this process. This devolution, it was also hoped, would put local government at the forefront of the fight against poverty. The code established three levels of local government (provinces, cities and municipalities, barangays) and assigned to them major responsibilities in the fields of agriculture, environment and natural resource management, health, public works and highways.[102]

4.37 Considerable resources are involved in this initiative. Alongside the devolution of responsibilities, the Local Government Code of 1991 granted local governments with revenue raising powers and expanded the share of national revenues transferred to under the Internal Revenue Allotment (IRA).[103] The magnitude of these transfers is rapidly rising: from 18 percent of the national government budget in 1996 to 24 percent in the President's budget for 2000 (excluding debt service).[104] Over time, these transfers should allow local government expenditure to rise from 3.7 percent of GNP in 1998 to 5.5 percent of GNP by the end of the decade (see Table 5.4 at the end of the next chapter).

4.38 Has performance been commensurate? So far, unfortunately, no systematic evaluation has been made of how local governments have actually performed in delivering the functions devolved to them, or in alleviating poverty. It is probably safe to

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[102] ***Agriculture***: agricultural and fishery extension services, regulation and research; procurement and disbursement of seeds; purchase, expansion and conversation of breeding stocks; and construction, repair and rehabilitation of water impounding systems. ***Environment and Natural Resources***: forest management services; mine and geo-science services; environmental management services; and reforestation, integrated social forestry, and watershed rehabilitation projects. ***Health***: provincial health offices and district, municipal and medicare community hospitals; purchase of drugs and medicines; implementation of primary health care program; field health services; aid to puericulture; and operation of 5-bed health infirmaries. ***Public Works and Highways***: repair and maintenance of infrastructure; and barangay road, water supply and communal irrigation projects. ***Social Welfare Development***: program for rebel returnees; barangay day care centers; and poverty alleviation programs in low-income municipalities, barangays and depressed urban barangays.

[103] The total IRA allocation is set at 40 percent of internal revenues of 3 years hence. This amount is further subdivided between level and class of local governments according to some formula. The distribution formula based on population, land area and equal sharing among local governments was retained. A larger weight was given to land area and equal sharing and a smaller weight to population resulting in a double formula based on (i) population (50 percent weight), land area (25 percent weight) and equal share (25 percent weight), on the one hand; and (ii) class of local government (e.g., province, municipality, barangay), on the other.

[104] This phenomenon has raised the fear of a possible "IRA drift", i.e., the risk that IRA transfers eat up a growing portion of the national revenues, as customs revenue decline in line with the fulfillment of the country's commitments to APEC, ASEAN and WTO, and thereby deprive the national budget of the resources it needs to satisfy national, rather than local priorities.

assume that performance is mixed and that they vary across classes and levels of local government. Whereas there is considerable anecdotal evidence of decentralization having stimulated local authorities to improve service delivery, it is also the case that local governments have so far failed to assume some of the functions devolved to them, particularly for school construction. Many questions have also been raised about the local government's continuing capacity to deliver such key services as agricultural extension, primary health, or even local roads maintenance.

4.39 As concerns health, for instance, it has been noted that whereas the public health system had been relatively successful in providing health care services of reasonable quality (including first and second referral services), particularly to the poor (see Table 4.6), these services are now fragmented, and the technical integrity among the different levels of the system is not being maintained. Devolved hospitals, which enjoy a particularly high usage among poor households, are deteriorating. This neglect is jeopardizing the availability of reasonable quality health services to the poor. As a result, the provision of basic services is suffering at the local level, and this may explain the resurgence of diseases and stagnation in basic health indicators. This may also explain in part that political pressure led Congress recently to re-nationalize 13 of the devolved hospitals. Similarly, Congressional insertions into the national budget too often force to shoulder the cost of roads nominally under the jurisdiction of local authorities.

4.40 Would there be a mismatch at the aggregate level between newly devolved expenditure and revenue responsibilities? Some have argued it, seeking in larger national government transfers a solution to the problems mentioned above. No firm evidence is currently available one way or the other, though.[105] There is stronger evidence that horizontal imbalances might account for the diversity of experiences. In practice, if not by design, the IRA transfer mechanism would seem to reallocate resources toward wealthier local governments. What is certain is that the transfer formula—being unrelated to the actual cost of delivering devolved functions (or performance in doing so) or to the different needs prevailing in different parts of the country—may not do much to equalize the satisfaction of needs across jurisdictions.

4.41 Before reaching for financial solutions, however, it might be worth investigating whether local governments are properly equipped to deliver their tasks, and whether the framework of oversight, support and accountabilities in which they operate makes it likely that they would. It is a *priori* puzzling in this respect that, amidst the sweeping changes it introduced, the Local Government Code would have left existing local administrative structures it entrusted with such considerable new responsibilities, largely untouched. Moreover, with the role of oversight and review of local government decisions to other levels of local government (rather than to the national level—or state level in a federal system—as would be more common), little assurance is there that they actually assume their responsibilities under the law. One may also wonder whether local governments really require a larger payroll than the national executive does (excluding teachers and uniformed police) to discharge their duties, or whether patronage is a problem (25 percent of local employees are contractual workers). What is certain is that, with the number of political appointees almost as large as in the national executive and

[105] Analyses done right after the 1991 Code indicated that local governments would generally enjoy surpluses because of the outright increases in internal revenue allotment due them, although a good number of municipalities would experience financial difficulties, the large cities being the main beneficiaries.

with local elections every three years, continuity (or, rather the lack of it) is an even greater problem at the local level than it is at the national level.

4.42 Finally, it is the case that national departments have not provided all the support that local government may have needed. If some national departments (e.g., Social Welfare and Development) have diligently adjusted their structures and operations to support devolution, others are only now beginning in earnest (e.g., Health).

4.43 With decentralization, the Philippines has taken a fundamental option which equips it well to tackle the challenges of the new century, particularly those arising from rapid urbanization. Its full impact can only be judged over decades, not years, of implementation and adjustment. Indeed, the authors of the Local Government Code did not believe that they could get it 100 percent right the first time. Rather, they envisaged that decentralization would involve a substantial part of learning-by-doing, and a need regularly to review practical experience and make mid-term corrections. It is now time for such stocktaking to take place. One possible way to go about it would be for the Oversight Committee[106] to commission an independent evaluation of the experience with the Code, leading up to recommendations for possible legislative or administrative action.[107] A review of the international experience with such things as the professionalisation of local administration (e.g., city administrators in the United States, local civil service in the Netherlands), local finance development (e.g., the municipal banks of continental Europe), or local government transfers (e.g., various grant formulas seeking link funding to performance—e.g., Brazil—or needs—e.g., Australia, United Kingdom) would usefully broaden the evaluation's perspective.

Revamping the core machinery of government

4.44 Changes as fundamental as the ones outlined above, although they have repercussions on the entire machinery of government, rarely take place in test-tube conditions and following a consistently designed blueprint. Functions previously essential become obsolete or redundant, but the bureaucracies which perform them hold on to dear life; new requirements emerge which are only imperfectly attended to; parts of the bureaucracy are overstaffed while others hardly have the manpower to cope with the most pressing issues.

4.45 The Philippines is no exception to this. Creating new bodies seems to come more easily than abolishing old ones, though. On the face of it, the administration, with its 22 Executive Departments (and equivalent) would appear to be only marginally oversized.[108] But a closer inspection brings to light all manners of bureaus, offices, councils, centers, commissions, councils, boards, committees, administrations, agencies, staff, and other administrative bodies. In total, there are currently 454 such bodies under the Office of the President and the main Executive Departments, not counting the 133 universities

[106] Joint legislative executive committee created by the local government code and in charge of overseeing its implementation.

[107] Agenda items might include: (i) reassessing the scope of devolved services against the actual performance of local governments; (ii) reviewing the IRA formula with a view to improving its equity, incentives for local revenue mobilization, as well as its overall fiscal sustainability; and (iii) re-evaluating the appropriateness of the existing arrangements for administrative, financial, and human resource management at the local government levels, as well as the effectiveness of existing accountability (to local constituencies and oversight agencies), and audit mechanisms.

[108] In comparison, the United Kingdom had, on recent count, 20 ministries, Sweden 14, and Italy 19, while the United States' federal government comprises 14 Cabinet-level departments, and 9 other major executive agencies.

colleges, institutes, and academies that the national government operates. Parallel structures sometime also proliferate within departments: the 75 project management offices (PMO) created (in the national government only) for the purpose of looking after foreign donors' projects is one example. As a result, the action of the state is fragmented and the staff, which—as we saw in Tables 4.3 and 4.4—is not grossly overweight in the aggregate, is thinly spread, sometimes too thinly to deliver much public service at all.

4.46 The best way to deal with such dysfunctionalities would obviously be to proceed in a systematic fashion and (i) review the functions performed by government, (ii) redefine its external boundaries, (iii) recalibrate its internal structures; and, (iv) redeploy the staff accordingly. This is what the proposal for "Reengineering the Bureaucracy" would seek to achieve.

4.47 The difficulty of the undertaking cannot be underestimated, though. Beyond the sheer magnitude of the work involved, the political difficulties are huge, as diverging interests easily coalesce to block the process. This has been the fate of the Reengineering the Bureaucracy process, ever since the enabling legislation was presented to Congress in 1994.[109] For behind each agency lies an interest group, which may share the view that structures need to be trimmed, but is loath to be itself a victim of the process, and whatever care is taken to reassure government employees that mass layoffs are not in the offing, each individual fears for his own job.

4.48 The hope that, with time and consultation, sufficient consensus will emerge in support of the first-best solution should not distract from pursuing more modest goals, and second-best approaches at the departmental level. Efforts could concentrate on: (i) supporting and making a success of the efforts already undertaken on a voluntary basis by individual departments, such as DSWD, DOH, DPWH and DND; as well as (ii) revamping functions which are key to achieving the government's development policy objectives: agriculture and revenues stand out as potential candidates for early attention. It would greatly enhance the Government's credibility if the reforms could be seen as having achieved concrete and tangible results in areas where it has placed priorities.

Creating a Motivated, Meritocratic Civil Service

4.49 "Whether making policy, delivering services, or administering contracts, capable and motivated staff are the lifeblood of an effective state. Pay is certainly important, but so are other things, such as merit-based recruitment and promotion and *esprit de corps*. Meritocratic recruitment and promotion restrain political patronage and attract and retain more capable staff. A healthy *esprit de corps* encourages closer identification with

[109] More than fifteen years ago, the World Development Report on Managing Development noted already that most comprehensive administrative reforms efforts have had *"only limited impact...To overcome (bureaucratic) obstacles, reform requires the sustained support of political leaders. Without that, reform will be undermined by those most directly affected – civil servants themselves – or be ensnared by the legal and constitutional framework of public service laws. Political leaders intent on reform should therefore concentrate on a few priorities at a time and pursuing them to completion attempting other changes."* (World Bank. 1983. *World Development Report*. New York, N.Y.: Oxford University Press. pp. 92-93). The Philippines is no exception to this observation. Government reorganizations are as old as the country itself. Indeed, the first official act of the first President of the Philippines (Quezon, 1935) was to create a government reorganization committee. Six of the following administrations, determined to put an end to bureaucratic growth and improve performance, appointed government reorganization task forces to prepare plans to that effect (Roxas in 1946; Magsaysay in 1954; Garcia; Marcos in 1968; Aquino in 1986; and Ramos in 1992). The only efforts which actually resulted in any major changes were carried out at times when the Executive had extraordinary powers, i.e., under martial law, and during the "people's revolution" of 1986-1987.

organizational goals, reduces the costs of making people play by the rules, and nurtures internal partnership and loyalty" stated the 1997 *World Development Report* of the World Bank.[110] And the report went on to show why these things matter. Not only does empirical evidence show a clear correlation between the degree of meritocracy and the index of bureaucratic capability we were puzzling about in para 4.15; they also exhibit a positive link between the latter and economic growth. That report also singled out the Philippine Civil Service as among the most politicized in Asia, and submitted that this might explain the gap in bureaucratic capability between the Philippines on the one hand, and Indonesia, Korea, Malaysia, Singapore, Taiwan (China), and Thailand, on the other.

4.50 That situation has unfortunately not changed. By any standard, an extraordinary number of positions at all levels of government remain filled through political appointment. Within the national Executive, as many as 8,400 officers are appointed at the discretion of the political authority.[111] Even in comparison with the United States, which has a much higher proportion of political appointees than other parliamentary or presidential systems, such numbers are excessive. Adjusting for the difference in civil service size, the Philippines has at least three times the number of political appointees.[112] As a result, only 39 percent of all Career Executive Services (CES) positions are currently filled by fully qualified Career Executive Services Officers (CESOs).[113] This situation has adverse effects on career prospects and on overall performance. It also creates severe problems of continuity: if the President may appoint a non-CES individual to a CES position, this tenure is only at the pleasure of the President and in any case, lapses with his /her term of office. Managerial turnover is therefore high.

4.51 Furthermore, merit and performance are poorly rewarded. First, appointment and promotions, although in theory based on "fitness and merit," are in practice subject only to minimum qualification requirements (i.e., minimal fitness), leaving total discretion to agencies to employ whoever meets minimum requirements whether or not this is the best candidate available for the job. Influence and personal contacts obviously talk.[114] In the circumstances, the better-qualified younger people appearing in the middle grades find it difficult to break through into the higher ranks.

4.52 Not that the career would be particularly attractive. If salaries of rank-and-files are now broadly in line with the private sector, those at senior levels are typically 60 percent below market. The salary structure underwent a major change as a result of the implementation of the Salary Standardization process mandated by the 1997

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[110] World Bank. 1997. *World Development Report*. New York, N.Y.: Oxford University Press. pp. 92-93.

[111] Another potential source of patronage is the ease with which casual and contractual workers are hired to circumvent regulations requiring applicants to pass the civil service entrance examination. For example, there were 153,000 casual employees within the civil service, or roughly 11 percent of the entire civil service. Problems were particularly pronounced at the level of local governments, where approximately 85,000 casuals were hired, equivalent to almost a quarter of all permanent jobs. Other devices exist to go around even the "fitness" requirement. Although recruitment into technical and professional positions is prohibited without the requisite qualifications, other positions—such as advisors—are not subject to civil service qualifications.

[112] Under the Aquino administration, Congress became so concerned about the proliferation of political appointments—which sometimes numbered as many as seven undersecretaries per department—that it eventually passed a law limiting the number of departmental undersecretaries and assistant secretaries to three. With the passage of time however, this measure is now, more of than not, honored in the breach.

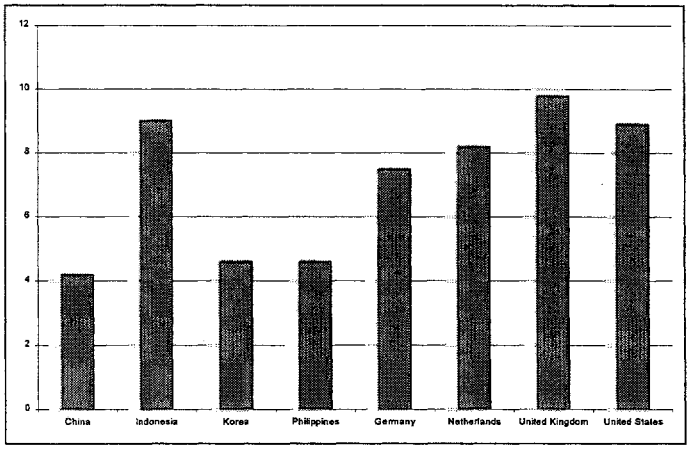
[113] The only NG agencies with an "eligibility" ratio above 50 percent are the NEDA, CSC, Social Welfare and Development and the Agriculture. The worst ratios of the larger groups at the NG level were DPWH (20.98 percent), DILG (26.07 percent), Agrarian Reform (27.52 percent), DOJ (23.47 percent) and DTI (35.75 percent).

[114] Other devices exist to around even the "fitness" requirement. Although recruitment into technical and professional positions is prohibited without the requisite qualifications, other positions—such as advisors—are not subject to civil service qualifications.

Constitution,[115] with a view to aligning government salaries with private sector compensations, particularly for lower and middle-level employees. The second Salary Standardization Law (SSL2) gradually reset all basic salary levels for all grades over the period 1993-97. As a result, average government wages increased by over 75 percent between 1994 and 1998.

4.53 Unfortunately, the wage compression which emerged from the process did little however to improve morale. At the final stage (decompression under a proposed SSL3), the process was aborted due to the advent of the Asian crisis, leaving the wage compression ratio at 4.7, down from 8.8 before SSL2, a ratio which only observed in countries (like Korea) where the overall distribution of income is also more equal than in the Philippines (see Figure 4.2). The situation is rapidly becoming untenable however, as agencies are encountering growing difficulties in retaining good staff, while others exploit existing loopholes to give extra pay to their staff,[116] further exacerbating morale problems in the rest of the public sector.

Figure 4.2: WAGE COMPRESSION RATIOS IN SELECTED COUNTRIES



4.54 Second, if performance evaluation system exists on paper, as do productivity bonuses, their significance has been debased overtime. Nowadays, over 80 percent of civil servants are rated "very satisfactory" or "outstanding." It is doubtful whether the general public shares this glowing assessment of its civil servants. In the circumstances, the risk of anybody having the two consecutive unsatisfactory evaluations required for termination is remote, as is the prospect of loosing one's job for performance reasons. Conversely, while applicable regulations stipulate that the amounts involved may vary according to individual performances, the so-called "productivity bonuses" are actually distributed across the board as a matter of course, irrespective of them.

4.55 Money is not the only problem, though. Given the number of people concerned (perhaps half a percent of the payroll), decompressing only the top of the wage scale should not be prohibitively expensive. Surprisingly, the idea finds little political support. In the political arena, the proposition runs counter to deeply felt egalitarian sentiments (as well perhaps also considerable doubt that senior officials actually deserve much more,

[115] The wage structure within the public sector had become disjointed during the martial law.

[116] The Government Service Insurance System (GSIS) managed in 1997 to be exempted by Congress from SSL and granted itself such pay increases that the salary of a senior GSIS official is now four times that of a Cabinet Secretary.

judging from their levels of merit or from the quality of the services provided). Witness only the aborted attempt to initiate SSL3 in the context of the 2000 budget as proposed by the departments, and the political choice made to give a 10 percent raise across the board instead. Needless to say, patronage on the other hand finds considerable support in the same arena.

4.56 One can hardly overestimate the impact that these issues have on performance of public services. The damages are countless: lack of continuity in the affairs of the state; absence of accumulation of know-how and institutional memory; difficulties in attracting and retaining capable staff; lower loyalty and dedication to the general (viz., private) interest.

4.57 The leading agencies in charge of these matters (Civil Service Commission and the Department of Budget and Management) are keenly aware of the problem and they have taken a number of initiatives to ameliorate it. To address immediate needs, a range of allowances have been introduced as stopgap measures, for instance. For its part, the Civil Service Commission is endeavoring to raise the minimum standards of "fitness" and has put in place a program to identify promising elements within the ranks and promote their careers.

4.58 A more permanent solution would require a reform of the Civil Service Code with a view to: (i) limiting political appointments to Cabinet-level positions only; (ii) restrict use of contract workers, except where this will clearly improve performance by providing access to specialist skills; (iii) change definition applicable to selection and promotion to competitive assessment of merit (not just fitness); and, (iv) open the door to performance pay for the CES. A draft bill is currently before Congress, which would go some way in that direction. It deserves priority attention. The DBM, on the other hand, is also in the process of installing a performance management system, which includes among others accountability systems for the rank and file and the CES.

4.59 Pay reform has to be part and parcel of any strategy to professionalize the civil service. This process needs to be anchored in a comprehensive review of the entire compensation and benefit package. There are a number of reasons for that. First, non-basic elements of the package are significant and account for close to half of the civilian wage bill. Second, there is a need to coordinate pay and pension policies. Finally, it might be easier politically to change the parameters of government's pay policy altogether, than to proceed incrementally. The pay review should be accompanied by a study to recommend basic reform of the position classification system. Fundamental questions, such as the desirability of a single salary structure/regime for all government employees and the appropriateness of the present position classification system (or whether these systems need to be made more versatile, as a first step towards the longer term changes contemplated below) should be raised. The Civil Service Commission has prepared well thought-out terms of references for a redesign of the system (to be co-sponsored by DBM), which deserves to be taken up as soon as possible.

4.60 Looking towards the longer run, the government might be well advised to initiate a reflection on the proper scope of the civil service. With all categories of government workers (national and local governments, government corporations, judiciary, cabinet members, teachers, health personnel) lumped together under one single Civil Service Code, the present statutory regime is unnecessarily rigid. This "one size fits all"

approach makes it difficult to tailor careers and rewards to the features of the various jobs being performed, and "the security of tenure" provisions extend considerably beyond what would be required to insulate the civil service from political meddling. The government may want to move, over time, to a narrower definition and begin to engage in a dialogue with various interested parties (e.g., leagues of local governments, judiciary authorities, trade unions) on the new statutory regimes or collective bargaining agreements for employees which, in the future, may fall outside the realm of the main statutory regime.

Containing the Payroll

4.61 How then do we reduce the share of wages in government expenditures? The experience of the 1990s shows that not one, but a whole variety of instruments will be needed. It also shows how much can be achieved when their influence is combined. It is estimated[117] that, by the end of 1997, the combined impact of the Attrition Law,[118] devolution and privatization programs, enabled the government to terminate 323,000 national government positions.

4.62 It seems promising to continue in that direction. A first step might be to re-instate a partial hiring freeze, and to abolish the more than 100,000 positions frozen under the Attrition Law. In addition, voluntary departure programs (e.g., through early retirement) could also be introduced to assist individual departments in their efforts to reorganize. Such programs have had a bad press in the Philippines ever since the failure of 1988 Early Retirement Program which accompanied the government reorganization undertaken by the Aquino administration,[119] but it does not need to be so. Properly targeted, they can be of great assistance.

4.63 A combination of these measures would help keep the payroll in check. But a reduction of the relative price of food, through agricultural trade liberalization, may be required to make a serious dent into the wage bill itself (while paying competitive salaries). Indeed, a drop in the effective protection of major food items in 1998-99 already helped curb personnel expenditure from 38 percent to 36 percent of the national government budget between 1998 and 2000 (President's budget); a small step perhaps, but the first one taken in that direction in a very long while.

Improving Expenditure Management

4.64 Budget reform can also be a powerful instrument to improve public service performance. In recent years, a number of countries, mainly from OECD (e.g., Australia, New Zealand, Sweden) but also non-OECD ones (e.g., Singapore) have blazed new trails in this field, based in part on the idea that public resource allocations systems can be

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[117] See National Economic Development Authority. 1998. *Medium-Term Philippine Development Plan, 1999-2004.* Manila, Philippines.

[118] The Attrition Law, passed in 1992, forbid for a period of five years, external filling of vacated civil service positions, except in exempt sectors, such as education and local government.

[119] "The few who availed of it were generally the more productive, younger employees who should have stayed in the service," deplores the Civil Service Commission (see Civil Service Commission. 1998. "The State of the Philippine Civil Service." Manila, Philippines. June 17, 1998).

made to mimic private markets. These reforms open new prospects for the Philippines over the medium term.

4.65 A prerequisite, however, is to create a culture that demands performance and expects accountability (see Box 4.1: First Things First in Budget Reform). Much remains to be done in this respect. The main issue of the day is not so much with the way the budget is put together (which is being improved, as will be seen in the next section), but with the way it is spent and accounted for (as will be discussed in the following section).

Budgeting for performance

4.66 The idea of using *budget management as a tool to improve performance* is actually not new in the Philippines. Nor is the idea that in a constrained situation, such as the one the country experiences, *lengthening the planning horizon* can be a useful way to gain some room for maneuvering, not immediately discernible in the short term. The former idea is at the heart of the performance budgeting system which the country embraced in the early 1950s.[120] Similarly, the budget legislation in place[121] since 1987 envisages that the annual budget should be designed in the context of medium term expenditure program.

4.67 But only now are these ideas being acted upon. The 2000 budget has piloted a system to link medium-term planning and the budget, in the context of a new medium-term expenditure framework. The approach has been to determine agency baseline expenditures and notional allocable ceilings, based on the medium term development plan. While originating departments used to have little incentive to undertake a first screening of the feasibility and desirability of their own proposals, therefore overwhelming oversight agencies with ill-prepared proposals, they are now required to formulate proposals with regard to prioritize within a set envelope. This effort should expand with the formulation of 3-year expenditure program to support the preparation of the 2001 budget. The plan is to use this process to begin to instill a degree of performance culture within the government, first by helping agencies formulate even rudimentary performance indicators to substantiate their plans and requests for resources, as they will have to do in the context of the 2001 budget.

4.68 The next order of priority will then be to strengthen the evaluation process by which these performances can be assessed both ex-ante and ex-post. One major task would be to establish routine procedures to evaluate ongoing projects and programs once they have made it into the budget (at present, little is done by way of reality-checking whether projects and programs once approved do, in fact, later deliver the benefits expected).

4.69 Over time, it is envisaged that these reforms would lay the groundwork for a greater devolution of spending responsibility and managerial accountability to agencies. Ultimately, agencies would be expected to account less for the use of inputs than for the performances they achieve against agreed objectives. Much stronger information

[120] The Philippines adopted the concept only a few years after the seminal report of the Hoover Commission enunciated the concept of it. But at some point during the quarter of a century that it took to fully restructure the budget to conform to performance budgeting tenets, the performance focus got lost.

[121] Included in the Administrative Code of 1987.

systems will need to be put in place, however, before it is safe to proceed to this ultimate stage (see Box 4.1).

BOX 4.1: FIRST THINGS FIRST IN BUDGET REFORM

Allen Schick, one of the world's leading experts in the field of budgeting offers the following Five Commandments in shifting budget systems towards performance management:

(a) The government should foster an environment that supports and demands performance before introducing performance or outcome budgeting.
(b) It is necessary to have an effective system to control inputs before seeking to control outputs.
(c) Effective internal control needs to be established in agencies before introducing managerial accountability
(d) Financial auditing needs to be operating effectively before moving to performance auditing.
(e) It is necessary to adopt and implement predictable budgets before insisting that managers efficiently use the resources entrusted to them.

Fostering financial accountability

4.70 Sophisticated accounting and monitoring systems do actually already exist, but they are often too unwieldy to be of much use in the day-to-day management of expenditure programs. Take the accounting system, for instance. The fact that it does not correspond to any of the accepted international standards codified by the International Federation of Accountants (IFAC)[122] would be a minor inconvenience, if the system provided agency and fiscal managers the management information that they need. But it does not. This very complex system—comprising three interlocking subsystems of ledgers maintained manually by three separate agencies—Bureau of Treasury (BTR), Commission on Audit (COA), and spending agencies themselves—is too cumbersome to generate timely information, or even produce books that balance.[123] Furthermore, the accounting system does not communicate readily either with the budget execution system (which uses a different coding system) and fails to capture such an essential piece of information as how much is exactly owed to government suppliers.

4.71 Worse, because of these defects, fiscal managers are condemned to piloting the budget "blind," and are forced to resort to cash rationing when they need to contain aggregate spending in line with resource availability (an exceedingly crude instrument, rarely utilized outside of the cash-strapped former Soviet economies). It is difficult to hold spending agencies accountable for performance in such circumstances.

4.72 How can you even know whether the books are sincere? Much of the burden rests on the government's external auditors, i.e., the Commission on Audit Too much perhaps. In the Philippines, the government's external auditors have traditionally performed many accounting and internal control functions. But, in line with international best practices developed under the International Organization of Supreme Audit (INTOSAI). COA, however, has been gradually moving away from those non-audit functions, better to be able to focus on audit *per se*. Having disengaged from internal

[122] i.e., cash, modified cash, accrual, and modified accrual.

[123] The unreconciled difference widened to PhP123 billion in 1997, i.e., an amount equivalent to almost 5 percent of GDP.

control during the 1990s,[124] it now plans to move away, over time, from most accounting activities.

4.73 To protect the integrity of government operations as this "disengagement process" unfolds, the Executive branch needs to step in with proper mechanisms and standards of its own for accounting and internal control. First steps have been taken, at least on paper. Agencies have been mandated since 1992 to establish internal audit service in all agencies. These audit units are supposed to ensure the adequacy and effectiveness of internal control and the quality of performance information generated by the agencies. Implementation, however, is still in infancy,[125] and where capacities exist, they are often not placed in such position as to ensure them independence and authority.

4.74 The situation calls for a systematic effort to: (i) overhaul the accounting system, including by adopting one of the IFAC standards; (ii) simplify budget reporting systems; (iii) upgrade financial programming, banking operations and cash management; and (iv) strengthen internal control and financial management capacity within agencies. Progress in this area could reinforce COA's own efforts to modernize traditional external audit activities,[126] expand its value-for-money auditing activities, better combat graft and corruption, and audit revenue departments (see below).

4.75 Much of these priorities are incorporated in the strategy statement adopted by the Commission last April 1999 (in the wake of a UNDP-supported project). However, they still need to find a relay within the Executive Branch. This may be accomplished by creating an Office of the Comptroller General to take over the accounting function as the latter is separated from COA's audit functions.

Rationalizing procurement

4.76 Much gain would also arise from improving the Government Procurement System. Although the latter espouses the principles of competition, economy, efficiency and transparency, reality can be often quite different. A recent review of the procurement system[127] concluded that the system was beset with problems, which made it unlikely that these principles be observed in practice, including:

(a) *Inconsistent and fragmented laws, rules and regulations*. The fundamental problem is not the lack of rules, but rather that the excess of inconsistent ones. At present, there are more than 60 laws, rules and regulations governing the country's public procurement system. This proliferation of piecemeal regulations and non-harmonization of rules, is indicative of a long history of leakage in the public procurement system,

[124] COA auditors are not supposed any longer to carry out pre-audit. The Commission has also adopted the concept of "team audit" and started pulling out its resident auditors from smaller agencies.

[125] A number of agencies have begun to organize their respective internal audit units, and those units have, correctly, first focused on financial pre-audit functions. Even for those internal units which are operational, performance, systems, and policy evaluation still belong to the future.

[126] For instance, by adopting international audit standards of INTOSAI, rewriting and publishing updated State Audit Manual, and refocusing its guidelines on significant and material audit issues away from minutia or irrelevant details.

[127] Source: "Modernization of Public Procurement" 1999. Consultant study under the AGILE Project of the USAID.

which each rule in turn tried to solve.[128] But, too often, additional regulation intended to plug a source leakage serves instead to conceal it, thereby making corruption increasingly difficult to prevent.

(b) *Inefficient and non-transparent rules and practices.* Where they are clear, procurement rules and practice may be inefficient, and lead up to higher bid prices, lower competition, cartels, or invite bribery. Chief among those are: (i) the practice of negotiating with the lowest evaluated and complying bidder prior to award of contract,[129] (ii) the excessive recourse to pre-qualification, even for small procurement,[130] (iii) the bracketing of bids[131]; and, (iv) the room that exist for tampering with specification and other contractual obligations during contract execution.[132]

(c) *Abnormally long approval processes.* Finally, where efficient, procurement may not always be economical. In an effort to stamp corruption, regulations have added layers after layers of review and clearance.[133] As a result, a contract may commonly require at least 40 initials under the signature of the approving authority, each of which is personably liable for any wrongdoing in the transaction. This situation inevitably causes delays,[134] and can render procurement uneconomical, if it leads bidders to increase their offers to cover the risks involved (e.g., currency fluctuation, interest rates and inflation). On top of these risks, bidders are forced to add to their offers the costs for lobbying activities, influence peddling and collusion in order to keep pace with competitors.

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[128] The issuances date back to the Commonwealth days in the 1930s up to the recently promulgated Republic Act No. 8182, also known as the Official Development Assistance Act and its implementing rules and regulations. Aside from these issuances, each government agency promulgates its own procurement rules, guidelines and procedures through department or memorandum orders to amplify, interpret and operationalize national laws, rules and regulations. On top of all these, the Commission on Audit, through its Government Accounting and Auditing Manual (GAAM) adopted applicable rules and procedures intending to guide their auditors in implementing procurement in each agency. The GAAM was promulgated in 1992 and has been the bible of auditors in determining what expenditures are to be disallowed.

[129] The rationale is the rule that award should be given to the "bid most advantageous to government." In following this rule, agencies are accustomed to request discounts from the winning bidder. This undermines the integrity of the process, as bidders are keeping their best price for the negotiation phase.

[130] Under the present system, it is easy to disqualify a legitimate and capable bidder on account of flimsiest of reasons such as non-notarization of a document, or non-submission of lease contract for equipment, the number of years of experience is short for non-key staff. As such, it may be one way of eliminating unwanted competition.

[131] In effect, bracketing of bids, based on agency "estimates" suppresses fair competition. To unscrupulous suppliers, the key to winning the bid can be to corrupt the government estimators in charge, rather than offering the lowest price.

[132] The practice, in a number of instances, has been abused where contract cost of the lowest priced bidder will suddenly increase after contract signing.

[133] Regulations provide for the creation of a number of committees composed of at least five persons to oversee the procurement process. For a medium size procurement of works, there will be at least four committees, namely: the pre-qualification committee, the technical evaluation committee, financial evaluation committee and the bids and award committee. The obligation made to agencies to submit all procurement above PhP50 million to the approval of the Office of the President recently added yet another layer. The process is further stretch by layers of individual reviewers from the final end-user of the works, the legal staff and the staff of the final approving authority.

[134] Thus, for instance, the Department of Health procurement processing can often take long periods, as follows:

Mode	No. of Days
National Competitive Bidding	163 to 837 days
International Competitive Bidding	543 to 811 days
Negotiated Contracts (Direct Purchase)	256 to 272 days

(Source: Commission on Audit. 1998. "Transparency and Internal Control Study." Manila, a study on a DOH Bank-assisted project based on sampling analysis of 1996 1998 contracts).

4.77 Key priorities should therefore be given to: (i) clarifying the principles that guide procurement (a consensus is emerging that the vague notion that contracts should be awarded to the "bid most advangeous to government" could usefully be tightened to something like "lowest calculated responsive bid"; (ii) consolidating existing rules in a harmonized procurement code and streamlining those applicable to smaller contracts; (iii) developing prescribed, standardized forms and formats, the use of which would limit discretion, and facilitate the execution of procedures as well as contract monitoring and audit; it may also permit a streamlining of the approval process; and, (iv) publicizing public procurement system performance for the public at large to scrutinize.

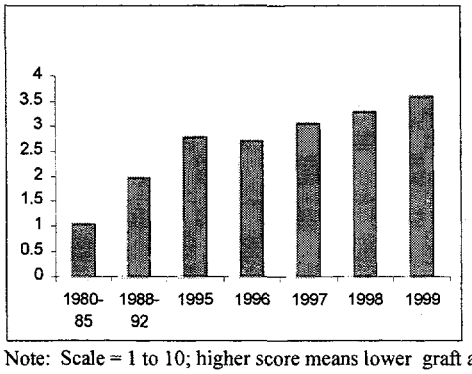
Potential benefits

4.78 Just how important might these expenditure management reforms be? Recent procurement under a social expenditure loan from the World Bank provides a test case. It was shown that a more open and competitive procurement and promise of prompt payment could be enough to drive down the prices of basic social input like drugs and textbooks by as much 30-40 percent. Add to this, the impact of improved quality (e.g., design, longevity) and better distribution and inventory control mechanisms and the orders of magnitude become quite impressive indeed.

Combating Corruption

4.79 One way in which these benefits would materialize is by limiting the scope there remains for graft and corruption. The fact that corruption has declined in the Philippines since the restoration of democracy in 1986 is well recognized internationally (see Figure 4.3). All indications show however that it remains a major bottleneck. While no one knows precisely what amounts are involved, the magnitude of the direct costs incurred is likely to be dwarfed by the amount of indirect costs, such as the missed opportunities due to sub-standard education, poor farm-to-market transportation, lives lost due to shoddy construction, subverted building and fire inspection and the absence of essential medical supplies.

Figure 4.3: TRANSPARENCY INTERNATIONAL CORRUPTION PERCEPTION INDEX (CPI)
Philippines Scores, 1980-99



Note: Scale = 1 to 10; higher score means lower graft and corruption

4.80 This report will not explore what the ultimate causes of the problem are.[135] They are likely to lie somewhere at the intersection of requirements of the campaign financing, the kinship and tributary obligations of traditional societies, and the rents associated with economic power, and to be best addressed through a combination of civic education, campaign reform, and economic liberalization. The previous sections have touched upon some of the proximate causes of the phenomenon that lie in the institutional culture and control environment of government operations. The reforms outlined above should go some way toward reducing the opportunities and temptations that present arrangements create.

4.81 There remains however the question as to why is repression not more effective at stamping abuses? On the face of it, the Philippines appears to have a complete arsenal of rules and institutions to identify and suppress the syndrome, including an Ombudsman whose vast powers in the field must be the envy of its peers around the world. A comparison with the situation in Hongkong (see Box 4.2: Repression of Corruption in Hong Kong and in the Philippines) points towards two weak points: (i) the identification of potential cases, and (ii) the ultimate sanction of the culprits.

Box 4.2: REPRESSION OF CORRUPTION IN HONG KONG AND IN THE PHILIPPINES

A benchmarking comparison between the Philippine's Ombudsman and Hong Kong's Independent Commission Against Corruption (ICAC)—widely considered to be among the most effective anticorruption agencies in the world—is highly instructive. One of the most telling statistics is that in 1997, Hong Kong's ICAC successfully prosecuted approximately 8.24 corruption cases per 10,000 civil servants. In the Philippines, the comparable figure is less than 0.25 per 10,000. In short, after adjusting for the differences in size between the two civil services, the probability that a Hong Kong officials will be successfully prosecuted for corruption is almost 35 times greater than his or her counterpart in the Philippines.

Where does the leakage occur? As a result of the ICAC's extensive public relations campaign, Hong Kong citizens are over 5 times more likely to report alleged incidents of graft and corruption than their Filipino counterparts. The ICAC also practices more robust triage up front, launching investigations on only slightly more than half of the reports that come in. Approximately 10 percent of these reports result in prosecution or the imposition of administrative sanctions. The ICAC pursues administrative sanctions on less than 2 percent of the reports, and seeks to prosecute about 8 percent of these cases—a 4:1 ratio in favor of prosecution. The ICAC wins approximately 4 out of every 5 cases when it opts for prosecution, resulting in approximately 6 percent of all corruption related reports ending in a successful criminal prosecution.

The Philippines actually advances a significantly higher proportion of cases—roughly 28 percent—for prosecution and administrative sanction. Of these cases, the vast majority (approximately 7:1) is for prosecution. At an average of 5 percent of the number of reports received, the rate of administrative sanctions imposed compares favorably to that of Hong Kong. However, at best only 12 percent of the cases advanced for prosecution ultimately result in a sustained conviction. The net result is that less than 2 percent of the reports result in successful criminal prosecution (against 6 percent in Hong Kong). The data does not allow to ascribe responsibility for this low success rate to between the prosecution and the courts, although is fair to presume that both play a part.

Source: Ombudsman, ICAC

4.82 Let us explore these points a little further to see what lessons they might bring for the government's future course of action. The first weak link, as was noted in the accountability chain, is the unwillingness of many Filipinos to come forward with information about abuses. Survey data from 1998 tend to indicate that perhaps 22 percent of the public has been asked for money or a gift to speed up their transactions with a government official. However, only 8 percent of those who were asked for a bribe ever bothered to report it. Those who did not come forward offered a range of reasons,

[135] For a thorough discussion of corruption in the Philippines, see World Bank. "Combating Corruption in the Philippines." Manila, Philippines, April 2000.

including "it's too small" (40 percent); or worse, that "nothing would be done about it" (36 percent).[136]

4.83 Other means of identification are underutilized. For instance, although civil servants are supposed to file statement of assets and liabilities for that purpose, no systematic use seems to be made of them to identify cases of illegitimate enrichment. Worse, although it is one of the agencies most heavily suspected by the general public, the Bureau of Internal Revenues has so far resisted all attempts to subject it to the normal oversight of the Commission on Audit.[137]

4.84 Among the cases that are reported, the rate of sanction is very low. Data from the Ombudsman's Office from 1997 and 1998 indicate that only slightly more than 16 percent of reported cases are advanced for prosecution, less than 5 percent result in administrative penalties being imposed and at best, less than 2 percent ultimately result in a conviction.[138]

4.85 Responsibility for this lack of success is equally divided. Part of it lies with the judiciary, whose performance in those types of cases is not different than in others (see below). Part of it also lies with the balkanization of the Philippines anti-corruption efforts. It currently involves eight different agencies (the Commission on Audit, the Civil Service Commission, the Department of Justice, the National Bureau of Investigation, the Ombudsman, and the Presidential Commission on Good Government, and the Presidential Commission against Graft and Corruption) with overlapping jurisdictions, separate rules of procedures, sometime weak forensic capacities and low budgets, and often great difficulties in cooperating with each other.

4.86 Drawing upon global experience and Philippines-specific analysis, the World Bank has recommended that "a national strategy for fighting corruption in the Philippines should focus on reducing opportunities and motivation for corruption and should make corruption a high-risk, low-reward activity. International experience suggests that a successful anti-corruption should focus on the root causes of corruption in the public sector, enhance the effectiveness of sanctions against corrupt behaviors, and increase public oversight of government."[139] Within that framework, the World Bank report recommends to focus on the following nine key elements:

- reducing opportunities for corruption through policy reforms and deregulation
- reforming campaign finance
- increasing public oversight
- reforming budget processes
- improving meritocracy in the civil service

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[136] The others did not know where to report (13 percent); or they were concerned about retaliation (7 percent). Source: Social Weather Stations. 1998. "Personal Experience of Paying to Speed Up Transactions." Manila, Philippines. September 1998.

[137] The capacity of the BIR to compromise on tax assessments is believed to be a major source of corruption in the Bureau as well as a major source of revenue leakage. Unfortunately, although this is mandated under the Constitution, COA has not been able been able to audit BIR, for lack of cooperation from the latter.

[138] The data on convictions is estimated from the approximately 22.5 percent of anticorruption cases tried before the Sandiganbayan, the nation's premier anticorruption court. The other cases are tried before local courts, where the number of successful prosecutions is widely perceived to be significantly less.

[139] World Bank. "Combating Corruption in the Philippines." Manila, Philippines, April 2000.

- targeting selected departments and agencies
- developing partnerships with the private sector
- supporting judicial reform
  and
- enhancing sanctions against corruption.

4.87 Indeed, for such strategy to be effective, it will be important to overcome the public's skepticism by showing clear evidence that "something is being done" to suppress corruption and that offenders are being brought to book. The recent decision of different anti-corruption agencies to establish an interagency council constitutes also an encouraging development in this respect.[140] A systematic review of the net asset statements filed by senior officials and a thorough audit of BIR by COA would also add credibility to the campaign. On that basis, it should be easier to mobilize the support of the citizenry and to activate mechanisms to engage civil society in the struggle against corruption.

C. Delivering Effective Justice

4.88 A nation's courts also play an important role in fostering economic growth and equity. The courts give the law stability by uniformly and predictably applying it to the disputes brought before them. The secure legal framework that results allows firms and individuals to enter into mutually beneficial exchanges, confident that rights to property will be recognized and bargains enforced. Similarly, when the courts do not further stability, uniformity, and predictability, development will be retarded. As noted above, private investors might for instance not be as keen on performance guarantees in private infrastructure deals, if they were less concerned that their profitability might be at the mercy of capricious court rulings. It is not only that investors, businesses and banks who face problems in the enforcement of their legal or contractual rights. Poor citizens are even more helpless, and too often have to fall back on traditional frameworks of personal allegiance and kinship, when they can not depend on the authority of universal rules.

4.89 In the Philippines today, there is a widespread feeling that courts are not promoting these "rule of law" virtues. Nearly three-quarters of the managers of foreign firms surveyed by the Economist Intelligence Unit in early 1999 called Philippine courts "capricious." In 1997, members of the Makati Business Club ranked the courts among worst public bodies. Of the 30 government bodies members were asked to rate, only two, the national police force and the traffic management agency, scored worse.

4.90 Nothing so undermines the courts' ability to further the rule of law as corruption, for nothing is so inconsistent with predictability, uniformity, and stability as the sale of a decision to the highest bidder. In the Philippines, large numbers of citizens and lawyers believe that decisions can be bought. In a 1994 survey of lawyers in Metro Manila, 48 percent claimed they knew of a judge that had taken a bribe. Surveys by the Social

[140] This coordinating mechanism should focus upon three areas: (i) harmonizing rules and procedures across jurisdictional boundaries; this is where historically most problems have occurred; (ii) **keeping comprehensive records of anti-corruption cases**, particularly those that are referred between agencies for action, and monitoring overall progress in sanctioning corrupt officials; and (iii) **advancing joint efforts** in certain areas, such as training in forensic accounting, where collaboration allows the agencies to take advantage of economies of scale.

Weather Station over the past five years regularly show that upwards of half of all Filipinos think that "some" or "a quite a few" judges accept bribes.[141]

4.91 This is not to say that the Philippines has not made significant strides in reforming its legal system. Table 4.10 shows how an expert panel convened by ICRG, a firm that advises foreign investors, has rated the Philippine system over the past decade. While approximations at best, these evaluations provide the only way to compare the performance of a legal system over time or against that of other countries. As the table indicates, in the judgement of the ICRG experts, the Philippines system has continuously improved since 1988. On the other hand, as the table also reports, the Philippine legal system still lags behind that of two of its East Asian neighbors: Singapore and Malaysia.

Table 4.10: RULE OF LAW RATINGS FOR SELECTED EAST ASIAN COUNTRIES, 1988-98

COUNTRY	1988	1993	1998
SINGAPORE	5	5	6
MALAYSIA	4	4	5
PHILIPPINES	**1**	**3**	**4**

4.92 Though there are several reasons as to why ICRG's experts might conclude that the Philippines legal system does not perform as well as those of other nations in the regions, poorly functioning courts would seem to be a major reason.

4.93 The new Chief Justice of the Supreme Court (who, in the Philippines, supervises judges and courts in addition to maintaining the integrity of the legal system per se) is determined to do what is in his power to bring the judiciary up to standards, and has asked donors for advice and support in this. The Judicial Assessment now underway at the World Bank, along with the kind of data reviewed above, suggest that two problems are at the heart of the court system's poor performance: (i) lengthy delays in resolving civil and criminal cases; and, (ii) unpredictable results when a decision is finally reached.

Delays in Resolving Cases

4.94 Delay compromises the courts' ability to decide cases correctly. As time passes, witnesses' memories fade and physical evidence deteriorates. Delay also undermines citizen confidence in the courts and the justice system generally. Those who have a grievance come to court expecting a resolution of their claim within a reasonable period. They do not want the filing of a lawsuit to turn into a several year, and often costly, commitment.

4.95 Delay has been a perennial problem in the Philippines. But despite a number of initiatives over the years to reduce case processing times, there is a widespread perception that court delays are increasing. What data there is suggests that the problem

[141] However, the public's perception of institutions does not always coincide with how those institutions are actually operating. Perception-based information about what institutions do and how well they do it is problematic even when drawing on the experience of those working day-to-day in an institution. The public's perception of the functioning of the courts may differ from the institutional reality, depending upon the nature of the sources of information available to the public about the institutions (see Kritzer, "Using Public Opinion to Evaluate Institutional Performance: The Experience with American Courts," Prem Note. Washington D.C.: World Bank. December 30, 1999). In the Philippines, just prior to the period covered by this survey, a number of allegations of corruption and improper approaches to Supreme Court justices had appeared in the press (see, for example, Coronel, "Justice to the Highest Bidder." *Business World*, May 21-23, 1997). In order to assess the judiciary accurately, it will be important to derive systematic information from the day-to-day operations of the courts.

is indeed on the rise. Table 4.11 shows the number of cases awaiting decision at year-end for the Court of Appeals and key trial courts for 1992, 1995 and 1998. As the figures in that table indicate, the backlog in the Court of Appeals and the lower courts has steadily increased, growing from a total of just under 300,000 cases in 1992 to over twice that number, or 650,000, by the end of 1998.

Table 4.11: CASE BACKLOG IN PHILIPPINE COURTS
(number of cases, December 1992-December 1998)

COURT	PENDING 12/31/92	PENDING 12/31/95	PENDING 12/31/98
COURT OF APPEALS	13,400	15,325	16,173
REGIONAL TRIAL COURTS	175,185	194,939	225,884
METROPOLITAN TRIAL COURTS, MTCS IN CITIES AND MUNICIPAL CIRCUIT TRIAL COURTS	99,473	279,470	422,735
TOTAL	292,094	493,028	664,792

Source: Annual reports of the Supreme Court of the Philippines supplemented with data provided by the Office of the Court Administrator

4.96 Over the years, policymakers in the Philippines have taken a number of steps to reduce court delay. Judges have been ordered not to grant adjournments freely and to insist that, once a trial is begun, it will continue until all witnesses are heard. Congress has passed legislation providing that judges who fail to move their docket quickly or are tardy in issuing opinions are to be sanctioned, and the 1987 Constitution itself even contains provisions mandating that cases be decided quickly. But the data reported in Table 4.11 shows that these various initiatives have apparently had little effect.

4.97 To make a dent in the problem, a first requirement is to involve those within the court system in the development of a reform program.[142] Studies of court delay conducted in the United States[143] found that individual court rooms develop their own norms about what procedures are reasonable and what delays are acceptable, based on the expectations of judges, lawyers, clerks, and others who work with them on a daily basis. Courtrooms, at least in the United States, turn out to resemble small communities, and like small communities everywhere, they generally resist change imposed from without. Nor is imposed change likely to succeed in changing behavior. Courts are governed by a complex set of formal rules and informal practices. Those who work within the court system know these norms far better than any outsider and can use this information advantage to defeat any reforms with which they disagree with.

4.98 At the same time, delay reduction programs need a broader framework within which to locate various initiatives and rank their importance. The Supreme Court has, at least implicitly, begun to develop such a framework in the context of its recent orders governing the filing of cases brought under B.P. 22, the law making the drawing of a check without the funds to cover it a crime (see Chapter 2 for further discussion of the issue). The Court has recognized that most of the benefits from the resolution of these cases accrue to the creditors left holding an unpaid check. It is accordingly imposing fees

[142] The recent work on judicial reform sponsored by the United Nation's Development Program reflects this learning, and Supreme Court Chief Justice Davide is building on it, traveling throughout the nation to meet with judges and court personnel to hear their views on the problems the courts confront. He has also reached out to the lawyers, whose support, if experience elsewhere, will be critical if delays are to be reduced.

[143] World Bank. 1999. "Reducing Court Delays in the United States: Five Lessons of Experience." PREM Note 36, December 1999.

on the filing of these cases to recover at least some of the costs the courts incur in deciding them. This approach reflects the growing recognition by courts around the globe that different types of lawsuits provide different mixes of public and private benefits. In cases such as those brought under B.P. 22 most of the benefits are private.

4.99 By contrast, there are other types of actions that provide significant public benefits as well. Actions that put an end to environmental pollution or create new precedent are two examples. Court resources in all countries are scarce and should be concentrated in resolving those cases where the public benefits are most pronounced. One output of the Judicial Assessment will be information about the most common kinds of cases brought in Philippine courts and the types of litigants bringing them. This will help policymakers target court resources more effectively.

Unpredictability of Court Decisions

4.100 Reducing court delay will help reduce the unpredictability of the resulting decisions, for one factor in the unpredictability calculus is the length of time before a decision will be rendered. Focusing on court resources, and in particular judges' time, on high priority matters will also help. The more attention a judge is able to devote to a case, the more likely it is that he or she will be able to properly research existing law to ensure that the decision conforms to precedent.

4.101 Better training for judges on substantive law will also make a difference. As with freeing judges to spend more time deliberating, it will increase the likelihood that their decisions will reflect existing statutes and precedent. The Philippine judiciary has made the upgrading of judicial training a priority, and the Bank's Judicial Assessment will contribute by bringing the latest learning and experience from other judicial training programs to bear on the effort.

4.102 But the biggest hurdle to increasing the predictability of court decisions remains corruption. So long as judges' decisions can be purchased, the law will be neither be predictable nor uniformly applied. Rooting corruption out of the judiciary, however, will take time and will require action on several fronts.

4.103 Perhaps most important, the conduct expected of judges and other court personnel must be clearly stated. The outright payment of money in return for a favorable decision is only one of many ways the judicial process can be corrupted. What type of gifts and entertainment can judges and their employees accept? What offers of employment may immediate family entertain? What rules should apply to outside investments and other opportunities to supplement judicial pay? To what extent should judicial personnel be required to disclose their income and assets? To whom? The authorities may want to review the applicable Canons of Judicial Ethics and related issuances to make sure that they are as explicit and specific in this respect.

4.104 A process for enforcing these rules that encourages complainants to come forward must also be in place. At the same time that the process encourages the filing of meritorious complaints, it must also protect judges from scurrilous accusations and ensure that allegations are resolved expeditiously and transparently. The Supreme Court is reviewing the operation of the current disciplinary process with an eye towards

reforming it along these lines. The Judicial Assessment will include an analysis of the process and on the basis of experience in other jurisdictions recommend changes.

4.105 But as important as it is to monitor the behavior of judges and other court personnel now employed, such monitoring is difficult, costly, and can interfere with the discharge of judicial responsibilities. In the long run, the solution to the corruption problem is better recruits. More explicit, merit-based appointment criteria, more effort put into screening potential candidates for the judiciary, and those who would be clerks and other court personnel, and a greater transparency in appointment decisions will be far more effective than trying to police the behavior of those already hired. Redesigning the compensation package for judicial personnel in ways that encourage a long-run commitment to public service is also key.[144] Studies under way as part of the Judicial Assessment will review the current system for selecting judges and other court personnel and suggest ways they might be modified to attract candidates with the most desirable characteristics to serve.

D. Improving Revenue Performance

4.106 Much of the above agenda will unfortunately remain beyond reach unless the government gets fiscal revenues back on track. The main source of the recent revenue loss appears to lie in the administration rather than in the design of the tax system. The main objective of the fundamental overhaul of the tax system that the Philippines underwent throughout the nineties (Comprehensive Tax Reform, or CTRP) had been bid to make taxation more buoyant, remove distortions in incentives, and reduce corruption by streamlining tax provisions, closing loopholes, and generally limiting the room for discretion. But actual implementation has not kept up with policy changes.

Bringing the Comprehensive Tax Reform Process to Closure

4.107 Even at the policy level, the task is unfinished. It had initially been hoped that the third round of tax reform (CTRP3 of December 1997) would complete the process. But Congress found it impossible to reach internal consensus on the rationalization of tax incentives to investment, and on taxation of financial intermediation, leaving the matter up to today's policy makers.

4.108 **Rationalizing fiscal incentives** has indeed become urgent. Until the early 1990s, income tax incentives and duty-free import privileges were available through a small number of schemes, notably those under the Omnibus Investment Code of 1987. Export-oriented manufacturers received a package of benefits through the Export Processing Zone (EPZ), duty drawback and bonded warehouse schemes. Over the past few years, however, the number and range of investment incentives has expanded greatly (Table 4.12). These include the formulation of the freeport regime (Subic, Cagayan, and Zamboanga), and the enactment of a law on economic zones under the aegis of the Philippine Economic Zone Authority (PEZA).

[144] American judges in the federal system, for example, can retire at full pay once they reach 65, but if they leave one day before turning 65, for whatever reason, they receive nothing. "Backloading" compensation in this way provides a powerful incentive for personnel to remain with the courts and to resist any temptation to engage in corrupt behavior.

Table 4.12: MAJOR FISCAL INCENTIVE SCHEMES IN THE PHILIPPINES

SCHEME	INCOME TAX INCENTIVES	DUTY FREE IMPORT BENEFITS
BOI (EO 226)	X	X
PEZA	X	X
FREEPORTS	X	X
EXPORT DEVELOPMENT ACT	X	X
DUTY DRAWBACK	--	X
VAT REFUNDS	--	X

4.109 This situation was made worse with the passage of an increasing number of special laws favoring special groups and activities.[145] There is clearly a "beggar thy neighbor" competition underway, as laws outbid each other in providing incentives. Beyond eroding the revenue base, this proliferation of incentives also provides multiple opportunities for unscrupulous businesses to evade taxes by shifting income from taxable to tax-exempt activities under different schemes.

4.110 Various studies and analyses have highlighted a number of weaknesses with the Philippine package of investment incentives and implementing institutions.[146] The most important of these criticisms are: (i) high fiscal cost: estimates vary but generally range between 1 and 1.6 percent of GDP; (ii) ineffectiveness in investment promotion, due to a heavy reliance on non-performance based incentives, such as income tax holidays; (iii) distorting impact on the Philippine economy; (iv) duplication and double availment of incentives; and, (v) excessively broad coverage. On the other, it must be said that the reintroduction, in the wake of the crisis, of income tax holidays and other fiscal incentives in East Asian countries that previously removed such measures in favor of broad-based tax reform, is putting pressure on the Philippines."

4.111 There is a growing consensus that the country should evolve towards a system of uniform and performance-based investment incentives available through the tax code (the so-called "universalization" of incentives). The move has started under CTRP3 with the introduction of net operating loss carryover and accelerated depreciation provisions. What the next steps should be has the subject of a heated debated. A reasonable compromise has however emerged within the inter-agency Task Force on Fiscal Incentives which would involve: (i) the elimination of income tax holidays; (ii) a narrowing down of the list of targeted industries (exporters plus ten 4-decimal positions of the Philippine industrial classification (PITC); and (iii) the repeal of all existing special laws. This should be complemented with an uniformization of Net Operating Loss Carry-Over and Accelerated Depreciation under the general tax code, and a full consolidation of PEZA and BOI schemes for export-oriented enterprises. This package could be fine-tuned through a careful analysis of revenue benefits and costs. The reform would be worth undertaking even if "on paper" its revenue impact turns out not to be very large. Indeed, the main expected contribution of the reform from the revenue perspective would be considerably to simplify tax administration.

[145] Special tax breaks and duty exemptions are now available through some 150 so-called special laws, granting statutory exemptions to various promoted companies or special groups.(e.g., tourism, mining, agriculture, book publishing, shipping, iron and steel manufacturing, and cooperatives).

[146] For a more complete discussion, see World Bank. "Managing Global Integration." November 1997.; "Directions in Public Sector Reform." July 1998. and "Reinforcing Governance." June 1999. Washington, D.C.

4.112 Proposals to reform the **taxation of financial intermediation** have been discussed in the previous chapter.

4.113 Approval of the two sets of legislation (i.e., on incentives and on financial intermediation, together with the publication of the many important implementations rules and regulations of the new tax codes, which are still missing, would bring to a close an enterprise of historical proportions.

4.114 Once this is done, the best option might well be to leave tax policy alone for a while, and give CTRP time to succeed. Perhaps, the one major exception to this line of conduct would concern petroleum products, if only for microeconomic reasons, the low rates at which they are currently taxed being a considerable source of energy waste and urban congestion.

Revamping Tax Administration

4.115 Beyond this however, a pause in policy reform would, it seems, better allow the authorities to turn their attention more firmly to tax administration. This is an area where substantially less progress has been accomplished, at the least as it concerns internal revenues. This is also where bad habits are most deeply entrenched. There is admittedly little point in putting more good laws on the books, if implementation fails to keep up. There is no good reason why it should not. The experience with reforms at the Bureau of Customs (BOC) shows how that success is possible, but that it requires authority, persistence and tenacity.

4.116 The onus is now on the Bureau of Internal Revenue to show commensurate resolve (and on BOC to sustain its early achievements). Some progress has admittedly been achieved over the past year, including: (i) the initial piloting of a new BIR structure (based on types of taxpayers, rather than functions) with the creation of a Large Taxpayer Unit in Metro Manila and surrounding tax jurisdictions (handling about 40 percent of internal revenues) and related measures to speed up revenue remittance by banks of tax payments made by the large taxpayers; (iii) the resumption of the national audit program, after a hiatus in 1998, and the development of industry specific audit guidelines (banks, insurance); and, (iv) the initial deployment of BIR computerization.

4.117 These positive developments still fall short of what would be required to put internal revenues back on track. Furthermore, their impact has been undermined by the recourse to such short-term expedients (e.g., ERAP program[147]) and repeated announcement of an impending tax amnesty.[148] One should also add that the obdurate resistance imposed by BIR to COA does not do much to dispel the fear that corruption too might be part of the problem.

[147] A limited tax amnesty, assuring firms they would not be audited if their tax payments were increased by 10 percent from the previous year, was offered to firms during the spring

[148] Discussion is currently underway in the Congress to allow a much broader based amnesty program, similar to one that occurred about 10 years ago.

4.118 The following priorities emerge clearly:

(a) The continued pattern of granting tax amnesties should be stopped both at the national and at the local level (where they interfere with the operation of land and real estate markets, see Chapter 2). Repeated amnesties discourage taxpayers from compliance since they can underpay for a period of time knowing full well that they will eventually receive forgiveness in exchange for only a fraction of the unpaid tax liabilities. The government should distance itself publicly from the various efforts currently afoot in Congress in favor of a new one.

(b) The Commission on Audit must be given access to BIR as provided for under Executive Order No. 38 of October 1998. A year and a half after being signed by President Estrada, the latter remains to be implemented.

(c) A comprehensive compliance improvement strategy (**excluding** the use of amnesties) for other segments of taxpayers (e.g., small businesses, employees) needs to be devised and implemented as a matter of urgency. An important element of the strategy for each taxpayer segment should be the wider use of taxpayer audit processes, as seen in many other countries, as well as wider recourse to third party information and taxpayer benchmarking.

(d) The system of large taxpayer operations needs to be fully implemented to ensure that a good level of administrative control exists over those taxpayers that contribute to the order of 70-75 percent of the tax revenue. Care must be taken that the system covers not only **actual** large taxpayers, but also the **potential** ones, which for one reason or the other are not currently contributing as much as they should.

(e) Action must be expedited to fully implement the completed program of tax computerization, with emphasis on completing implementation during 2000 in the 40 or so regional district offices that contribute the bulk of tax revenue.

(f) Initiatives are required to develop/enhance the human resource capability of the BIR and BOC, with special consideration being given to the issues of staff protection, remuneration, conduct and ethics. In particular, tax personnel should be protected from lawsuit by recalcitrant tax payers (taxpayers should address their grievance to the bureaus themselves), while errant personnel and poor performers should be dealt with all the vigor allowed by the Civil Service Code.

(g) A concerted program of action should be taken across the BIR (and other agencies) to generate efficiency savings, including from restructuring, business process redesign, improved resource management.

E. CONCLUSIONS

4.119 The discussions above have highlighted a number of important ways in which the government can make growth and poverty reduction its business. Priority should go to improving the quality of the institutions in charge of government affairs, while resuming fiscal consolidation, now that there is no more need for pump-priming the economy.

4.120 Three lessons emerging from international experience and that of the Philippines should guide the policies. The first one is that institutional reforms do not lend themselves to leap-frogging. First things need to be attended first, and a firm basis needs to be laid before moving to the next stage of reform.

4.121 Second is the need to determine a few priorities at a time and see them through to completion. In the case of the Philippines, the main ones appear to be:

(a) Deepen efforts to enlist private and local initiative in support of public objectives, while

  (i) focusing related administrative reforms in areas where early success is essential for achieving government's growth and equity objectives, particularly economic regulation, agriculture and revenue administration; and,

  (ii) limiting related financial risks, particularly as they arise from off-balance sheet exposures.

(b) Nurturing performance, integrity and accountability, by

  (i) professionalizing the civil service, and decompressing its pay scale;

  (ii) underpinning incipient budget reform initiatives with an all-out program to shore up accountability frameworks (particularly in the areas of accounting and internal control); and,

  (iii) reinforcing the credibility of anti-corruption mechanisms.

4.122 What goes for the Executive is also true for the Judiciary Branch. Little advance will be made on the broader governance agenda until and unless the judiciary better upholds the rule of the law emanating from the other branches of government. It would be naive to expect any quick fix to deeply rooted cultural features. Two issues deserve however priority attention: (i) the lengthy delays in resolving civil and criminal cases; and, (ii) unpredictable results when a decision is finally reached. Depoliticizing appointments and rooting out corruption in the judiciary would help in both respects.

4.123 The third lesson from international experience is that no silver bullet or stroke-of-the-pen measure will do. The purpose of the reforms is to set out cultural change, i.e., develop a performance and integrity culture. New or revised sets of rules or laws are unlikely on their own to contribute much towards the desired cultural change. Only a few key elements are actually *sine-qua-non* conditions for successfully bringing about cultural change, within government or any large corporation. These include:

(a) top level support;

(b) a coalition of like-minded agencies to steer and drive the process of change;

(c) some quick wins;

(d) actions that reinforce the rhetoric;

and above all, persistence over the long haul.[149]

[149] One should not lose sight that the Malaysia reforms, for instance, which earned that country comparatively good marks in international surveys (see Table 4.7) were initiated thirty years ago and are still into their third phase. Similarly, the Australian reforms to which the country is often turning its attention started 15 years back, and are still unfolding. Australia introduced program budgeting and performance information in 1984. The running costs system commenced in 1987, and an output/outcome-based accrual budget was introduced only this year (and should be fully integrated into the management culture only over the next three to five years).

5. VULNERABILITY / SUSTAINABILITY

A. INTRODUCTION

5.1 The state must carry the two essential functions discussed in the previous chapters —ensuring that basic services are delivered, especially to the poor, and delivering effective justice—without losing sight of a third fundamental role it has, which is to maintain overall macroeconomic stability. As the first section below will note, the poor are least able to cope when instability arises. Reducing instability is hence part and parcel of a pro-poor policy stance. On this score, domestic fiscal and capital market developments have been a source of recurring concern, notwithstanding recent balance of payments surpluses.

5.2 A lack of savings goes a long way towards explaining why the country as a whole, and its lower income groups in particular are vulnerable. To sustain the level of growth required for rapid poverty reduction, while minimizing the scope for future financial troubles, its investment-savings coverage ratio will need to rise over time, the second section argues.

5.3 Private savings mobilization will play an important role. Given the inertia of the behaviors involved, the authorities would be best advised to rely on a resumption of fiscal consolidation for a more immediate impact; this is the topic of the third section.

5.4 The task of fiscal consolidation is essentially twofold. The first one is to get internal revenues back on track, so that the government can continue to face up to its responsibilities, despite the loss of international revenues which trade liberalization entails. International experience, and the Philippines' own has moreover shown that the biggest threats to fiscal stability often arise from outside the government, rather than from the mainstream of budget operations per se. Although the government has come a long way towards liquidating the legacy of the 1980s debt crisis, it remains exposed in many ways to off-balance sheet risks. Going forward, a more careful use of guarantees and a better monitoring—and pricing—of the risks involved will be in order.

5.5 Even if the Philippines succeeds in cutting back its investment/savings gap substantially during this decade, it will continue for some time require official development assistance to meet its development priorities. For this assistance to be forthcoming, the final section emphasizes, the country will need to improve its record of aid utilization.

B. LIMITING VULNERABILITY

A New Resiliency

5.6 With information flowing around the globe instantaneously, global financial markets are less forgiving of policy mistakes or governance weaknesses. Their reactions can be swift and harsh. Whether financial market volatility is the result of macroeconomic fundamentals or herd behaviors, the globalization of capital flows exposes countries to an increased level of vulnerability. Among the important lessons from the Asia crisis are that

(a) Countries need to strengthen their banking systems to deal with and absorb shocks.

(b) Countries also need to maintain a higher level of reserves than they would have done in the past, when more sluggish trade flows dominated foreign exchange markets.

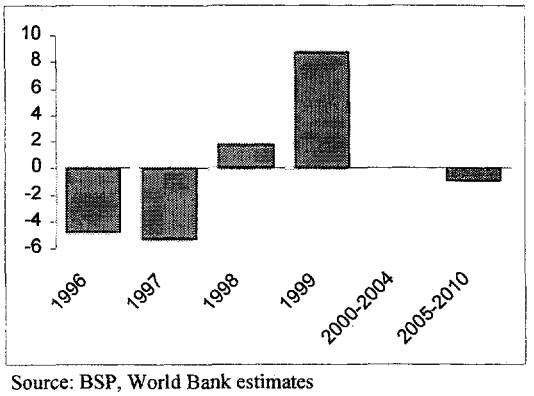
(c) Countries cannot safely run current account deficits of the size the Philippines was getting into when the Asia crisis came; and, conversely, they cannot disregard for long the domestic imbalances which rapid currency appreciation brings.

(d) Countries need to increase their reliance on their own domestic savings and capital markets to finance long-term investment.

5.7 On the first three counts, the Philippines has achieved considerable progress

(a) From a deficit of 13 percent of GDP in 1997, the trade account swung to a 5.4 percent of GDP surplus in 1999, the first surplus in 26 years. Similarly, the current account balance has turned from a negative 5 percent of GDP in 1997 to a positive 9 percent of GDP in 1999 (see Figure 5.1). Although the current account is expected to revert to deficit, its evolution under the baseline scenario should remain manageable.

Figure 5.1: CURRENT ACCOUNT BALANCE, 1996-2010
(percentage of GDP)

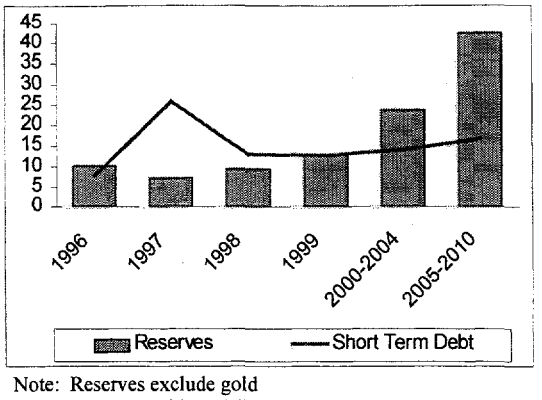


Source: BSP, World Bank estimates

(b) The ratio of nonperforming loans of the banking sector is being contained (at 13.4 percent as of end-January 2000, one of the lowest in the region), while progress continues towards strengthening regulatory frameworks (see Chapter 3).

(c) After drawing on its reserves at the beginning of the crisis, the central bank has managed to rebuild them to the record level of US$16 billion, level at which they now exceed the country's short term debt (see Figure 5.2). It should be able, under the baseline scenario, to strengthen them further over the decade.

Figure 5.2: FOREIGN RESERVES, 1996-2010
(billions of U. S. dollars)

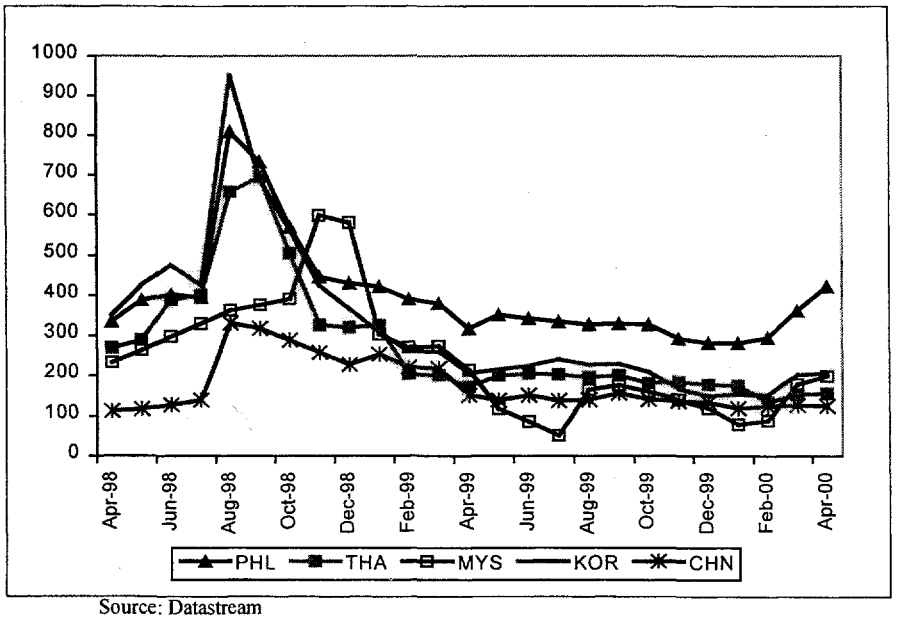


Note: Reserves exclude gold
Source: BSP, World Bank Estimates

Sources of Fragility

5.8 These macroeconomic considerations notwithstanding, financial markets are nevertheless restive. Although the Philippines was less affected by the crisis, it is emerging from it with levels of spread on its Eurobonds, which are second only to Indonesia's (see Figure 5.3).

Figure 5.3: EUROSPREADS, SELECTED COUNTRIES,
(base points)

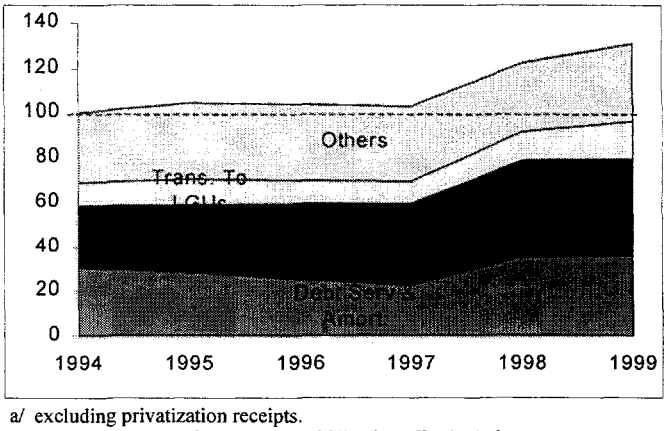


Source: Datastream

5.9 What markets may be apprehensive about is that

(a) With revenue losses, a growing portion of what revenue is being collected is devoted again to debt service (see Figure 5.4), and to non-discretionary items in general. The squeeze on government finances also increases the risk of default (however distant that may be). Markets would also note that, although key debt ratios have improved since 1994, the country remains vulnerable due to the debt overhang inherited from the crises of 1980s. A greater propensity to borrow abroad (including US$4.4 billion of sovereign borrowing in 1999 only) also brings back memories of that episode.

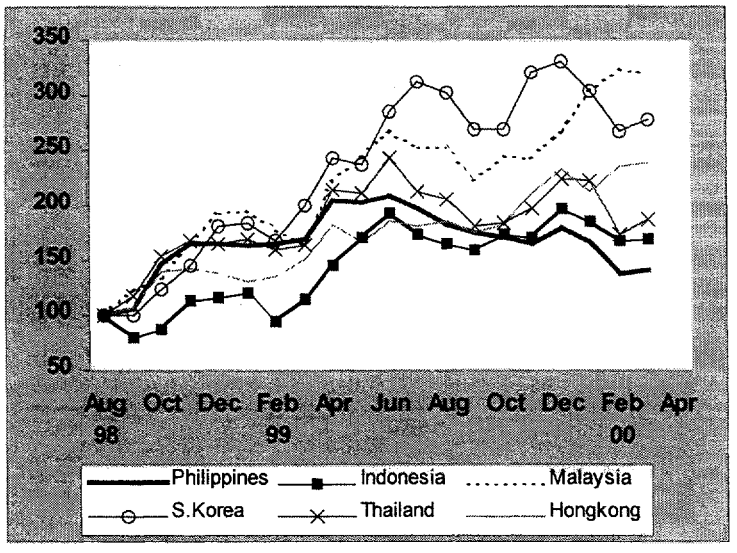
Figure 5.4: NATIONAL GOVERNMENT EXPENDITURE
(percentage of current revenues)[a/]



a/ excluding privatization receipts.
Source: Department of Finance, World Bank staff calculations

(b) A recent spate of murky corporate maneuvers, alleged stock manipulations and loss of authority on the part of financial market regulators might be early symptoms of resource misallocation, dampening the country's growth prospects. The performance of the Philippines stock exchange compared to the rest of the region (see Figure 5.5) could be interpreted in that light.

Figure 5.5: STOCK EXCHANGE DEVELOPMENTS IN SELECTED COUNTRIES
(August 1998 = 100)



Source: Bloomberg

Social Vulnerability

5.10 Markets are not the only ones who should be concerned about the country's potential vulnerability. So should the poor. The El Niño / Asia crisis confirmed once again that they are the ones who can least afford macroeconomic shocks. In a recent study, Balisacan (1999) shows that the probability of households changing their eating patterns, taking children out of school, migrating to other places, and increasing working hours, as a result of the shock was inversely related with pre-crisis living standards. The finding that a large proportion of poorer households took their children out of school is particularly disturbing given the role education attainment plays in the poverty dynamics, and the implication this finding has for second-generation poverty.

C. DOMESTIC SAVINGS MOBILIZATION

Sources of Vulnerability

5.11 A lack of savings helps to explain why the country as a whole and poorer individuals in particular are so highly exposed to shocks and turbulence. As a nation, the Philippines has one of the lowest domestic savings rates in the region. Thus, any spur of development energy rapidly threatens its external balance.

Table 5.1: DOMESTIC SAVINGS RATES
(percentage of GDP)

	1980	1998[a/]
PHILIPPINES	**27**	**15**
INDONESIA	38	24
THAILAND	23	42
MALAYSIA	33	48
KOREA	24	34
WORLD	24	23
O.W		
LOWER MIDDLE INCOME COUNTRIES	--	20
EAST ASIA AND PACIFIC		
LOW AND MIDDLE INCOME COUNTRIES	30	37

Source: World Development Indicators, 2000; NSCB
a./1999 in the case of the Philippines

5.12 The same goes for low-income groups: taken together, the lowest three income deciles of the population do not save (see Figure 5.6). Hence, they have little cushion to fall back on in hard times or capacity, even in good times, to access formal credit markets or make the most basic investments (a roof over one's head, a carabao to help in the fields). For many people, the house they built, their livestock and farming tools, or their social security money, if they have any, might be the only saving they would ever make.

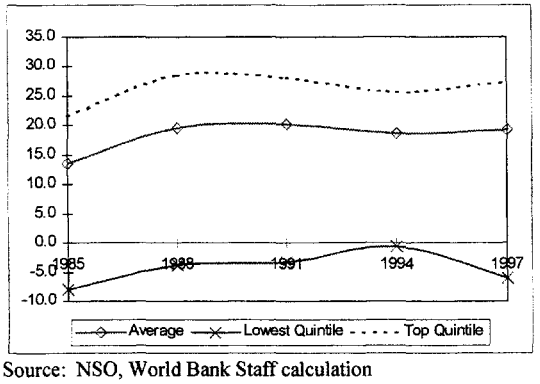
5.13 Not only are savings rates low in the aggregate, they have also been stagnating since the mid-1980s (see Figure 5.7).[150] Although the data available is of uncertain quality, Figure 5.7 directs attention towards

(a) An apparent switch between enterprise and family savings, with the latter rising as the former shrank. This may correspond to the redistribution of rents of the previous producer rents which accompanied trade liberalization (as discussed in Chapter 1 and 2). Since family savings appear remarkably stable (barring the major downturn of the mid-1980s), (see Figure 5.7), their contribution to national savings would have expanded in line with their share in national disposable income.

(b) The contribution of the fiscal deterioration to the recent setback.

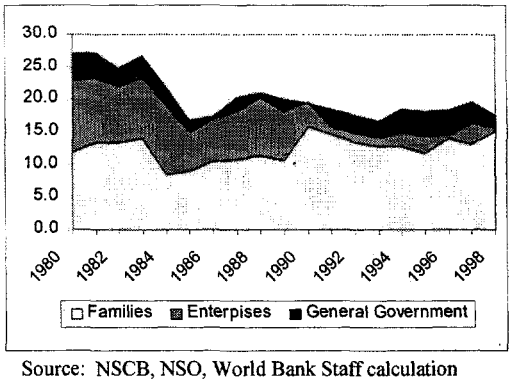
[150] As in Chapter 1, Figure 1.10 replaces the net savings of household and unincorporated enterprises. There needs to be some doubt as to whether the level of savings achieved in the early 1980s were indeed as high as official statistics would have it, or whether the latter record by residual as savings the use of resources which cannot be otherwise accounted for.

Figure 5.6: FAMILY SAVINGS RATES BY LEVEL OF INCOME
(percentage of disposable income)



Source: NSO, World Bank Staff calculation

Figure 5.7: GROSS NATIONAL SAVINGS BY SECTORS
(percentage of gross national disposable income)



Source: NSCB, NSO, World Bank Staff calculation

5.14 Consistent with Philippines as well as international research,[151] a closer inspection of Figure 5.7 appears to indicate a positive correlation between national savings rates and growth rates, and therefore the prospect of a virtuous cycle should the country succeed in sustaining growth for longer periods of time than it has so far been able to.

Investment–Savings Balance

5.15 To sustain the levels of growth required for rapid poverty reduction, the country will need to increase investment. But if it is to reduce its exposure to macroeconomic instability, a greater portion of its investment must be financed out of domestic savings.

5.16 Table 5.2 illustrates the nature of the challenge. By 1997, the coverage ratio of investment by domestic savings had dropped to 50 percent. This required the economy to rely on a net inflow of savings from abroad equivalent to 12.6 percent of GDP to finance the remainder, half of which generated by overseas worker remittances. The counterpart to this inflow of course was an external imbalance of similar magnitude, which signaled the country as a vulnerable spot to foreign investors.

5.17 If the country succeeded in reducing its investment-savings gap sharply in 1998-99, this owes unfortunately more to a contraction in investment (linked itself to a contraction in foreign inflows, see Chapter 1, Table 1.3) than to a major increase in domestic savings. Private savings do appear to have rebounded substantially from the 1997 low, but this was partly offset by the deterioration of fiscal performance.

[151] See for instance, Vos, R., and J. Yap. 1996. "The Philippine Economy: East Asia's Stray Cat?" Institute of Social Studies, The Hague. on savings behaviors in the Philippines, and World Bank, 1999: Savings: What Do We Know and Why Do We Care, PREM Note No. 28, Washington, DC, and the World Saving Data Base (accessible at http://www.worldbank.org/research /projects/data.htm) for an international comparison.

Table 5.2: INVESTMENT-SAVINGS BALANCE, 1997-2010
(percentage of GDP)

		1997	1998	1999	2000-04	2005-10
1. INVESTMENT		25.2	20.2	18.5	20.8	23.6
	PUBLIC SECTOR	5.0	4.8	4.9	4.8	6.1
	REST OF THE ECONOMY	20.1	15.4	13.6	15.9	17.5
2. DOMESTIC SAVINGS		14.0	12.4	14.6	14.9	16.7
3. RESOURCE BALANCE		-11.2	-7.8	-3.9	-5.9	-6.9
NET INCOME AND TRANSFERS						
4. ABROAD		7.0	6.2	6.1	6.3	6.1
5. NATIONAL SAVINGS		21.0	18.6	20.7	21.1	22.8
	PUBLIC SECTOR	6.1	4.5	n.a.	6.2	6.0
	REST OF THE ECONOMY	14.9	14.1	n.a.	14.9	16.7
6. FOREIGN SAVINGS (1.-6.)		4.2	1.6	-2.1	-0.3	-0.8
DOMESTIC SAVINGS COVERAGE RATIO 7. *(8.=2./1.)*		*55.7*	*61.5*	*78.7*	*71.6*	*70.8*
NATIONAL SAVINGS COVERAGE RATIO 8. *(B.=6./1)*		*83.5*	*92.2*	*111.6*	*101.9*	*96.6*

Source: National Income Accounts, BSP SPEI, World Bank staff calculations

5.18 Over time, with the right policy and governance framework, the country should be able to regain better access to foreign savings to sustain a recovery in investment. Still it would be unwise to plan on the investment coverage ratio to return to its low pre-crisis level.[152]

Generating Private Savings

5.19 Higher domestic savings mobilization will therefore be needed to sustain growth. As in the past, a large portion those savings will need to be generated from the private sector. The following factors should contribute.

(a) Maintaining confidence in the country's banks and currency will obviously remain central to the effort. The considerable advances in banking system reforms over the past decade contributed to the banking system's relatively robust performance during the crisis. However further reforms are warranted as discussed in Chapter 3.

(b) Diversifying savings instruments and broadening the coverage of contractual savings schemes, pensions systems in particular, should further help, as should the development of efficient capital markets. Chapter 3 also presented a number of suggestions in this field.

(c) Bringing down food prices through trade liberalization would also release some saving capacity, particularly among low-income groups.

[152] The scenario outlined in Table 5.2 indicates that with a 71% coverage ratio, this would still leave the country in need of substantial infusions of foreign savings, to the tune of US$ 7 billion by 2010.

(d) A secular reduction in the age dependency ratio (potentially helped by more vigorous population policies) should raise the proportion of breadwinners, hence of potential savers, among the population.

(e) Sustaining faster growth in itself may also help lift private savings rates.

5.20 One needs to recognize however that private savings behaviors have a high degree of inertia. Hence the need for consistence and persistence in applying the above measures listed above.

D. Resuming Fiscal Consolidation

5.21 For a faster impact on aggregate savings, however, the authorities will be better advised to depend on a resumption of fiscal consolidation. The main challenges often arise from outside the mainstream of budget operations *per se*. The reason is that in its overall role of protecting the common good and furthering development, government is often called upon—some time unwittingly—to extend explicit or implicit guarantees for a range of activities and ventures seen to be beneficial to society as a whole (e.g., placing savings with banks, building up power plants). When these sour, bailouts become difficult to resist. International experience, and the Philippines' own has shown time and again that the public debt accumulated in the "routine" management of the budget can pale against the amounts involved in such rescue operations.

5.22 This is what happened when the Philippines emerged from the debt crisis of the 1980s with an uncommonly large public debt burden, reflecting the "nationalization" of the bad debts accumulated during the Marcos years. As a result, the public debt[153] climbed up 94 percent of GNP in 1993. The same is happening now to other countries of the region as they commit public funds to rescuing their financial and corporate sectors (see Table 5.3).

Table 5.3: Public Debt in Selected Countries
(percentage of 1998 GDP, unless noted otherwise)

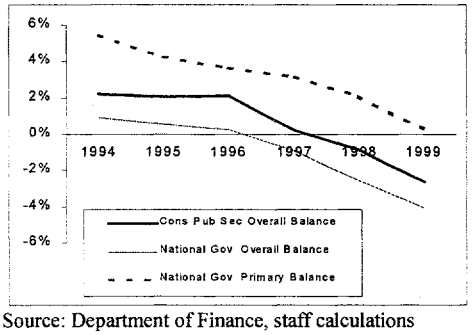
INDICATOR	INDONESIA	REP OF KOREA	MALAYSIA	THAILAND
Public debt stock, 1997	48.3	10.5	31.6	6.5
Fiscal recapitalization cost to date	37.3	15.8	10.9	17.4
Expected additional fiscal cost	12.7	10.7	5.5	15.4
Total expected public debt burden	98.3	37	48	39.3
Annual interest payment on this burden	15.4	2.9	1.5	1.2
Interest payment as percentage of 1998 revenue	91.8	14	6.5	6.5
Memorandum Item				
Fiscal deficit (percentage of GDP), 1999	6.5	5	5.5	5
Interest rate used (percent)	15.7	7.9	3.1	3
Revenue/GDP (percent), 1998	16.8	21	23.1	18.4

Source: IMF, 1999; JP Morgan, 1999, Deutsche Bank; authors' calculations

[153] Non-financial public sector (including former central bank liquidation).

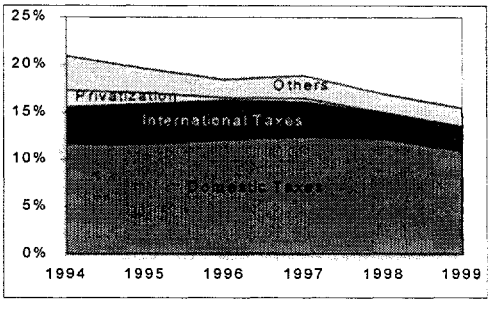
5.23 The Philippines worked hard during the 1990s towards liquidating that legacy of the past, and succeeded in bringing its public debt to GNP ratio back down to 72 percent by 1996. The measures taken were twofold. First, the country reached an agreement in 1992 with its creditors to restructure its foreign debt. Second, it undertook a vigorous program of fiscal consolidation, which turned the national government—as well as the consolidated public sector—into surplus in 1994 and it sustained this achievement until the advent of the Asia crisis (see Figure 5.8). Even more significantly from a debt-reduction point of view, it succeeded in maintaining a primary fiscal surplus up to 1998. The resulting de-escalation of interest rates helped a virtuous circle to set in. Reflecting the progress accomplished, the percentage of fiscal revenues which the country had to devote to servicing the public debt[154] came down from 51 percent to 27 percent of current revenues between 1990 and 1997, releasing that much resource for important expenditure programs.

Figure 5.8: EVOLUTION OF NATIONAL GOVERNMENT AND PUBLIC SECTOR GOVERNMENT BALANCES
(percentage of GNP)



Source: Department of Finance, staff calculations

Figure 5.9: EVOLUTION OF NATIONAL GOVERNMENT REVENUES
(percentage of GNP)



Source: Department of Finance, staff calculations

5.24 These achievements remain fragile, though. First, as was shown in, Table 4.9 the government remains exposed in many ways to off-balance sheet risks. For instance, the government will need to assume perhaps upward from PhP100 billion of NPC debt, and PhP20 billion in non-performing mortgages accumulated by NHMFC. While "social concerns" (for "affordable" power or "affordable" housing in these cases) have often either guided the interventions, or delayed remedial action, it is worth keeping in mind that the amounts involved could have paid for over 50 years of government procurement of textbooks and drugs (at the current rate of spending). Going forward, a more careful use of guarantees and better monitoring—and pricing—of the risks involved will be in order.

5.25 Furthermore, the recent widening of the fiscal deficit is beginning to call into question whether the results of this effort will be sustained. The national government incurred a primary deficit in 1999 for the first time in the decade. Up to a point, this wider deficit has reflected the normal (and actually welcome) operation of automatic stabilizers during the downturn.

[154] Interest payments plus amortization of the external debt.

5.26 It is more the source of this deficit—loss of internal revenue—that is cause for concern. Whereas they need to expand over the medium-term to offset the inexorable loss of customs revenues which trade liberalization entails, internal tax revenues are slipping back. The official objective is that they should reach 14.5 percent of GNP by 2003. But, after slowly rising up to 12.5 percent of GNP by 1997, they have slipped back below 11 percent in 1999 (see Table 5.4).

5.27 Another concern is that, on current policies, the surplus of the public pension funds is bound to shrink over time, as their levels of "funding" deteriorates (see Chapter 3). These resources will not be as readily available to underwrite, directly or indirectly, deficits in the rest of the public sector (see Table 5.4). This situation, if allowed to last, would put the public sector into more direct competition for scarce savings with the rest of the economy.

5.28 Conservatism will therefore be needed across the public sector. The baseline scenario assumes that the government can still make up for the recent slippage, and at least approach its target within the set timeframe (see Table 5.4). The overall fiscal situation would then remain manageable..

5.29 Failure to do so, however, may set the fiscal position on a different trajectory. Even returning only to the 1997 performance in terms of internal revenue collection would not be sufficient to prevent the emergence of mounting deficits over the medium term (see Table 5.4, Alternative Scenario 1).

5.30 Worse, the perspective of such deficits may quickly fray the nerves of markets and affect the cost of funds the government is able to raise. Although the baseline scenario foresees further progress towards rolling back the public debt, the Philippine government is and will remain for some time to come in a situation of high indebtedness, hence highly exposed to interest rate risks. Furthermore, because it does not have the record of fiscal prudence of other East Asian countries, markets may be less forgiving in the face of any slippage. As Table 5.4 shows (see Alternative Scenario 2 which computes the additional impact of a 2 percentage points hike in interest rates), the fiscal scenario may then take a worrisome turn. Exogenous interest rate shocks, arising from tensions in the global markets would have a similar impact.

Table 5.4: FISCAL DEVELOPMENTS UNDER VARIOUS SCENARIOS, 1997-2010
(percentage of GNP)

			1997	1998	1999	2000-04	2005-2010
NATIONAL GOVERNMENT							
REVENUES			18.5	16.8	15.2	17.7	17.9
	INTERNAL REVENUES	BASELINE	12.4	12.1	10.7	12.9	13.8
		ALTERNATIVE SCENARIO 1	12.4	12.1	10.7	12.0	12.3
	CUSTOMS DUTIES		3.7	2.7	2.7	2.8	2.1
	OTHER		2.3	1.9	1.8	1.9	2.0
EXPENDITURE			19.4	19.4	18.8	19.0	20.1
	CONSUMPTION		8.8	9.2	8.6	8.4	8.7
	INTEREST PAYMENTS	BASELINE	4.1	4.7	4.2	3.5	2.9
		ALTERNATIVE SCENARIO 2	4.1	4.7	4.2	4.0	4.4
	TRANSFERS		2.2	2.1	2.5	3.9	4.9
	CAPITAL EXPENDITURES		3.9	3.1	3.1	3.1	3.4
SURPLUS / DEFICIT		BASELINE	-0.9	-2.6	-3.6	-1.3	-2.1
		ALTERNATIVE SCENARIO 1	-0.9	-2.6	-3.6	-2.2	-3.6
		ALTERNATIVE SCENARIO 2	-0.9	-2.6	-3.6	-2.7	-4.6
LOCAL GOVERNMENT							
REVENUES			1.4	1.7	1.9	1.5	1.5
TRANSFERS FROM NATIONAL GOVERNMENT			1.9	2.1	2.6	3.5	4.1
EXPENDITURE			3.1	3.7	4.2	4.1	4.2
SURPLUS / DEFICIT			0.1	0.1	0.2	0.9	1.4
REST OF THE PUBLIC SECTOR							
SURPLUS / DEFICIT			1.0	1.7	0.8	0.9	-0.1
CONSOLIDATED PUBLIC SECTOR							
SURPLUS / DEFICIT		BASELINE	0.2	-0.9	-2.6	0.5	-0.9
		ALTERNATIVE SCENARIO 1	0.2	-0.9	-2.6	-0.4	-2.7
		ALTERNATIVE SCENARIO 2	0.2	-0.9	-2.6	-0.9	-3.7

Source: World Bank staff calculation, based on DOF and NSCB. The definition of the consolidated public sector defers from the one used by the DOF

E. REQUIREMENT FOR FOREIGN ASSISTANCE

5.31 The Philippines will continue for some time to require official development assistance for some time. The Asia crisis may have temporarily reversed the process, but its secular direction under the baseline scenario appears clear. With the success of reforms, the Philippines has gained greater access to private sector savings (in the form of banking, portfolio, and direct investment as well remittance flows). With that, much of the initiative in steering the country's development has also shifted to the Filipinos themselves,... and to international capital markets. The importance of ODA has declined accordingly: ODA disbursements declined from 17 percent to 10 percent of the country's external financing between 1994 and 1996 (see Chapter 1—Table 1.3). This relative decline is likely to continue during this decade (see Table 5.5).

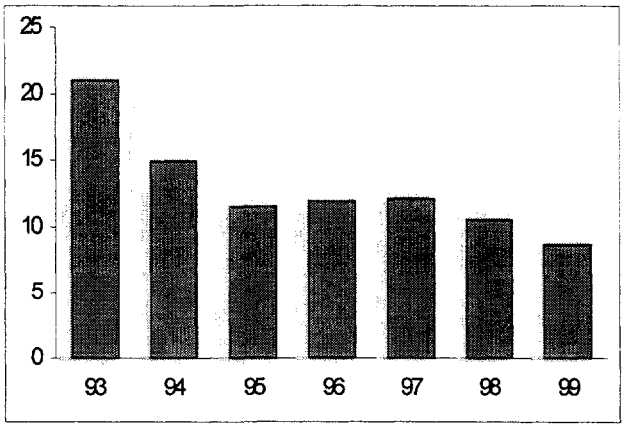
Table 5.5: EXTERNAL FINANCING REQUIREMENT, 1998-2010
(millions of U.S. dollars)

	1998	1999	2000-04	2005-10
CURRENT ACCOUNT, EXCL. TRANSFERS AND REMITTANCES ((-) = DEFICIT)	-3680	134	-7803	-12032
MLT LOANS AMORTIZATION	-2757	-3282	-3523	-4171
IMF REPURCHASES	-78	-54	-190	-93
CHANGE IN GROSS RESERVES	-2035	-4304	-3418	-3691
REQUIREMENT	**-8550**	**-7506**	**-14934**	**-19987**
REMITTANCES [a/]	4926	6795	7960	10797
OFFICIAL TRANSFERS [b/]	300	259	14	20
DIRECT INVESTMENT	1752	1077	1302	2053
PORTFOLIO INVESTMENT	264	512	298	579
MLT LOANS DISBURSEMENTS	2740	4716	5130	4478
O.W. ODA LOANS [c/]	2196	1866	1128	35
NET FOR. ASSETS OF COM. BANKS	-1330	-1836	349	1500
SHORT TERM CAPITAL	-1521	-3610	517	600
IMF PURCHASES	730	346	0	0
OTHER (INCL. ERRORS AND OMISSIONS)	-3553	-10953	-637	-40
FINANCING	**8550**	**7506**	**14934**	**19987**

a/ OCW factor service plus remittances
b/ to government
c/ multilateral and bilateral, gross values
Sources: BSP-SPEI, IMF
Projections for 2000 to 2010 are Bank calculations based on the World Bank's Debt Reporting System and may not be directly comparable with historical numbers from BSP

5.32 There will, however remain a need for substantial amounts of ODA, for three reasons. First, even if the country succeeds in cutting back its investment/savings gap over the decade, a substantial gap will remain. Second, for the foreseeable future, many of the basic public goods, which the country requires, may not get financing from sources other than official ones, even if funding is readily available for other purposes. And finally, there is little reason to believe that the cycles of instability which have afflicted the country in the past would abate with further globalization. When market funding dries up, the country will still need to fall back more heavily on the ODA safety net, just as it did during the Asia crisis: in 1998-99, official assistance provided almost a quarter of the funding the country required.

Figure 5.10: ODA UTILIZATION RATE[a/]
(percent)



a/ratio of annual disbursements over total outstanding commitments
Source: Coordinating Council of the Philippine Program

5.33 For this assistance to be forthcoming, however, the country will need to improve its record of aid utilization. Recent reviews of the ODA-financed projects show a sharp deterioration of utilization performances, with implementation of many projects currently unsatisfactory, resulting in delayed development impact on the ground, exceedingly slow disbursements, and negative resource flows in the case of ADB and the World Bank. Overall, the ODA disbursement ratio dropped from over 20 percent to less than 10 percent between 1993 and 1999 (see Figure 5.10). In 1999 only, project disbursement ($646 million) fell by 25 percent compared to 1998 ($862 million) with total undisbursed amounts of $7.0 billion as at end-December 1999. Even more perplexing, of the 11 most directly poverty-related World Bank projects, only 10 percent is disbursed. ODA donors are likely to expect stronger signs of the country's dedication to poverty reduction to sustain their own commitment to growth and equity in the Philippines.❐

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STATISTICAL ANNEX

TABLE 1: NATIONAL ACCOUNTS, 1994-99
(percentage of GNP)

	1994	1995	1996	1997	1998	1999
GDP AT MARKET PRICES	97.5	97.3	96.2	96.0	95.5	95.3
AGRICULTURE	21.4	21.0	19.8	17.9	16.1	16.7
INDUSTRY	31.7	31.2	30.8	30.9	30.1	29.1
MINING AND QUARRYING	1.0	0.9	0.8	0.7	0.7	0.6
MANUFACTURING	22.7	22.4	21.9	21.4	20.9	20.4
SERVICES	44.3	45.1	45.4	47.1	49.2	49.5
IMPORTS OF GNFS	39.1	43.0	47.3	57.0	56.1	48.5
EXPORTS OF GNFS	33.0	35.4	38.9	47.1	49.7	48.9
TOTAL CONSUMPTION	83.0	83.2	82.0	82.5	83.6	81.4
PUBLIC	10.5	11.1	11.5	12.7	12.7	12.3
PRIVATE	72.5	72.1	70.5	69.8	70.9	69.0
STATISTICAL DISCREPANCY	-2.8	0.1	-0.6	-0.5	-1.2	-4.4
GROSS DOMESTIC INVESTMENT	23.5	21.8	22.8	23.9	19.4	17.9
FIXED CAPITAL	23.0	21.6	22.3	23.5	20.1	18.1
CONSTRUCTION	9.5	9.4	10.1	10.7	9.6	8.8
DURABLE EQUIPMENT	12.0	10.7	10.7	11.3	9.1	8.0
BREEDING STOCK & ORCHARD DEVELOPMENT	1.6	1.5	1.4	1.5	1.4	1.3
CHANGES IN STOCKS	0.4	0.2	0.6	0.3	-0.7	-0.2
NET FACTOR INCOME	2.5	2.7	4.0	4.0	4.5	4.7
GNP (MILLION PESOS)	1,736,382	1,958,932	2,282,958	2,522,884	2,794,066	3,137,945

Source: NSCB

TABLE 2: NATIONAL ACCOUNTS, 1994-99
(real growth rates)

	1994	1995	1996	1997	1998	1999
GDP AT MARKET PRICES	4.4	4.8	5.7	5.2	-0.5	3.2
AGRICULTURE	2.6	0.8	3.8	2.9	-6.6	6.6
INDUSTRY	5.8	7.0	6.2	6.1	-1.9	0.5
MINING AND QUARRYING	-7.0	-0.8	-4.8	1.7	2.8	-8.2
MANUFACTURING	5.0	6.8	5.6	4.2	-1.1	1.4
SERVICES	4.2	5.0	6.4	5.5	3.5	3.9
IMPORTS OF GNFS	14.5	16.0	16.7	13.5	-14.7	-2.7
EXPORTS OF GNFS	19.8	12.0	15.4	17.2	-21.0	1.8
TOTAL CONSUMPTION	3.9	4.0	4.6	4.7	2.9	3.0
PUBLIC	6.1	5.4	3.9	2.0	-2.1	5.5
PRIVATE	3.7	3.8	4.6	5.0	3.4	2.7
GROSS DOMESTIC INVESTMENT	8.7	3.5	12.5	11.7	-16.4	-2.1
FIXED CAPITAL	7.5	4.7	12.0	11.5	-11.4	-3.4
CONSTRUCTION	3.7	7.9	15.9	14.6	-5.9	-2.1
DURABLE EQUIPMENT	11.4	2.2	9.6	9.2	-18.1	-5.5
BREEDING STOCK & ORCHARD DEVELOPMENT	2.6	3.9	6.0	8.5	0.2	1.6
GROSS NATIONAL PRODUCT	5.3	5.0	7.2	5.3	0.1	3.6

Source: NSCB

TABLE 3: CONSOLIDATED PUBLIC SECTOR FINANCIAL POSITION, 1994-99

(BILLIONS OF PHILIPPINE PESOS)	1994	1995	1996	1997	1998	1999
NATIONAL GOVERNMENT	16.3	11.1	6.3	1.6	-50.0	-111.7
MONITORED GOCCS	-9.7	-1.3	-11.2	-17.2	-38.0	-4.6
CENTRAL BANK RESTRUCTURING	-24.3	-20.0	-13.8	-25.7	-26.4	-20.5
OIL PRICE STABILIZATION FUND (OPSF) [A]	2.6	-9.2	4.8	-0.8	0.7	1.9
ADJUSTMENT TO GOCCS [B]	7.6	2.8	1.5	2.5	0.9	3.0
OTHER ADJUSTMENTS [C]	0.0	0.0	0.0	0.0	1.5	-6.1
PUBLIC SECTOR BORROWING REQUIREMENT (PSBR)	-7.5	-16.7	-12.4	-39.6	-111.3	-138.0
SSS/GSIS/PHIC	-12.0	0.0	8.5	3.9	17.8	36.4
BANGKO SENTRAL NG PILIPINAS	5.3	3.6	-2.3	2.2	3.2	-4.0
GOVERNMENT FINANCIAL INSTITUTIONS	3.1	5.0	8.4	4.3	5.4	3.3
LOCAL GOVERNMENT UNITS	5.0	1.9	5.7	4.2	2.0	3.2
TIME ADJ. OF INTEREST PAYMENTS TO BSP	-2.3	1.5	-0.7	2.3	-0.3	-2.3
OTHER ADJUSTMENTS	0.1	0.6	0.0	0.0	0.0	0.8
CONSOLIDATED PUBLIC SECTOR (CPS)	-8.3	-4.0	7.3	-22.7	-83.2	-100.5

(PERCENTAGE OF GNP)	1994	1995	1996	1997	1998	1999
NATIONAL GOVERNMENT	0.9	0.6	0.3	0.1	-1.8	-3.6
MONITORED GOCCS	-0.6	-0.1	-0.5	-0.7	-1.4	-0.1
CENTRAL BANK RESTRUCTURING	-1.4	-1.0	-0.6	-1.0	-0.9	-0.7
OIL PRICE STABILIZATION FUND (OPSF) [A]	0.1	-0.5	0.2	0.0	0.0	0.1
ADJUSTMENT TO GOCCS [B]	0.4	0.1	0.1	0.1	0.0	0.1
OTHER ADJUSTMENTS [C]	0.0	0.0	0.0	0.0	0.1	-0.2
PUBLIC SECTOR BORROWING REQUIREMENT (PSBR)	-0.4	-0.8	-0.5	-1.6	-4.0	-4.4
SSS/GSIS	-0.7	0.0	0.4	0.2	0.6	1.2
BANGKO SENTRAL NG PILIPINAS	0.3	0.2	-0.1	0.1	0.1	-0.1
GOVERNMENT FINANCIAL INSTITUTIONS	0.2	0.3	0.4	0.2	0.2	0.1
LOCAL GOVERNMENT UNITS	0.3	0.1	0.3	0.2	0.1	0.1
TIME ADJ. OF INTEREST PAYMENTS TO BSP	-0.1	0.1	0.0	0.1	0.0	-0.1
OTHER ADJUSTMENTS	0.0	0.0	0.0	0.0	0.0	0.0
CONSOLIDATED PUBLIC SECTOR (CPS)	-0.5	-0.2	0.3	-0.9	-3.0	-3.2

a. Includes OPSF balance, transfers between NG and OPSF, and adjustments for PNOC share of OPSF balance.
b. Includes NG transfers to monitored corporations, NPC transfers to NG, NG transfers to PNOC and PNB transfers to NG.
c. Includes adjustments for net lending for debt buyback, reconciliation of cash accounts with bank data and other adjustments.
Source: DOF

TABLE 4: OUTSTANDING PUBLIC SECTOR DEBT, 1993-99
(year end, billions of Philippine pesos)

	1993	1994	1995	1996	1997	1998	1999 7/
TOTAL PUBLIC SECTOR 1/	1,912.7	1,949.8	2,167.1	2,237.3	2,669.5	2,951.5	3,322.7
DOMESTIC	1,260.7	1,289.2	1,453.7	1,502.7	1,586.9	1,721.2	1,619.2
EXTERNAL	652.0	660.6	713.5	734.6	1,082.6	1,230.3	1,703.5
(BILLIONS OF U.S. DOLLARS)	23.5	27.1	27.2	27.9	27.1	31.5	41.4
NATIONAL GOVERNMENT 2A/	1,268.8	1,227.5	1,325.5	1,331.8	1,624.0	1,800.4	2,054.2
NATIONAL GOVERNMENT 2B/	1,074.2	1,028.5	1,103.1	1,107.3	1,282.9	1,421.1	1,622.3
DOMESTIC 2/	682.1	670.6	724.6	748.3	757.3	859.6	942.7
EXTERNAL 3/	586.7	556.9	600.9	583.6	866.7	940.8	1,111.5
(BILLIONS OF U.S. DOLLARS)	21.2	22.8	22.9	22.2	21.7	24.1	27.0
13 MONITORED GOCCS 4/	268.6	269.9	343.2	453.3	622.0	643.9	712.2
DOMESTIC	139.1	147.3	205.9	312.1	436.0	419.1	188.5
EXTERNAL	129.5	122.6	137.2	141.1	186.0	224.8	523.7
(BILLIONS OF U.S. DOLLARS)	4.7	5.0	5.2	5.4	4.7	5.8	12.7
CENTRAL BANK/CB-BOL 5/	59.6	81.1	82.6	77.1	112.0	102.2	101.2
DOMESTIC							
EXTERNAL	59.6	81.1	82.6	77.1	112.0	102.2	101.2
(BILLIONS OF U.S. DOLLARS)	2.2	3.3	3.2	2.9	2.8	2.6	2.5
BANGKO SENTRAL 5/	209.3	240.9	253.8	332.0	338.6	387.5	576.5
DOMESTIC	173.6	183.9	185.8	227.1	126.3	123.3	286.8
EXTERNAL	35.7	57.0	68.0	104.9	175.9	264.2	289.7
(BILLIONS OF U.S. DOLLARS)	1.3	2.3	2.6	4.0	4.4	6.8	7.0
GOVERNMENT FINANCIAL INSTITUTIONS	301.1	329.4	384.5	267.6	350.4	396.8	310.5
DOMESTIC	271.1	293.0	343.5	221.4	275.0	327.9	216.5
EXTERNAL	30.0	36.3	40.9	46.2	75.4	68.9	94.0
(BILLIONS OF U.S. DOLLARS)	1.1	1.5	1.6	1.8	1.9	1.8	2.3
LESS: GOCC DEBT ONLENT OR GUARANTEED BY NG 6/	194.6	199.0	222.4	224.5	341.1	379.3	431.9
DOMESTIC	5.2	5.6	6.2	6.2	7.7	8.7	15.3
EXTERNAL	189.4	193.4	216.2	218.3	333.4	370.6	416.6
(BILLIONS OF U.S. DOLLARS)	6.8	7.9	8.2	8.3	8.3	9.5	10.1
MEMORANDUM ITEMS							
EXCHANGE RATE (P/US$1)							
END OF PERIOD	27.70	24.42	26.21	26.29	39.98	39.09	41.10
AVERAGE	27.12	26.42	25.71	26.22	29.97	40.89	41.11
NG DEBT STOCK/GNP	71.6%	59.2%	56.3%	49.0%	50.9%	50.9%	51.7%
NG DOMESTIC DEBT	45.5%	38.6%	37.0%	33.1%	30.0%	30.8%	30.0%
NG EXTERNAL DEBT	39.1%	32.1%	30.7%	25.8%	34.4%	33.7%	35.4%
PUBLIC SECTOR DEBT STOCK/GNP 1/	127.5%	112.3%	110.6%	98.9%	105.8%	105.6%	105.9%
PUBLIC SECTOR DOMESTIC DEBT 1/	84.0%	74.2%	74.2%	66.5%	62.9%	61.6%	51.6%
PUBLIC SECTOR EXTERNAL DEBT 1/	43.5%	38.0%	36.4%	32.5%	42.9%	44.0%	54.3%
NONFINANCIAL PUBLIC SECTOR	1402.4	1379.5	1528.9	1637.7	2016.9	2167.2	2435.7
% OF GNP	93.5%	79.4%	78.1%	72.4%	79.9%	77.6%	77.6%

1/ Includes National Government, 14 monitored GOCCs, CB/CB-BOL/BSP and GFIs.
2/ Includes direct, assumed and contingent liabilities
2A/ Includes direct, assumed and contingent liabilities
2B/ Excludes onlent and contingent/guaranteed liabilities which have not been assumed
3/ Includes direct, guaranteed and assumed liabilities
4/ Includes borrowings relent/guaranteed by NG
5/ Liabilities less currency issue and intergovernment accounts
6/ Includes relent, guaranteed and contingent liabilities
7/ Full year estimates as of September 1999

TABLE 5: NATIONAL GOVERNMENT CASH OPERATIONS, 1994-1999

(MILLIONS OF PHILIPPINE PESOS)

	1994	1995	1996	1997	1998	1999
TOTAL REVENUE	336,160	361,220	410,449	471,843	462,515	478,502
TAX REVENUE	271,304	310,517	367,894	412,165	416,585	431,686
BUREAU OF INTERNAL REVENUE	187,445	210,105	260,774	314,697	337,175	341,319
BUREAU OF CUSTOMS	81,610	97,691	104,566	94,800	76,005	86,497
OTHER OFFICES	2,249	2,721	2,554	2,668	3,405	3,870
NON-TAX REVENUE	64,856	50,703	42,555	59,678	45,930	46,816
TOTAL EXPENDITURE	319,874	350,146	404,193	470,279	512,496	590,160
CURRENT EXPENDITURE	267,813	277,265	318,462	370,900	428,480	470,609
PERSONNEL SERVICES	92,678	109,074	135,406	172,800	194,100	202,695
MAINTENANCE AND OPERATIONS	46,837	46,950	48,702	51,800	69,588	70,758
SUBSIDIES	7,021	3,580	5,862	5,900	4,739	6,565
ALLOTMENT TO LGUS	37,753	41,394	45,275	56,400	60,100	78,733
INTEREST PAYMENTS	79,123	72,658	76,522	78,000	99,792	106,290
TAX EXPENDITURES	4,401	3,609	6,695	6,000	161	5,568
OPSF			10,000			
CAPITAL EXPENDITURE AND NET LENDING	52,061	72,881	75,731	99,200	84,016	118,901
CAPITAL EXPENDITURE	43,068	64,461	69,628	93,600	82,918	114,176
INFRASTRUCTURE AND OTHER CAPITAL OUTLAYS	33,606	52,673	57,547	79,100	65,188	96,508
TRANSFERS TO LGUS	9,462	11,788	12,081	14,500	17,730	17,668
EQUITY AND NET LENDING	8,993	8,420	3,176	5,600	1,098	4,725
CARP LAND ACQUISITION AND CREDIT	0	0	2,927	0	0	0
OVERALL SURPLUS/DEFICIT	16,286	11,074	6,256	1,564	-49,981	-111,658
FINANCING	-16,286	-11,074	-6,256	-27,113	88,896	181,698
NET DOMESTIC FINANCING	-4,709	2,272	-348	-20,295	76,550	98,898
NET FOREIGN FINANCING	-11,577	-13,346	-5,908	-6,818	12,346	82,800
MEMO ITEMS:						
TOTAL REVENUE	19.4	18.4	18.0	18.7	16.6	15.2
TAX REVENUE	15.6	15.9	16.1	16.3	14.9	13.8
CURRENT EXPENDITURE	15.4	14.2	13.9	15.6	15.4	15.0
CAPITAL EXPENDITURE AND NET LENDING	3.0	3.7	3.3	3.9	3.0	3.8
OVERALL SURPLUS/DEFICIT	0.9	0.6	0.3	0.1	-1.8	-3.6

Source: Bureau of Treasury. DOF, IMF

TABLE 6: MONETARY SURVEY, 1994-99						
	1994	1995	1996	1997	1998	1999
TOTAL LIQUIDITY	630.8	786.4	913.9	1174.4	1219.3	1430.9
BROAD MONEY	607.6	761.4	881.4	1066.0	1144.5	1365.1
OTHER LIABILITIES	23.2	25.0	32.5	108.4	74.8	65.8
NET FOREIGN ASSETS	123.6	117.9	69.9	-76.9	27.6	19.2
O/W CENTRAL BANK	129.3	155.5	263.8	266.7	312.6	478.5
DEPOSIT MONEY BANKS a/	26.5	10.5	-130.5	-251.5	-192.8	-145.9
NET DOMESTIC ASSETS	690.3	907.3	1196.9	1684.7	1669.6	1760.7
NET DOMESTIC CREDIT	821.5	1084.0	1507.8	1932.1	1868.8	1920.2
PUBLIC SECTOR	299.8	335.3	377.2	477.3	459.7	528.8
PRIVATE SECTOR	521.7	748.7	1130.5	1454.7	1409.1	1391.3
FCDS, RESIDENTS	-158.8	-206.7	-317.6	-433.4	-477.9	-521.7
OTHER ITEMS (NET)	-131.3	-176.7	-310.8	-247.4	-199.4	-159.5
BROAD MONEY	26.5	25.3	15.8	20.9	7.4	19.3
NET DOMESTIC ASSETS	20.4	32.0	39.1	48.2	-3.8	5.5
PRIVATE SECTOR CREDIT	27.9	43.5	51.0	28.7	-3.1	-1.3
BROAD MONEY	35.0	38.9	38.6	42.3	41.0	43.5
NET FOREIGN ASSETS	7.1	6.0	3.1	-3.0	1.0	0.6
NET DOMESTIC ASSETS	29.2	46.3	52.4	66.8	59.8	56.1
PRIVATE SECTOR CREDIT	30.0	38.2	49.5	57.7	50.4	44.3

a/ revised to reclassify accounts of residents from foreign accounts to domestic.

Sources: BSP

TABLE 7: EXCHANGE RATES, INFLATION AND SELECTED INTEREST RATES, 1998-99

			1998				1999			
	1998	1999	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
EXCHANGE RATES:										
PERIOD AVERAGE (PESOS/$)	40.9	39.1	40.7	39.4	42.9	40.6	38.7	38.0	39.2	40.4
END OF PERIOD (PESOS/$)	39.1	40.3	37.1	42.1	43.8	39.1	38.9	37.9	40.2	40.6
REAL EFFECTIVE (DEC 1980=100)	72.0	70.3	67.5	72.5	68.5	69.6	75.2	77.4	74.8	70.7
INFLATION:										
CPI (1994=100)	136.9	146.0	131.6	135.7	138.7	141.5	144.8	144.8	146.5	147.9
YEAR CHANGE (%)	9.8	6.6	7.8	9.9	10.4	10.5	10.1	6.8	5.6	4.5
INTEREST RATES:										
MANILA REFERENCE RATES:										
ALL MATURITIES	15.4	10.4	17.4	14.1	14.1	13.6	12.3	9.9	8.6	9.2
BANK LENDING RATE (ALL MATURITIES)	18.4	11.8	20.1	16.0	14.6	14.8	14.0	11.5	10.1	12.9
TIME DEPOSITS:										
SHORT-TERM (< 1 YR)	12.7	9.1	13.9	11.6	11.1	11.0	10.6	8.9	7.2	8.3
LONG-TERM (> 1 YR)	13.2	12.8	11.2	12.4	13.8	12.2	16.6	10.5	11.2	13.0
91-DAY TREASURY BILL RATE	15.3	10.2	16.6	14.0	13.8	13.4	12.1	9.3	8.6	8.9
REVERSE RP RATE	14.3	9.8	16.1	14.5	13.9	13.5	12.2	9.5	9.1	8.8
REPURCHASE RATE	15.8	14.5	15.0	15.1	18.0	15.4	14.0	11.2	11.0	11.8
INTERBANK CALL LOAN RATE	13.8	10.8	13.3	13.3	15.9	13.9	12.3	9.5	8.8	8.7

Source: BSP, NSO

TABLE 8: BALANCE OF PAYMENTS, 1994-99

(MILLIONS OF U.S. DOLLARS)

	1994	1995	1996	1997	1998	1999
TRADE BALANCE	-7850	-8944	-11342	-11127	-28	4306
% OF GNP	-11.9	-11.7	-13.1	-13.0	0.0	5.4
EXPORTS (FOB)	13483	17447	20543	25228	29496	35032
IMPORTS (FOB)	21333	26391	31885	36355	29524	30726
SERVICES (NET)	3964	4765	6800	5696	1139	2401
RECEIPTS	10550	14374	19006	22835	13917	12854
O/W OFW REMITTANCES	3008	3868	4307	5742	4926	6795
PAYMENTS	6586	9609	12206	17139	12778	10453
O/W INTEREST	1579	2179	2206	2567	2257	2465
TRANSFERS (NET)	936	882	589	1080	435	481
CURRENT ACCOUNT BALANCE	-2950	-3297	-3953	-4351	1546	7188
% OF GNP	-4.5	-4.3	-4.6	-5.1	2.3	9.0
FOREIGN INVESTMENT (NET)	2492	2944	3621	843	2016	1589
DIRECT INVESMENT	1591	1459	1520	1249	1752	1077
PORTFOLIO INVESTMENT	901	1485	2101	-406	264	512
MLT BORROWING (NET)	1313	1276	2841	4824	2740	4716
INFLOWS	4369	3927	6540	7724	6024	9279
OUTFLOWS	3056	2651	3699	2900	3285	4563
SHORT-TERM CAPITAL (NET)	1002	-56	540	495	-1521	-3610
TRADING IN BONDS IN SECONDARY MARKET	..	..	-37	-676	-1082	102
CHANGE IN COMMERCIAL BANKS' NFA (- INDICATES INCREASE)	674	564	4214	1188	-1330	-1836
ERRORS AND OMISSIONS	-49	454	-3010	-5245	-761	-4219
OTHERS /A	254	81	-5	-360	96	280
CHANGES IN NET RESERVES /B (- INDICATES INCREASE)	-1802	-631	-4107	3363	-1359	-3839

Source: BSP.

a. Includes monetization of gold, revaluation adjustments and $469 million purchase of collateral in 1992.

b. Includes net credit of IMF.

TABLE 9: EXPORTS AND IMPORTS BY MAJOR COMMODITY GROUP, 1994-99

(MILLIONS OF U.S. DOLLARS)

	1994	1995	1996	1997	1998	1999
COCONUT PRODUCTS	639	989	730	835	831	466
SUGAR AND PRODUCTS	77	74	140	99	100	70
FRUITS AND VEGETABLES	429	458	486	459	447	455
OTHER AGRO-BASED PRODUCTS	530	575	506	506	466	476
FOREST PRODUCTS	26	38	42	45	24	21
MINERAL PRODUCTS	780	893	772	764	592	645
PETROLEUM PRODUCTS	132	171	273	237	129	216
MANUFACTURES	10,615	13,868	17,106	21,462	25,843	31,305
ELECT. & ELECT. EQUIPMENTS	4,984	7,413	9,988	13,028	17,137	21,165
GARMENTS	2,375	2,570	2,423	2,349	2,356	2,267
OTHERS	255	381	488	821	1,065	1,378
TOTAL EXPORTS	13,483	17,447	20,543	25,228	29,496	35,032
	1994	1995	1996	1997	1998	1999
CAPITAL GOODS	6,868	8,029	10,472	14,369	12,051	11,827
RAW MATERIALS & INTERMEDIATE GOODS	9,606	12,174	14,058	14,634	11,584	12,598
UNPROCESSED RAW MATERIALS	1,278	1,562	1,720	1,645	1,168	1,518
SEMI-PROCESSED RAW MATERIALS	8,328	10,612	12,338	12,985	10,416	11,080
MANUFACTURES	2,893	3,572	3,948	3,981	2,807	3,175
EMBROIDERIES	411	472	349	356	346	332
MATERIALS FOR ELECT. EQUIPT.	2,711	3,772	5,130	5,406	4,634	4,708
MINERAL FUELS AND LUBRICANTS	2,040	2,461	3,008	3,073	2,020	2,420
CONSUMER GOODS	2,109	2,784	3,331	3,091	2,623	2,642
DURABLE	1,124	1,459	1,653	1,516	901	1,093
NON-DURABLE	985	1,325	1,678	1,575	1,722	1,549
OTHERS	710	943	1,016	1,188	1,246	1,239
TOTAL IMPORTS	21,333	26,391	31,885	36,355	29,524	30,726

Source: BSP

TABLE 10: EXTERNAL DEBT, 1994-99 1/

(MILLIONS OF U.S.DOLLARS)

	1994	1995	1996	1997	1998	SEPT 1999
BY TYPE OF DEBT	38,723	39,367	41,875	45,433	47,817	51,172
MEDIUM AND LONG-TERM 2/	33,526	34,088	34,668	36,994	40,632	44,534
SHORT-TERM	5,197	5,279	7,207	8,439	7,185	6,638
TRADE	3,401	2,674	4,096	4,157	2,551	2,091
NON-TRADE	1,796	2,605	3,111	4,282	4,634	4,547
BY BORROWER	37,079	39,367	41,875	45,433	47,817	51,172
BANKING SYSTEM 3/	3,027	5,452	8,632	10,664	11,215	10,754
BANGKO SENTRAL	855	1,212	1,415	2,499	3,437	3,287
COMMERCIAL BANKS	2,172	4,240	7,217	8,165	7,778	7,467
PUBLIC AND PRIVATE	34,052	33,915	33,244	34,768	36,602	40,418
PUBLIC	27,193	26,664	24,132	22,271	24,506	27,369
PRIVATE	6,859	7,251	9,112	12,497	12,096	13,049
BY CREDITOR	37,079	39,367	41,875	45,433	47,817	51,172
COMM. BANKS	4,688	5,106	7,415	8,872	8,584	8,636
OTHER FINAN. INST.	841	1,239	958	1,304	1,088	1,267
SUPPLIERS' CREDITS	3,549	2,587	2,588	2,359	1,562	1,699
MULTILATERAL	8,216	9,617	8,634	8,638	10,058	10,115
o/w IBRD	3,985	4,995	4,676	4,146	4,298	3,961
ADB	2,558	2,643	3,117	3,091	3,490	3,509
IMF	1,139	814	405	889	1,562	1,855
BILATERAL	15,033	14,393	13,439	13,307	14,926	16,224
EXPORT AGENCIES	4,487	3,939	4,677	4,718	5,312	5,761
OTHERS	10,546	10,454	8,762	8,587	9,614	10,463
OTHERS	4,752	6,425	8,841	10,953	11,599	13,232
MEMO ITEMS:						
DEBT SERVICE 4/	4,188	5,032	5,026	5,596	5,095	6,247
DEBT SERVICE/ EXPORTS	17.4	15.8	12.7	11.6	11.7	13.1
TOTAL EXTERNAL DEBT / GNP (%)	58.9	51.7	48.6	53.1	70.0	..
TOTAL EXTERNAL DEBT / EXPORTS (%)	161.1	123.7	105.9	94.5	110.1	..

1/ Excludes liabilities of foreign banks in the Philippines to their headquarters, branches, and agencies, some external debt not registered with the central bank, and private capital lease arrangements

2/ Includes cumulative foreign exchange revaluation of US$-denominated multi-currency loans from the World Bank and Asian Development Bank of $433 and $384 million, respectively, for end-1996.

3/ Effective July 3, 1993, accounts of old CB were split between Bangko Sentral ng Pilipinas and Central Bank Board of Liquidators

4/ From 1990 onwards, figures represent principal and interest payments after rescheduling.

Source: BSP

TABLE 11: LOANS OUTSTANDING OF COMMERCIAL BANKS, 1994-99

	1994	1995	1996	1997	1998	1999
ECONOMIC ACTIVITY						
GROWTH RATES (% ON YEAR EARLIER)						
AGRICULTURE, FISHERIES, & FORESTRY	8.1	19.6	6.4	11.5	-11.0	-6.5
MINING AND QUARRYING	-48.1	55.9	9.4	70.3	23.5	-17.9
MANUFACTURING	32.5	33.9	42.5	17.3	-15.7	6.9
ELECTRICITY, GAS & WATER	25.7	24.7	90.6	34.0	12.5	12.7
CONSTRUCTION	32.3	37.4	74.2	19.6	6.6	-2.9
WHOLESALE & RETAIL TRADE	39.8	37.3	38.1	28.0	-8.9	-3.3
TRANSPORTATION, STORAGE & COMMUNICATION	53.8	72.0	53.3	47.7	-2.6	-7.7
FIN. INST., REAL ESTATE & BUSINESS SERVICES	37.4	24.8	97.2	42.6	-0.3	-1.3
COMMUNITY, SOCIAL & PERSONAL SERVICES	-10.4	61.8	57.6	11.4	13.6	2.5
TOTAL	25.4	35.8	51.9	26.5	-4.8	0.4
SHARE OF TOTAL LOANS (%)						
AGRICULTURE, FISHERIES, & FORESTRY	9.2	8.1	5.7	5.0	4.7	4.3
MINING AND QUARRYING	1.0	1.2	0.9	1.1	1.5	1.2
MANUFACTURING	34.9	34.4	32.3	29.9	26.5	28.2
ELECTRICITY, GAS & WATER	2.4	2.2	2.8	3.0	3.5	3.9
CONSTRUCTION	3.3	3.4	3.9	3.6	4.1	3.9
WHOLESALE & RETAIL TRADE	17.5	17.7	16.1	16.3	15.6	15.0
TRANSPORTATION, STORAGE & COMMUNICATION	4.8	6.1	6.1	7.1	7.3	6.7
FIN. INST., REAL ESTATE & BUSINESS SERVICES	18.3	16.8	21.8	24.6	25.8	25.3
COMMUNITY, SOCIAL & PERSONAL SERVICES	8.5	10.2	10.5	9.3	11.1	11.3
TOTAL	100.0	100.0	100.0	100.0	100.0	100.0

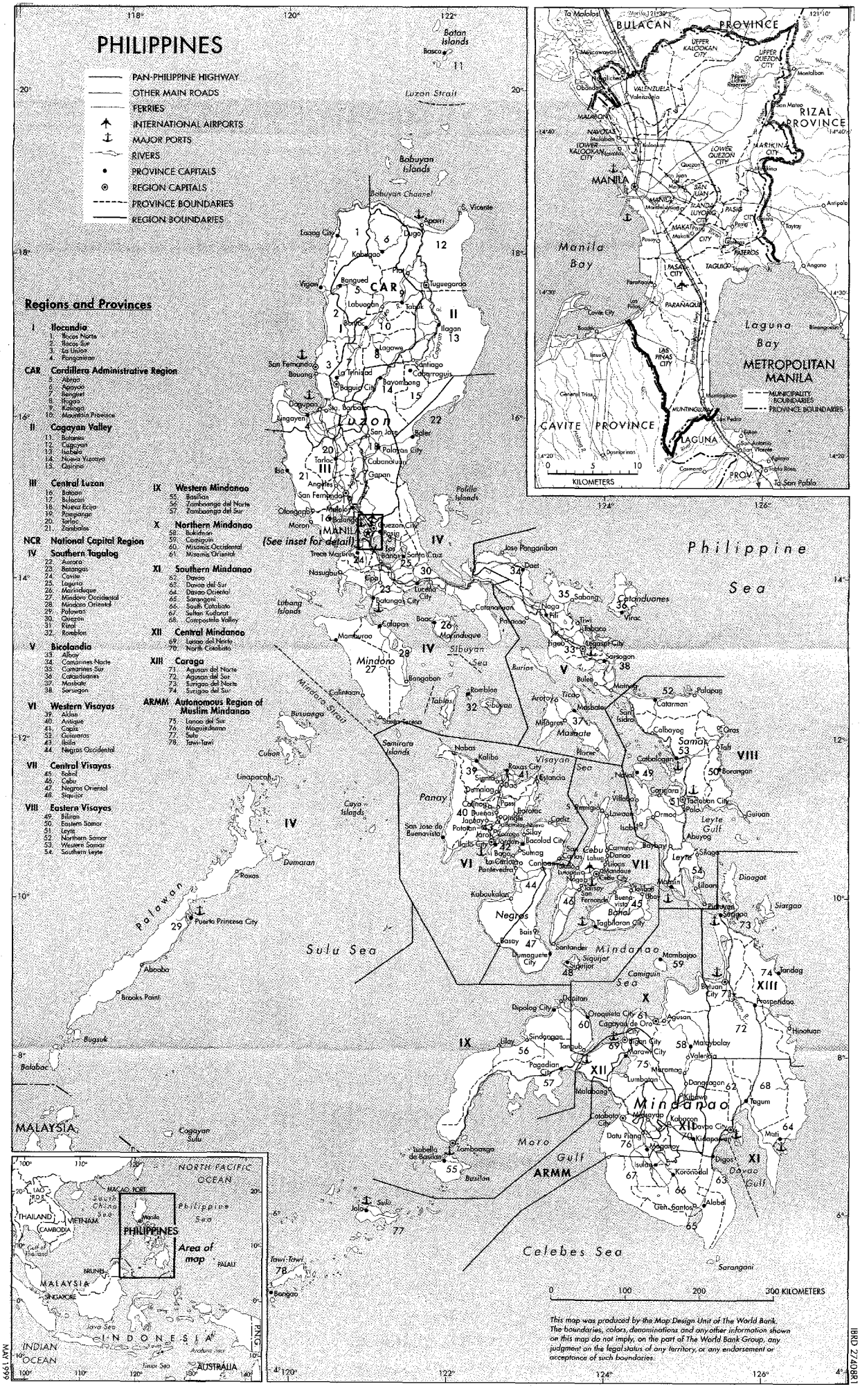
SOURCE: BSP

TABLE 12: LABOR MARKET DEVELOPMENTS, 1994-99

	1994	1995	1996	1997	1998	1999
POPULATION	68661	70267	71899	73527	75138	76792
TOTAL LABOR FORCE	27654	28380	29733	30354	31054	32081
UNEMPLOYED	2622	2704	2546	2640	3144	3102
UNEMPLOYMENT RATE (%)	9.5	9.5	8.6	8.7	10.1	9.7
TOTAL EMPLOYED	25033	25676	27187	27716	27912	28980
AGRICULTURE	11286	11147	11645	11314	10933	11624
INDUSTRY	3948	4139	4430	4631	4583	4533
MINING AND QUARRYING	111	100	113	130	120	100
MANUFACTURING	2538	2696	2696	2732	2716	2746
CONSTRUCTION	1187	1230	1504	1637	1605	1543
UTILITIES	112	114	118	132	142	144
SERVICES	9799	10392	11112	11771	12389	12823
TRANSPORT AND COMMUNICATIONS	1393	1487	1631	1742	1849	1942
TRADE	3520	3790	4013	4138	4312	4500
FINANCE	490	534	615	688	672	720
GOVERNMENT SERVICES	4386	4569	4850	5196	5555	5654
OTHER	10	12	4	6	6	8
TOTAL EMPLOYED	100	100	100	100	100	100
AGRICULTURE	45.1	43.4	42.8	40.8	39.2	40.1
INDUSTRY	15.8	16.1	16.3	16.7	16.4	15.6
MINING AND QUARRYING	0.4	0.4	0.4	0.5	0.4	0.3
MANUFACTURING	10.1	10.5	9.9	9.9	9.7	9.5
CONSTRUCTION	4.7	4.8	5.5	5.9	5.8	5.3
UTILITIES	0.4	0.4	0.4	0.5	0.5	0.5
SERVICES	39.1	40.5	40.9	42.5	44.4	44.2
TRANSPORT AND COMMUNICATIONS	5.6	5.8	6.0	6.3	6.6	6.7
TRADE	14.1	14.8	14.8	14.9	15.4	15.5
FINANCE	2.0	2.1	2.3	2.5	2.4	2.5
GOVERNMENT SERVICES	17.5	17.8	17.8	18.7	19.9	19.5
OTHER	0.0	0.0	0.0	0.0	0.0	0.0

Source: DOLE-BLES, Statistical Yearbook (for population figures)

MAP SECTION


PHILIPPINES
PAN-PHILIPPINE HIGHWAY
OTHER MAIN ROADS
FERRIES
INTERNATIONAL AIRPORTS
MAJOR PORTS
RIVERS
PROVINCE CAPITALS
REGION CAPITALS
PROVINCE BOUNDARIES
REGION BOUNDARIES
Regions and Provinces
I Ilocandia
1. Ilocos Norte
2. Ilocos Sur
3. La Union
4. Pangasinan
CAR Cordillera Administrative Region
5. Abra
6. Apayao
7. Benguet
8. Ifugao
9. Kalinga
10. Mountain Province
II Cagayan Valley
11. Batanes
12. Cagayan
13. Isabela
14. Nueva Vizcaya
15. Quirino
III Central Luzon
16. Bataan
17. Bulacan
18. Nueva Ecija
19. Pampanga
20. Tarlac
21. Zambales
NCR National Capital Region
IV Southern Tagalog
22. Aurora
23. Batangas
24. Cavite
25. Laguna
26. Marinduque
27. Mindoro Occidental
28. Mindoro Oriental
29. Palawan
30. Quezon
31. Rizal
32. Romblon
V Bicolandia
33. Albay
34. Camarines Norte
35. Camarines Sur
36. Catanduanes
37. Masbate
38. Sorsogon
VI Western Visayas
39. Aklan
40. Antique
41. Capiz
42. Guimaras
43. Iloilo
44. Negros Occidental
VII Central Visayas
45. Bohol
46. Cebu
47. Negros Oriental
48. Siquijor
VIII Eastern Visayas
49. Biliran
50. Eastern Samar
51. Leyte
52. Northern Samar
53. Western Samar
54. Southern Leyte
IX Western Mindanao
55. Basilan
56. Zamboanga del Norte
57. Zamboanga del Sur
X Northern Mindanao
58. Bukidnon
59. Camiguin
60. Misamis Occidental
61. Misamis Oriental
XI Southern Mindanao
62. Davao
63. Davao del Sur
64. Davao Oriental
65. Sarangani
66. South Cotabato
67. Sultan Kudarat
68. Compostela Valley
XII Central Mindanao
69. Lanao del Norte
70. North Cotabato
XIII Caraga
71. Agusan del Norte
72. Agusan del Sur
73. Surigao del Norte
74. Surigao del Sur
ARMM Autonomous Region of Muslim Mindanao
75. Lanao del Sur
76. Maguindanao
77. Sulu
78. Tawi-Tawi
(See inset for detail)
Luzon
Mindoro
Palawan
Mindanao
Panay
Negros
Samar
Leyte
Bohol
Cebu
Basilan
Sulu
Tawi-Tawi
Philippine Sea
Sulu Sea
Celebes Sea
Moro Gulf
Leyte Gulf
Davao Gulf
Visayan Sea
Sibuyan Sea
Camiguin Sea
Luzon Strait
Mindoro Strait
Manila Bay
Laguna Bay
BULACAN PROVINCE
RIZAL PROVINCE
CAVITE PROVINCE
LAGUNA PROV.
METROPOLITAN MANILA
MUNICIPALITY BOUNDARIES
PROVINCE BOUNDARIES
KILOMETERS
NORTH PACIFIC OCEAN
PHILIPPINES
Area of map
MALAYSIA
INDONESIA
INDIAN OCEAN
AUSTRALIA
0 100 200 300 KILOMETERS
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