Report No: 26946-PH

PHILIPPINES
DEVELOPMENT POLICY UPDATE

October 16, 2003

Poverty Reduction and Economic Management Sector Unit
East Asia and Pacific Regional Office

CURRENCY EQUIVALENTS

(As of 16 October 2003)

Currency Unit	=	Peso
$1.00	=	PhP54.69

FISCAL YEAR

January 1 – December 31

ACRONYMS AND ABBREVIATIONS

AMLA	Anti-Money Laundering Act
APJR	Action Program for Judicial Reform
ARMM	Autonomous Region for Muslim Mindanao
BIR	Bureau of Internal Revenue
BOC	Bureau of Customs
BOI	Board of Investment
BSP	Bangko Sentral ng Pilipinas
BTr	Bureau of Treasury
CHED	Commission on Higher Education
CAR	Capital Adequacy Ratio
COA	Commission on Audit
CPA	Corrective Prompt Action
CPS	Consolidated Public Sector
CPSD	Consolidated Public Sector Deficit
CSC	Civil Service Commission
DBM	Department of Budget and Management
DepEd	Department of Education
DOF	Department of Finance
DST	Documentary Stamp Tax
ECs	Electric Cooperatives
EIU	Economic Intelligence Unit
EPIRA	Electric Power Industry Reform Act
ERC	Energy Regulatory Commission
FATF	Financial Action Task Force
FDI	Foreign Direct Investment
IPO	Initial Public Offering
GDP	Gross Domestic Product
GENCO	Generation Companies
GNP	Gross National Product
GOCC	Government-Owned and Controlled Corporation
GSIS	Government Service Insurance System
HIV/AIDS	Human Immune Virus/Acquired Immuno Deficiency Syndrome
ICT	Information, Communication and Technology
IPP	Independent Power Producer
IT	Information Technology
LFPR	Labor Force Participation Rate
LGC	Local Government Code
LGU	Local Government Unit
LTS	Large Taxpayer Service
MDGs	Millennium Development Goals
MFN	Most Favored Nation
NCR	National Capital Region
NG	National Government
NGAS	New Government Accounting System
NGO	Non-government organization
NPA	Non-Performing Assets
NPC	National Power Corporation
NPL	Non-performing loan
NSO	National Statistics Office
PCA	Prompt Corrective Action
PCAGC	Presidential Commission Against Graft and Corruption
PDIC	Philippine Deposit Insurance Corporation
PSALM	Power Sector Assets and Liabilities Management Corporation
PPI	Private Participation in Infrastructure
PPP	Purchasing Price Parity
PSE	Philippine Stock Exchange
ROPOA	Real and Other Properties Owned and Acquired
ROSC	Report on Standards and Codes
SEC	Securities and Exchange Commission
SPV	Special Purpose Vehicle
SSS	Social Security System
TESDA	Technical Education and Skills Development Authority
TLP	Total Loan Portfolio
TRANSCO	National Transmission Corporation
UNDP	United Nations Development Programme
WESM	Wholesale Electricity Spot Market
WTO	World Trade Organization

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Acknowledgement

This report is prepared by a team led by Lloyd McKay which included Joven Balbosa, James Villafuerte, and Marjorie Espiritu. Other major contributors were Miguel Navarro-Martin, Gaurav Datt, Chorching Goh, Arvind Gupta, Teresa Ho, Selina Shum, Idah Pswarayi-Riddihough, Amitabha Mukherjee, Sameer Goyal and Sanjay Dhar. Bernard Funck and Brian Pinto served as peer reviewers.

Executive Summary

The Philippines has achieved reasonable economic growth of about 4 percent per annum over the past two years, in spite of adverse global developments (e.g. slow world economic growth, depressed demand for electronics, the war in Iraq, and SARS), sporadic conflict in Mindanao, political uncertainty and investor concerns regarding fiscal sustainability. Moreover, this growth has been geographically widespread, with agriculture and service sector growth being particularly prominent. As a result, poverty is being reduced, but the high population growth rate means that per capita GDP has only grown at about 2 percent per annum and poverty reduction has been modest.

The economy has been particularly resilient in view of concerns regarding fiscal management and the limited recovery in investment since the 1997 Asian financial crisis. As acknowledged by government and economic analysts alike, the expansion of the National Government (NG) deficit to 5.3 percent of GDP in 2002, and the five year decline in tax revenues to below 12 percent of GDP posed a major challenge. Progress has been made in 2003 in turning around both these trends through tight expenditure control in the first half of the year and a concerted improvement in tax administration. But it will take several years of good progress to recreate a reasonable level of fiscal flexibility, bring the fiscal deficit to GDP and the debt to GDP ratios down, rebuild market confidence and thus reduce bond spreads and real interest rates to previous levels, and increase resources for social expenditures and strategically important public investments.

The persistent low levels of investment – below 20 percent of GNP compared with about 23 percent in the early to mid 1990s - raises concerns about future growth. Without a rebuilding of investor confidence and parallel rise in investment, it is difficult to envisage the hoped for rapid growth, employment creation and poverty reduction being sustained. Indeed, the rate of investment has been so low relative to expansion of the labor force that the ratio of capital per worker has fallen—in marked contrast to other rapidly developing countries such as Thailand. And questions about the quality of education amplify the concerns with stagnation of labor productivity.

In recent years it has been consumption rather than investment that has underpinned growth, and this cannot continue indefinitely. This relatively strong growth of domestic consumption, coupled with a slowdown in export growth in 2003 and a lack of capital inflows has increased pressure on external balances and the Peso. In fact, the Peso has depreciated by 4 percent against the weakening US dollar over the past two years while the Thai Baht, for example, has appreciated by 8 percent. However, continued strong overseas worker remittances (more than $8 bn per annum), the prospects for a rise in export growth if the Philippines can effectively link with China's growth, and renewed investment as political uncertainties wane and there is sustained peace, could reverse this pressure and contribute to higher growth.

Sustained geographically dispersed economic growth and relatively stable prices (inflation of 3-4 percent per annum) have resulted in a decline in poverty. And there has been reasonably good progress with most of the Millennium Development Goals (MDGs) since 2000. The percentage of Filipinos living on less than $1 per day is projected to have fallen from about 13.5 percent in 2000 to 11.2 percent in 2003, while the percentage living on less than $2 per day is projected to have fallen from about 47 percent to 44 percent. Others MDGs for which there is a high probability of success are access to water, universal primary education, gender equality in access to primary education, reducing child mortality, and stopping the spread of

HIV/AIDS. The two where extra effort appears to be needed for the goals to be reached are halving the proportion of underweight children and reducing maternal mortality by 75 percent.

Both the public and private sector will need to contribute for the Philippines to more fully achieve its development objectives. Three issues are central to improved public sector performance – fiscal management (especially revenue mobilization), off-budget losses and contingent liabilities (GOCCs and pension funds), and governance:

- ***Increase revenues while containing expenditures.*** As the tax revenue to GDP ratio had fallen from over 16 percent in 1997 to less than 12 percent in 2002, the welcome improvement in mid 2003 is just a beginning. Ongoing efforts to further improve tax administration must be continued and need to be complemented by legislative actions to sustain a recovery in the tax to GDP ratio of 0.5-1 percentage point per annum for the next few years. As planned this should include restoring the real value of excise taxes and preventing them from again being eroded by inflation. And tax-based investment incentives need to be limited to contain tax losses. Without a recovery in revenues and the continued containment of recurrent expenditures, government would continue to lack the necessary resources to improve human resource investments, protect the poor, and address critical shortcomings in infrastructure.
- ***Reduce off-budget public sector losses.*** The ballooning expansion of NPC losses needs to cease and off-budget losses as a whole decline to avoid offsetting the hard-won gains in NG fiscal management. The objectives of the power sector reforms need to be realized through transparent privatization, stronger governance in GOCCs awaiting privatization, and reinforcement of a credible, non-politicized regulatory environment. The prospective deficits of the largest government-managed pension fund (SSS) also need to be addressed. Recent measures, such as a one percentage point increase in contributions, are helpful, but will need to be complemented by further actions to achieve financial sustainability of the Social Security System.
- ***Improve governance.*** Third, efforts to improve public sector governance need to continue to improve the efficiency of resource use, help rebuild investor confidence, and enhance peace and personal security. Recent finalization of implementation arrangements for procurement reforms will help, and reforms under way for the judiciary are widely acknowledged. So too are the planned civil service reforms, well researched lifestyle checks of government officials and efforts to increase audit effectiveness. Overall, though, there is a need for continued vigorous efforts to enhance public sector governance and reduce corruption as part of the effort to rebuild confidence, increase efficiency and improve the rule of law.

Mindful of the Philippines' relatively poor competitiveness coupled with the fact that growth, employment creation and poverty reduction depend critically on private sector performance, this update has focused on three key investment issues – infrastructure, the financial sector, and competition. Improved private sector performance depends on success with actions in these areas to complement macroeconomic stability, efforts to enhance peace and security, and reduced uncertainty:

- ***Improve infrastructure.*** The importance of accelerating efforts to alleviate infrastructure bottlenecks and reduce the cost of infrastructure services is widely acknowledged. This calls for further privatization of infrastructure, a stable and credible regulatory environment for private providers of infrastructure in transport, water, power and telecommunications, and an increase in maintenance and investment from private and public sources.

- ***Strengthen the financial sector.*** Ongoing efforts to strengthen and deepen the financial sector need to succeed to support improvements in productivity and the much needed recovery in investment. Efforts under way to reduce the burden of non-performing loans on banks need to succeed to reduce risks, enable banks to expand lending, and reduce margins. And further banking sector reforms, including increased authority and legal protection for bank regulators, are still needed to facilitate the rapid resolution of distressed banks and bring the Philippines in line with international and regional best practices. Strengthening non-bank financial institutions and capital markets calls for further improvements in property, shareholder and creditor rights, insolvency laws and corporate governance.

- ***Strengthen competition.*** To increase investment the Philippines also needs to keep pace with other developing countries in terms of the investment environment. To enhance productivity, markets need to be contestable. Investment needs to be rising, but in response to market incentives and opportunities. In this context, it is important that the temptation to role back import tariff rates to previously higher levels be resisted as this would impede competition and implicitly tax exports. Barriers to entry need to be reduced, and efforts under way to strengthen transparency, corporate governance, contract security and investor rights need to succeed.

Summary of Key Priorities – The Ten Most Needed

- Increase the tax to GDP ratio by at least 0.5 percentage points per year. Supportive measures should include continued vigilance on tax administration, appropriate legislation on excise taxes and tightening the investment incentive regime.
- Reduce NPC and other GOCC losses to avoid them offsetting hard won improvements in NG fiscal management.
- Articulate a vision for making the pension funds financially sustainable and progressively implement it.
- Press ahead with plans for civil service reform, including rationalizing, de-politicizing, professionalizing, and moving to a meritocratic system.
- Accelerate efforts, such as the power sector reforms, to alleviate infrastructure bottlenecks and reduce the cost of infrastructure services.
- Facilitate a reduction of non-performing loans in the banking sector and associated corporate restructuring.
- Further strengthen property, shareholder and creditor rights to help deepen capital markets.
- Resist pressure to increase import protection, but instead, press on with efforts to increase productivity, market competition and competitive behavior.
- Improve the quality of basic education, and ensure resources for priority health programs including reproductive health.
- Enhance peace and personal security.

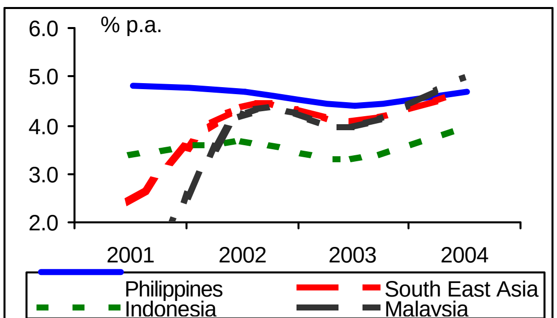
I. RECENT ECONOMIC AND SOCIAL DEVELOPMENTS

A. Economy Exhibits Resiliency to Shocks

Output

Over the past two years, the Philippines has achieved reasonable though modest economic growth (4.4 and 3.9 percent per annum for GDP in 2002 and the first half of 2003)[1] with services sector and agriculture growth being particularly prominent. And this has been achieved in spite of adverse global and domestic developments, such as slow world economic growth, weak demand for electronics, war in Iraq, SARS, renewed conflict in Mindanao and political uncertainty. Indeed, since 2002 the Philippines performed at par with most Southeast Asian economies (Fig. 1.1). Moreover, this growth was geographically dispersed with 12 out of 16 regions posting growth. On average, per capita GDP has grown at about 2 percent per annum (Figure 1.1).

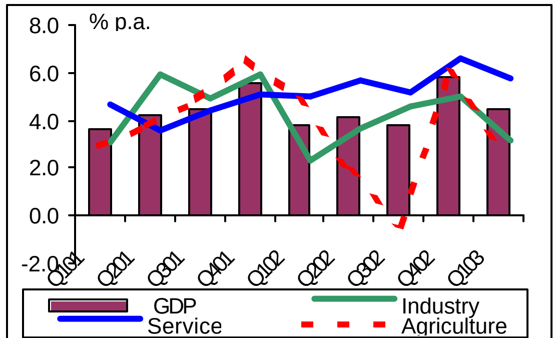
Figure 1.1: Economic growth is reasonable



Source: WB Forecast

A large proportion of this growth has taken place in the services sector (5.4 percent growth in 2002 and 5.3 percent in the first half of 2003) where telecommunications, transportation, and the trade sectors have grown strongly. In particular, the demand for wireless services, roll-on-roll-out transport schemes, and cargo handling, rose significantly, while recovery in the housing and real estate sectors provided an extra boost to services. Transferring public holidays to create additional long weekends has also encouraged the growth in local travel and domestic tourism (Figure 1.2)

Figure 1.2: Services lead growth



Source: NSCB

Solid growth in agriculture (3.3 percent in 2002 and 2.4 percent in the first half of 2003) occurred without the benefit of ideal weather given the prolonged spell of *el nino*. This performance appears to be attributable to a number of factors - larger public outlays since 1997 for irrigation systems, post-harvest facilities, and agricultural extension services, the application of fertilizers, the use of hybrid crop varieties and the wider adoption of modern farming techniques. Agricultural production also expanded in response to the upswing in the prices of key agricultural commodities and credit provided by banks and micro-credit facilities.

Manufacturing growth has been relatively broad, with 13 out of 20 sectors enjoying an increase. Growing sub-sectors include metals, machinery except electrical, products of petroleum and coal, chemicals, paper and paper products, textile, footwear and food manufactures. These industries have grown due to rising demand for industrial products.

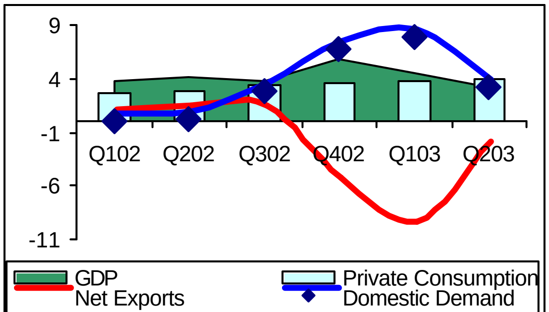
Demand was underpinned by the sturdy growth of private consumption (4.1 percent in 2002 and 5 percent in the first half of 2003) which has been sustained by a healthy inflow of factor income from abroad, particularly overseas worker remittances which have grown by 17 percent in the first half of this year[2]. Remittances have risen on account of the growing pool of nurses, caregivers and IT

[1] The corresponding rates of growth for GNP were 5 percent and 4.6 percent.

[2] Remittances reached $4.5 billion from January-July 2003.

professionals abroad. Stable food prices, have supported a bigger volume of household spending for food, housing, and utilities. A significant reduction in lightrail fares in Manila triggered substitution in transport demand, with people shifting to lightrail. Moreover, with more open borders, this strong consumer demand is reflected in strong import growth (Figure 1.3).

Figure 1.3: Consumption underpins growth (percent per annum)

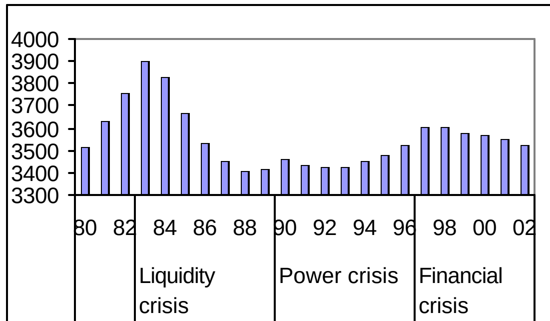


Source: Computed from NSCB Data.

In mid-2003, however, the pace of growth moderated, with GDP growing at 3.2 percent compared to 4.5 percent growth in the second quarter 2003. This slowdown has emanated from the adverse effects of weak external demand on exports, drought on rice and corn production, and tighter government spending. Export growth tumbled as import demand from industrialized countries contracted. Trade in Asia was also severely affected by SARs. The tight fiscal budget has reduced capital outlays for such activities as water supply, irrigation and roads. And fiscal austerity measures have also weakened public spending on social services.

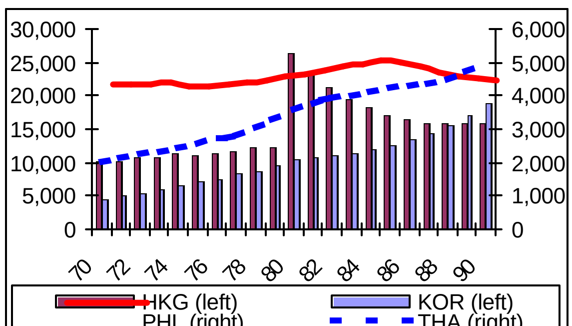
Structural weaknesses have also contributed to this slow-paced growth. In recent years, the consistent growth in output combined with the low rate of capital replacement has depleted the country's excess production capacity. The share of investment to GDP has fallen from a high of 25 percent in 1997 to around 20-21 percent from 2000 to 2002. Together with rapid population growth, this has led to a fall in the capital stock per worker being stagnant or falling over the past 20 years (Figure 1.4). There were two periods where marked declines in capital stock per worker were observed. The first from 1983, to 1986 during the liquidity crisis when the country defaulted on debt. The second came after the Asian crisis when there was a large capital outflow and investor confidence has been slow to recover. As a result, the Philippines now has one of the lowest capital stock per worker among market economies in Southeast Asia[3]. In contrast, Thailand's capital stock per worker, which was only half of the Philippines' in 1970, exceeded that of the Philippines by 1990 (Figure 1.5)

Figure 1.4: Capital stock per worker falls (in US dollars)



Source: Computed from NSCB

Figure 1.5: Philippine capital stock per worker lags behind (in US dollars)



Source: Easterly and Ross Levine.Dataset.

[3] The computation of capital stock for the Philippines was based on the method described in Easterly, W. and Ross Levine, "It's not factor accumulation: stylized facts and growth models." The country comparison was based on the original dataset obtained from Easterly and Levine.

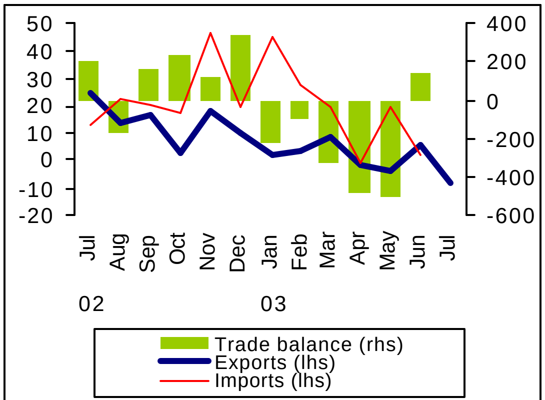
At the same time, the unbalanced demand structure suggests that the present growth path may not be sustainable. At present, approximately 80 percent of growth comes from private consumption. Investment and Government consumption make very modest contributions to growth. As the trade balance has moved for positive to negative, net exports have made a negative contribution to growth. The concentration of growth in consumer demand and services has been associated with imports rising more rapidly than exports. In the first five months of 2003, imports of consumer goods rose by almost 21 percent. To date, only the strong inflow of remittances is offsetting the deterioration in the trade balance. If overseas worker remittances were to weaken, the current account balance and Peso would be further pressured.

Trade & Balance of Payments

During the last two years, the tentative global recovery, coupled with cyclical volatility in electronics has weakened exports. This was further exacerbated by SARs which affected demand from within East Asia. On a year-on-year basis, merchandise exports grew 1 percent in the first seven months of 2003, compared to the 14 percent growth in the second half of 2002. The drop in exports was pronounced for electrical equipment, parts & telecommunications (-7.5%), travel goods and handbags (-23.4%), and footwear (-12.5%). Exports to major markets have also contracted – US (-16%), Taiwan (-16%), Singapore (-8%), Netherlands (-6%), and Korea (-2%). On the import side, increases in oil prices, higher demand for oil inventories, increased imports of capital goods, and the more expensive cost of transport and insurance contributed to a 16.6 percent growth in imports[4]. These two factors, together, resulted in a reversal in the balance of trade from a surplus of $0.8 bn in the first half of 2002 to a deficit of $1.5 bn in the first half of 2003. In spite of this, and due to the offsetting inflow of remittance, a current account surplus equivalent to 2.1 percent of GNP was still recorded for the first half of this year (Figure 1.6).

On the capital account, the small inflow of portfolio and equity investments, weak credit disbursement from official sources, and large debt amortization suggest a larger than usual outflow of capital. Investment inflows have remained low due to weak exports and an uncertain political environment. From January-June, FDI inflows had fallen by around 90 percent from US$0.9 bn during a comparable period last year to US$0.1 bn this year. In the first six months of this year, a net capital outflow of $2.4 bn was recorded in contrast to a net inflow of $1.7 bn last year. Net official flows have slowed due to rising amortization payments and delays in utilizing project loans. For this year and next, it is expected that the country will make net repayments of about $2 billion to official creditors.

Figure 1.6: Trade balance weakens (in percent [lhs], in USD mn [rhs])



Source: NSO

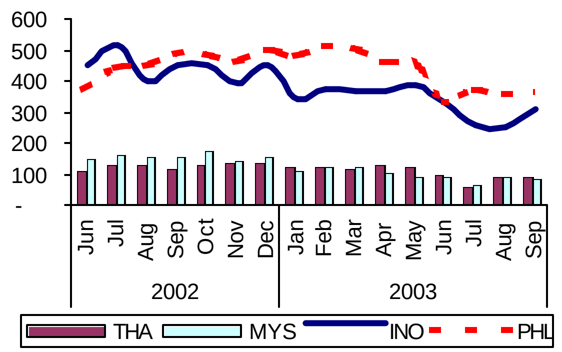
The combined effect of this is that the balance of payments have registered a net outflow of $0.6 bn for the first half of 2003, compared with a net inflow of $1.7 bn last year. Sovereign and private bond issues offset this but at still relatively expensive terms – of around 370 basis points for Eurospreads. Overall, the perceived risk to the country's external position is manifested in the bond spreads which have remained one of the highest in the region (Figure 1.7).

Immediately after the financial crisis in 1997, the maturity period for new debt was shortened to five years, resulting in repayments for this and loans incurred in the early 1990s, when the country borrowed

4 The import value of oil rose 42%, capital goods rose 16.6%, and consumer goods rose 21.3%.

heavily to avert a power crisis, being heavily concentrated in 2003 and 2004. As a result, the ratio of debt service to exports has gone up by more than a percentage point from 20.6 percent to 22 percent this year.

Figure 1.7: Eurospreads still high (in basis points)



Source: Haver Analytics

Investment and Savings

During the last three years, gross national savings as a proportion of GDP has been reported at 24-27 percent, largely on the back of strong inflow of remittances from abroad (Table 1.1). In part, this pool of savings was used to accumulate foreign assets. The public sector has also utilized private savings to finance the budget deficit.

Table 1.1: Investment stagnates

As % of GDP	1999	2000	2001	2002
Gross domestic saving	14.3	17.3	18.1	19.5
Gross national saving	21.7	24.2	25.4	26.8
Gross domestic capital formation	18.8	21.2	20.6	19.3
Fiscal Balance	-3.8	-4.1	-4.0	-5.2

Source: Computed from NSCB

Despite the availability of savings, however, domestic investments continue to suffer from the negative effect of a poor investment climate, and a contraction in public investment. In addition, perceptions of fiscal and external vulnerability, regulatory and political uncertainty, corruption, and concerns about personal security have undermined business confidence. Based on the August 2003 business confidence survey, 76% of respondents did not have expansion plans. In a similar vein, the leading economic indicators for the third quarter of 2003 have weakened with declining energy consumption, falling imports, softening producer prices, declining sales volume and a depreciating Peso.

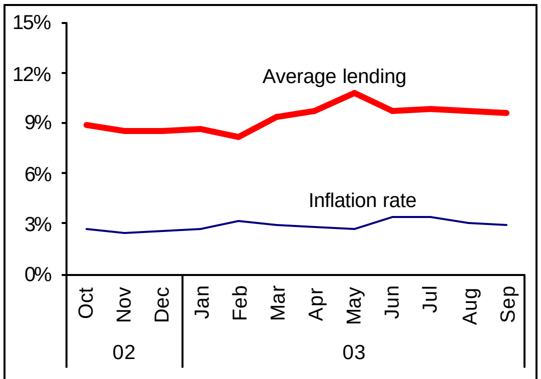
Money, Prices and the Peso

During the last two years, monetary policy has generally supported growth. Since 2001, the central bank has cut policy interest rates ten times, bringing the rates down by 225 basis points. A tiering deposit system was also introduced and effectively lowered the yields on deposits with the central bank[5]. The central bank has also reduced the reserve requirement by two percentage points. The result from this monetary expansion was a fall in the average bank lending rate by 350 basis points, and private sector credit growing again after contracting in 2001.

Inflation for the first nine months of 2003 remained well below target and at par with last year's rate at around 3 percent. Due to ample liquidity and low inflation, and cuts in the policy rate by the central bank, domestic interest rates have fallen substantially in nominal terms. The 91-day treasury bill rate fell from almost 10 percent in 2001 to around 5.4 percent in 2002 and lending rates dipped from 12.4 percent in 2001 to 8.9 in 2002. Between February to May 2003, rates crept up marginally but have trended down again since. It is notable, however, that the spread between the deposit and the lending rate has widened and remains one of the highest in the region (Figure 1.8)

[5] The tiering system was first introduced in August 2001 to encourage bank lending and to support the issuance of treasury bill rates. The tiered rates offer different yields to different volume of deposits, i.e., P5 billion deposit gets 7 percent, P5-10 billion gets 4 percent, and deposits greater than P10 billion received only 1 percent. This tiering was removed in mid 2003.

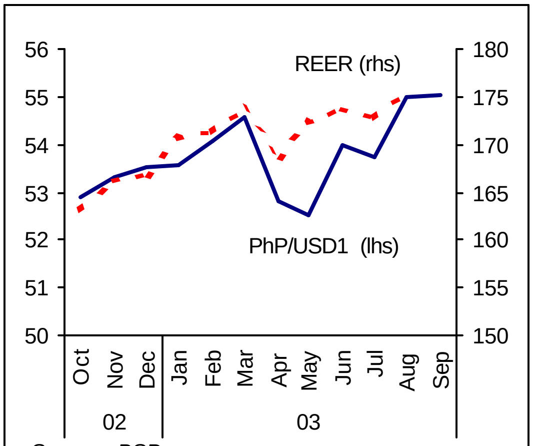
Figure 1.8 Inflation modest



Source: BSP, NSO

In contrast to most regional currencies which have appreciated vis-à-vis the US dollar, the Peso has depreciated in 2003 (Table 1.2). This weakness can be traced to a number of factors including fiscal performance, weaker than expected export growth, security concerns, and political uncertainty. To arrest the slide of the currency, the central bank has taken precautionary measures including, the reduction of the maximum tenor of forward contracts, limitation on the foreign exchange overbought positions of banks, and increasing the outstanding short position of the central bank in the non-deliverable forward contracts.

Figure 1.9 Peso weakens again (Peso/USD[lhs], Index [rhs])



Source: BSP

Table 1.2: Local currencies/USD

	2001	2002	8 Sep 03	Depre-ciation from 2001 level
Phil. Peso	51.6	53.4	55.2	-6.5
Singapore $	1.8	1.7	1.8	5.2
Thai Baht	44.2	43.1	40.5	9.3
Indo Rupiah	10,400	8,950	8,463	22.9

Source: Concensus Economics, Sept. 2003

Employment

The large number of unemployed and underemployed have historically reflected the absence of sustained, rapid economic growth amidst high population growth. In the last four years, the labor force has grown by 3.4 percent per annum, compared to the 3.1 percent growth per annum in jobs. Another factor that explains the labor market imbalance is the significant recovery in the labor force participation rate (LFPR). LFPR rose from about 65 percent in 2000 to 67.4 percent in July 2003. Mostly, these people reentered the labor market based on the perceived improvement in employment opportunities. The quality of employment is also often low as the numbers of own-account workers and unpaid family labor accounts for more than half of those employed.

Weak labor market institutions also contribute to the unsatisfactory level of employment. These institutions are intended to promote job facilitation, training and retraining, social dialogue, and social security. However, except for promoting social dialogue, their achievements have been modest. For job facilitation, the absence of institutional information on job vacancies has resulted in a small number of workers being placed. Technical Education and Skills Development Authority (TESDA) and Commission on Higher Education (CHED) have had limited manpower compliment, management capability, and financial resources for training and retraining activities. In terms of social security, records on labor standards show that only a limited number of institutions are being inspected and only a small portion of those inspected are complying. Thus, the only significant success appears to be in promoting effective labor market conciliation which has contributed to a peaceful labor market as evidenced by the small incidences of labor disputes (28) with very limited man-days lost (128).

Table 1.3: Labor force and employment

	July 02	July 03
(000)		
Total 15 yrs old & over	50.5	50.7
Labor Force	33.9	34.2
Employed	30.1	29.8
Unemployed	3.8	4.3
Underemployed	5.1	6.2
(percent)		
LF Participation rate	67.1	67.4
Employment rate	88.8	87.3
Unemployment rate	11.2	12.7
Underemployment rate	17.1	20.8

Source: NSO

B. Social Development Outcomes Have Been Mixed

Poverty

Notwithstanding the achievement in economic growth, the performance of the country in terms of social development has been mixed. In the 1990s poverty fell significantly as the share of Filipinos living on less than $1 per day feel from 19.1 percent in 1994 to 12.1 in 1997 and as per capita GNP grew 3 percent during the period 1995-1997. During this period the elasticity of poverty reduction with respect to growth was high as growth in services and construction facilitated the transfer of labor to the more advance sector. Thereafter, between 1997-2000, poverty increased due to lower growth, especially in labor absorbing activities such as construction.

Table 1.4: Headcount index (%) and number of the poor, 1997 - 2004

Year	1993-PPP-US$1/day, % below	Number living below (mn)	1993-PPP-US$2/day, % below	Number living below (Mn)
1997	12.1	8.6	45.2	32.3
2000	13.5	10.3	47.1	35.9
2001	12.2	9.5	45.8	35.6
2002	11.9	9.5	45.3	36.0
2003	11.2	9.1	44.3	35.9

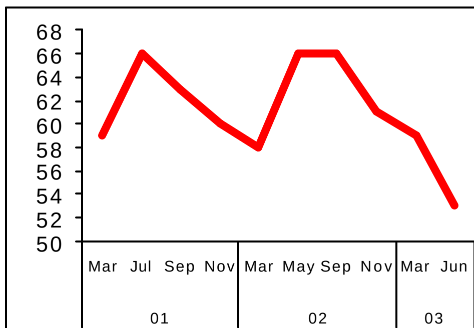
Source: World Bank

<u>Note</u>: Years 1997 and 2000 are based on actual data from Family Income and Expenditure Surveys, years 2001-2004 are Bank Staff's projectors.

Projections of poverty changes suggest that the incidence of poverty has again begun to fall since 2000. Growth of 4.0-4.5 percent per year and the geographically widespread nature of this growth leads to this projected fall in the incidence of Filipinos living on less that $1 per day ($2 per day) from 13.5 (47.1) percent in 2000 to 11.2 (44.3) percent in 2003.

Social Weather Station's recent self-rated poverty data supports this observation. After attaining a peak of 66 percent in mid-2002, it has fallen to 53 percent in mid-2003 (Fig. 1.10).

Figure 1.10: Self-rated poverty falls (in percent)



Source: Social Weather Station

On a regional basis, the disparity in income is still stark. Based on government data, the 10 poorest provinces are found in the ARMM, Cordillera, and Bicol regions. These areas are frequented by armed conflict, are economically isolated, and are endowed with little infrastructure[6]. Among the four poorest provinces, poverty incidence ranges from 53-63 percent based on the government's income measure. In comparison, the least poor provinces has poverty incidence ranging from 5-12 percent. Not surprisingly the poorest regions also experience the worst gap and severity of poverty.

Table 1.5: Poverty measures of the poorest provinces, 2000.

	Headcount (%)		Poverty Gap (%)		Poverty Severity (%)	
Based on	Expenditure	Income	Expenditure	Income	Expenditure	Income
Provinces						
Masbate	70.8	62.8	24.2	22.6	10.4	10.6
Romblon	74.3	55.2	23.6	18.5	9.8	8.2
Tawi Tawi	75.3	56.5	25.7	15.4	11	5.6
Sulu	92	63.2	37.1	17.1	16.9	5.8

Source: NSCB

Occupational choice and education play an important role in the determination of poverty. Six out of ten poor families are in agriculture. Equally notable, fifty percent of the poor have very little education. More importantly, the consumption shortfall for the uneducated poor was twice that of the poor with primary education and five times that of the poor with high school education.

Millennium Development Goals

Sustained economic growth, stable markets and strong commitment from the government have generated substantive progress in attaining most of the Millennium Development Goals (MDGs)[7]. This section reviews six out of the eight goals which are closest to human development, namely: a) eradicate extreme poverty and hunger; b) achieve universal primary education; c) promote gender equality; d) reduce child mortality; e) improve maternal health; and f) combat HIV/AIDs, malaria and other diseases. Based on the most recent review, six out of the eight basic targets under these goals have a high probability of being attained. These are: a) halving the proportion of people below the poverty threshold; b) halving the proportion of people without access to clean water; c) achieving universal primary education; d) attaining equal access for boys and girls in primary school; e) reducing child under-5 mortality by two-thirds; and f) stopping the spread of HIV/AIDS, malaria and tuberculosis. Two targets - hunger (halving the proportion of underweight who are under five years old) and maternal health (reducing maternal mortality by three-fourths) - are not likely to be met as the current rate of progress is very low. Among outstanding issues which needs to be addressed are:

- *Eradicate Extreme Poverty and Hunger* - despite the significant reduction in subsistence poverty there are still 2.5 million households who are food poor and the proportion of stunted children is high.
- *Achieve Universal Primary Education* - the gender neutral and almost universal enrollment rates have masked the problem in educational effectiveness or quality (see Table 1.6).

Table 1.6 Quality of education is poor

Countries	Average Scale Score
Taiwan	569
Singapore	568
Korea	549
Hongkong	530
Malaysia	492
Thailand	482
Indonesia	435
Philippines	345
Intl. Ave. Score	488

Source: TIMSS

- *Reduce Child Mortality* - while average child health has improved, the disparity of health status across income groups and geographic locations has not narrowed.
- *Reduce Maternal Mortality* - maternal mortality rates in the Philippines have remained one of the highest in the region. Regional disparity is also high

[6] For instance, renewed conflict in Mindanao has displaced over 100,000 people. The per capita income of ARMM is 40 percent of that for Mindanao and only 12.6 percent of that for National Capital Region. Six out of the ten poorest provinc es on the official list are in Mindanao.

7 This section draws primarily from the UNDP Progress Report of January 2003, Philippines Progress Report on the MDGs.

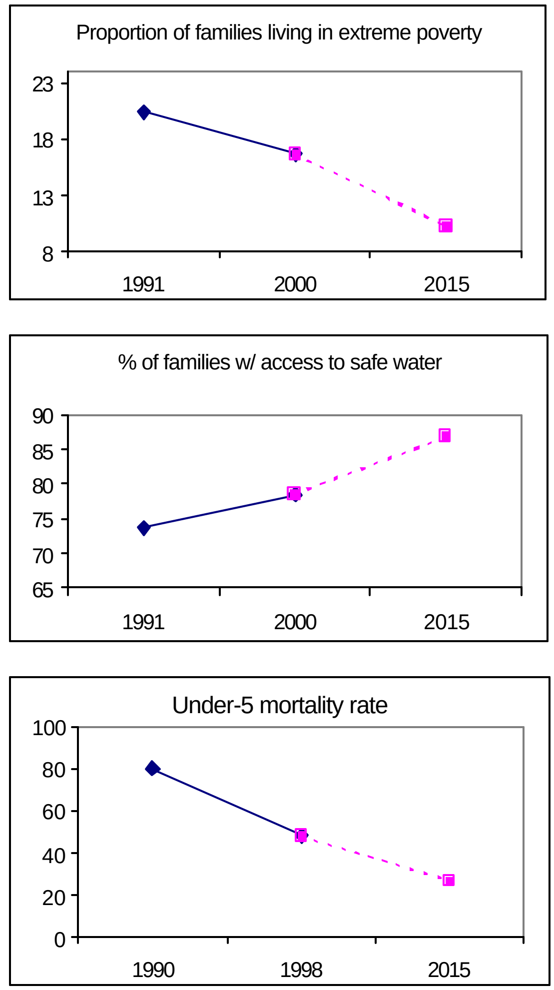
with mortality rates in ARMM almost three times that for the National Capital Region. The devolution of health care services continue to pose a threat to maternal health care.

- *Combat HIV/AIDS, Malaria, and Tuberculosis* - while HIV/AIDs is under control, Malaria and Tuberculosis continue to be primary health concern especially for the high-risk groups, i.e., indigenous people, upland subsistence farmers, forest workers, and migrant agriculture workers in the remote areas. There is a need to increase capacity of local health programs to handle the prevention and control of malaria and tuberculosis.

The government's commitment to the MDGs and to programs that emphasized poverty issues is commendable. These programs, together with growth, have improved human development outcomes reduced poverty substantially since the early 1990s. However, moving forward, income inequality remains acute, and disparity in health and education outcomes, and access to services are wide between income groups and provinces and need to be reduced. To do this, there are needs for further analytical work, a review of existing policies, and consultation in defining priority areas of public action for equitable growth and focused poverty programs. Several important areas include creating an investment climate with a stable macroeconomic environment conducive to growth; improving governance and reducing corruption; promoting and sustaining regional peace in areas of conflict; addressing issues in agriculture to improve rural livelihoods; improving human capital by ensuring the poor have access to quality education and health care; and improving access to basic infrastructure such as water, sanitation, transport, power and communications.

Figure 1.11: MDG goals are attainable

(in percent)



II. IMPROVING PUBLIC SECTOR PERFORMANCE

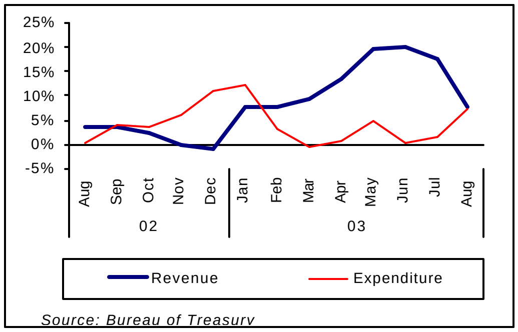
The National Government (NG) achieved an important turnaround in its fiscal performance in the first eight months of 2003. Government spending has, however, accelerated in the third quarter and will have to be checked if the NG deficit target is to be met. Moreover, this improving NG performance is being undermined by rising deficits of government owned and controlled corporations (GOCCs), emanating primarily from losses in the power sector. As a result, the consolidated public sector deficit (CPSD) is expected to continue to grow in 2003, adding to the debt stock, and ultimately, threatening to crowd-out needed social expenditures to the poor.

A. Fiscal Performance and Revenue Mobilization

For the first eight months of 2003 the NG fiscal deficit amounted to P114 billion, P14 billion below target. For the same period, revenues reached P408 billion, P25 billion above target, or 12.4% higher than the same period last year. Expenditures reached P522 billion, P11 billion or 2.2% above program, and 3% higher than last year's level (Figure 2.1). The turnaround in revenue performance is quite significant, particularly in the context of declining tax revenue[8] for five consecutive years.

Underpinning this increase in revenue was a 13% increase for the Bureau of Internal Revenue (BIR) and a 14% increase for the Bureau of Customs (BOC). Revenue collections at the BOC improved as measures were put in place to improve trade facilitation, track revenue collection from the major ports, and promote transparency and accountability. The upsurge in oil imports in the early part of the year and the weakness of the peso have also contributed to

Figure 2.1: NG revenue outpace expenditure (% yoy, 3-month moving average)



Source: Bureau of Treasury

improved collections. At the BIR, on-going administrative reform efforts have had a positive effect. Beginning early this year, the bureau has implemented a five-point strategy in boosting collection:

1. *More effective compliance control systems*. This includes electronic-based tax collection and monitoring systems, resolution of pending court cases, and review of tax exemption rulings, tax refunds, use of VAT input credits, income tax holidays, and net-operating-loss-carryover policies.

2. *Detection and reduction of revenue leakages*. The expansion and better utilization of existing third party information databases of the BIR, and enhancement of existing detection systems that cover stop filers tracking, delinquent accounts and case management systems.

3. *Intensified enforcement focusing on pro-active and computer assisted audits; and special operations on professionals and self-employed (e.g., doctors, lawyers, and other professionals)*. A very visible component of this strategy is the "BIR on Wheels" program, where BIR staff wearing conspicuous red shirts visit malls and market areas to check tax records of various establishments.

4. *Organizational adjustments*. Review of the Large Taxpayer Service unit (LTS), and regional district office operations, collaboration with the Presidential Commission Against Graft and Corruption (PCAGC) on life-style check[9],

8 Tax revenue has deteriorated by about 5 percentage points of GDP since 1997. A mix blend of three factors is found to be responsible for the decline in tax revenue since 1997: 1) the slowdown in the economy in the aftermath of the East Asia crisis and the El Nino phenomenon; 2) policy changes affecting tax collection – or in the case of excise taxes the lack thereof; and 3) administrative efficiency.

9 The DOF recently filed a case in court against 3 BIR and 1 BOC officials under the life-style check initiative.

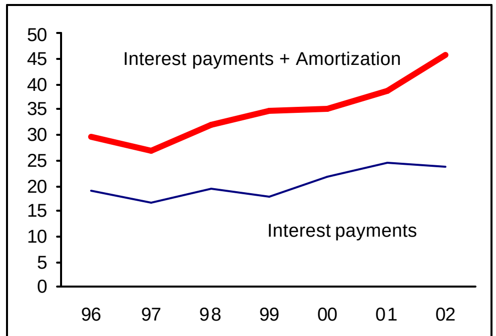
and linking up with Commission on Audit (COA), Board of Investments (BOI) and other regulatory agencies on tax compliance.

5. *Campaign with the private sector for good and honest governance program*. In this initiative, the bureau has link up with various private sector associations and academe to improve awareness and provide information on the efforts of BIR to raise revenue.

As commendable as these efforts are, sustaining the increase in tax effort over the medium term—which is essential given the extent of revenue decline since 1997— will require more than administrative efforts alone. These administrative efforts must be continued and complemented by legislated changes in tax policy to further increase the tax revenue to GDP ratio. Obvious priorities include legislative measures to adjust excise taxes for liquor, tobacco and petroleum products to reflect movements in their prices over time[10] and rationalization of tax incentives given to various industries.

Expenditure management also needs continuing attention. Since the Asian crisis, the debt service burden of the national government has steadily increased as a share of total expenditures, from 27 percent in 1997 to 46 percent last year (Figure 2.2). Interest payments alone take up a quarter of total expenditures, up from 17 percent in 1997. From January to August 2003, NG interest payments comprised 28% of expenditures, twice the size of capital outlays. Increasingly, the much needed expenditure for social services, infrastructure and maintenance takes a smaller share of the budget pie, endangering growth and poverty reduction objectives. Education expenditures are being compressed while it is readily acknowledged that more resources are needed to improve the quality of education. And additional resources are needed for priority public health programs, including family planning.

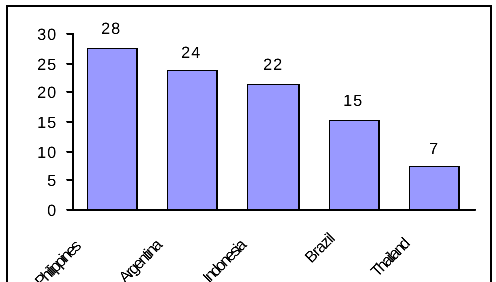
Figure 2.2: Rising NG debt service burden (percent of total expenditures)



Source: Bureau of Treasury

The combined constraint of debt servicing and low revenues is also illustrated by the fact that the Philippines has a relatively high share of interest payments to revenues (28 percent) when compared with other countries (Figure 2.3). High and rising interest payments are a direct result of the high and rising debt stock. As of end 2002, NG debt reached USD 53 billion (71 percent of GDP), up from USD 46 (64 percent of GDP) in 2001. In addition, NG reported contingent liabilities of USD 12 billion (15 percent of GDP).

Figure 2.3: High share of interest payments in revenue (% of total revenues, 2000)



Source: World Development Indicators 2003

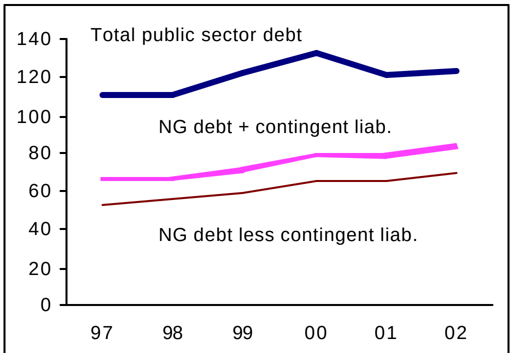
Reducing the debt to GDP ratio and ensuring fiscal sustainability depends critically on the primary fiscal balance, the difference between economic growth and the interest rate, the magnitude of off-budget losses and privatization receipts. With the consolidated public sector debt at 124 percent of GDP by the end of 2002 and economic growth roughly equal with the real interest rate, the consolidated public sector balance[11] needs to

[10] Tax rates for these products have been fixed per liter volume since 2000 despite changes in their retail prices over time. Thus, government tax collection has been eroded over time by inflation.

[11] The NG primary fiscal balance (NG deficit less interest payments) plus the off-budget net balance.

show a primary surplus to reduce the consolidated public sector debt to GDP ratio (Figure 2.4) This again highlights the importance of increasing revenues as quickly as possible and avoiding further large off-budget losses as discussed below.

Figure 2.4: Rising public sector debt (percent of GDP)



Source: DOF

B. GOCC Performance and Contingent Liabilities

While NG fiscal balance performance is showing improvement in 2003, the same cannot be said of the consolidated public sector deficit (CPSD), largely because of rapidly growing losses in the power sector (Figure 2.5 and Table 2.1)[12]. In fact, combined GOCC losses are projected to rise by more than PHP 50 billion, thus more than offsetting the hard-won gains in the NG deficit.

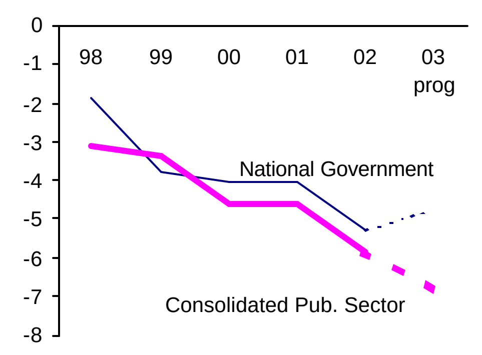
The National Power Corporation (NPC) losses alone are now expected to rise from PHP 22 billion in 2002 to PHP 73 billion in 2003. Most of the financial problems of NPC are attributable to inadequate tariff adjustments, inadequate capitalization, and the high costs imposed by independent power producer (IPP) contracts signed in the early 1990s. This has resulted in large losses for NPC notwithstanding electricity tariffs that are high by regional standards. In addition, a number of rulings by the government, the Energy Regulatory Commission (ERC), and the Supreme Court have triggered additional losses in the power sector. NPC had also incurred liabilities amounting to $18.3 billion and this expose the corporation to a heavy debt service burden -- $1.5 billion annually. Combined, these factors contribute to a high gearing ratio that is above the prudent corporate threshold. Over time the high cost of borrowing by the National Power Corporation (NPC) has led to the national government increasingly borrowed directly to finance NPC's cash deficits, thus replacing loan guarantees and the associated contingent liability, with direct government liabilities. More recently, increases in retail and wholesale power rates are expected to begin to address this problem.

Table 2.1: Consolidated public sector balance (peso billion)

	2001	2002	2003 estimate
Total Surplus (+) / Deficit (-) [12]	-167	-231	-291
National Govt.	-147	-211	-202
CB restructuring	-26	-15	-20
Monitored GOCCs	-23	-46	-97
o.w. NPC	-8	-22	-73
NFA	-2	-8	-13
SSS/GSIS	11	26	11
BSP	5	4	1
GFIs	5	5	4
LGUs	4	3	1

Source: DOF

Figure 2.5: NG & consolidated public sector balance (percent of GDP)



Source: DOF

[12] DOF defines financing deficit to include net current expenditure, capital expenditures, and net cash generation. The definition does not include amortization which is a substantial amount of the borrowing requirement of GOCCs.

Actions to reform the power sector have progressed in a number of directions: the Electric Power Industry Reform Act (EPIRA) was enacted in 2001, which has permitted the unbundling of the generation and transmission segments of the National Power Corporation's (NPC) operations and opening up power generation to competition; and a transmission company (Transco) has been created, the operation of which the government has attempted to privatize through a concession contract. However, uncertainty over the regulatory environment in the Philippines, the protracted delays in Congress' approval of the Franchise Bill, the weak global investor appetite for investment in the Philippine power sector, and adverse rulings on contractual disputes have slowed implementation of the intended power privatization and restructuring program.

Short-term action that could pave the way for a meaningful power sector reform could include:

- Timely implementation of ERC decisions on power tariffs based on the principle of full cost recovery with a reasonable return on investment. This would help restore the financial viability of the sector and attract additional private investments needed for economic growth.
- Expedite passage of the Franchise Bill and negotiate only with qualified companies. The Government may need to provide risk mitigation measures (e.g. guarantee for termination payment in the event of failure of Congress to approve the transfer of franchise within a specific time period).
- Expedite implementation of Wholesale Electricity Spot Market.
- Reduce the fiscal burden for rural electrification through:
  - ERC approval for a universal charge for missionary electrification, thereby reducing the deficit of Small Power Utilities Group (SPUG) of NPC
  - Leveraging public funds with increased private sector participation through privatization of SPUG assets; use of management contracts for distressed electric cooperatives; and invitation for qualified third parties to accelerate barangay electrification.
  - Realignment of the role and organization of the National Electrification Administration (NEA) to minimize government financial and risk exposure.

Another component of the CPS that will have profound impact in the medium term is the pension system. The slow pace of pension reforms continues to be of concern. In particular, the financial condition of Social Security System (SSS), the largest pension fund serving private sector employees, remains problematic. The actuarial valuation of the reserve fund of SSS shows that benefit payments have exceeded contributions in 1993 to 1995 and in 1999 to 2002. The deficit has been paid out from the pension fund reserve thus continuing to reduce the life expectancy of the fund at an accelerated pace, with complete depletion by 2015 if no further actions are taken. In an effort to contain the short-term financial problems faced by SSS, some adjustments have been made including a 1% increase in the employers' contribution. These actions have alleviated the deficit situation but only partially and temporarily. A carefully planned and phased-in increase in contribution rates together with other parametric and structural changes is needed to ensure SSS's medium and long-term viability.

The Government Service Insurance System (GSIS) is facing a different problem. Despite current allegations that its finances are deteriorating due to unpaid Government premiums[13], the reality is that GSIS has had several years of ample liquidity. Contributions still exceed pension payouts and will continue to do so if more Government employees opt to retire under rule RA 1616[14] instead of retiring with a GSIS pension. As such, the pension fund continues to grow but investment income remains constrained by the lack of local investment instruments and the continued deterioration of the stock and

13 One of the reasons cited by GSIS on why it cannot fulfill its loan-granting activities.

14 Under RA 1616, a government employee eligible for retirement benefits has the option to choose a lump-sum retirement fund paid for by the National Government, rather than the usual GSIS pension. In which case the GSIS keeps the premiums paid and does not have to reimburse the National Government.

real estate markets. This shortage has meant that returns on investment are below the levels needed for long-term sustainability. GSIS needs to find alternative investment options (locally and/or abroad) for its excess liquidity, diversify its portfolio and obtain better returns. In addition, GSIS needs to improve the management of its loan portfolio and its management information systems.

The Local Government Units (LGUs) are another component of the CPS which is worth noting. The 1991 Local Government Code (LGC) provided the policy framework for the increased role of LGUs in the provision of quality public services to the public. While demand for effective and efficient delivery of social services has increased over time, the LGUs have continued to predominantly rely on national transfers (i.e., the Internal Revenue Allotment) to meet their financing needs, and have not succeeded in mobilizing revenue from measures within their purview[15]. Success with efforts to strengthen LGU's own revenues will be important to sustain, and expand LGU programs without further adding to the burden on national government finances.

GOCCs, pension programs and LGU finances all need to be addressed as part of a comprehensive program to strengthen public finances and avoid growing off-budget needs off-setting improvements in national government finances. Without improvement in overall public sector finances, the consolidated public sector financing needs are in danger of crowding out a recovery in private investment and limiting the prospects for higher growth.

In summary, recent fiscal performance shows improvement in the national government's fiscal position reflecting commendable gains in tax administration and tighter spending in the first eight months of 2003. However, the recent collective performance of other public sector entities has offset these hard-won gains from the NG so there has been a further deterioration in the overall public sector balance. Steps to reverse this trend include:

1. Continuing and sustaining the gains in government revenue mobilization of government and supporting the gains with legislative measures, such as, adjustment of sin tax rates, and rationalization of fiscal incentives;
2. Facilitating the mandate of the PSALM (Power Sector Assets and Liabilities Management Corporation) in the privatization of NPC generation assets, real estate, and IPP contracts, among others, to ease the burden on the national government in absorbing the stranded costs of the NPC;
3. Tightening control of debt management by national government over government corporations and greater selectivity in providing guarantees to them. This may entail changes in the charter of the GOCCs;
4. Improving the monitoring of contingent liabilities of the national government and risks assessment;
5. Action to ensure the financial viability of the pension funds; and
6. Accelerating efforts to improve local government revenue mobilization.

C. Closing the Governance Gap

The Philippines continued poor ranking on international corruption ratings reinforces the general perception that institutional weaknesses persist in such key areas as the judicial system, enforcement of the rule of law, expenditure management, public financial accountability and management, and the civil service. Since the present administration assumed office on a platform of anti-corruption and good governance programs, progress has been uneven, though much has been done to improve governance. Key measures and achievements are outlined below.

Judicial reform. Over the past four years, the judiciary has prepared a reform program to address shortcomings in access to justice, corruption, weak administrative structures and operating systems, deficient court

[15] This is discussed in-depth in an ongoing joint World Bank-Asian Development Bank study (Philippines: Decentralization and Service Delivery, Report no. 26104-PH).

technologies and physical facilities, underdeveloped human resources, and limited public understanding, and has begun to implement it. This reform program, the Supreme Court's Action Program for Judicial Reform (APJR), includes institutional reform (e.g., procedural, administrative, and management), together with improvements to supporting technology, infrastructure and human resources.

Procurement reforms to improve public expenditure management. From 2000 to 2002, outlays for procurement of goods, works and services by national agencies, LGUs and GOCCs averaged more than PhP115 billion annually. Although no reliable estimates are available of losses due to public sector procurement-related corruption, the perception of large leakages persists. An October 2001 study by Procurement Watch Inc. indicated that the potential leakage through procurement corruption could have been about PhP 95 billion in 2001, an amount that the DBM noted could have funded the DepEd twice over or build more than 500,000 houses. The experience of textbook and drugs procurement under World Bank-financed projects indicates that the adoption of improved procurement processes and practices can reduce prices by about 40 percent.

The new Government Procurement Reform Act, signed into law in January 2003[16], is a key government achievement. This law simplifies pre-qualification procedures, encourages electronic procurement, reduces officials' discretion on bids and awards, establish a Government Procurement Policy Board for oversight and regulation of government procurement, protects procurement officials from unjust legal suits arising from the performance of their duties, and imposes criminal and civil liabilities for those found guilty of collusion. The implementing rules and regulations (IRR) for this Act was issued in September.

Strengthening accounting, reporting and financial controls. The Commission on Audit (COA) has begun phased implementation of a new government accounting system (NGAS). The NGAS aims to simplify government accounting, bring it into closer conformity with international accounting standards, and generate timely and accurate financial statements for better monitoring. The NGAS has several features that make it a significant improvement, including a modified accrual accounting basis, improved accounting for assets, the adoption of a single fund concept and a simplified three-digit chart of accounts. A key challenge now is the timely provision of technical advice and implementation assistance to the many national and local government agencies.

Internal audit. Internal auditing is not a well-developed function in government agencies, although internal audit units are authorized under the Internal Audit Code. With 11,000 auditors under COA, a careful study needs to be carried out before embarking on a program to universally establish internal audit units. Such a study would review the transfer of some of the routine audit functions from COA to internal audit units and the implications for COA staffing needs.

Lifestyle or asset consistency checks. As part of efforts to promote integrity by strengthening the threat of detection and retribution for misbehavior, the Department of Finance and the President's Office has initiated asset consistency checks. Tax collection officers have been an early focus of this effort and it has already lead to several prosecutions. When carefully researched and well documented, such independent asset checks can help enhance integrity.

Civil service reforms. Given the pressing fiscal constraints, it is clear that the size and cost of the civil service requires review and adjustment as a priority. The key civil service constraints are long-standing and well-known to policy makers: many civil servants are paid relatively low salaries, shortcomings in personnel information and the control system, large numbers of political appointees[17], and institutional capacity.

[16] Implementing rules and regulations were issued in September, 2003.

[17] Appointments to about 11,000 positions are made directly by the President.

Establishment control is relatively weak despite efforts in recent years to control recruitment and impose selective hiring freezes. At present, there is no reliable method to verify information on the number of filled and unfilled positions. The DBM, Civil Service Commission and the GSIS currently maintain their own personnel information databases, but these are not integrated with each other. The situation is exacerbated by the employment of a considerable number of non-permanent staff such as casuals and contractuals, particularly at the LGU level.

Low salary levels for executives in the top pay grades and for some professionals in the middle grades have made it difficult to attract and retain key categories of personnel, such as lawyers, auditors, IT professionals and doctors. And allowances are often non-transparent and do not fulfill their objectives.

Key steps in controlling the wage bill could consist of expediting the establishment of a workable personnel information system, and deciding on fiscally affordable compensation improvement and rightsizing options.

Administrative streamlining and consolidation would need to accompany employment and compensation adjustments. Expediting national government initiatives to streamline the structure and functioning of the central executive would be appropriate. Starting and sustaining the transformation of the BIR would be widely seen as a litmus test of the government ability, willingness and resolve to implement core institutional reforms.

The Civil Service Commission (CSC) has drafted a new Civil Service Code (now under legislative review) focusing on merit-based recruitment; competitive compensation within fiscal constraints and linking compensation to performance; protecting civil servants; and strengthening accountability and integrity mechanisms. Measures to strengthen the merit-based competencies of public servants could help in de-politicizing their ranks and ultimately contribute to a more effective delivery of public services.

III. STRENGTHENING PRIVATE SECTOR PERFORMANCE

Strengthening private sector performance necessitates increased investment and productivity and hence an improvement in competitiveness and the investment environment. This would complement concurrent actions to improve fiscal management, strengthen public sector governance, increase peace and security, and reduce political and other uncertainties, in achieving national development objectives.

Philippine competitiveness has not managed to keep pace with most other competing Asian economies (Table 3.1). As a result, it is not ranked with Indonesia and Vietnam and is well behind Malaysia, Thailand, China and India. This poor performance stems from the relatively low volume and productivity of investments[18]. And this low level of investment arises from perceptions of risk and deficiencies in the investment and operating environment for private sector enterprises[19].

Table 3.1: Competitiveness rankings and risk scores

	EIU Risk Score	1998	1999	2000	2001	2002
Singapore	…	10	12	9	9	9
Korea	…	28	28	27	26	23
Malaysia	35	27	27	30	37	26
Thailand	42	37	39	40	38	35
India	…	44	42	37	36	37
China	42	42	49	44	43	38
Vietnam	49	43	50	53	62	60
Philippines	49	45	44	46	53	61
Indonesia	62	51	53	47	55	64

Source: IMD World Competitiveness Yearbook 2003

In view of the importance of private sector performance to employment creation, growth and poverty reduction, this chapter looks at a subset of key, namely, infrastructure; banking and capital market; and trade, competition, and security of contract.

A. Infrastructure Development

Inadequate infrastructure has long been rated as a key constraint to rapid economic growth in the Philippines. Consistently, most business surveys have found the country's infrastructure as grossly insufficient and of generally poor quality. This observation was echoed in the recent World Economic Forum survey that ranked the country 68th, in terms of infrastructure quality, out of 75 economies rated. In most of these surveys, infrastructure has been perceived by respondents as one of the most important bottlenecks to the conduct of their business.

Data on infrastructure support this perception. Road networks, water and sanitation facilities, and power generation and distribution are among the poorest in the region. Road access, and road quality are both sources of concern. In the water sector, access is relatively high and is cheap but the disparity between urban and rural access to water remains wide. The water utilities are also poorly managed with high rates of accounts receivable. In the power sector, access to electricity is good but the cost of power is high. Yet, most of the power firms are barely making profit and there are large system leakages through transmission and distribution losses. Service quality of these firms is also poor with high frequency of power interruptions. And, a power shortage seems likely by 2007 unless there is new investment. The ICT infrastructure, however, remains at par or better than most East Asian economies as the volume of internet and cellular subscribers are high. However, fixed lines density can still be improved.

These deficiencies in infrastructure are primarily the result of two factors. First, there has been low and declining public sector spending on capital investments and maintenance. Between 1997 and 2001 public sector capital expenditures fell by over 1 percent of GNP and at around 3 percent is the lowest in the region. The share of capital outlay to total expenditure has gone down from 21 percent in 1997 to 16 percent in

[18] The country's investment to GDP ratio is lower than other East Asian economies.
[19] A recent survey of top 1000 firms by A.T. Keaney shows that the country is not among the top 20 destinations of foreign investors.

2002. Second despite expectation that private investors would take on a larger role to meet the growing need, private sector investment in infrastructure has also fallen during this period. Private sector investment in infrastructure contracted from around $4 billion in 1993-1997 to about $1 billion in 1997-2001. This decline reflects a combination of large financial losses in the late 1990s and the negative corporate environment arising from barriers to entry, distorted regulations, unclear and changing policy on the respective roles of the public and the private sectors, and weak administrative capacity from the government.

It is clear that investments in infrastructure contribute to increased growth and improved living standard. Inadequate infrastructure imposes high economic cost. In the long run, improvement in the budget balance is offset by the deterioration in public infrastructure which leads to higher costs of business, lower private sector investments, and lower growth. The social impact is even greater as poor infrastructure contributes to persistent unemployment and deterioration in access to key basic services such as water, sanitation, and power.

Presently, a number of controversies have arisen in key infrastructure projects involving water, power, and transportation. These have arisen from: a) contract disputes; b) unreasonable tariff rates and take or pay contracts; c) weak provisions for exchange rate risks; and d) political interference. These controversies have discouraged private sector participation in infrastructure. Together with the poor current state of Philippine infrastructure, they highlight the importance of a clear stable operating environment to generate the needed increase in investment and the delivery of reliable and cost effective infrastructure services.

Telecommunications. Despite good ICT infrastructure, the sector would benefit from an improved regulatory environment that enhances competition and prevents dominant large firms from behaving uncompetitively. At present, there are two sector policies that warrant review. First, is the decentralized setting of interconnection fee that gives the dominant carrier a natural advantage to charge higher fees for interconnection thereby squeezing out their competitors. This practice has prohibited the development of an open system and has created technological barriers between communication network. Second, the policy of providing cross-subsidies to the development of less lucrative areas have further segmented the market. This arises from the behavior of firms to charge higher interconnection fees to compensate for network development. Third, the absence of regulations on mergers and consolidation can open the market to abuse from vertical integration among the big networks. Effective implementation of regulations is needed to contain this risks.

Power. Reform in the power sector aims to encourage private investments through the unbundling of generation, transmission, and distribution facilities, and the privatization of NPC. PSALM was created to take over the liabilities of NPC while TRANSCO was organized to handle the transmission function. In the absence of private sector interest in the sector and an expected power shortage by 2007, there is a need to review the public sector role and the regulatory design. For one, the current rate on return cap is a big disincentive for investors. And regulatory risk is perceived to be quite high. Second, the sector is also bearing the cost of financially distressed power cooperatives which imposes huge financial cost to restructuring. Providing guarantees to these cooperatives without reforming these institutions would expand the contingent liability of the public sector without addressing the issue of governance. For TRANSCO, the series of failed biddings suggests that there are regulatory issues that pose risks to investments and these need to be examined and contained.

Roads. At present, the poor quality of roads reflects the lack of management framework, insufficient budget, and weak role of local government units in road development. The weak management framework arises from the unclear mandate given to various agencies assigned to oversee the road development. Often implementation remains fragmented as various agencies have overlapping functions and have little coordination. The required budget for maintenance and rehabilitation has been estimated at P10 billion a year. And despite the local government units' closeness to most of the service areas, LGUs have played a limited role in local road programs. Much effort is needed to decentralize road management and to transfer the responsibility of programs and projects implementation to LGUs. There are also a number of distortions that prohibit effective public-private sector partnership. These include: a) ambiguity of the PNCC franchise which discourage private investors; b) inadequate information on viable roads projects; c) government's preference for mega-type projects which reduces the number of participants; d) short maturity for commercial loans which does not match the cash profile of road projects; e) large foreign exchange risks which introduces large contingent liability on investors; and f) contracting uncertainties which make project management difficult.

The realities in the infrastructure sector are very challenging. First, the financing requirement for infrastructure is huge. Based on a recent estimate, the Philippines need USD 200 million a year to provide for the maintenance, operations, and development of roads. The stranded cost of power also amounts to USD 8.3 billion. Second, the economic and social importance of infrastructure as well as the consequence of not having sufficient infrastructure is equally enormous. Twenty-one percent of the urban population and thirty-one percent of the rural population lack access to clean water and adequate sanitation, respectively. 5,000 barangays have no access to electricity. Only half of the 4,200 tons of solid waste produced daily are accommodated by existing facilities. Third, the public sector does not have the resources nor the capability to undertake this growing need alone. Hence, private sector participation is indispensable, but recent experience with private sector partnership in infrastructure has not been as satisfactory as hoped.

Given this fact, the lessons from other countries offer clear insights regarding the mixture of policies that are needed to achieve effective infrastructure development. First, empowering the market necessitates changing the regulatory structure to promote privatization that favors fair competition. This requires regulation that ensures competitive behavior. It is important to focus on doing the small things effectively and to move away from mega-type projects that are often associated with large monopolies or public utilities. These monopolies are often inefficient and end up serving the middle class rather than the poor. Second, there has to be a reasonable division of risk between the public and the private investors to enter the infrastructure sector. There are non-market risks which the public sector is better able to assume than the commercial market. Third, the poor are willing to pay and are actually paying a high price for the absence of infrastructure. But at the same time targeted subsidies to enhance connection and ensure access by the poor may need to be considered. Fourth, financial support for infrastructure needs to be made more effective by focusing on outcomes and linking the disbursement of funds to the actual deliveries of services. Lastly, improving infrastructure within a constrained fiscal situation will be a challenge. The thrust of reforms could be to: a) restructure municipal and development finance institutions to become efficient vehicles for mobilizing and pooling both public and private financing; b) introduce competition and transparency in the design and award of concession contracts and use of government guarantees; c) quickly settle high profile contractual disputes in the infrastructure sector; d) develop a strategy to deal with legacy of PPI contracts that have become highly politicized; e) immunize further the regulators from political and legal interference and f) systematically develop a domestic bond and securitization market.

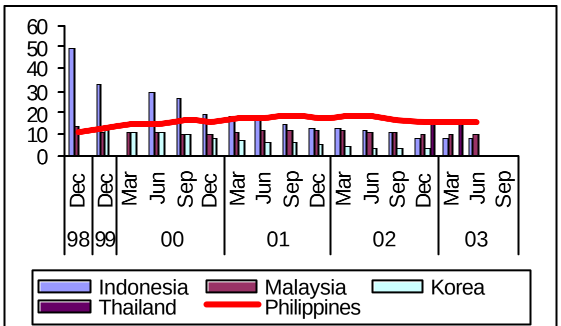
B. Banking and Capital Market Development

A quick recovery of the financial system from high stress levels does not appear likely. The ratio of non-performing loans to total loans of the financial system remains as one of the highest among the post-crisis countries (Figure 3.1)[20]. In this regard, the priority areas are enactment of the amendments to

[20] It is acknowledged that Indonesia sharply reduced NPLs by transferring them to the public sector.

the BSP and PDIC charter, and the fast transition to a consolidated risk based supervision to provide them with increased authority and legal protection for bank regulations. Strengthening non-bank financial institution and capital markets calls for further improvement in property, shareholder and credit rights, insolvency laws and complete governance. Pension reforms are also a high priority and are covered in chapter 2.

Figure 3.1 NPLs are still high (in percent)



Source: ARIC Database, ADB

Asset Quality & Capital Position

The asset quality and capital position of the commercial banking sector remains weak with little change in the first half of 2003. At the end of June 2003, the non-performing loans (NPLs) of commercial banks were 15.2 percent of the total loan portfolio (TLP). If ROPOA (Real and Other Properties Owned and Acquired) are factored in, the ratio of the sum of NPLs and ROPOA to the sum of TLP and ROPOA works out to 23.8 percent. Reserves for non-performing assets (NPAs) cover less than a third of the NPAs in the system and even though NPA's are likely to be discounted during NPA workouts and transactions, these reserves are likely to be inadequate to cover the losses. Furthermore, given weaknesses in the accounting and auditing standards and slow transition towards international standards (particularly in the banking sector where coordination is required between the securities and exchange commission and the central bank), the financial position of the banks appears stronger than what it would be if international accounting standards are applied. Thus, the relatively high capital adequacy ratio for the commercial banking sector, averaging more than 16%, partly conceals continuing vulnerability in the banking system. There is also a tendency in the system to postpone prudent measures, exercise regulatory forbearance, and find temporary fixes to systemic weaknesses. This is evident from the use of liquidity support by the central bank instead of closing troubled institutions; and relaxing rules on the issuance of tier II capital rather than setting deadline for owners to put in tier I capital. Despite substantial liquidity in the system, lending growth has been relatively slow due to the limited number of credible borrowers with sound proposals and limited growth in demand. Given these factors, there are few options for the banks to improve their asset quality and strengthen their capital position.

Table 3.2 Indicators of the health of the banking sector

	2000	2001	2002
Interest margins			
Korea	1.05	2.16	-
Indonesia	3.3	3	3.8 a/
Malaysia	3.95	3.46	3.2 a/
Philippines	3.7	3.5	3.4
Thailand	1.62	2.23	--
Rate of return on assets			
Korea	-0.57	0.76	0.8 a/
Indonesia	0.7	1.5	1.8 a/
Malaysia	--	1.42	1.78
Philippines	0.4	0.5	0.8
Thailand	-3.55	-0.19	--
Rate of return on equity			
Korea	-10.8	16.3	--
Indonesia	20.1	21	16.8 b/
Malaysia	--	16.89	20.94
Philippines	3	3.4	6.1
Thailand	-130.9	-3.68	--
Capital adequacy ratios			
Korea	10.5	10.8	---
Indonesia	12.7	20.5	23.2 a/
Malaysia	12.5	12.8	--
Philippines	15.6	15.3 c/	15.6 c/
Thailand	13.4	12.9	

Source: Philippine Deposit Insurance Corporation
a/ As of August 2002. b/ As of July 2002. c/ Beginning July 1, 2001, computation for capital adequacy ratio in the Philippines is in accordance with Circular 280 dated March 29, 2001 (Risk based Capital Adequacy Ratio). The latest CAR data is as of September 30; BSP does not provide data on interest margin. This figure is from the Philippine Deposit Insurance Corporation website.

Asset Recovery and Restructuring

In terms of asset recovery, the passage of the Special Purpose Vehicle (SPV) law in December 2002 strengthened the framework to deal with bad debts. However, no investment partnerships have yet been completed. The major hurdles are the valuation and pricing principles, and the principles for booking the losses from these transactions. In short, the gap between what the sellers want for their assets versus what the buyers want to pay for them is reportedly wide. Part of the difficulty is that valuation and appraisal guidelines were not included in the Implementing Rules and Regulations. Presently, consultations with the accounting industry are still in progress to finalize these valuation and appraisal rules. More so, there is a need to clarify the treatment of loan losses as this will effect asset price and the conduct of the deals. Other concerns that are important and will likely affect NPA workouts in the future are: the absence of real servicing companies; propensity by debtors to use temporary restraining orders to block or delay workouts; restrictions on foreign ownership of assets (particularly land, the primary collateral from most credits); and lack of a unified registry for properties.

Regulation and Supervision

Though the Philippine authorities have been making efforts to improve the regulatory and supervisory framework, amendment to the charters of the BSP and the PDIC continue to face delays. The proposed amendments are expected to enhance compliance with existing regulations and strengthen the framework for prompt corrective action (PCA) against distressed banks. They would also insulate the supervisors and senior management of BSP from fear of undue legal prosecution[21]. However, opposition to granting additional powers to supervisors may limit the effectiveness of initiatives in terms of prompt corrective action Hence, alternative administrative measures may be needed to strengthen the framework for PCA.

The Financial Action Task Force (FATF) decided not to impose countermeasures on the Philippines as it accepted the March 2003 amendments to the Anti-Money Laundering (AMLA) Act. In late August 2003, the implementing rules and regulations of the amended AMLA were also approved. The passage of the rules, among other things, empowers the AML Council to seek freeze orders on accounts linked to any frozen accounts. However, the Philippines will remain on the FATF list of non-cooperating countries and territories until it has shown the effective implementation of the amended AML law. Presently, the AML Council is preparing the AMLA implementation plan for discussion with the Asia Pacific Group, the regional coordinator for the FATF.

Presently, changes to the rules governing the Securities Regulation Code have been proposed by the Securities and Exchange Commission. These changes plan to protect the investing public through stricter rules on the registration and issuance of share or securities, enhanced public disclosure and improved credibility of financial statements, and greater transparency in stock market transactions. Among the salient features of the proposal are: i) it broadens the disclosure requirement for material information that are relevant to the price and value of shares or securities; ii) it expands the scope of public offering to include random or indiscriminate sale of securities; iii) companies that have debt papers to be rated by accredited rating agencies; iv) stricter rules on sale of proprietary and non-proprietary shares; v) stricter rules on delivery of shares bought by clients; vi) additional requirement for the licensing of brokers and dealers; and vii) broader function for the stock exchange's compliance and surveillance group.

[21] In mid-August the Court of Appeals found the Governor of BSP and four other senior officials "administratively liable of gross neglect of duty" when the BSP ordered the closure of medium sized bank and its two subsidiaries in April 2000. The Court of Appeals decision ordering 1 year suspension of the BSP Governor and four other BSP officials not only has an immediate negative impact on the regulatory and supervisory functions but also damages the investor confidence in the economy as such. And the fact that another part of the Court of Appeals to rule in favor of the BSP officials does not yet alleviate this problem.

Capital Markets

In the Philippines, equity and debt markets and non-bank financial institutions play a minor role in mobilizing resources and managing risks. There are limited IPOs; primary and secondary housing finance systems are underdeveloped; specialized housing finance services are limited; government housing financial institutions are not viable; equipment leasing has not taken off; factoring and forfeiting arrangements that use non-land collateral to secure lending do not exist; and securitization of cash flows to enable the recycling of resources and to reduce the need to borrow is undeveloped. The absence of these institutions and practices heightens the vulnerability of the private sector to shocks, tends to shorten investment horizons and inhibits long-term investments. In view of these gaps, the government could aim to strengthen domestic debt markets. Many measures have been proposed including the Banker's Association blueprint for a fixed-income exchange to provide a platform for secondary trading of private and publicly issued debt securities. Efforts are also underway to rationalize the documentary stamp tax (DST); address the cascading impact of DST on financial transactions and correct the current tax rate distortions between equity and debt instruments. SEC has also proposed draft legislation relating to non-bank financial companies, futures trading and alternate trading systems. These proposals could be expedited to develop the regulatory capacity that could catalyze the development of the equity and debt markets. Also crucial is the credible enforcement of rules and regulations as the country fares poorly in this area (Table 3.3).

Table 3.3: Corporate governance indicators

	Rules & Regs.	Enforcement	Political/ Regulatory	Institutional Mechanisms	Country Score [1]
Singapore	8.5	7.5	6	8	7.7
Hong Kong	8	6.5	6.5	7	7.3
India	8	6	6	6.5	6.6
Taiwan	7	5	5	6	5.8
Korea	7	3.5	5	6.5	5.5
Malaysia	79	3.5	4	6.5	5.5
Thailand	7.5	3	4	4.5	4.6
China	5	4	5	3	4.3
Philippines	6.5	2	2	4	3.7
Indonesia	4.5	1.5	4	2.5	3.2

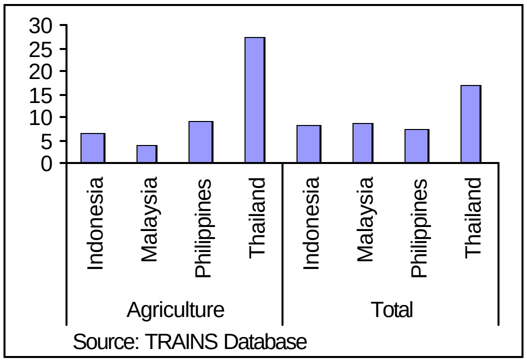
Source: CLSA
1) Higher score implies a better corporate governance environment

C. Competition and Security of Contract

Competition

Since the 1980s, a number of policy reforms were undertaken to promote greater competition. These were embodied in the different programs including trade liberalization, investment deregulation, foreign investment reforms and the pursuit of a market based exchange rate. The trade liberalization program was implemented in four phases. First, from 1981 to 1985, the import tariff was reduced from 100% to 50%. Second, from 1986 to 1989 non-tariff import barriers to trade were largely eliminated. Third, from 1991 to 1995 tariff rates were reduced further, though the maximum tariff remained at 50 percent. This has resulted in the Philippines now having relatively low import tariff on manufactured goods but higher rates on agricultural goods (Figure 3.2). In the early 90s, new investment deregulation and foreign investment laws provided an assortment of investment incentives and lifted certain constitutional restraints on investment. And export-processing zones were also created to provide efficient business infrastructure to foreign investments.

Figure 3.2: Average tariff, 2000 (in percent)



As a result of these reforms, the economy became more open and more competitive in export markets. Average effective protection rate fell from 38 percent in 1985 to 12.6 percent in 2002. The share of exports to GDP also rose from 16 percent in 1980 to 44 percent in 2002. The composition of exports shifted into new growth. Based on the ratio of domestic resource cost to the shadow exchange rate[22], the share of highly efficient firms in production rose from 19 percent in 1983 to 42 percent in 1994. And total factor productivity estimate have risen by 2.1 p.a. from 1990 to 1992.

It is notable, however, that the impact of this export growth was limited due to its high concentration in enclave activities, highly import-intensive nature of exports and the weak linkages with the rest of the economy. Most of local suppliers appear not to have the capability to ensure product quality and prompt service delivery. Poor infrastructure also serves as natural barriers to integration as administrative and transport costs are high. Moreover, the employment effect of such exports is largely confined to the export enclave.

At this time, the government is reviewing WTO commitments and has proposed slowing down or reversing these commitments and returning many import tariffs to their 1998 levels. Since, 2002 reversals have already happened in cement, petrochemicals, glass, and vegetables. The Philippines has also become more aggressive in implementing trade defense measures and product regulations. At present, for purposes of tax assessment, the Bureau of Customs has frozen import tariff rates at their 2000 level. Other measures that are being used to limit the free entry of goods are: a) authority granted to the Secretary of Agriculture to restraint imports to protect the domestic fishing industry; b) import restrictions on rice, automobiles, satellite phones, and coal; c) nationality requirements in the telecommunications, banking, advertising, public utilities, and shipping sectors; d) minimum capitalization, local sourcing, and divestment requirements for retail trade; e) incentives and subsidies granted under the Investments Priorities Plan; and f) administrative regulations in the BOC.

The worldwide evidence is overwhelming that the benefits from trade liberalization far outweigh its cost. Reversing the tide of reform would forgo the benefits, create uncertainty, and lessen productivity and competitiveness. Most of the products covered by the proposed tariff reversals are intermediate inputs. Hence, raising the tariff would make the impacted industries less competitive, less able to take advantage of the opportunities presented by China's growth and to effectively integrate with regional production networks.

Since 1991, the value of exports have grown by more than four-folds and reached $34 billion in 2002. From 1995 to 2002, exports grew by more than 10.6 percent p.a. and contributed more than 4 percent to GDP growth. This significant contribution from exports derives mainly from the transformation of exports from being primarily agricultural and resource based to electrical and electronics including semiconductors and ICT. During the last two years, the Philippines sold over $47 billion worth of electronics accounting for 70% of total exports[23].

[22] A DRC/SER ratio greater than one means an industry is an inefficient earner or saver of foreign exchange. It uses up more domestic resources in earning/saving a unit of foreign exchange compared to what a unit of foreign exchange is worth to the society.

[23] The biggest chunk of electronic exports went to the US (19.5 %), Japan (13.9 %), Netherlands (11.5 %), Taiwan (8.9 %), and Singapore (8.7 %).

The recent weakness in global demand and the cyclical volatility in electronics pose a significant risk to export growth. As global trade weakened in 2001, exports contracted for 14 consecutive months resulting to a double digit fall in exports for the year. Exports recovered in the second half of 2002 due to further weakening of import demand from the US and Europe, and the effect of SARs on Hong Kong, Singapore, and Taiwan has resulted in export being stagnant in the final half of 2003.

Regional development provides hope for renewed export growth. First, the reorganization of the production chains have contributed to the rapid ascent of Asian countries in the global value chain. Second, China has become a major player in the global and regional trade and its import demand is rising rapidly. Historically the US (20.5%) and Japan (15.4%) were the Philippines' major trading partner but recently the markets for Philippine exports have become more diversified. The share of China in total exports has increased from 0.8% in 1990 to 2.5% in 2001 as Beijing has become a dominant player in the electronics trade[24].

As China is a global powerhouse, growing at 8% and absorbing imports equivalent to $244 billion a year, the potential benefit from RP-China trade is large. Traditional exports such as tropical fruits, minerals and manufacturing could expand into China. And cross border investments are expected to further expand this trade[25].

In the long run, export competitiveness depends on FDI. Mainly, FDI inflows can enhance competitiveness by bringing new technology and developing management capability among local firms. It also gives access to the global production chain and the world product markets. As of 2001, the cumulative stock of inward investments stood at around $14 billion and accounted for 9.2 percent of gross fixed capital formation and about 16.6 percent of GDP. Malaysia, in contrast, maintains an FDI stock of $53 billion that accounts for about 16.5 percent of their fixed investments and almost 60 percent of their GDP (Table 3.4).

Table 3.4: FDI stock 1990 – 2001

	1990	1995	2000	2001
Philippines				
FDI Stock (US$ Bn)	3.3	6.1	12.4	14.2
% of GDP	7.4	8.2	16.6	19.9
Malaysia				
FDI Stock (US$ Bn)	10.3	28.7	52.7	53.3
% of GDP	23.4	32.3	28.8	58.4
Thailand				
FDI Stock (US$ Bn)	8.2	17.4	24.5	28.2
% of GDP	9.6	10.4	20	22.3

Source: World Investment Report 2002

In support of trade reform, the government has taken a number of other steps to further open up the market to competition. These included privatization of government corporations, deregulation of the shipping and airlines industries, demonopolization of telecommunications, oil deregulation, easing the entry of foreign banks, easing the equity limits on foreign investments, and the liberalization of retail trade. However, despite these efforts, market structure in the Philippines has remained highly concentrated. Aldaba (2002)[26] has noted that 74 percent of manufacturing value added in manufacturing was accounted for by the top four firms in the sub-sectors. Saldana (2001)[27] observed that the top shareholder in industry on average controls about 41 percent of the company's market value, while the top five shareholders control about 65 percent. This domination became even more concentrated as equity financing fell in the aftermath of the financial crisis.

Barriers to entry persist in spite of trade and investment liberalization, and deregulation.

[24] It has moved in rank from the 9th place to become the 4th exporter of computer components in 2001. The Philippine's top five exports to China are semi-conductor devices, copper cathodes, parts and accessories of automatic data processing machines, fresh bananas, and fuel oils.

[25] To date among the major companies with foreign operations in China are San Miguel, the Tan Group of companies, Universal Robina Corporation, Solid Group of companies among others.

[26] Aldaba R.M. 2002. "The State of Competition in the Philippines". PIDS.

[27] Saldana C.G. 2001. "Corporate Governance and Finance in East Asia". ADB.

These barriers to entry have taken several forms. First, the policy of picking winners or champions has created a special class of entrepreneurs who are vested with fiscal incentives and trade privileges. Examples are the incentives given to synthetic fibers, steel mills, shipping, motorcycle, and cars. Second, there are still sectors which are protected by import tariffs and non-tariff restrictions. These include rice, sugar, petrochemicals, steel, cement, and glass. The protection accorded to these industries is high given that their inputs have low tariffs. Third, there are behavioral impediments to entry as reflected in the strategic behavior of firms to exert market power. Such behavior can be manifested through collusion among key players to set the price; exclusive dealership to limit product distribution of the product; predatory pricing; price discrimination to capture various segments of the market; and producing excess capacity to discourage entry. Collusion has been noted to exist in the sugar, flour milling, inter-island shipping, and the cement industries. Natural and technological constraints have also served as barriers to entry. These are especially true in infrastructure where there are high capital requirement, and large economies of scale, and sunk costs. Fourth, continuing dominance of public sector enterprises discourage competition.

Further reforms are needed to achieve genuine competition that will improve productivity. Completing the remaining agenda for trade liberalization, including services and agriculture, to ensure that markets become more open and contestable would help. So would privatizing the remaining GOCCs where feasible. However, privatization should not only entail a transfer of ownership but should come hand in hand with reforms to ensure that any unwanted advantages previously enjoyed by the firm should be removed to ensure competition. Third, where natural monopolies are more likely to occur, there is a need for an effective regulatory framework to ensure competitive behavior. Finally, the government could consider a policy to promote competition. This could begin with an information and education program to disseminate understanding on the benefits derived from competition and the costs from the lack of it. There could be an institution to safeguard against uncompetitive behavior.

Security of Contract

Security of contracts and protection of investors' rights are crucial for private sector development. Without this the private sector will not participate in market activities even though the expected return may be large. Uncertainties also affect the nature of investment as firms prefer contracting and partnership arrangements that provide lower exposure and cost of exit. In the Philippines, the cost of dispute resolution is one of the highest in the world[28]. As a consequence, the supply of foreign capital, the technology transfer, and the integration into global production networks is low. Evidence of this can be found in the modern retail sector in Philippines where foreign firms prefer franchise arrangements to arrangements that involve greater capital commitments.

Interestingly, the protection accorded to creditors under the law as well as under bankruptcy protection and workout arrangements in the Philippines has also been among the weakest in the world. Secured creditors are not protected from stay of foreclosure and do not enjoy a priority in payment. Several steps have already been taken which could provide the bases for constructing a broader range of options for affording relief to distressed companies and their creditors. The draft Securitization bill could enable both banks and buyers of distressed assets to mobilize capital and distribute risks more efficiently. This is evident from the experiences of Malaysia and Korea. In India the enactment of the Securitization, Reconstruction of Financial Assets and Enforcement of Security Interest Act of 2002 is playing a vital role in accelerating NPL resolution along with measures such as a pilot asset restructuring company, corporate debt recovery mechanism, debt recovery tribunals, and one-time settlement process. The Philippines could also consider measures to establish a unified property and collateral registries and to ease foreign ownership restrictions of land in the context of NPL recovery. Both Thailand and Malaysia eased restrictions on

[28] World Bank, Doing Business Database.

condominium ownership as a way of accelerating NPL resolution and securitization.

Table 3.5: Comparative cost of doing business

	Business Registration (Days)	Contract Enforcement (Days)	Insolvency (Years)	Labor Restructuring Flexibility Index [1]
Philippines	59	164	5.7	39
Indonesia	168	225	6	43
Malaysia	31	270	2.2	15
China	46	180	2.6	57
Thailand	42	575	2.6	30
Singapore	8	50	0.7	1
Hong Kong	11	180	1	1
India	88	225	11.3	45

Source: World Bank, Doing Business Database

[1] Lower value indicates higher flexibility.

There is also little protection given to small shareholders. Most of the listed corporations are family owned where effective ownership and management control is captured by the top shareholders. Often, public disclosure of corporate records is incomplete and inaccurate. As a result, there is information asymmetry and asset stripping is not an uncommon practice. More so, the capability of regulatory agencies such as the Securities and Exchange Commission and the Philippine Deposit Insurance Company is limited in terms of technical staff expertise, unclear definition of unlawful practices, weak penalties for non-disclosure and inadequate information and monitoring system, and the presence of blind spots or gray areas for regulation. Regulation could be improved by more effectively integrating the efforts covering banking and non-bank financial institutions, with those covering other corporate entities. Unfavorable rulings on commercial contracts have increased uncertainty. There are no quick institutional remedies for these problems but a number of steps can be taken to minimize the uncertainty arising from these concerns. These include: a) improve the access to information and increase penalty of non-disclosure; b) strengthen the judiciary; and c) rationalize the functions of the different regulatory agencies. Efforts are already underway in these areas and the government needs to continue and strengthen these reforms.

To enable private firms to compete effectively in a rapidly changing world environment calls for a strategy built around an open and stable investment, trade and regulatory environment supported by a financial and physical infrastructure and which leverages off high quality human capital.

Table 1. Economic and Social Indicators, 1997-2003

	1997	1998	1999	2000	2001	2002
Social Sector						
Population growth (Mn)	71.5	73.2	74.9	76.6	78.3	80.0
Poverty Incidence (1$ a day)	12.1	13.7	13.5	13.5	12.2	11.9
Per Capita GNP, Atlas Method	-	1,080	1,040	1,030	1,030	1,020
Contribution to GDP Growth						
GDP	5.2	-0.6	3.4	4.4	3.0	4.4
Domestic Demand	7.1	-1.8	0.3	4.4	2.8	2.5
Private Consumption	3.8	2.6	0.2	2.8	2.8	3.2
Government Consumption	0.4	-0.2	0.5	0.5	-0.4	0.2
Gross Domestic Investment	2.9	-4.3	-0.4	1.2	0.4	-0.9
Net Foreign Balance	0.1	-1.6	3.0	5.3	-3.4	-0.8
Agriculture	0.7	-1.3	1.3	0.7	0.7	0.7
Industry	2.2	-0.8	0.3	1.7	0.3	1.3
Manufacturing	1.1	-0.3	0.4	1.4	0.7	0.9
Services	2.3	1.5	1.8	2.0	2.0	2.4
As % of GDP						
Gross National Savings	21.2	22.6	21.7	24.2	25.4	26.8
Gross Domestic Investment	24.8	20.3	18.8	21.2	20.6	19.3
Resource Gap	-6.0	-3.6	2.9	3.0	4.7	7.5
Public Sector Budget Balance (% of GDP)						
Consolidated Public Sector	-1.0	-3.0	-3.4	-4.6	-4.7	-5.8
National Government Balance	0.1	-1.9	-3.8	-4.1	-4.0	-5.2
Revenue	19.4	17.4	16.1	15.6	15.3	14.1
Expenditure	19.4	19.2	19.8	19.6	19.3	19.3
Monetary and Financial Sector						
Broad Money, Growth Rate	20.9	7.4	19.3	4.6	6.8	9.5
Private Sector Credit, Growth Rate	-	-47.6	-10.4	29.5	-18.5	-2.1
91-day Treasury bill rate	13.1	15.3	10.2	9.9	10.2	5.9
PSE composite index (end-period)	1,869	1,969	2,143	1,495	1,168	1,018
Prices						
Consumer Prices (change, average)	6	9.7	6.7	4.4	6.1	3.1
Exchange rate (peso/$, ave of period)	29.47	40.89	39.09	44.19	51.3	51.3
External Sector (US$ Billion)						
Current Account Balance			7.2	6.3	1.3	4.2
(as % of GDP)	-	-	9.5	8.4	1.8	5.4
Merchandise Exports			34.2	37.3	31.2	34.4
Growth rate	-	-	19.1	9.0	-16.2	10.1
Merchandise Imports			29.3	33.5	32.0	34.0
Growth rate	-	-	4.2	14.5	-4.5	6.2
External Debt (US$ Billion)	45.4	47.8	52.2	52.1	52.4	53.9
(% of GDP)	55.2	73.4	68.6	69.5	73.1	68.7
Debt Service Ratio	11.6	11.7	14.1	12.4	15.8	16.4
Gross International Reserves	8.8	10.8	15.1	15.0	15.7	16.2
(as % of imports)	2.0	3.1	4.5	4.2	4.6	4.7

Table 2. Social Indicators

	1990	1995	2001	2002
GNI Per Capita	740	1,040	1,030	1,020
Life Expectancy	65.6	67.7	69.5	69.8
Poverty and Hunger				
Population below $1 a day	19.1	14.8	11.9	11.5
Population below minimum level of dietary energy consumption	26.0	…	23.0	…
Education				
Net primary enrollment ratio	97.5	100.6	92.7	…
Secondary participation rate [a]	55.4	…	73.4	…
Water & Sanitation [b]				
% with access to potable water	73.7	77.4	78.5	…
% with access to sanitary toilets	71.6	74.9	82.5	…
Gender Equality				
Ratio of young literate females to males	100.4	100.4	100.4	100.4
Child Health				
Under 5 mortality rate (per 1000)	66.0	51.0	38.0	35.3
Infant mortality rate (per 1000 live births)	45.0	36.0	29.0	29.0
Immunization, measles (% children under 12 months)	85.0	72.0	75.0	…
Maternal Health				
Maternal mortality ratio (per 1000 live births)	…	240.0	…	…
HIV/AIDS, malaria and other diseases				
Contraceptive prevalence rate (% of women ages 15-49)	36.1	48.1	47.0	…
Incidence of TB (per 100,000 people)	…	…	329.7	…

Source: Philippine Progress Report on the Millennium Development Goals

Table 3 : Gross National Product, Annual Percent Change
(Constant 1985 Prices)

	1997	1998	1999	2000	2001	2002	2003 Sem 1
Growth Rate (percent per annum)							
GDP	5.2	-0.6	3.4	4.4	3.0	4.4	3.9
GNP	5.3	0.4	3.7	4.8	3.5	4.5	4.8
By Industrial Origin							
Agri, Fishery, Forestry	3.1	-6.4	6.5	3.4	3.7	3.3	2.3
Industry	6.1	-2.1	0.9	4.9	0.9	3.7	2.8
Manufacturing	4.2	-1.1	1.6	5.6	2.9	3.5	4.6
Construction	16.2	-9.6	-1.6	1.4	5.0	-3.3	-8.2
Utilities	4.8	3.3	3.1	4.2	0.7	4.3	2.8
Service	5.4	3.5	4.0	4.4	4.3	5.4	5.3
Transp,Storage,Telecom	8.2	6.5	5.3	10.4	8.8	8.9	8.4
Trade	3.9	2.4	4.9	5.2	5.6	5.8	5.4
Finance	13.0	4.4	1.9	0.9	1.2	3.4	5.8
Real Estate	3.8	1.6	0.6	0.0	-0.5	1.7	3.5
By Expenditure							
Personal Comsumption Expenditure	5.0	3.4	2.6	3.5	3.6	4.1	5.0
Government Consumption Expenditure	4.6	-1.9	6.7	6.1	-5.3	2.4	-5.5
Capital Formation	11.7	-16.3	-2.0	5.5	2.1	-3.5	8.5
Fixed Capital	11.5	-11.2	-2.3	3.1	-3.7	2.4	0.5
Exports	17.2	-21.0	3.6	17.7	-3.4	3.6	2.6
Imports	13.5	-14.7	-2.8	4.0	3.5	4.7	14.4
Memorandum Items							
Gross International Reserves, Bn $	7.2	9.2	13.2	13.1	15.7	16.2	16.1
Exchange Rate (P/$, end of period)	29.5	40.9	39.1	44.2	51.3	51.3	52.9
Tax Effort (% of GDP)	17.0	15.6	14.5	13.9	13.3	12.3	13.0
Deficit (% of GDP)	0.1	-1.9	-3.8	-4.1	-4.0	-5.2	-3.9
Non-Performing Loans (% of Total Loans)	4.7	10.4	12.3	15.1	17.3	15.0	15.2

Sources: National Statistical Coordination Board, Bangko Sentral ng Pilipinas
National Statistical Office, and Department of Finance Websites

Table 4. Inflation Rates, 1997-2003

	1999	2000	2001	2002	Mar 03	Jun 03	Aug 03
(in percent per annum)							
All Items	6.7	4.4	6.1	3.1	2.9	3.4	3.0
Food, Beverages & Tobacco	5.2	2.0	4.1	2.0	1.8	2.7	1.5
Clothing	6.3	2.6	3.7	2.6	2.0	2.3	2.4
Housing and Repairs	9.3	5.3	6.8	4.9	2.7	2.6	3.2
Fuel, Light and Water	7.0	10.2	12.1	4.8	5.2	7.8	9.5
Services	10.5	11.6	11.5	5.0	6.7	5.6	5.8
Others	5.3	1.3	5.2	1.9	1.6	1.8	1.9

Source: National Statistics Office

Table 5. Monetary Survey, 1997-2003

	1997	1998	1999	2000	2001	2002	Jun-03
(in billion pesos)							
Total Liquidity	1,608	1,679	1,938	2,079	2,165	2,351	2,363
Broad Money (M3)	1,066	1,145	1,365	1,427	1,525	1,670	1,647
Narrow Money	258	282	394	387	388	470	445
FCDU Deposits	433	478	522	586	586	628	652
Other Liabilities	108	57	51	66	54	53	63
Net Domestic Assets	1,685	1,539	1,609	1,737	1,760	1,809	1,772
Net Domestic Credit	1,923	1,870	1,923	2,088	2,106	2,208	2,191
Public Sector	468	460	529	581	645	727	727
Private Sector	1,455	1,411	1,394	1,507	1,462	1,480	1,464
Net Other Items	-238	-332	-315	-351	-347	-398	-419
Net Foreign Assets	-77	141	329	343	405	541	591
Central Bank	267	314	367	430	449	538	519
Deposit Money Banks	-251	-80	-38	-87	-44	4	72
(in percent of GDP)							
Broad Money	42.2	40.8	43.5	40.8	38.9	38.9	40.4
Net Domestic Assets	66.6	54.9	51.3	49.7	44.9	42.2	43.5
Private Sector Credit	57.5	50.3	44.5	43.1	37.3	34.5	35.9
Net Foreign Assets	-3.0	5.0	10.5	9.8	10.3	12.6	14.5

Source: Bangko Sentral ng Pilipinas

Table 6. National Government Operations

	1997	1998	1999	2000	2001	2002	2003 Sem I
(in billion pesos)							
Total Revenue	471.8	462.5	478.5	514.8	563.7	567.1	306.3
Tax Revenue	412.2	416.6	431.7	460.0	489.9	496.4	265.2
Bureau of Internal Revenue	314.7	337.2	341.3	360.8	388.7	394.5	209.2
Bureau of Customs	94.8	76.0	86.5	95.0	96.2	96.3	53.0
Nontax Revenue	57.9	45.5	46.5	53.4	71.9	69.7	40.2
Total Expenditure	470.3	512.5	590.2	649.0	710.8	777.9	385.9
Current Expenditure	419.4	467.9	524.2	585.4	648.9	-	333.4
Personnel Services	150.4	172.9	167.0	182.7	190.9	-	137.1
Maintenance and Operations	108.1	118.3	141.6	149.3	155.6	-	27.6
Allotment to LGUs	71.0	72.0	96.4	99.8	118.2	140.5	55.9
Interest Payments	78.0	99.8	106.3	140.9	174.8	185.9	111.1
Capital Outlay	47.9	43.5	61.2	60.4	57.4	-	49.8
Equity	1.6	0.8	1.5	0.5	0.5	1.5	0.2
Net Lending	1.4	0.3	3.2	2.6	3.9	2.6	2.8
Surplus/(Deficit)	1.6	-50.0	-111.7	-134.2	-147.0	-210.7	-79.6
Financing	27.1	88.9	181.7	203.8	175.2	264.2	83.5
Net Domestic Financig	-20.3	76.6	98.9	119.5	152.3	155.0	37.6
Net External Financing	-6.8	12.3	82.8	84.4	22.9	109.1	45.9
(as % of GDP)							
Total Revenue	19.4	17.4	16.1	15.6	15.3	14.1	15.0
Total Expenditure	19.4	19.2	19.8	19.6	19.3	19.3	18.9
Overall Surplus/Deficit	0.1	-1.9	-3.8	-4.1	-4.0	-5.2	-3.9
(in billion US$)							
Debt and Debt Service							
Total	33.8	38.3	44.0	43.3	46.4	53.0	54.8
Domestic Debt	18.8	21.8	24.3	21.4	24.3	27.7	28.5
Foreign Debt	15.0	16.5	19.8	22.0	22.1	25.3	26.3
Total Debt Services	3.1	4.2	5.1	4.6	5.3	6.7	3.7
Interest Payments	2.0	2.6	2.6	2.8	3.4	3.5	2.1
Principal Payments	1.2	1.7	2.5	1.7	1.9	3.2	1.6
(as % of GDP)							
Total	55.7	56.1	59.6	65.5	64.9	70.0	72.9
Domestic Debt	30.9	31.9	32.9	32.3	34.0	36.6	37.9
Foreign Debt	24.8	24.2	26.8	33.2	31.0	33.4	35.0
(as % of Exports of Goods and Services)							
Total Debt Services	5.0	5.9	6.5	6.5	7.0	8.3	9.2
Interest Payments	3.1	3.6	3.4	4.0	4.5	4.3	5.1
Principal Payments	1.9	2.3	3.2	2.5	2.5	4.0	4.1

Source: Bureau of Treasury

Table 7. Consolidated Public Sector Deficit

	1998	1999	2000	2001	2002
(in billion pesos)					
TOTAL SURPLUS+/DEFICIT-	-83.2	-100.5	-151.9	-167.1	-231.1
Percent of GDP	-3.0%	-3.4%	-4.6%	-4.7%	-5.8%
National Government	-50.0	-111.7	-134.2	-147.0	-210.7
CB restructuring	-26.4	-20.5	-19.1	-25.7	-15.1
Monitored GOCCs	-38.0	-4.6	-19.2	-23.0	-46.1
o.w. NPC	-16.2	-1.1	-3.4	-8.3	-21.7
NFA	-11.9	-0.8	-1.9	-2.3	-8.1
SSS/GSIS	17.7	36.4	15.4	10.5	25.6
BSP	3.2	-3.9	0.2	5.0	4.2
GFIs	5.4	3.3	2.8	4.8	5.4
LGUs	2.0	3.2	3.8	4.2	3.4

Source: Department of Finance

Table 8. Balance of Payment, 1997-2003

	1999	2000	2001	2002	Jun-03
(in million US$)					
Exports of Goods & Services	39,014	41,267	34,391	37,439	18,045
Remittances	6,795	6,050	6,031	7,189	3,880
Imports of Goods & Services	36,767	39,883	37,184	38,295	20,181
Net Trade in Goods & Services	8,082	1,384	-2,793	-856	-2,136
Net Income Receipts	4,460	4,437	3,669	4,550	2,698
Net total current transfers	512	437	447	503	306
Current Account	7,219	6,258	1,323	4,197	868
				4,197	
Capital Account Balance	-8	38	-12	-19	-11
Financial Account	8,628	1,660	2,192	2,938	-2,428
Net direct investment	1,754	1,453	1,142	1,026	10
Net portfolio investment	6,874	207	1,050	1,912	258
Others	-10,953	-5,817	-3,260	-5,023	-2,696
Errors and ommissions	-1,300	-2,651	-435	-1,433	955
Reserves, net change	-3,586	513	192	660	616
Total External Debt [1]	52,210	52,060	52,355	53,874	55,806
Medium and Long-Term	46,465	46,112	46,306	48,315	49,383
Short-Term	5,745	5,948	6,049	5,558	6,423
Trade	1,836	1,640	1,285	1,055	1,205
Non-Trade	3,909	4,308	4,765	4,503	5,218

Source: Bangko Sentral ng Pilipinas

Table 9: Labor and Employment Indicators (000)

	1997	1998	1999	2000	2001	2002	Jul-03
Population	71,521	73,177	74,878	76,627	78,317	80,040	-
Growth Rate	2.2	2.3	2.3	2.3	2.2	2.2	-
Working Age Population	45,770	44,995	46,321	47,640	48,929	50,344	50,751
Growth Rate		-1.7	2.9	2.8	2.7	2.9	-1.3
Total Labor Force	30,355	29,674	30,759	30,911	32,809	33,936	34,206
Growth Rate		-2.2	3.7	0.5	6.1	3.4	0.1
Labor Force Participation Rate	66.3	65.9	66.4	64.9	67.1	67.4	67.4
Unemployed	2,640	3,043	3,017	3,459	3,653	3,874	4,348
Unemployment Rate	8.7	10.3	9.8	11.2	11.1	11.4	12.7
Underemployed	6,121	5,758	6,127	5,955	5,006	5,109	6,211
Underemployment Rate	22.1	21.6	22.1	21.7	17.2	17.0	20.8
Employment by Sector							
Agriculture	11,314	10,091	10,774	10,181	10,850	11,122	10,384
Industry	4,631	4,542	4,515	4,454	4,713	4,694	4,953
Manufacturing	2,732	2,715	2,759	2,745	2,906	2,869	3,026
Services	11,771	11,999	12,453	12,817	13,593	14,246	14,520
Total	27,716	26,632	27,742	27,452	29,156	30,062	29,858
Jobs Generated							
Agriculture	-331	-1223	683	-593	669	272	-769
Industry	201	-89	-27	-61	259	-19	232
Manufacturing	23	-17	44	-14	161	-37	189
Services	659	228	454	364	776	653	123
Distribution by Class of Workers (percent of total)							
Wage and Salary Workers	48.6	49.9	49.6	50.7	49.5	48.7	53.9
Own-account Workers	37.4	37.0	36.8	37.1	37.5	37.9	35.6
Unpaid family Workers	14.1	13.1	13.6	12.2	13.0	13.3	10.5

Source: National Statistics Office

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