Regulations, Institutions, and Economic Performance

The Political Economy of the Philippines' Telecommunications Sector

Hadi Salehi Esfahani

The private delivery of infrastructure can fail in the absence of adequate background institutions, which may need to be fostered before a credible regulatory system can be put in place.
Summary findings

Esfahani addresses the puzzle of sluggish investment in the Philippines' dominant telecommunications firm, PLDT. This case allows a study of the underlying causes of success or failure in a privately owned infrastructure sector in a developing country.

Since its inception, PLDT has been privately owned and has had direct access to international capital markets. But its services have been deficient, in quality and quantity, since the early 1960s.

Using a transaction costs approach, Esfahani hypothesizes that contracting problems between various economic players are important determinants of observed outcomes. Poor services are attributed to factors that impede implementation of performance-improving implicit or explicit contracts, including regulatory rules and regulations.

After reviewing PLDT's responses to events in the last six decades, Esfahani demonstrates that the problem can be traced to lack of commitment to regulatory policies beyond the term of each administration — because a relatively weak legislature and judiciary are dominated by the executive branch. This system of governance is linked to the nature of Philippine society: a small elite engaged in competitive politics among themselves tries to bar the rest of the population from active participation, without actually denying their citizenship. (This social structure is beginning to change.)

The president of the country has great leeway in setting and implementing regulations, so the elite group associated with the president can unilaterally modify telecommunications policy in a way that serves its interests. Those in control of PLDT find investing in the company's highly capital-intensive facilities risky if they are not connected to the president's circle. As a result, the government has an incentive to redistribute quasi-rents through regulatory mechanisms. This imposes a strong "political business cycle" on PLDT's growth pattern. Investment rises only in the early years of "friendly" administrations and remains low at all other times. Esfahani establishes this relationship by empirical analysis.

Despite the failure of cyclical investment, no attempt has been made to reform the regulatory system because most solutions require an institutional commitment to a set of rules and procedures that are either infeasible or contrary to the interests of the elite. Certain reforms are becoming increasingly feasible, however, as a new middle class develops and elite alliances shift.

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Policymakers the world over have come to see privatization as an important remedy for the ills of economies long dominated by state-owned enterprises. Private sector involvement is expected to bring increased resources and efficiency to ailing public enterprises. Yet it is still an open question whether private enterprises can perform well in situations where public ones have failed. Indeed, many private enterprises in developing countries have track records no better than those of typical public enterprises in similar situations. What are the necessary conditions for the success of the private sector in a developing economy? Certainly, it takes more than a simple transfer of ownership for a firm or industry to prosper.

What does the experience of the telecommunications sector in the Philippines tell us about this question? The Philippines case is particularly interesting because it provides an opportunity to study the underlying causes of success and failure in an infrastructure sector in a developing country in which most firms have been privately owned since the industry’s infancy. The main operators in the sector have had direct access to international capital markets and have managed to raise large amounts of debt relative to their equity, yet the sector has not performed very well: telephone density is low (about 1.7 telephone sets and 1.1 mainlines per 100 people), waiting lists for basic services are long, and service quality is roundly attacked (Gavino 1992). Even taking the country’s level of development into account, the sector seems to have had no edge over its counterparts in other countries, including those under public ownership or with more restricted access to foreign capital (figure 4.1).

These observations compel us to ask what factors impeded growth of the sector. Why wasn’t there any effective regulatory reform to create stronger investment incentives for the firms involved in the sector? Why did the sector remain in private hands despite its poor performance? The approach adopted in this paper to answer these questions presumes that the nature of contracting problems between various players in the economy is an important determinant of observed outcomes. The analysis that follows traces the sector’s poor performance to the weakness of commitment mechanisms needed to make contracts credible. The inadequacy of commitment mechanisms springs from a system of governance in which the legislature and judiciary are relatively weak and dominated by a strong executive. This system of governance can in turn be related to a "fundamental" characteristic of the Philippine society: the dominance of a small elite who engage in competitive politics among themselves, but try to bar the rest of the population from active participation without formally taking away their citizenship.

Certainly, the above characteristic, shaped by the country’s past, is not immutable. Therefore, implications of the analysis that follows for future policy needs to take account of changes in the distribution of political power in response to external factors and internal dynamics. Indeed, the
economic and political developments in the country over the past four decades seem to have brought about a wider distribution of power in recent years. This change has the potential to mitigate some of the main shortcomings of the telecommunications policy.

To make the task of the study manageable, the discussion focuses on the history of the sector's dominant firm, the Philippine Long Distance Telephone Company (PLDT), which owns about 90 percent of the working phone lines and has a virtual monopoly over domestic and international long-distance telephone circuits in the country. A government-owned company, TELOF, operates about 2 percent of the country’s telephones, and more than sixty small private and local-government-owned operators control the remaining 8 percent. There are also several other firms engaged in providing telegraph, telex, paging, cellular telephony, and similar services.¹

Political structure and commitment capability

Identifying the origins of weak regulatory commitment capability in the Philippines is critical to an understanding of the dynamics of telecommunications policy and performance and to the design of institutions that can contribute constructively to rapid development.

The making of basic Philippine institutions

The Philippines became a U.S. colony in the closing years of the nineteenth century, soon after four centuries of Spanish rule had come to an end. An important legacy of Spanish domination was an open economy based on exports of primary products by large farms, a pattern that continued under U.S. rule. Over time, a strong patronage system arose headed by an agrarian elite with close ties to U.S. politicians and business leaders. The group's small size, common interests, and pervasive kinship network enabled it to overcome internal political and economic rivalries and promote the group's interests over those of the rest of the population. U.S. policy interests in the region worked to foster the economic and political dominance of this group as well, since the U.S. government was interested in establishing a political system in the Philippines that would remain stable and friendly to the United States. Through a process of negotiated independence, this elite group gradually acquired

¹Data on the performance of PLDT are based largely on information provided by the company and in its annual reports. Additional information has been obtained from annual reports of the National Telecommunications Commission and from the 20K forms the company has filed with the U.S. Securities and Exchange Commission. The macroeconomic data are based on the International Monetary Fund's International Financial Statistics.
the knowledge, skills, and institutions necessary to run the government and, following independence in 1946, that group took control. The country's institutions reflected the dualism of Philippine society, the objectives of the U.S. government, and the elite's desire to maintain its privileges. Several features were especially prominent.

- **Competitive politics.** To ensure stability and effectiveness, the institutions of government had to have legitimacy among the population at large and to minimize damaging infighting among the elite. A U.S.-style constitution inaugurated in 1935 called for separation of powers and competition for control of the executive and legislative branches through elections. The executive, headed by a directly elected president, was to lead the country. Presidents were limited to two 4 years terms. A bicameral legislature, consisting of a 110-member House of Representatives elected from the provinces and a 24-member Senate elected at large, was to provide an arena for political brokerage. The judiciary, led by an eleven-member Supreme Court, was to serve as referee.

- **Qualifications control and plurality rule.** To restrict political competition to members of the elite, a nine-member Electoral Tribunal—three members from the Supreme Court and three members each from the two parties with the largest number of votes in the Congress—was established to rule on the qualifications of members of Congress. This arrangement effectively undermined any third party stirrings and kept political outsiders at bay. The influence of those outside the political elite was further weakened by the plurality rule for elections: the candidate with the highest share of the popular vote won the seat. The plurality rule reduced the bargaining power of the non-elite and contributed to the weakening of third parties and the entrenchment of a two-party system.

- **Dominant executive.** Power was concentrated in the hands of the president, and the functions of the legislature and the judiciary were circumscribed. It would be risky to give Congress too strong a hand in setting policies and allocating resources because its members were in close contact with the voters, which could give political outsiders opportunity to exploit rivalries among the candidates and influence them once elected. The most effective powers vested in Congress were negative powers (restricting budget allocations, limiting civil service salaries, blocking entry of new firms). Similarly, a strong and independent judiciary was viewed unfavorably because it could be used by the non-elite to restrict the actions of the elite. The presidency, on the other hand, as a single, nationally elected office, could hardly be influenced by the non-elite.

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2When six members of the communist-led Democratic Alliance were elected to the Congress in 1946, the Electoral Tribunal chose to disqualify them (Wurfel 1988, 101).

3Shugart and Carey (1992, 175, 187) attribute the strength of the executive in the Philippines to the importance of local politics and the desire of the elite to bring benefits to their regions while "freeing themselves of direct involvement with broader national policy matters." However, facts such
The power of the presidency was embodied in a number of constitutional and legal provisions. The president could issue decrees with the force of legislation and had line-item veto power over legislation (overrule required a two-thirds majority of both houses), and could suspend elected officials for cause (Wurfel 1988, 76, 77, and 90). In times of national emergency Congress could authorize the president to rule by decree for a limited period. The president could also declare martial law without the consent of the Congress. While Congress could not increase budget items proposed by the president, the president could treat the budget approved by the Congress as partially fungible. Thus members of Congress needing to keep their patronage machines well-oiled were at the mercy of the president.

- Weak judiciary. The judiciary's weakness was manifest mainly in the control of its resources by Congress and the president. The president, with the approval of Congress, appointed judges at all levels, while Congress set judicial budgets and salaries. Although the Supreme Court gained respect for its relative independence, political appointees at the lower courts were often entangled in patronage politics (Wurfel 1988, 88-90). This system allowed the elite to control the judicial process while the non-elite suffered the effects of the inordinate delays and costs of pursuing justice. The system also gave the president a relatively free hand in issuing executive orders and taking arbitrary action without being challenged. The Supreme Court was further restrained by a number of constitutional provisions, particularly the requirement of a two-thirds majority vote for declaring a law or treaty unconstitutional.

- Two-party system with weak, indistinguishable parties. Competition for control of the presidency was intense, since the presidency brought with it the power to channel enormous resources. Elite groups outside the ruling coalition were always looking for ways to replace those

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as the highly centralized nature of the Philippine government and the president's considerable control over local government do not support this view.

4 Indices developed by Shugart and Carey (1992) to gauge the relative legislative and nonlegislative powers of the popularly elected presidents around the world place the Philippines in the group of countries with the most powerful presidencies (figure 8.1, 156).

5 The executive also exerted some control over cases being brought before the courts by having state prosecutors screen lawsuits before they are seen by a judge (Bacungan and Tadiar 1988, 178).

6 Several clearly excessive cases, however, were brought before the Supreme Court and struck down, among them President Quirino's attempt to ram the budget through by executive order in 1949 and President Marcos's creation of thirty municipalities by decree in 1968 (Wurfel 1988, 77).
inside. Given the electoral rules, their best chance was to coalesce as an opposition party and support those in the coalition with the greatest political talents. All involved realized that if their coalition won, some members would gain more than others, eventually forcing some of them to switch sides, resulting in a frequent shifting of political alliances. These incentives gave rise to a two-party system, in which parties had no serious role in policymaking and were indistinguishable by platform or program (Tancangco 1988). Belonging to a party was essentially a means of declaring allegiance to the patronage system of a particular leader and benefiting from the distribution of the spoils. Parties alternated in power every 4 to 8 years. The succession of generations and the term limitation on the presidency created the potential for shifting fortunes among elite groups.

- **Weak constitutional restrictions on rent extraction.** The constitution restricted the types of rent extraction allowable by those in office, guaranteeing that at least some of the rents would remain for the elite who were out of power at the time. For example, transfer of ownership of private enterprises to government officials was prohibited. As a result, rent extraction required changing regulations and taxes, which allowed some of the surplus be left for those in control of the enterprises. However, the weakness of the judiciary meant that detailed restrictions on rent extraction could not be enforced. Thus it made little sense to engage in effort-intensive consensus building to establish strong constitutional restrictions that were not enforceable and, furthermore, could undermine the government’s ability to protect the interests of the elite. The elite avoided formal restrictions on rent extraction since any explicit redistribution rule acceptable to them had to be discriminatory toward the non-elite, thereby, jeopardizing the system’s legitimacy among the non-elite. Instead, a complex set of informal constraints—incorporated in institutions such as kinship, religion, and patron-client networks—developed that helped regulate group relations and limit opportunistic activities within and between various groups (Wurfel 1988, chap. 2).

- **Free trade and economic parity rights for U.S. citizens.** As part of the conditions for independence and future assistance, the U.S. government imposed a number of long-term restrictions on Philippine government policies that were intended to maintain its influence in the country (Wurfel 1988, 14). The Philippines agreed to accept a U.S. military presence in the country and to maintain a

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7The size of the group in power could not be very large, since once a support group got beyond a certain size, the marginal political gain from adding new members to the ruling coalition diminished while the marginal cost rose. For a discussion of this "minimum winning coalition" principle, see Riker (1967).

8The 1935 constitution prohibits the heads of government departments and their assistants from intervening, directly or indirectly, in the control or management of private enterprises in any way related to or regulated by the government. The 1973 and 1986 constitutions have similar paragraphs.
fixed exchange rate and free trade with the United States (free trade was to be phased out gradually after 1954). The Philippine Congress also amended the 1935 constitution to grant U.S. businesses 28-year parity with Filipinos in exploiting natural resources and operating public utilities. To preserve U.S. interests in the country, the United States offered substantial foreign aid, credit, trade, and investment opportunities for the elite. This level of U.S. involvement helped make Philippine international commitments credible, providing U.S. investors in the Philippines with a sense of relative safety. As a result, the flow of foreign investment and loans to the country was greatly facilitated.

The dynamics of the system

These basic institutional features changed somewhat over time, and with them the commitment capabilities of the Philippine government. For the telecommunications sector these changes induced a pattern of stagnation and growth (discussed later in this chapter).

As the economic parity and free trade agreements with the United States expired, the Philippines expanded its economic ties to Europe and Japan, diminishing the prominence of relations with the United States. These trends meant fewer guarantees for U.S. direct investors in the Philippines. Indeed, as time passed, U.S. businesses found it increasingly difficult to defend their interests through the legal system. However, this did not jeopardize foreign lending because loans could be more effectively backed by threat of various sanctions. As a consequence, many U.S. businesses divested their assets in the Philippines and concentrated on lending, trade, and some joint ventures.

During the 1950s the Philippines introduced import and foreign exchange restrictions in response to the downward trend in the relative price of primary products in international markets, large government deficits driven by the reelection concerns of incumbent presidents, and increased demand for foreign assets under a fixed exchange rate regime that resulted in foreign exchange

9 The 1935 constitution had restricted these activities to Filipino-controlled enterprises. In other areas, only joint ventures were permitted with at least 60 percent Filipino equity.

10 The leverages also allowed U.S. politicians to mediate among the Filipino elite and thus contribute to the long-term stability of the system.

11 An important example of this difficulty concerned interpretations of how U.S. investments made under the Parity Amendment should be handled after 1974. U.S. corporations had assumed that they could maintain their ownership over the land they had purchased before 1974, but the Supreme Court disagreed, obligating them to sell their lands by the end of 1974.
shortages.12 These moves ushered in a period of import-substitution-based industrialization and the emergence of a large industrial urban working class and a burgeoning middle class. These developments introduced new elements into the Philippine politics that reduced the cohesiveness of the old elite and raised serious challenges to their continued rule (Wurfel 1988, 20-22, 112-13). As education and employment opportunities improved, the non-elite populations gained greater independence. Patron-client relationships started to break down, and it became increasingly costly to satisfy clients. Voters outside the political machines gained importance, and the influence of the non-elite on policymaking increased. Given the structure of the Philippine government, these dynamics intensified policy uncertainty.

As new players entered the political game, conflicts arose within the existing institutions, which had been designed specifically to prevent a shift in the balance of power away from the elite. Demands for a constitutional overhaul began to build. In 1970, largely under political pressure from students, Congress voted to form a constitutional convention.13 By then, even the elite had grown dissatisfied with the rules of the game (Fernando 1974) and hoped that a new constitution would correct the problems of "excessive centralization of power in the presidency and the penetration of partisan politics into every type of government decision" (Wurfel 1988, 108).

Meanwhile, President Marcos was looking for ways to prolong his rule beyond the end of his second term in office in 1973. The increasing political turmoil, especially the formation of the constitutional convention, provided him with the opportunity he was waiting for. He lobbied for support at the convention and, using the pretext of political agitation, declared martial law in September 1972. With the strong support of the military and members of the elite who felt threatened by the rise of the new political forces Marcos was able to suppress the opposition. His position was further strengthened by the support of the U.S. government and its allies, which saw in the political trends of the early 1970s a threat to their own long-term interests (Wurfel 1988, 191, 330). Congress was prevented from convening, elections were suspended, and opposition political leaders were coopted, imprisoned, or exiled. Labor and peasant organizations were suppressed, and strikes were outlawed.

To help legitimize Marcos's continued rule, he kept the constitutional convention open, despite the move by its members to suspend deliberations. More than a dozen delegates were arrested,

12 In fact, with the consent of the U.S. government, a set of expanding import and foreign exchange controls was imposed on the economy beginning in 1950 (Wurfel 1988, 14-15).

13 The controversial re-election of President Marcos in 1969 also seems to have played a role in this decision. (Abueva, 1972).
and a similar number went underground or fled the country. Marcos then prevailed on the convention to pass a set of transitional provisions for the new constitution being drafted, confirming the legitimacy of all presidential orders and decrees and giving the president extraordinary powers. The new constitution, ratified in a plebiscite of dubious legitimacy, effectively abolished the old Congress and took away all forums from the opposition.

The judiciary was neutralized as well. Though the Supreme Court proclaimed that the new constitution had not been properly ratified, it dismissed the challenge to the constitutionality of martial law, apparently apprehensive about its own survival. The two swing votes in the court feared that Marcos would claim that he could replace the members of the court following ratification of the new constitution since one of his transitional powers was the right to remove any justice by appointing a successor. The Supreme Court ruling conferred some legitimacy on the martial law regime, and Marcos moved boldly and virtually unchecked, serving as both legislature and executive. He prevented the Supreme Court from ruling on the constitutionality of any law by keeping a number of court seats vacant. All lesser judges had been required to submit signed resignations, which were kept on file, allowing Marcos to free himself of the constraints of the judiciary while maintaining the appearance of constitutionality (Wurfel 1988, 133).

Martial law completely changed the institutional structure of the Philippines. A small group of the elite, Marcos's cronies, could enjoy the spoils of absolute power for an unspecified period. However, opposition to their rule was growing from elite and non-elite quarters alike. In search of a stable outcome, in addition to use of force, they attempted to introduce a new system of governance in which the legislature served as a new arena for political brokerage, while Marcos maintained the powers of the president and prime minister. Meanwhile, in 1978 rumors of Marcos's illness spread among the elite and signalled the possibility of an abrupt end to the existing regime (Wurfel, 1988, p.234). This created a succession crisis. Wary of serious changes in their fortunes, Marcos's cronies began to act in such a short-sighted, blatantly venal manners that Marcos's regime collapsed long before his death.

A successful coalition of opposition political parties and personalities took control of the government in 1986. Given the relatively small size of Marcos's crony group, the opposition coalition

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14 The two justices wrote "if a new government gains authority and dominance through force, it can be effectively challenged only by a stronger force; no judicial dictum can prevail against it" (quoted in Wurfel 1988, 117).

15 For detailed and well documented accounts of how the crony system worked and its extent of activity, see among others, Manapat (1991) and Hawes (1987).
was quite diversified and span a very wide range of interests, including those of the now larger and more influential middle class. As a result the new government was initially rather unstable, and the ruling coalition went through a number of realignments. The institutional structure that emerged from this process resembles that of the pre-martial law system, but with fewer restrictions on the participation of non-elite groups and more safeguards against the abuse of power by the executive.\footnote{For example, the composition of Electoral Tribunals has been changed to proportional representation of parties in Congress. Also, in the case of martial law, the president is required to convene and notify Congress of the declaration.}

While politics is now more competitive and open, the old elite has managed to maintain a large part of its control of the system. The Presidential Commission on Good Government (PCGG) created in the early days of the new Aquino administration to dismantle the Marcos crony system, hit major obstacles after a few months as its findings began to implicate many members of the elite still in positions of power (Manapat 1991; Clad 1987a,b). Many of the investigations were closed, and the commission failed to recover any significant part of the assets transferred abroad by Marcos and his cronies.

*Investment and ownership in a predatory state*

Under the institutional structure of the Philippines the group in power faced a high probability of ending up on the losing side some time in the future, so its members had to devise mechanisms for protecting their assets when they were out of office. One way was to shift away from sectors with nonsalvageable assets such as public utilities and to place some assets outside the country. Thus as the probability of turnover in the executive branch increased, real investment tended to fall. Another protection mechanism was to finance investment with debt rather than equity, which helped shift the risk and increased the number of people concerned about expropriation, while involving little loss of control by the original owners. Foreign debt was particularly desirable for this purpose because foreign lenders had strong leverage over the elite, and default by any borrower could hurt those controlling the government.

The relatively strong degree of enforceability of international borrowing contracts had other far-reaching effects as well. The elite group in power could borrow against the future income of the country and then invest the proceeds abroad (Boyce 1992). Essentially, once in power, members of the elite tried to cash in as much of the country's long-term surplus as possible and then to allocate their portfolios inside and outside the country, according to expected returns. The more the group could cash in, the more of its assets it tried to shift out of the country, fearing retaliation from future
ruling groups who would be left with less to extract. However, to be able to borrow and keep assets abroad, Philippine enterprises had to make some investments at home. Thus real domestic investment rose along with foreign borrowing, but not dollar for dollar.

Direct foreign investment was not as secure as foreign lending because it was more vulnerable to regulations and taxation. As a result, as the economic parity agreement with the United States neared its end, foreign investment declined. Foreign investors sought to share control of their subsidiaries with the Philippine elite and limited their involvement to simple lending and contracting whenever the transfer of intangible assets was not a major concern.

Though there were no prohibitions against state ownership, economic assets remained largely private. Public ownership of an enterprise meant the total loss of the associated surplus once the ruling group was out of power. Turning an enterprise into the group members' private property, in contrast, could help maintain the group's control over the assets and at least part of the returns. Thus many foreign-owned enterprises were "Philippinized" but not nationalized, as similar enterprises in other developing countries had been. Philippine leaders could put pressure on foreign investors to sell their assets to members of the ruling coalition rather than to the government. Also, on those occasions when the enterprises of rival groups could be expropriated or when failing domestic firms fell into government hands, the ruling coalition arranged for its members to purchase the enterprises and secure them as their private property.

Since the non-elite had no access to executive power, their investments could never be safe. As a result, ownership was highly concentrated in the hands of the elite, with most enterprises owned by families or cliques of friends. Corporate forms of ownership with widespread subscription were rare. When an elite group was in control of a corporation, its members could siphon off profits to their private accounts and leave other shareholders with little return. As a result the non-elite rarely invested their savings in corporate stocks, and the elite who invested committed very little money to corporations they did not control. Consequently, the Philippine stock market remained undeveloped.

Under the martial law regime, incentives to invest greatly diminished for all but the Marcos cronies, who were able to acquire the enterprises of opposition members and to create investment incentives for themselves (Hawes 1986; and Manapat 1991). Thus lack of commitment did not reduce investment in the early years of martial law. However, investment did not rise significantly either, because the cronies understood that their rule would end someday and that when it did, their losses could be substantial. Foreign borrowing and capital flight became more important, especially after 1978 (figure 4.2). Investment finally came to a halt after 1983, when the Marcos regime entered a crisis stage, and foreign lending ceased following the assassination of the opposition leader, former Senator Benigno Aquino.
Politics, regulation, and implications for telecommunications

To maintain control of political and economic rents, the Philippine elite have helped shape a political structure that has stunted the development of efficient institutions for market governance and resource mobilization. This institutional failure is clearly reflected in the main characteristics of the Philippine regulatory system. Though the initial form of the country's regulatory institutions was borrowed from the United States, some key aspects were modified to adapt those institutions to the Philippine's political structure.

**Characteristics of the regulatory structure**

- **Lack of independence.** Regulatory agencies are quasi-judicial bodies whose decisions can be appealed to the Supreme Court. Agency heads are appointed by the president, subject to approval by Congress, and have no fixed tenure. The president can dismiss regulators unilaterally.

- **Congressional control of the budget.** Congress maintains influence over regulatory agencies by controlling their budgets, including salaries and other expenses.

- **Inadequate resources.** Regulatory agencies often lack the equipment, experienced staff, and other resources needed to perform their tasks. Their budgets are too restrictive to allow them to effectively monitor or evaluate conditions in the sector for which they are responsible.

- **Ambiguity of regulations.** The mandate of regulatory agencies is typically so general that there is wide scope for discretion. Congress has not tried to achieve sectoral goals by providing detailed instructions about the content of regulatory rules. For example, there is no fixed rule for setting utility prices, though Congress could have stipulated specific procedures or even specific price formulas.

- **Bias toward restricted entry.** Public utility regulators control entry by issuing or canceling investment permits, known as Certificates of Public Convenience and Necessity, in response to applications from franchised companies, but they have no control over franchises. Franchises must be obtained from local governments or from Congress if the coverage is nationwide. Thus regulators' control of entry is circumscribed, and the system is biased toward entry restriction.

These characteristics make efficient regulation virtually impossible. Lack of resources prevents regulatory agencies from collecting the data and developing the expertise necessary to design and implement appropriate policies, while the discretionary power of the president makes regulations uncertain and limits their credibility. The reasons for such institutional limitations are relatively easy to identify. Specific rules, such as price formulas, that can create investment incentives are difficult to
guarantee in a system in which the executive has so much discretionary power. The president can use a variety of means, often difficult to predict, to circumvent a specific rule. If the judiciary were strong enough to establish and defend a particular interpretation of the rule, the government could be forced to abide by it. However, when judicial power is constrained, the judiciary may yield to executive demands. That makes it a futile exercise to try to muster the political support necessary to get a specific rule established in law or in the constitution.

A strong, independent regulatory agency could bring stability to the regulatory policy, but it would be a threat to the interests of the elite. Professionals running such an agency could use their control to redistribute the assets of businesses owned by the elite. The interests of those in power are better protected when regulatory agencies have no independence and few resources. Even the elite outside the coalition in power may favor weak regulatory agencies, which keep the president from being too effective in taxing the assets of rivals. Congressional veto power over entry also seems to be a means of reining in the president’s power to share the profits of opposition businesses. In this sense, congressional control of franchises and the budgets of regulatory agencies is a means of maintaining some harmony in the balance of power within the elite.

The problem of regulatory institutions in the Philippines is similar to that of the judiciary. When these institutions are strong, they may be used by the non-elite to achieve power and rent sharing. When they are weak, corruption and inefficiency thrive, but the institutions remain under the control of the elite.

*Implications for the telecommunications sector*

The historical dominance of a small and competitive elite has become an impediment to credible regulatory policy in the Philippines. The weakness of commitment mechanisms is an especially severe impediment to public utilities because nonsalvageable capital constitutes such a large share of their costs. Some policy credibility may nevertheless exist, even in the absence of other commitment mechanisms, if opportunistic policy changes by the government would bring private investment to a standstill that imposes large costs on the government. In a country where existing investment in a sector is grossly inadequate and there is a large pool of new technology that could be imported, private operators can guarantee a minimum return on their investments because of their ability to "punish" the government in case of adverse regulations. However, this implicit contract mechanism works effectively only in a stable environment. When the benefits of implicit expropriation fluctuate as a result of changes in the country’s political or economic conditions, in
some situations the government may find it worthwhile to engage in rent extraction and to jeopardize investment. Thus strong commitment is necessary to reduce the risk of such possibilities.

The analysis of the Philippine political economy developed in the previous sections has numerous implications for the country's telecommunications sector:

Implication 1. Telecommunications enterprises are primarily domestically owned. Foreign-ownership was possible only under colonial rule or in the early years of independence, under the Parity Amendment. When foreign-owned firms are Philippinized, they are sold to members of the ruling coalition rather than being nationalized.

Implication 2. Telecommunications enterprises are primarily privately owned, with ownership typically concentrated in the hands of the elite.

Implication 3. Telecommunications enterprises with more widespread corporate ownership are controlled by a minority elite with friendly ties to the administration. The enterprises generate large surpluses, but yield low rates of return to stockholders. The difference is captured by the elite through overreporting of costs and underreporting of revenues.

Implication 4. Public telecommunications firms tend to be privatized before the end of the administration under which they are established.

Implication 5. Private investment in telecommunications firms is likely to be high under colonial rule, in the early years of independence under the parity amendment, and in the early years of a friendly administration. Investment declines toward the end of friendly administrations and remains low under unfriendly administrations. Reduced investment is accompanied by capital flight.

17 The model of the Philippine political economy developed above has a myriad of implications. The dozen or so listed below are derived and worded with an eye on the empirical observations in the following section. Explicit presentation of these implications in this section is essentially a means of organizing the assessment of the model against the historical experience of PLDT.
Implication 6. Telecommunications firms tend to finance their investments through debt, especially foreign debt, rather than equity. They maintain high debt-equity ratios.

Implication 7. Real investment by domestic telecommunications operators rises with their foreign borrowing, but less than dollar for dollar, with capital flight accounting for the difference. Their foreign borrowing depends largely on supply rather than demand factors.

Implication 8. Price, tax, and regulatory conflicts between telecommunications enterprises and the government develop mostly during unfriendly administrations or during periods of increased political competition, when the non-elite become influential.

Implication 9. Price adjustments under administrations friendly to the telecommunications firms are favorable to the industry. Under a friendly authoritarian administration, prices approach monopoly levels.\(^8\)

Implication 10. Given the bias of the regulatory system toward restricted entry, established telecommunications firms are likely to succeed in fending off competition whether the administration is friendly or not. In addition, under unfriendly administrations or intense political competition, excess demand will grow since the government is unable to bring in new firms. Entry may be blocked even in undeveloped regions of the country because established firms may want to reserve the markets for later development when more friendly administrations take office.

Implication 11. Private investment in international circuits is not much influenced by domestic commitment capabilities.

\(^8\)Monopoly pricing may not be optimal if the ruling coalition is at all concerned about support from consumers, some of whom may be its own clients. For a theoretical exposition of this point see Peltzman (1976).
The international network is far more difficult to expropriate through regulatory action than the domestic network. Regulators have no control over a company's agreements with foreign operators on the settlement price of international calls. If regulators try to lower international long-distance rates for calls originating in the home country, the company can claim that it needs to collect more to pay high settlement costs. It can also limit the number of outgoing calls, forcing domestic customers to have their calls originate outside the country. Revenues will then be collected by the foreign counterparts and will not depend on the rates set domestically. Thus, contracting problems do not much affect telecommunications firms in their international circuit investments, and these investments continue largely independent of the domestic regulatory situation.

**Historical perspective on commitment capabilities**

The history of the telecommunications sector in the Philippines provides strong evidence that the commitment capabilities of government have had a significant impact on investment in the sector. The focus is on the experience of Philippine Long Distance Telephone and a number of other closely related enterprises.

*Policy credibility during colonial administration*

The experience of PLDT under colonial rule supports Implications 1 and 5. During colonial rule, the administration depended on U.S. institutions and adhered mainly to the strategic interests of the United States in the Philippines. As a result, the danger of opportunistic policy changes was minimal, and government credibility was high. Thus, effective performance and rapid growth should be expected in this period.

The basis for telecommunications regulation in the colonial period was a vague law requiring regulators to approve investments that affected "public welfare" and to set tariffs so that utility companies received a "fair" rate of return on investments. A decision by the Supreme Court set the fair rate at 12 percent on revalued assets. All public utilities, including telecommunications, were regulated by a single agency, the Public Service Commission. All decisions were made by the commissioner, a centralization of authority that placed the administration in firm control of regulatory decisions.

PLDT was franchised in November 1928 as a U.S.-owned company, allowed to operate in a number of large cities and all intercity roots. The franchise was for 50 years and stipulated a 1 percent tax on the company's gross receipts in lieu of all other taxes. The company soon took over
many of the local telephone companies in Manila and other population centers and supplemented them with long-distance circuits. During the depression of the 1930s, the company’s local service stagnated, but it continued to invest in long-distance services. Investment in local service resumed after 1934, and until 1940 the number of telephones grew at an average rate of 8.6 percent a year. The Japanese invasion during World War II destroyed most of PLDT’s network. Thus, expect during the depression and the war, the company invested vigorously.

**Foreign ownership and U.S. hegemony, 1946-59**

The performance of PLDT in the first decade and a half after independence provides further evidence for Implications 1 and 5, and for 9 as well. The continuity of pre-independence institutions, the strong leverage of the United States, and the concessions granted to U.S. citizens provided a predictable and safe investment environment for both Filipino and U.S. businesses. These factors contributed to a stable and robustly growing economy. PLDT realized high profits and performed well under foreign ownership based on the commitment powers of the U.S. government. The U.S. army took control of the company’s network in 1945, and in 1947, after some preliminary rehabilitation, control of the company was transferred to General Telephone and Electronics Corporation (GTE), a U.S. company that acquired some 28 percent of PLDT’s common stock. Most of the remaining shares were held by other U.S. corporations, often as a means of portfolio diversification rather than control. The Filipino elite also acquired a small share of the company. Between 1947 and 1959, PLDT rapidly increased its fixed assets and telephones in service (figures 4.3 and 4.4).¹⁹

During this period the company enjoyed decent, though declining, real rates of return on its assets and equity (figure 4.5). Telephone tariffs had been set at relatively high levels after the war to attract the investment needed to rebuild the system. Rates were then kept nominally constant throughout the 1950s (figures 4.6-4.9), and real values eroded very slowly because inflation was low.

¹⁹Real fixed assets are calculated by deflating the values of annual investment by the consumer price index, using the perpetual inventory model and an 8 percent depreciation rate. The base year is 1967. A reliable appraisal was made of the capital stock as of December 31, 1966. Figure 4.2 compares these accounting values with replacement cost appraisals for the years for which such data are available and an economic measure of fixed assets. The economic measure is close to the appraised values in 1980, 1983, and 1988, but overestimates the appraised value in 1975 and underestimates it in 1972. These differences are probably due to shifts in relative prices and measurement errors in the two variables. In any case, using the appraised values only strengthens the booms and busts in Philippine Long Distance’s real fixed investment and emphasizes the seriousness of the cycles identified here. The prewar system was completely restored in 5 years and then growth continued consistently until 1959. Between 1950 and 1959, the number of telephones in service grew 14.4 percent a year.
PLDT was ensured of receiving reasonable return on its investments for several reasons. First, the U.S. influence meant that the company could count on the legal and political leverage at its disposal to prevent its profitability from falling too far below the competitive rate of return on capital. Second, the probability of a currency devaluation, which could have hurt PLDT, was low, given the fixed exchange rate stipulated by the independence agreements between the Philippines and the U.S. Moreover, any planned devaluation would have been known well ahead of the time because of the requirement for prior U.S. approval. Third, PLDT's customers were mainly the foreigners and the Filipino elite. They were concerned about the availability and quality of service, and were not interested in a confrontation with PLDT that could jeopardize service expansion at a time when there was still a great deal of excess demand (figure 4.10). Essentially, GTE's control of technology and rate of investment allowed it to capture part, though not all, of the surplus of PLDT's operations.

These same factors influenced the government's forthcoming attitude in meeting PLDT's foreign exchange needs during the country's balance of payments difficulties in the second half of 1950s. Many other businesses were rationed.\(^{20}\) The government did impose some restrictions on remittances of dividends to foreign shareholders, but that was a uniform policy affecting all businesses, and the fixed exchange rate imposed by the U.S. government meant that any losses due to the delay in remittance would be small. In addition, since the government did not restrict debt amortization, the company could easily circumvent remittance restrictions by increasing its foreign exchange debt in place of raising equity (figure 4.11).

On the whole, U.S. influence implied ownership security, institutional continuity, and economic stability, all factors that made the investment environment relatively safe. In addition, GTE's control of technology and investment and the excess demand for telephones among the elite ensured the company that confrontation with the government was unlikely. Telephone service grew fast.

*Currency devaluation and conflict, 1960-63*

By the late 1950s, the U.S. role in the Philippines had changed, as the Philippine elite grew more independent and established new relationships around the world. The U.S. government lost its influence as a source of commitment for domestic policies. Sensing the growing weakness of the commitment mechanisms and lacking close ties to those in control of the government, PLDT sharply

\(^{20}\)This point is clearly reflected in PLDT's *Annual Reports* during those years. PLDT was even spared the exchange rate tax instituted in the 1950s to effectively devalue the peso.
reduced its investment in the domestic telephone network during 1960-1963 (Implication 5). A balance of payments crisis exacerbated the problem and ultimately created an open conflict between PLDT and the government when no price increase was granted despite a major devaluation in 1962 (Implication 8). The conflict fully confirmed PLDT's perception of an impaired commitment mechanism in the new environment. Interestingly, on the international side of its operation, where commitment was not a serious concern, PLDT continued to invest without hesitation (Implication 11).

As a major balance of payments crisis developed in 1960, the government negotiated with U.S. and IMF authorities on a stabilization plan. The IMF recommended a major devaluation and decontrol of the foreign exchange market, which the United States approved. PLDT would be little affected by the decontrol because it had not faced much foreign exchange rationing. The devaluation, however, could be very costly for the company, which depended on imported equipment and foreign capital and whose controlling shareholders evaluated their profits in U.S. dollars. Had the government committed itself to adjust telephone tariffs in line with the devaluation, the company could have gone forward with a major expansion project (x-1) it had prepared in 1960. But the company had little reason to believe that prices would be adequately adjusted. Holding down public utility prices was a practical means of controlling inflation, and the government needed to keep inflation down to avoid further devaluations that could vitiate its stabilization efforts.

In 1961 PLDT decided to postpone its expansion plan, even though the peso had not yet been devalued. Holding off on investment gave the company some leverage against the government. The company did not formally seek to obtain a rate increase before the devaluation, but when the new administration announced a 95 percent devaluation in January 1962, PLDT and other public utilities immediately filed for rate increases. Utility owners argued that they would have difficulty financing expansion projects without a rate increase (Ronquillo 1965). The Public Service Commission was slow to respond. PLDT announced publicly that it would not invest until a rate increase was approved (Ronquillo 1963). The confrontational tone of the company's Annual Report, published in March 1962, attested to the poor relationship between the company and the commission.

Unmet demand mounted as the telephone network grew very slowly after 1960, and the company hoped that further delays in investment would incite the elite to press the government to grant a rate increase. But the government, concerned with the failure of the stabilization plan, found the cost of satisfying the demands of public utility companies too high. The Public Service Commission was instructed to take no action on the rate-increase applications until further notice. The government's stabilization policies worked, and inflation remained relatively low, exports picked up, and GDP grew at a reasonable rate. However, the decline of import-substitution industries and the mounting deficiencies in infrastructure soon slowed GDP growth. Finally, the weakening of the
economy, the pressures generated by the shortages, and the confidence in the stability of prices prepared the stage for approval of public utility tariff increases in June 1964. PLDT received a 40 percent rate increase for its local services effective January 1, 1965. The company immediately launched its expansion plan.

Had the owners of the major public utilities been close allies of the Macapagal administration, which took office and initiated the devaluation in January 1962, rate increases might have been granted earlier. In particular the owners of two major companies in the power and telecommunications sectors had little direct leverage. PLDT’s owners were mostly Americans, while the main supplier in the power sector was Meralco, which had been taken over from U.S. interests in 1961 by the powerful Lopez family, political opponents of Macapagal.

An important aspect of PLDT’s investment withholding strategy during 1960-63 was its focus on the domestic side of operations. On the international side, PLDT was eager to continue investing in joint ventures. The company’s international circuit investments were generally unaffected by the kinds of contracting problems it faced domestically, and it continued such projects largely independent of the domestic regulatory situation. Indeed, a submarine cable project from the Philippines to Guam, with links to Hawaii and the U.S. mainland, was implemented during 1963-1964 at the height of conflict with the government. This project boosted the company’s profitability during the second half of the 1960s far more than the 40 percent rate increase approved for local services. The share of long-distance revenues—in which international calls play an important role—in total revenue jumped up from less than 20 percent in 1964 to more than 45 percent in 1967 (figure 4.12).

Philippinization, 1964-70

PLDT’s Philippinization in the second half of the 1960s provides clear evidence for Implications 1, 2, 3, 5, and 6. With the Parity Amendment set to expire and the absence of commitment remaining a serious problem, GTE would sooner or later have to divest its PLDT assets. Implications 1 and 2 suggest that under the Philippine political structure, allies of the president would be able to outbid others for the divested assets and that investment would be high in the first few years, with the company relying heavily on foreign debt financing. And since PLDT was a corporation, with a large number of passive investors, the rate of return for the stockholders would decline as those in control received large payoffs.
In the mid-1960s GTE was negotiating to sell its shares in PLDT (GTE 1976; U.S. SEC 1977). By 1966 GTE had found a group of interested Philippine investors headed by Jose Cojuangco, Jr., and negotiations reached an advanced stage. But soon after the inauguration of President Marcos, high-level government officials urged GTE for political and security reasons not to sell its interest in PLDT to the Cojuangco group—Cojuangco had been an ally of the Liberal party leadership, which lost the 1965 election to Marcos. GTE was told to deal with another group of Philippine nationals the owners of the Philippine Telecommunications Investment Corporation (PTIC) (U.S. SEC 1977).

The new group, led by Ramon Cojuangco (Jose Cojuangco's cousin), Luis Tirso Rivilla (Ramon's brother-in-law), Alfonso Yuchengco (a banker), and Antonio M. Meer (a lawyer), formed PTIC as a holding company to take over GTE's shares in PLDT. A deal was concluded in 1967, and a new board of directors took over in December of that year. GTE received a stake in the holding company (22.5 percent, as reported by Manapat 1993) that enabled it to appoint one director to the board of PLDT. The terms of the contract provided that GTE's shares in the company would be bought for approximately $7 million in cash and $7 million in promissory notes (GTE 1976; U.S. SEC 1977). According to Meer (reported in Tiglao 1993c), the loan was guaranteed by the Development Bank of the Philippines. The notes were to be written off through a 5 to 7 percent commission on PLDT's purchases of GTE equipment "caused" by the PTIC group.

The GTE was promised to pay cash commissions, amounting to $484,000 by 1976, to be delivered through the Stamford Trading Co., a Bahamian concern whose linkages the U.S. SEC could not trace. The commissions were paid "to provide [the buyers] with sufficient funds to pay back [the loans]. Neither the investment company [PTIC] principals nor a Bahamian company apparently controlled by them and used as a conduit for the GTE payments were expected to perform any services for GTE, the SEC suit contends" (Wall Street Journal, 1977). Finally, GTE provided PTIC with an option to purchase 40 percent of GTE Industries Inc., a subsidiary that manufactured telephone equipment in the Philippines. PTIC exercised the option in 1971 in exchange for a $486,459 "non-interest bearing promissory note payable at the rate of $1 [sic] per annum" (Wall Street Journal, 1977).

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21The details of the ownership transfer described here became public in 1977 as a result of investigations carried out by the U.S. Securities and Exchange Commission (U.S. SEC) and GTE management. A legal case was filed in U.S. District Court in Washington, D.C., by the U.S. SEC on January 12, 1977, against a group of Filipino businessmen controlling PLDT. The case was settled out of court, with the defendants accepting a court injunction without admission of guilt.
Further deals were made as PLDT continued to purchase its equipment from GTE. According to Rosenblatt (1977):

The SEC said that GT&E made personal loans of $580,000 to Cojuangco, $280,000 to Rivilla, $100,000 to Yuchengco, and $40,000 to Meer in 1971 when their investment corporation needed cash to repay bank loans. The personal loans were made by GT&E "on the condition" that the telephone company "promptly sign a $20 million equipment purchase agreement with GT&E," according to the SEC suit. The GT&E assigned the promissory notes to an independent escrow agent with the instructions to handle the notes "in accordance with the wishes of the people who signed the notes," the SEC said. This means that the notes can be canceled without ever being paid.

The deals were clearly beneficial to PTIC and damaging to PLDT. According to Wall Street Journal (1977), "GTE executives have testified ... that one of the factors in setting the price for equipment purchase by PLDT was the amount of commissions GTE paid or credited through the Bahamas concern." Indeed, when the U.S. SEC filed suit in 1977 against the PTIC group, it had no difficulty getting the defendants to agree to the court injunction of $1 million transfer from PTIC to PLDT.

After the GTE-PTIC deal, other U.S. and Filipino shareholders in PLDT remained by and large passive investors. The PTIC group came to dominate the PLDT board, and business was directed to enterprises held directly or indirectly by the PTIC group. Insurance, construction, and many financing contracts went to related companies. This supply system created the possibility for directors and management to transfer the company's profits to their own accounts rather than sharing them with other stockholders. The Philippine Securities and Exchange Commission and the Public Service Commission never questioned these practices.

Although President Marcos had no interest in PLDT under his new name, revelations after his departure in 1986 show that he must have had a major stake in PTIC, represented by the Cojuangco family. The PCGG attorneys investigating the case found that in May 1978 Ramon Cojuangco and Luis Rivilla had transferred 46 percent of PTIC's shares with a current market value of P170 million to Prime Holdings Co. at the price of P6.5 million (Sison 1986).22 Prime Holdings had been formed

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22 As of 1986, the rest of PTIC shares were held by the Cojuangco family (43 percent), Yuchengco (7 percent), and Meer (4 percent). Further details of the PTIC-Prime Holding transaction are documented by Manapat (1993, 13-14), quoting the minutes of the Special Meeting of the PTIC board of directors on 20 December 1977 and the records of President Marcos and his daughter, Imee, found in the presidential palace after their departure in 1986. These details show that the shares transferred to Prime Holdings were in three blocks. One block sold by Ramon Cojuangco was 20 percent of the total PTIC shares and was priced at P1.95 a share. Two other blocks of 13 percent
by two of Marcos’s financial advisors, one of whom admitted in 1986 to have acted as a Marcos front. Based on interviews with those involved and the evidence recovered, the PCGG attorneys concluded that the sale had not been forced, rather the shares had belonged to Marcos all along. The reason they were transferred to another front group in 1978 is not very clear. It seems that the transfer may have been prompted by Marcos’ disease, as his family members became concerned over securing his fronted assets after his death. Evidently, they had greater trust in the two financial advisors who did not come from elite families and owed their positions to the Marcoses. (Manapat 1991, 353-366).

In 1969 PLDT’s franchise was extended for 25 years beyond its 1978 expiration date. The extension generated some debate in the Congress and the government among those who believed that PLDT should be subject to corporate income tax and those who maintained that the franchise tax was sufficient. A final compromise raised the company’s franchise taxes to 2 percent of its gross receipts and exempted it from other taxes.

Between 1964 and 1970 PLDT experienced one of its fastest periods of growth. The transactions between the GTE and Filipino investors described above shed light on why PLDT was investing so rapidly both before and after the transfer of ownership. The company’s immediate rate of return had risen substantially as a result of the rise in telephone tariffs, the expansion in domestic and international long-distance revenues, and the decline in real wages in the mid-1960s (see figure 4.5). For the longer term, Philippinization promised stronger commitment because of direct government ties. GTE had a strong interest in starting the expansion early because, besides immediate profits, a larger network and an ongoing expansion project could help GTE obtain larger and longer-term equipment-supply contracts, thus allowing it to share in the surplus generated by the ownership change. PTIC’s incentive to invest was, of course, quite clear: After 1967 PLDT could count on supportive government policy at least as long as President Marcos remained in office. It invested with vigor particularly because, following the investment stagnation of early 1960s, major shortages in telephone service had developed. Moreover, as the economy and the middle class expanded, demand continued to grow at rapid rates (see figure 4.10). Most of the new telephones were installed in the

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were transferred by Cojuangco and Rivilla at the prices of P110 and P113 per share, respectively. The value of a PTIC share in early 1978, based on its corresponding PLDT shares, was approximately P1500.

Interestingly, there was no change in PLDT’s board of directors between 1977 and 1981, suggesting that the 1978 transaction was not intended to shift control of the Company. The high ranking officials of the Marcos government interviewed also indicated that both before and after 1978 President Marcos had been consistently supportive of PLDT and its president, Ramon Cojuangco.
Manila metropolitan area, where demand was growing fastest and subscribers were more likely to use international long-distance services.

PLDT's profitability was also quite high in the second half of the 1960s. Although calculations based on declared profitability show real rates of return lower than those in the 1950s (see figure 4.5), the value of the profits captured by PTIC through its contracts with GTE could alone cover the difference. However, there were no further telephone tariff increases at the time, probably because of increased political competitiveness, particularly middle-class activism (Implication 8).

PLDT was not the only telecommunications firm benefiting from a close relationship with the administration in the late 1960s. In 1966 a group of President Marcos's close associates led by Defense Minister Juan Ponce Enrile formed the Philippine Overseas Telecommunications Corporation (POTC), which entered into a joint venture with the government to create the Philippine Communications Satellite Inc. (Philcomsat). Philcomsat was franchised as a carriers' carrier in 1969 to provide international satellite services to the Philippines. Unlike other telecommunications enterprises, however, it was placed beyond the jurisdiction of the Public Service Commission, purportedly because of the government's ownership share. Philcomsat has been a major supplier of international circuits for all Philippine telecommunications companies, including PLDT. At the same time POTC's owners have had interests in all the major telecommunications enterprises in the country (Isberto 1986). The company also received handsome deals from GTE, similar to those provided to PTIC. In fact, the bulk of POTC's equity was built in this way (Isberto 1986). Again, after the fall of the Marcos regime, it was discovered that Marcos's front companies had obtained POTC shares amounting to 40 percent of the total in 1982 (Isberto 1986).

Devaluation and the end of Marcos's second term, 1970-72

PLDT's experience in the early 1970s demonstrates the problem of commitment beyond a president's term in office in the Philippines and clearly supports Implications 5 and 6. As the end of Marcos's second term neared, investment declined, capital flight picked up, and the debt-equity ratio stayed high.

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24 In the late 1960s, a $1 million increase in profits could raise the rate of return on equity by 2 percentage points.

25 However, the company's unregulated status continued after the government sold its shares at a controversial price to POTC in 1982 (Isberto 1986).
In 1970 PLDT’s costs shot up, primarily because of a 65 percent devaluation. The company had borrowed heavily in foreign markets, and the higher value of the dollar made repayment difficult (see figure 4.11). In addition, the tighter labor markets of the late 1960s and greater labor militancy had substantially increased real wages and PLDT’s labor cost. However, in contrast to events following the 1962 devaluation, the Public Service Commission gave provisional approval for rate increases for public utilities almost immediately after the devaluation in 1970. Meralco, the power company owned by the family of the vice president, received an automatic 3 percent adjustment for every P0.30 change in the peso-dollar exchange rate (which had jumped from P3.90 per dollar to P6.44). PLDT received a 40 percent rate increase on all its local telephone services. Permanent approval of the rate adjustments came more than a year later, delayed by challenges from business user groups. The opposition could not get the approved rate increases rescinded, and only managed to postpone consideration of additional increases in the following two years. The liberal attitude toward rate increases was not accidental; events would have transpired differently had the companies not had patrons in the administration. Indeed, as events under martial law demonstrated, Meralco received very different treatment once its owners were expelled from the ruling coalition.

Although the increase in telephone tariffs in 1970 enabled PLDT to remain profitable for the year, the impact was short-lived. The real rate of return on equity fell significantly, becoming negative in 1971-72. Investment dropped sharply, and real capital stock stopped growing (see figure 4.4). The decline in PLDT’s profitability during 1971-72 could have been due to undercompensation in the face of high inflation following the 1970 devaluation, while slow investment could have been a consequence of the low profitability and the high cost of foreign exchange, which caused difficulties for foreign financing. But the company’s annual reports do not make such claims. The relative stability of the peso after the 1970 devaluation and the slow growth of nominal wages also suggest that the sudden drop in profitability could not all have been due to continued significant cost increases.

An alternative explanation based on weak commitment seems to better fit the facts. In the early 1970s the main contender for the presidency after Marcos was Senator Benigno Aquino, whose relationships with the Marcos group were adversarial. The Lopez family, which could have presented an alternative candidate promising continuity with the Marcos regime, broke with Marcos in the early 1970s. As a result the probability of adverse regulatory action after 1973 was quite high. In this situation it makes sense for a business to transfer its assets abroad and turn from equity to debt. This

\(^{26}\)However, Meralco’s 1971 Annual Report presents financing problems as the main cause of its investment restriction in those years.
effect would simultaneously explain the decline in investment, continued borrowing, and low declared rates of return. In this regard, it is important to recall that in 1971 PTIC owners had signed a new $20 million dollar contract with GTE, on behalf of PLDT, receiving an immediate $1 million in U.S. bank accounts (U.S. SEC 1977). At the same time they borrowed another half a million dollars to gain a stake in GTE Industries, Inc. Of course, GTE was only one of PLDT’s suppliers. Dealings with others have not been documented.

*Martial law and international scrutiny, 1973-78*

Barring other overriding effects, the first few years of martial law should be times of high real prices and increased investment for sectors controlled by government associates (Implication 5 and 9). Other sectors would also be expected to follow suit, giving in to the tremendous pressures unleashed by the broad presidential powers under martial law. Indeed, many sectors of the economy did display these patterns, and economywide investment mounted, GDP grew rapidly, and real wages declined sharply in the mid-1970s. PLDT also received tariff increases and regulatory support, but made no net investment (see figure 4.4). This seemingly contradictory outcome can be explained by two factors: a decline in the demand for telephones, and the U.S. SEC’s suit against PLDT, which implied termination of the company’s relationship with GTE. The first factor made it unprofitable for the company to expand during 1973-76, and the second closed off its channels of borrowing and equipment supply during 1976-77.

Soon after the declaration of martial law, the Public Service Commission was broken up into specialized regulatory agencies. The new regulatory agency for the telecommunications sector (except radio) was the Board of Communications. This organizational reform was unaccompanied by change in the regulatory framework and had little impact on telecommunications enterprises. In 1973, shortly after its formation, the board approved a 35 percent increase for PLDT’s local tariffs, supplemented by an additional 5 percent increase the following year. The impact on real prices for telephone services seems to have been small and short-lived (see figures 4.6 and 4.7). However, the increases were accompanied by a subscriber investment plan instituted by presidential decree. Under the plan each subscriber was obliged to purchase 180 shares of PLDT’s preferred stock (at a par value of P10 per share), to finance part of the line installation costs and, according to the presidential decree, to achieve widespread corporate ownership. These stocks yielded annual dividends of P1 and

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7 This change had been recommended before martial law in response to the increased volume and complexity of regulatory tasks in various sectors under the commission’s jurisdiction.
could be converted into common stocks one year after issue at a 10 percent discount. Considering the lack of interest among telephone subscribers in holding PLDT's common stocks and the high rates of inflation in the 1970s and 1980s, these terms implied negative real rates of return on subscriber funds. More importantly, the funds provided PLDT with some nonvoting equity that it could use as a basis for securing larger foreign loans, without giving up any control.28

Another important change in regulations under martial law was the indexation of local telephone rates to the exchange rate. For every P0.10 increase in the peso cost of the U.S. dollar, telephone rates were automatically adjusted by 1 percent. Although this rule did not help much during the 1970s, when the exchange rate was maintained at a constant level, it provided PLDT with security against currency depreciation and boosted its foreign borrowing capacity. (Note that the rule allows the rates to increase geometrically when the exchange rate depreciates arithmetically.)

On the surface, it seems that during the mid-1970s PLDT's profitability was low and it had little incentive to invest (see figure 4.5). However, the situation is far more puzzling than it appears. The company's third expansion plan (X-3), which it was implementing slowly between 1973 and 1978, was designed in the early 1970s as a very small project (less than half the size of the previous expansion plan in terms of installations). Though the mid-1970s were boom years for the Philippine economy, the company made no attempt to expedite or enlarge the expansion plan. To the contrary, the expansion was largely completed by 1976, yet not until two years later did PLDT start its next project. During this time the government's supportiveness was clearly demonstrated through rate increases, the foreign exchange indexation of local rates, and the mandatory subscriber investment

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28The ratio of these funds to PLDT's real economic equity reached about 5 percent in the late 1970s and surpassed 6 percent in 1983. After that, their share in total equity declined.
plan. Though real local service rates were allowed to decline in the second half of 1970s, that seems to have been part of a strategy to hasten PLDT's takeover of smaller operators (see below).

A clue to understanding PLDT's stagnation in the first few years of martial law is provided by the trend in excess demand (see figure 4.10). Unmet demand fell sharply during the early 1970s and by 1974 it could have been eliminated by a 10 percent increase in the number of lines. This was hardly a situation that would induce large expansion plans. But in a booming economy, what factors lowered the demand for telephones? For one, the boom benefitted only those few who controlled the economy and enjoyed monopoly profits. For nearly everyone else, real income was falling. In fact, between 1970 and 1980 the average real wages rate steadily declined by 8 percent a year. Thus fewer and fewer households could afford telephones. PLDT's customers were essentially the elite and the upper-middle-class, and most of them already had telephones.

However, these arguments do not explain why investment continued to drag until 1978, though demand had begun to pick up in 1976. The delay is significant, because it seems to have been the root cause of the telephone shortages and quality deterioration of the late 1970s and early 1980s (see figures 4.10, 4.13, 4.14). The difficulties that arose in PTIC's dealings with GTE seem to be at blame for much of the delay.

Comparing these favors with the fate of Meralco is instructive. President Marcos was wary of the ambitions of the Lopez family and after martial law managed to effectively expropriate a large part of their assets. First, the family's newspapers, which had been closed down immediately after the martial law announcement, were not allowed to reopen until they were sold to the president's relatives. Then, declaring as a popular measure, electricity tariffs were reduced to force the sale of Meralco. When this tactic did not work, Eugenio Lopez's son was taken into custody and accused of trying to assassinate the president. Finally, Eugenio Lopez, who resided in the United States at the time, agreed to sell Meralco to the Meralco Foundation Inc., a non-stock firm set up by Marcos's brother-in-law. Later, Eugenio Lopez Jr. escaped from prison. (See Tiglao 1989 and Manapat 1991, 387-392.)

In other words, in accordance with Implication 9, telephone charges in 1974 must have approached monopoly prices. However, since PLDT's real tariff rates in 1974 were lower than in almost any previous year, the nominal rate adjustments could not have caused monopoly pricing by themselves. In this sense, the demand shift following the income concentration of the 1970s is an integral part of the above explanation for the evaporation of excess demand. With the demand shift, the new charge brought the telephone tariffs close to their monopoly levels and made a highly suboptimal capital stock the most profitable one.
During the mid-1970s the U.S. public became concerned about honesty in business and politics. In response, the U.S. Securities and Exchange Commission began investigating business misconduct and asked publicly traded corporations to carry out internal audits about inappropriate trading practices. GTE's audit uncovered its shady deals with PTIC, and in February 1976 GTE halted its arrangements with the Cojuangco group, informing them that commission payments would stop. It also refused to pay some $1.7 million that the group had earned under the existing arrangements (GTE 1976, 22). GTE maintained its stake in PTIC, however. In January 1977, the U.S. SEC filed a complaint against the PTIC group. PLDT would find it difficult to borrow and invest while its contracts with GTE were being terminated and the U.S. SEC was preparing an indictment against it. Although the case was quickly settled out of court, the conflict with GTE continued until December 1977, when the GTE quietly "abandoned" its PTIC shares. This resolution of the matter finally freed PLDT to resume its investments.

The only visible improvements in the PLDT network during these years were in the number of domestic and international long-distance circuits (see figure 4.15). Many of the circuits were rented from related telecommunications companies—firms that were franchised as carriers' carriers. An important supplier for the domestic long-distance network was Domestic Satellite Philippines, Inc. (Domsat), a company chaired by Ramon Cojuangco and directed by a number of well-known Marcos cronies (De Luna 1986). The main suppliers on the international side were Philcomsat, Philippine Global Communications (PhilCom), and Eastern Telecommunications Philippines, Inc. (Eastern Telecom), all highly profitable firms owned largely by the same group of Marcos associates and front companies. They also had close interlocking interests with PLDT (De Luna 1986).

Philcomsat's background has already been discussed. The history of the other firms is quite similar. PhilCom began in the 1920s as a subsidiary of Radio Corporation of America (RCA), providing international telegraph and telephone services. By 1974 it was 60 percent Filipino owned, with Defense Minister Enrile's family corporation, Jaka Investments, and some PLDT directors as major shareholders (De Luna 1986).33 Eastern Telecom was established in 1974 by more or less the same group that had formed Philcomsat, with the British firm, Cable & Wireless, holding a 40

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32 According to Manapat (1993, 11-12), the "abandoned" GTE shares, which had an approximate market value of $11 million, were transferred to Ramon Cojuangco, who paid $13,500 to PTIC. Other PTIC shareholders signed letters indicating that they were not interested in purchasing any of the shares. The per share price of this transfer was exactly the same as the first (20 percent) block of shares purchased by Prime Holdings from Cojuangco a few months later. (see note 2.2)

33 RCA recently sold all its shares to Filipino investors.
percent stake. The verified share of President Marcos in these companies was about 40 percent of the Filipino-owned capital (Isberto 1986).

This interrelated structure of enterprises provided an important channel for directing PLDT's profits. For example, Philcomsat's profits over the 1966-1989 period were far larger than those of PLDT (Isberto, 1986). The structure also permitted investment in long-distance services unaffected by PLDT's troubles. The demand constraint in the earlier years affected only local telephone service, not long distance. The greater concentration of income during the period implied a rise in demand for long-distance services, an opportunity quickly seized by the elite with interests in the sector. With the backing of the administration, they launched new projects, including two new firms, Domsat and Eastern Telecom. Thus PLDT's behavior seems to be an anomaly, a consequence of the decline in local-service demand and intensification of international scrutiny. In all likelihood, then, growth and investment in the telecommunications sector would have moved into the expansion pattern expected by the political-economy analysis had these two factors not intervened.

Entry into the telecommunications sector increased after martial law (Implication 10). Previously, entry had been restricted because obtaining a franchise from the Congress was politically costly. Under martial law President Marcos could grant franchise at will, and he used this power to arrange for entry into the growing long-distance telecommunications markets for firms to which he had ties. To avoid conflict among his associates, particularly, between PLDT and the newly established firms, Marcos restricted the new franchises to message or data communications. They were, of course, allowed to lease their circuits to PLDT for voice transmission.

Endgame effect with abundant supplies of foreign credit, 1978-85

The events in the Philippines between 1978 and 1985 clearly exposed the fundamental flaw in the country's underlying institutional structure. The weakness of the government to commit itself as an institution transcending individuals meant that the members of the ruling elite would be compelled to cut back sharply on investments inside the country as soon as they sensed an imminent change in the political balance, even though they still had access to ample supplies of foreign credit and could ensure profitability in their businesses. The experience of the telecommunications sector in 1978-85 conforms to this pattern and provides support for Implications 3-7, 9, and 11. PLDT received favorable treatment from the government that helped boost real telephone tariffs and provide access to enormous foreign loans. Yet PLDT's net investment in local service was modest, and its real rates of return were negative.
Indications of a crack in Marcos’s authoritarian regime started to appear in the late 1970s, with rumors of his illness. In hopes of institutionalizing the extraordinary powers of the president under the 1973 constitution and resolving the succession crisis, Marcos launched a “normalization” process. Reforms were introduced in several areas, but to little substantive effect. Cronies lost interest in investments and used every arm of the government to squeeze as much as possible from the economy. The economy slowed, inflation mounted, and foreign debt and capital flight soared (see figures 4.2 and 4.16). Opposition leaders saw an opportunity to bring down the Marcos regime and intensified their activities. When Senator Aquino was assassinated in 1983, foreign lenders, worried that they might be unable to collect on loans to Marcos’s cronies should the regime collapse, quickly cut off new loans. The country entered into economic as well as political crisis.

Meanwhile, the authorities in the telecommunications sector were providing favorable treatment to PLDT and other firms with ties to Marcos. The National Telecommunications Commission (NTC), the new regulatory agency formed in 1979 by merging the Board of Communications and the Radio Control Bureau, approved two major discretionary rate increases in 1980 and 1984. These increases, along with the automatic adjustment provision, turned around the downward trend in the local and domestic long-distance tariffs (see figures 4.6 and 4.8). Also, under a policy of sectoral integration and rationalization, PLDT was encouraged to take over several smaller telephone companies. These companies had been denied access to PLDT’s network and, with real local tariffs falling, had become losing operations. The most important was Republic Telephone Company (Retelco), the second largest telephone firm in the Philippines with a local network approximately one-tenth the size of that of PLDT and bordering its area of operation on the outskirts of Manila. When the initial negotiations for the sale of Retelco stalled in 1980, President Marcos appointed a special committee to resolve the matter. Soon after the takeover agreement in early 1981, local rates were increased by 35 percent.

To enable PLDT to borrow more in international markets than its existing equity permitted, state-owned banks were directed to purchase nonconvertible, nonvoting preferred shares in PLDT (Gonzaga 1982). In the early 1980s such purchases supplied about 10 to 16 percent of PLDT’s real equity without affecting PTIC’s control of the company.

Given the ample availability of credit, PLDT’s volume of investment and its debt-equity ratio rose substantially as it embarked on a new expansion project (X-4) in 1978 (see figures 4.3 and 4.17). However, the increase in investment spending did not translate into a commensurate expansion of the local telephone network: during the rapid expansion phase of 1978-83 real capital stock measured at cost grew at an average annual rate of 19.3 percent, the number of main lines in service by only 6.7
percent (see figures 4.3 and 4.18).\textsuperscript{34} In contrast, during the earlier expansion phase of 1965-70, growth rates of capital stock at 26 percent and main lines at 23 percent were more in line with each other.

The investments of 1978-85 seem to have gone mainly into expanding domestic and international long-distance networks (see figure 4.15) and improving the quality of service, especially for long-distance-related services such as direct dialing and digitalization. Indeed, these investments helped shift the composition of revenues toward long-distance services by leaps and bounds (see figure 4.12), even though real prices of local services were rising while those of long-distance services were not (see figures 4.6 and 4.9). Thus the pattern of investment seems to conform to Implications 5 and 11.

Considering the increases in real local service rates and the rapidly rising long-distance revenues, PLDT’s real rates of return should have improved after 1978. Instead, they worsened (see figure 4.5). The increase in PLDT’s franchise tax from 1 to 2 percent of gross revenues that took effect in 1978 does not seem to account for the decline, as a comparison of before- and after-tax rates of return shows (see figure 4.5). The substantial increase in interest rates during the late 1970s and early 1980s may have played a role. But if so, why did PLDT accelerate its rate of borrowing during 1979-83 despite consistently negative rates of return? It could be that the owners were anticipating large returns in a more distant future, but that they would maintain such a high level of investment in the face of continued losses on equity over several years strains credulity.

More plausibly, perhaps, profitability really was high, but it surfaced elsewhere. That would explain the high rate of borrowing and investment in long-distance services while the company was losing money. Some implicit evidence supporting this hypothesis was given in the previous section, in the discussion of PTIC’s connections with carriers’ carriers and with PLDT’s equipment and service suppliers. Sison (1986) and De Luna (1986) offer further evidence of business dealings with companies related to PLDT’s directors and managers and suggest that these companies were quite profitable. An important example of such a company was the Electronic Telephone Systems Industries, Inc., established in the Philippines as a joint venture between Siemens of Germany (30 percent share), Independent Realty (a Marcos front company, 42 percent share), and two other companies related to PLDT directors (De Luna, 1986). This venture served as PLDT’s main conduit of equipment purchases from Siemens, which after 1978 replaced GET as PLDT’s main equipment

\textsuperscript{34} If Retelco’s assets and lines are excluded from calculation, the growth rate of capital stock declines to 18 percent and that of main lines to 5.1 percent.
The extensive powers of Marcos after martial law made it easier for his cronies to carry out more of their transactions inside the Philippines and avoid damaging international scrutiny.

The picture that emerges for the period 1978-83 is that of a telecommunications company with friendly ties to the administration that is given the opportunity to earn high profits, take over the assets of other companies, and borrow heavily. Because it is a publicly traded company controlled by minority shareholders, its profits are channeled to more exclusive accounts. And because the company is concerned about the stability of the administration, it hesitates to expand the local network, except where the expansion facilitates long-distance services.

As the disintegration of the Marcos regime accelerated in 1984-85 and the economy collapsed, PLDT's investment came to a complete halt, and attempts to secure capital abroad intensified. The evidence on capital flight in this period is extensive (Sison 1986), and there is no disputing that PLDT's managers deliberately failed to remit foreign exchange earnings in 1985 (Friedland 1988). This effect is also reflected in the sudden decline in international long-distance revenue as a share of total revenues in 1985 (see figure 4.12).

Regime shift, political turmoil, and regulatory activism, 1986-89

The anti-Marcos coalition that took over in 1986 included a broad range of interests with many differences to settle. During the period of turmoil that ensued, political activism among the non-elite increased. Regulatory conflict would be expected to arise between PLDT and the new government (Implication 8) and investment to come to a halt in the local network (Implication 5), though not necessarily in international circuits (Implication 11). In fact, these are precisely the events that transpired in the early years of the new Aquino administration.

PLDT's first skirmish came less than three weeks after the inauguration, shortly after the establishment of the Presidential Commission on Good Government. The commission moved quickly to sequester PLDT's assets and to appoint a supervisory committee, headed by attorney Luis F. Sison, to oversee its management. A few days later, the committee's task was specified as the investigation of the company's connections with Marcos and its past business practices. Numerous allegations were

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35 PLDT declared some of the underreported foreign earnings later in 1986. Some of Sison's (1986) other findings were disputed by a subsequent PCGG study by Mario Locsin and Benjamin Guingona. When preparing their report, Locsin and Guingona were the commission's representatives on PLDT's board of directors. A senior Aquino government official has suggested that the latter study was orchestrated by the Cojuangco family (Friedland 1988).
leveled against those in control of the company. In particular, Marcos's holdings in PTIC were identified and expropriated.\textsuperscript{36} The sequestration was lifted on May 2.

On June 18, with the commission representing the sequestered Marcos shares, PLDT shareholders elected new members to the board of directors. Oscar Africa, from a prominent family with significant interests in other Philippine telecommunications firms, retired as president and was replaced by Antonio Cojuangco, Ramon's young son and a relative of President Aquino. PCGC placed two of its members, Benjamin Guingona and Mario Locsin, on the PLDT board. Over the following months, they reexamined the company's business practices and issued a more positive report about its management. Eventually, the commission set the whole matter of PLDT "anomalies" aside.\textsuperscript{37}

Meanwhile, in mid-April, the Philippine Bureau of Internal Revenue filed income tax deficiency claims against all telecommunications firms in the country for the period 1969-85. The firms maintained that the franchise tax had been intended to replace all other taxes. In a case involving Radio Communications of the Philippines, Inc., the Supreme Court disagreed, arguing that the tax code of June 1968 had implicitly repealed the income tax exemption of the franchisees because it made no exceptions for this purpose (\textit{Business Day}, June 12, 1986). PLDT, acting more cautiously, dealt with the matter on a case-by-case basis, eventually convincing the bureau to withdraw most of the tax deficiency assessments against the company. However, it was unable to evade Executive Order 27 of November 25, 1986, however, that assessed a 35 percent corporate income tax on all franchise holders and increased the franchise tax from 2 to 3 percent of gross revenue. These new taxes seem to have captured about 10 to 11 percent of PLDT's gross revenues and reduced the real rate of return on economic assets by about 4 percent (see figures 4.5 and 4.19).

During the same period the National Telecommunications Commission ordered a 10 percent cut in PLDT's local residential tariffs "to make telephones more affordable" (Friedland 1988), but

\footnote{\textsuperscript{36}The committee was presented with deeds of assignment showing that in 1981 Ramon Cojuangco and Oscar Africa had attempted to buy the shares of Prime Holdings in PTIC. However, the deeds were not notarized, did not specify any payments, and were not recorded in the books of Prime Holdings (Sison 1986).}

\footnote{\textsuperscript{37}Jovito Salonga, PCGG chairman in 1986, responded to criticism about the commission's failure to pursue its investigations of PLDT by claiming that President Aquino had discouraged him by saying that "the Antonio Cojuangco family is not that bad, and is different from Danding's," her other cousin, Eduardo Cojuangco, whose assets were sequestered in 1986 because of his close ties to Marcos. Aquino has confirmed the statement, but has denied discouraging her officials from pursuing any legal case (Tiglao 1993c).}
there was no change in other tariffs or in the automatic foreign exchange adjustment provision. Later, the commission became active in regulating PLDT's interconnection with the small local operators, setting a minimum share of long-distance revenues for the small operators to help them expand and improve their services. These changes cost PLDT about 3 to 4 percent of its gross revenues—much less than the cost of the new taxes.

In the first few years of the Aquino administration, the wide range of represented interests impeded the development of clear policy objectives and left individual government officials with broad discretionary authority. The new government seemed to prefer expropriating PLDT's assets through tax increases rather than rate reductions. The main common interest in these actions was to increase government resources. Explicit expropriation of PLDT was ruled out by the president, as the failed sequestration attempt in March 1986 made clear. PhilCom and Philcomsat also managed to avoid sequestration, because their patron, Defense Minister Enrile, who had participated in the coalition against Marcos, succeeded in retaining his post for a while (Isberto 1986). But Philcomsat lost its unregulated status and was ordered by NTC to cut its rates. Other Marcos-related firms, such as Domsat and Eastern Telecom, were less successful in evading penalties: their Filipino-owned shares were sequestered and new directors were appointed.

The presence of new interests in the government was also reflected in the desire to reverse the Marcos administration's policy of sectoral "consolidation" by allowing new entry into the sector. Ironically, this reversal was largely based on the entry authorized by Marcos. NTC began issuing Certificates of Public Convenience and Necessity for firms with franchises that could be interpreted as relevant. In particular, NTC authorized a number of small operators to establish new services, such as cellular telephony and paging, in competition with PLDT. In 1989 the commission approved applications by PhilCom and Eastern Telecom to establish their own direct international telephone service (gateway). The idea was to give these firms an incentive to develop local networks in less developed regions and to spur PLDT to expand as well. PLDT challenged most of these authorizations, and though it was initially unsuccessful, it managed to get some of the key decisions of the regulators reversed (see below).

Another policy initiative based on similar concerns was the National Telecommunications Plan, developed by the Department of Transportation and Communications. Under the plan the government would use official development assistance funds to build telecommunications facilities in areas where they would not be in competition with the private sector. Once established, the projects

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38 The Philippine Consumers Foundation Inc. did attempt to challenge the automatic foreign exchange adjustment provision, but the Supreme Court dismissed the case.
would be transferred to the private sector in a competitive process. PLDT would be eligible to participate in the privatization process, but it would have to compete with other firms. Around the same time PLDT was denied access to a concessional loan offered by West Germany's export credit agency on the grounds that the company was too profitable to receive access to scarce development funds (Friedland 1988).

In addition to changes in the regulatory environment, PLDT faced difficult foreign borrowing conditions because of its own accumulated debt and because of debt rescheduling negotiations between the government and foreign creditors. Although the company benefitted from a temporary debt service moratorium and rescheduling, new credit was difficult to obtain. The controlling PTIC group decided to let the domestic network stagnate until the dust had settled, though investment in international circuits continued. A major fiber-optic submarine cable project was completed in 1989. The group also used its capital to expand its activities in sectors and service areas where policy commitment was less problematic. For example, PLDT's related company, Piltel, broke into cellular telephony service.

PLDT's financing problems and slow growth were viewed by many in the government as stemming from the PTIC group's fear of losing control—the group could increase its equity in the company only at a limited rate and did not want to share control with new investors who would be willing to contribute more. This view, however, ignores the fact that in the past PLDT had managed to borrow heavily, well above its real equity, whenever it was confident of government support for a few years (see figure 4.17). As the company's history suggests, the financing problem is a consequence more of the weakness of government commitment capacity than of a shortage of funds or equity that the PTIC group could commit to PLDT. Members of the PTIC group have substantial assets outside the telecommunications sector and continue to make new investments elsewhere. If they were assured of a comparable rate of return in the local telephone network, there would be no reason not to invest at a more rapid pace.

"Normalization" and entry restrictions, 1990-92

The events of 1990-92 show that under the country's settled, nonauthoritarian regime, entry into the telecommunications sector is difficult (Implication 10). Also, increased political competition and influence by the non-elite can keep prices down (Implication 8). But, under the existing institutional structure this mainly gives rise to excess demand since entry barriers remain strong.

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39 For instance, in 1992 Antonio Cojuangco led the group of investors who took over the Philippine Airlines, which was being privatized.
Finally, the government tries to privatize the telephone systems it has developed before the end of the president's term in office (Implication 4).

By 1990 the new competitive political system had weathered several crises and become more settled. The leadership also had become more cohesive, as the elite regained control and reestablished the institutions through which they exercised control, although the non-elite groups, especially the middle class, had more influence than in the past.

The PTIC group managed to improve its political standing with the elite groups that finally won out in the leadership struggle. The influence of the Cojuangco family in the legislature and the bureaucracy and its control of a major newspaper turned government policies more favorable toward PLDT and ensured that the PCGG representatives on the boards of PTIC and PLDT remain inactive (Tiglao, 1933a). However, the increased competitiveness of politics kept a lid on telephone tariff rates (see figures 4.6—4.9), and the uncertainty about the post-Aquino administration slowed PLDT’s investment in its local network. The number of unfilled applications for new lines soared, and many undeveloped areas remained without telephones (see figure 4.10).

Some in the government had hoped that the competition stimulated by the authorizations of new gateways and services would bring about a fundamental change to the sector and enable it to meet the growing demand. But the road to competition proved a rough one, thanks largely to the weaknesses of the regulatory institutions and the strong anti-entry bias of the franchise system under the more normal political conditions of 1990-92.

PLDT’s appeals to the Supreme Court and evasion of interconnection orders threw effective obstacles in the way of greater competition. The court agreed with PLDT that Eastern Telecom’s franchise allowed it to carry only "messages," not "voice." Supporting the decision was the argument that PLDT had "sufficient" number of international circuits and there was no "necessity" to have another company operate additional circuits (Manila Bulletin, August 29, 1992). This was in sharp contrast with the court’s earlier decision that the mobile telephony authorization granted to Extelcom was valid because competition would be in public’s interest. (Gavino 1992, section IV.B.6.) Curiously, PLDT did not challenge PhilCom’s gateway in the courts and even granted it interconnection, apparently because of common interests between owners of the two companies.

40Someone familiar with the case explained in an interview that the fundamental difference between Eastern and PhilCom may be that Eastern has been penetrated by middle-class professionals while PhilCom is still an elite-controlled firm and maintains close ties with the PTIC group. According to the 1991 Annual Reports of PhilCom and PLDT, at least two of PhilCom’s directors in that year were related to PLDT’s chairman, Alfonso Yuchengco: Alfonso S. Yuchengco III and Helen Y. Dee, the president of Malayan Insurance Company, a Yuchengco-owned enterprise. Helen Dee has been a director at PLDT since 1986 and her company has been providing insurance services
Also, Eastern had established a partner company, Digitel, to invest in a system of local networks in areas not covered by PLDT, whereas PhilCom had been less ambitious in that respect. Digitel has been unsuccessful, however, in gaining a national franchise. Without it, establishing an efficient-size network in a contiguous area is nearly impossible. Even Extelcom that had won its court case against PLDT had a hard time getting interconnection until its major shareholder, Ruby Tiong-Tan, sold her shares to an undisclosed buyer. *

When the government moved to privatize two projects developed under the National Telecommunications Plan, initially those who favored a strong competition policy prevailed, and companies without franchises were permitted to bid for the projects on the assumption that such companies could operate the systems on a lease basis for 5 years while their franchise requests were pending. Thus Digitel, which still had no franchise, was allowed to participate, and it submitted the highest bid. Soon after the results of the bidding were announced, the Secretary of Justice issued the opinion that it would be illegal for Digitel to run the projects without a franchise. The Department of Transportation and Communication decided to cancel the results of the bid and called for a new one. Digitel filed suit and managed to get the rebidding postponed, but its managers realized that pursuing the case would involve a protracted court battle.

By the time the post-Marcos regime settled in, Aquino administration was approaching the end of its term. Although PLDT had gained strong support within all branches of the government, it invested slowly. Profitability could not have been the problem. The company’s profitability was on the rise and there was a number of firms struggling hard to enter the market. PLDT even fought to reserve underdeveloped regions and services for which it had no plans to invest any time soon. Clearly, all parties involved perceived highly profitable investment opportunities in the sector. Those in control of PLDT succeeded in restricting entry, but did not risk their own investment resources. They must have been seriously concerned about the government’s inability to guarantee them a competitive rate of return beyond the end of the Aquino administration.

Events took a new turn under the administration of Fidel Ramos, who took office in June 1992. Ramos decided to support the entry of new firms into the telecommunications market and to dismantle PLDT’s monopoly (Tiglao 1993a). In February 1993 he presided at the signing ceremony for a joint-venture between Globe Telecom of the Philippines and Singapore Telecom International, which hoped to take over a big part of the market from PLDT (Tiglao 1993b). At the same time, the

4 Manapat (1993, 40) quotes newspaper reports indicating that the buyer may have been a friend of the Cojuangco family.
The president's office also reversed the decision by the previous administration on rebidding the disputed privatization projects and allowed Digitel to operate them (Tiglao 1993c). The administration also asked the Supreme Court to reconsider its ruling against Eastern Telecom, a request made shortly after the author of the decision, Justice Hugo Gutierrez, resigned following allegations that the ruling had been written by a PLDT lawyer (Panaligan 1993). More recently, President Ramos replaced the representatives of the PCGG on the boards of directors of PTIC and PLDT, who had been accused of failing to vigorously represent the government's interests (Tiglao 1993c). PLDT now seems to be financially hard pressed, and financial analysts predict that its profitability may decline sharply in the next few years.

Lessons and approaches to reform

The political structure in the Philippines has been shaped by the desire of a small elite to maintain political and economic power by concentrating power in the executive, leaving the legislature and the judiciary relatively weak. Since the president can modify or reinterpret laws secure in the knowledge that the judiciary is unlikely to rule to the contrary, specific regulations to limit rent extraction are not very effective. Getting such constraints in place is a difficult task, with little political payoff. The formal restrictions that do exist are effective mostly when they take the form of Congressional veto power - e.g., the Congress's role in the controlling entry into public utilities through the franchise system. Other constraints on executive power are largely informal, exercised through personal relationships.

The regulatory system in the Philippines is weak and ineffective and lacks specific and transparent rules due to the same forces that have weakened the judiciary. With the elite maintaining control of the professionals who are supposed to serve as "referees," the government as an institution cannot commit itself to hold to certain policies and to rule out opportunistic regulations. This environment induces a cyclical movement in the investment of telecommunications firms.

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42 The allegations are based on the opinion of David Miles Yerkes, a professor of English at Columbia University and a specialist on the authorship of English-language texts. He was hired by Eastern Telecom to examine the text of the decision and compare it to the writing styles of Justice Gutierrez and the PLDT counsel. Justice Gutierrez, other Supreme Court members, and the PLDT counsel have denied the allegations (Tiglao 1993a).

43 Further allegations of impropriety have arisen from the fact that Mario Locsin, one of the two PCGG representatives on PLDT's board, "was appointed executive vice-president of Philippine Airlines in March [1992], when it was taken over by a consortium led by [Antonio] Cojuangco" (Tiglao, 1993c).
characterized by short periods of expansion and long spells of stagnation. Firms grow mainly during the early years of administrations with which they have close ties. At other times, they grow slowly or stagnate out of concern over the possibility of opportunistic regulations.

The most fundamental way to bring about improvements in the Philippine regulatory system is to shift the balance of power toward the legislature and the judiciary, institutions with inherently greater stability and continuity than the executive branch. The need for such a broad institutional change has long been recognized in the Philippines and, indeed, in the late 1960s and early 1970s a constitutional reform of this type became the main agenda for the political movements in the country. Unfortunately, that attempt backfired and the Philippines was put under an unchecked authoritarian rule for a decade and a half. The system put in place after the years of martial law is more open to non-elite than its pre-martial law predecessor and may eventually evolve toward a more balanced structure. However, short of a fundamental institutional change, what are the prospects for the telecommunications sector?

A number of important reform opportunities emerged under the new political coalition that came to dominate the government after the fall of Marcos. Many coalition partners had strained relationships with the telecommunications firms, most of which had fallen under Marcos’s circle of influence. The members of the new government were interested, at least initially, in increasing the flow of resources through the government. They also favored increased entry into the sector by new private firms. These interests manifested themselves in two developments after 1986: the government began to invest in underdeveloped areas using official development assistance funds, and entry by new firms was facilitated by a liberal interpretation of franchises. The cost-effectiveness of most of the public investments has been quite low, and the projects have been earmarked for privatization.

Though PLDT has had enough clout in Congress to stem any incipient tidal wave of new franchises, many firms already held specialized franchises that allowed them to operate in narrow fields without effectively competing with PLDT. This system of franchises proliferated under Marcos, who allowed his associates to divide the surplus of the sector among themselves. After 1986, when some of the Marcos-related firms were placed in new hands, the National Telecommunications Commission, liberally interpreting the scope of the existing franchises, allowed these firms to expand into areas controlled by PLDT.

The regulators hoped that investment by the expanding firms and the response to this competition by PLDT would invigorate the sector. They also expected that privatization of government assets would provide opportunities for the expanding firms to gain a foothold in their new fields. It is not clear whether these policies are working. Until recently, PLDT managed to hold back some of the expanding telecommunications firms by challenging the new interpretations of their
41 franchises in the courts. In other cases, conflicts with new entrants were resolved largely through interlocking interests among firms (for example, PhilCom, the new entrant into the international telephone service, shares common directors and stockholders with PLDT).

Despite disappointing results so far, current policies show a new potential for reform in which the World Bank and other international institutions may be able to play important roles. Among these potentials for reform:

- **More specific rules.** In the absence of a strong judiciary, getting specific regulatory procedures in place to control rent extraction may not be worth the effort, especially in the case of complex rules requiring expert judgment, whose impartiality is often questioned. A few simple and transparent rules, however, such as indexation to inflation with a limited range of adjustment toward the end of each presidential term, may prove effective. Although such rules are typically rigid and create inefficiencies of their own, they are likely to lead to better outcomes than the current discretionary system.

Other specific rules can also be applied to improve allocative efficiency, though they do not restrict rent extraction. Making the cross-subsidization from international long distance to local services more explicit can improve incentives for investment in the local network. Under the current system, cross-subsidies are implicit: local subscription rates are kept low and PLDT is allowed to earn its profits from long-distance services. This system induces heavier investment in long-distance services and relative neglect of local services. One way to ameliorate the problem is to explicitly subsidize local telephone tariffs, say by designating proceeds from a specific tax on international calls to go into a fund that can be drawn on only if the company invests in local services. This mechanism can improve allocative efficiency and channel more investment to the badly underdeveloped local network.

- **Greater independence of regulatory agencies.** A bill has been introduced that would grant greater independence to the NTC through self-financing and fixed tenure for the commissioner. These changes could reduce the risk of implicit expropriation by relieving political pressures on the regulators. A financially and politically independent regulatory body could more successfully withstand changes in the political climate. Such reforms could also help provide greater resources and incentives for developing the regulatory capability required for efficient operation in a technologically dynamic field such as telecommunications. Independence may raise the possibility of easier capture of regulators by the regulated firms, but a more severe problem of capture already exists under the current system, when the firm has ties with the executive. Capture cannot be a serious problem when the regulated firm lacks close ties with the executive because in that case, the government will put pressure on the regulatory body to keep service prices down and, indeed, it is more likely to be
successful if there is overpricing. Essentially, separation of the regulatory commission from the executive makes it difficult for either of them to unilaterally implement grossly one-sided policies, strengthening the system's check-and-balance mechanisms.

A major benefit of regulatory independence is that it offers stronger incentives to foster the agency's expertise and capabilities. After all, important regulatory policies in that case will be made by the commission itself rather being dictated from above. A relatively successful example of such a reform in a different context is the case of Commission on Elections. Granting of greater independence to that commission in the 1950s substantially reduced ballot-box fraud and rendered elections more legitimate.

Another argument in favor of regulatory independence is that once the NTC begins to act independently of the government, Congress will find it necessary to design more specific rules to restrain the commissioners. A combination of regulatory independence and specific rules can greatly improve the quality and stability of regulations and make policies more credible. Of course, given the existing structure of the Philippines' political economy, passing the appropriate bill through the Congress will not be an easy matter. However, if supported by conditioning of future multilateral foreign loans on the implementation of such charges, the existence of new forces in the government may present a chance for an effective regulatory reform.

- *Increased competition.* Pressures have intensified for the relaxation of entry barriers, although progress has so far been mixed. An important advantage under the Philippine institutional setup of having multiple firms is that at any given point in time at least some of the firms will find the government supportive and will have an incentive to invest. And to the extent that nonuniform treatment can be challenged in court, favorable treatment for some is likely to mean at least reasonable treatment for all. This is particularly the case since cancellation of franchises and authorization certificates is not easy for the government due to the same reasons that their establishment is difficult. As a result, there can be greater hope of policy continuity since each administration will have some incentive to maintain existing regulations. The increased diversity of interests in the sector would thus enhance policy stability and private sector confidence in the system.

In the context of the Philippines' political-economy, a greater number of firms does not necessarily mean increased competition since the possibility of cartelization is not ruled out. Indeed, there are reasons to believe that collusion rather than competition can be the outcome of freer entry: firms that manage to enter the market are likely to be associated with the coalition in control of the executive branch. While political turnover may modestly increase the number of firms in the sector over time, unless powerful new political forces gain influence in the government it does not imply removal of entry barriers that allow incumbent firms to block competition from new firms. As a
result, successful entrant firms have an incentive to cooperate rather than compete. This may explain why the entry of new firms in cellular and international long-distance telephone services has not provoked the kind of vigorous competition expected in these highly profitable areas. Thus, entry by itself may not generate the arms-length competition that is conducive to efficiency and growth.

Of course, the entry of more and more firms over time may by itself establish a new norm, and competition may eventually emerge, especially if political coalitions continue to shift, the threat of rent extraction by unfriendly administrations diminishes. But establishing new norms in this way may take a long time. A more effective reform would be to regularize and ease the process of awarding franchises, in order to reduce the ability of incumbent firms to keep potential entrants out. Easing entry for new firms will have greater impact if combined with more extensive use of transparent specific rules and increased political and financial independence for the regulatory agency.

Besides franchises and permits, an important obstacle to the growth of competition is PLDT’s domination of local networks and control of interconnections. The weaknesses of the regulatory agency allow PLDT to evade interconnection and stifle other firms with limited local networks. Although PLDT has recently agreed to open the company’s facilities to competing phone companies through interconnection (Tiglao 1993c), the problem may not go away easily since there is no guarantee that disputes over details will not arise in the future. However, the problem is likely to diminish if other operators gain control of large local networks. Of course, the most effective solution is to establish and enforce reasonable interconnection rights.

- **International commitment mechanisms.** International political and financial institutions, which have been relatively effective in enforcing the country’s foreign borrowing contracts, might be able to substitute to some extent for missing domestic institutions in providing assurances to investors, perhaps through conditions attached to loans. For a long time after the Philippines gained independence, the United States government played such a role for U.S. investments in the Philippines. Exactly how foreign institutions become involved in a country’s domestic policy concerns in a productive way is a complex and subtle issue. As the analysis here has shown, the enforceability of foreign lending contracts has sometimes been used for the purpose of capital flight by the ruling elite, to the detriment of the country. Similarly, an administration with friendly ties to telecommunications firms may want to use the power of international institutions to guarantee monopoly profits for the firms during future administrations. To prevent such abuses, international commitment mechanisms need to be combined with carefully-crafted regulatory rules verifiable by outsiders (a simplified version of Chilean-style best-practices long-run marginal cost pricing, for example).
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<td>Growth slowdown; High inflation; Easy foreign credit; High international interest rates</td>
<td>Favorable to PLDT; Takeover of small operators mandated</td>
<td>19.4</td>
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Real Fixed Assets
in 1000s of 1967 pesos
Assuming 8% Depreciation

No. of Lines in Service

No. of Telephones

Year

50 51 52 53 54 55 56 57 58 59 60 61 62 63 64 65 66 67 68 69 70 71 72 73 74 75 76 77 78 79 80 81 82 83 84 85 86 87 88 89 90 91
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- 40% Rate Increase
- Currency Devaluation
- 35% Rate Increase
- 5% Rate Increase
- Indexation
- 10% Rate Reduction

Real Fixed Assets in 1997 Prices with 6% Dep.

Currency Devaluation

Return on Equity

Year

X-1 X-2 X-3 X-5
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Rate of Return on Real Fixed Assets
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Year
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