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PHILIPPINE ECONOMIC UPDATE

Making Growth Work Better for Small Businesses

October 2015

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MAKING GROWTH WORK BETTER FOR SMALL BUSINESSES

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Macroeconomics and Fiscal Management Global Practice
Philippine Country Office
East Asia and Pacific Region

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PREFACE

The *Philippine Economic Update* (PEU) provides an update on key economic and social developments, as well as policies over the past six months. It also presents findings from recent World Bank studies on the Philippines. It places them in a longer term and global context, and assesses the implications of these developments and policies on the outlook for the Philippines. Its coverage ranges from the macroeconomy and financial markets to indicators of human welfare and development. It is intended for a wide audience, including policymakers, business leaders, financial market participants, and the community of analysts and professionals engaged on the Philippines.

The PEU is a report of the World Bank's Macroeconomics and Fiscal Management (MFM) Global Practice (GP), in partnership with the Trade and Competitiveness (T&C) GP. It was prepared by Joseph Louie Limkin (Research Analyst and Task Team Leader), Kevin Cruz (Research Analyst), and Justin Chan (Research Assistant), all from the MFM GP, Griselda Santos (Operations Officer) from the Finance and Markets GP, and Roberto Galang (Operations Officer), Beatrice Tanjangco (Research Assistant), Jean Francois Arvis (Senior Transport Economist), Teresita Lacerna (Legal Adviser), Gerard McLinden (Lead Specialist), Marcin Piatkowski (Senior Financial Economist), Daria Taglioni (Senior Trade Economist), and Guillermo Arenas, Christina Busch, Claire Hollweg, Jonathon Kirby, and Marieta Patag (all Consultants), all from the T&C GP.

The team worked under the guidance of Karl Kendrick Chua (Senior Country Economist) and Rogier van den Brink (Lead Economist and Program Leader). Mathew Verghis and Mona Haddad are the Practice Managers for MFM and T&C, respectively. Logistics and publication support by Maria Consuelo Sy (Program Assistant), Ayleen Ang, and Rita Angela Rivera (both Team Assistants) are gratefully acknowledged. The Manila External Communications Team, comprising David Llorito (Communications Officer), Justine Letargo (Online Communications Officer), and Geralyn Rigor (Program Assistant), prepared the media release, dissemination, and multimedia products for the web.

The report benefited from the advice, comments, and views of various stakeholders in the World Bank, the government, business, labor, academe, and civil society. The team is very grateful for their time and inputs. The findings, interpretations, and conclusions expressed in this *Update* are those of World Bank staff and do not necessarily reflect the views of its management, executive board, or the governments they represent.

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EXECUTIVE SUMMARY

The Philippines is among the strongest performers in the region, bucking the trend. In the first half (H1) of 2015, among the major economies in the region, the only countries to accelerate their quarterly growth rates were the Philippines, from 5 to 5.6 percent, and Vietnam. In spite of this acceleration, for the two quarters combined, Philippine growth rate came out at 5.3 percent—its lowest half year growth rate since 2011. On the demand side, the strong performance of private domestic demand at 8.1 percent, supported by record low inflation and robust remittances, drove GDP growth. However, the slow pace of public spending and the contraction in net exports pulled down GDP growth. On the supply side, the onset of El Niño led to stagnant agriculture growth. Meanwhile, growth in industry and services was respectable, with both sectors growing by around 5.8 percent. In Q3, available high frequency data suggest an improving economy, in particular, an acceleration in government spending.

Continued job gains in the services and industry sectors could not compensate for the substantial job losses in agriculture caused by El Niño.[1] Based on the latest round of the Labor Force Survey (LFS) in July 2015, job generation continued to be led by the services sector, majority of which belonged to the informal services sector, followed by industry. In industry, the construction sector, not manufacturing, drove job creation. However, job generation in both sectors were not enough to offset the substantial job losses in the agriculture sector, which lost some 877,000 jobs as agricultural production fell as a consequence of El Niño. In all, the country experienced a net loss of around 96,000 jobs between July 2014 and July 2015.[2]

In recent years, strong economic growth and effective government programs are improving poverty reduction, but, in 2014, natural disasters and delays in state-managed rice importation harmed the poor. Between 2012 and 2013, poverty fell by three percentage points (ppt), as underemployment among the poor fell significantly and domestic cash transfers to the bottom income quintile grew substantially. This suggests that the government's conditional cash transfer (CCT) program is well-targeted and reaching the poor. However, in the first half of 2014, the latest Annual Poverty Indicators Survey[3] suggests that poverty increased. The increase is attributed to Typhoon Yolanda (a one time, unprecedented event) and high rice prices (due to rice importation delays by the state monopoly). Nevertheless, poverty fell by around two ppt from 2012 to 2014.

[1] This paragraph is based on government press release. Further breakdowns are not available as the July 2015 round of the Labor Force Survey (LFS) included the province of Leyte while all 2014 LFS rounds excluded Leyte due to survey constraints caused by Typhoon Yolanda.

[2] This is based on preliminary estimates and is subject to change.

[3] To produce comparable annual estimates of poverty, the FIES (Family Income and Expenditure Survey) income module was adopted in the APIS starting 2013. The APIS is conducted during non-FIES years, but is only a first-semester estimate.

Like the rest of the region, the domestic financial market experienced large volatilities in recent months, but underlying fundamentals remain sound. After reaching a record high early in the year, the equity market experienced a sharp decline. By late August, year-to-date gains were wiped out. However, the sovereign bond market bucked the trend and prices rose, discounting uncertainties brought about by the anticipated hike in US interest rate and concerns about China's economy. The domestic financial market remains strong, with low levels of non-performing loans, high capital adequacy ratios, and prudential measures in place to mitigate risks. Likewise, monetary policy remains supportive with room to respond to higher global interest rates. The peso is stable in real terms, is flexible, and is in line with market fundamentals, offering a cushion to large capital outflows.

Gains from higher revenues and unprecedented increases in the budget have yet to translate into commensurate increases in government spending to support an investment-led growth. In H1 2015, tax effort increased to 14.1 percent of GDP from 13.7 percent in H1 2014 due to strong private sector growth and improved tax administration. However, government spending continued to be slow, led by the contraction in public infrastructure spending in Q1, before rebounding in Q2. Since 2010, government budgets have increased by an average of 15 percent annually, with sharp increases coming in the latter years. Existing government systems and procedures are facing considerable difficulties expanding at this pace. For instance, from H1 2014 to H1 2015, while the budget increased by 18.5 percent, government expenditures only increased by 8.5 percent. A counterfactual analysis shows that bringing spending closer to the budget could have yielded higher economic growth. For example, had the government increased its 2010 to 2014 average spending-to-budget ratio from 79.7 to 85 percent, GDP growth in the same period would have risen to an average of 6.9 percent, compared to the actual average of 6.2 percent.

In the medium-term, growth prospects remain positive. In 2016, growth is expected to accelerate to 6.4 percent before tempering to 6.2 percent in 2017. However, for 2015, growth projection is revised downwards to 5.8 percent. This takes into account the relatively weak first half growth brought about by slow government spending, negative net exports, and the initial impact of El Niño. In contrast, second half growth is projected to improve as government spending is ramped up. In addition, accelerated implementation of public-private partnership projects, valued at around 0.6 percent of GDP for 2015, and the continuing effect of lower food inflation and declining oil prices can further support growth. On the other hand, a stronger El Niño and weaker exports can pull down growth considerably.

Poverty reduction is expected to continue if the country is able to maintain the relatively high economic growth and better job trends in recent years. Using full-year estimates from the Family Income and Expenditure Survey, extreme poverty is projected to further decrease to 8.2 percent in 2017 (using the new international poverty line of USD 1.90/day PPP, new 2011 PPP prices, and the above growth assumptions), down from 10.5 percent in 2014. Government transfers to poor households are projected to continue to grow. However, official poverty estimates are particularly sensitive to food price inflation. Even as the outlook for international prices is favorable, poverty results will also depend on how the government manages its food policy, and rice imports in particular.

Simplifying business regulations can unleash the full potential of the private sector, in particular, small and micro businesses, as they are important contributors to inclusive growth. In H1 2015, private domestic demand grew by 8.1 percent compared to an economy-wide growth of 5.3 percent. However, business regulations have long been a cumbersome process in the Philippines. They limit the growth of innovative entrepreneurship and investments, contribute to large scale informality, and hence prevent the country from creating more and better jobs and reducing poverty at a faster rate. To make growth more inclusive, reforms to simplify business regulations are needed. Priority needs to be given to three major hindrances that affect micro and small businesses the most: starting and maintaining a business, paying taxes, and accessing finance. These are discussed in detail in the medium-term reform section.

The total costs, both direct and opportunity, of starting and maintaining a business, especially for MSMEs, need to be brought down (Special Focus 1). Reforms to reduce these costs would free up substantial resources and make growth more inclusive. Overall, the cost imposed on MSMEs in starting a business is very high. They not only have to pay for legitimate fees equivalent to 17 to 36 percent of per capita income (PHP 21,000 to 45,000), they also spend a considerable amount of time moving from one agency to another and waiting in line to process their documents, often resulting in significant loss of productive time and income. In some instances, businesses report that they need to pay bribes or give gifts to obtain various permits and government services. After a business commences, numerous annual regulatory requirements are needed to maintain the business, which can take many days every year. Moreover, there are tax and contribution payments that have to be paid frequently within the year. This productive time lost translates to an estimated annual opportunity cost of at least PHP 100 billion annually. Moreover, opportunity cost of around PHP 40 billion can arise from discouraged Filipinos who could have started a business if only the cost was reasonable. This translates to forgone employment of around 60,000, which is equivalent to about five percent of new labor force entrants every year.

Recognizing the adverse impact on the economy of costly business start-up, the government has begun to address a number of doing business constraints. For instance, the government enacted the “Go Negosyo Act” in 2014, which calls for the establishment of service centers to facilitate business start-up and operations of micro, small, and medium enterprises (MSMEs), and re-engineered the process of starting a corporation in Quezon City. However, more can be done to unleash the full potential of MSMEs. This includes: i) further simplifying and automating key business registration processes, ii) fully implementing the Philippine business registry and the regulatory simplification program, iii) introducing alternative payment systems such as online and mobile payments, iv) reducing the frequency of renewals of government licenses, permits, and clearances for employment purposes, iv) adopting a risk-based approach for business permitting purposes, and v) simplifying the tax regime for micro and small businesses to reduce compliance costs and encourage movement of firms to the formal sector.

Finally, Philippine export procedures and costs are very high for small exporters (Special Focus 2). Export transaction costs are high, relative to its neighbors. Not only is de jure exporting cost very high, exporters reveal that they have to pay more than the legally-mandated fees to expedite the process. For small exporters, the cost of exporting can be high enough to discourage them from entering or remaining in business. To lower export transaction costs, the report recommends: i) enhancing coordination among trade-related government agencies through the National Single Window and improving the efficiency of Bureau of Customs' information technology system, ii) establishing and publishing clear performance standards, and setting up a national trade website to provide information on export processes and procedures, and iii) eliminating or re-engineering redundant or inefficient export steps. These reforms would complement reforms to reduce non-tariff barriers, enhance logistics support, and improve productivity of key export products.

The remaining eight months of the Aquino Administration present an opportunity to clearly and practically define the "unfinished business" in the structural reform agenda. These are challenging reforms, as they would reverse decades of bad policies which have undermined the economy's capacity to generate more and better jobs. They include:

- Institutionalizing current reforms to increase budget transparency and accountability, and laying the foundation for more comprehensive budget reforms,
- Crafting a simpler, more equitable, and more efficient tax system to finance an investment-led growth, in particular, rationalizing tax incentives that are neither transparent nor performance-based, and adjusting taxes that have not been indexed to inflation (i.e., taxes on petroleum products and property valuations),[4]
- Further opening up the economy to more competition by tackling monopolistic practices and reducing the investment negative list,
- Securing property rights through land governance reforms, and
- Re-engineering business regulations to make them simpler and far less costly.

When sustained, these reforms can support high growth, accelerate good job creation, and eliminate extreme poverty.

[4] The current low oil price regime provides a good opportunity to adjust petroleum excise taxes without affecting real income.

RECENT ECONOMIC AND POLICY DEVELOPMENTS[5]

Output and demand

1. **The Philippines is among the strongest performers in the region, bucking the trend, because of strong fundamentals.** In the first half (H1) of 2015, among the major economies in the region, the only countries to accelerate their quarterly growth rates were the Philippines, from 5 to 5.6 percent, and Vietnam. In spite of this acceleration, for the two quarters combined, Philippine growth rate came out at 5.3 percent—its lowest half year growth rate since 2011. On the demand side, the strong performance of private domestic demand at 8.1 percent, supported by record low inflation and robust remittances, drove growth. However, the slow pace of public spending and the contraction in net exports pulled down overall growth. On the supply side, the onset of El Niño slowed agriculture growth to only 0.3 percent. Meanwhile, growth in industry and services was respectable, with both sectors growing by around 5.8 percent. In Q3, available high frequency data suggest an improving economy, in particular, an acceleration in government spending.

Table 1. GDP growth by sector

	H1 2014	H1 2015		H1 2014	H1 2015
Supply side			**Demand side**		
Agriculture, fishery, & forestry	**1.9**	**0.3**	**Household final consumption**	**5.9**	**6.1**
Agriculture & fishery	2.8	0.8	**Government consumption**	**0.9**	**2.9**
Forestry	-2.3	-2.2	**Capital formation**	**10.6**	**14.3**
Industry	**7.3**	**5.8**	Fixed capital	4.2	9.5
Mining & quarrying	4.9	0.1	Construction	5.0	10.2
Manufacturing	9.0	5.3	Durable equipment	3.9	10.4
Construction	4.3	10.5	Breeding stock & orchard development	-3.3	0.4
Electricity, gas, & water	1.7	4.0	Intellectual property products	20.0	2.6
Services	**6.3**	**5.8**	Changes in stocks	48.2	75.5
Transportation, communications, & storage	7.5	7.1	**Exports**	**10.2**	**5.0**
Trade	6.3	5.8	Merchandise exports	13.2	0.4
Finance	5.9	5.1	Non-factor services	0.1	22.4
Real estate, renting and business activities	9.3	6.6	**Imports**	**10.4**	**10.6**
Government services	3.5	-1.8	Merchandise imports	9.9	9.8
Other services	3.7	7.8	Non-factor services	12.4	14.0
Gross domestic product	**6.2**	**5.3**	**Gross domestic product**	**6.2**	**5.3**

Source: Philippine Statistics Authority

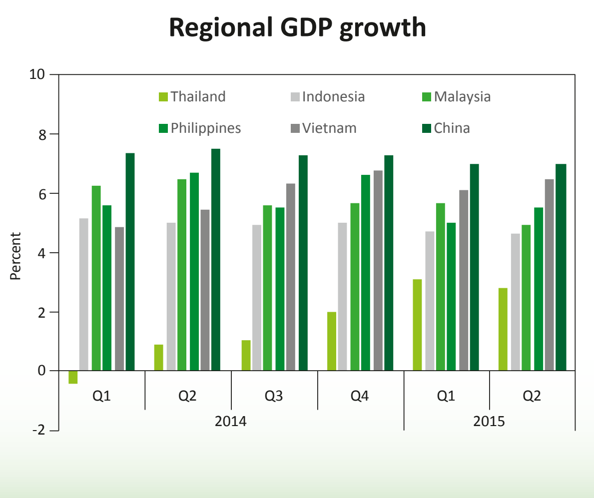
2. **On the supply side, the onset of El Niño exerted a further drag on a perennially underperforming agriculture sector** (Figure 2). In the last six years, the agriculture sector grew very slow at an average rate of 1.2 percent, the consequence of decades of policy distortions

[5] This section was prepared by Kevin Cruz (Research Analyst) under the guidance of Karl Kendrick Chua (Senior Country Economist) and Joseph Louie Limkin (Research Analyst), all from the Macroeconomics and Fiscal Management Global Practice.

and underinvestment in key public goods such as irrigation. The onset of “El Niño” in March 2015 (see Box 3 for more discussion) further exposed the sector’s vulnerability, contributing to a much slower growth of 0.3 percent. The crops sub-sector contracted by 0.5 percent,[6] led by rice, corn, and sugarcane, all water-intensive crops. The fisheries sub-sector also declined by 2.2 percent as El Niño has begun to affect fish distribution. Livestock and poultry—the third subsector—may soon be affected as feed production feels the brunt of El Niño.

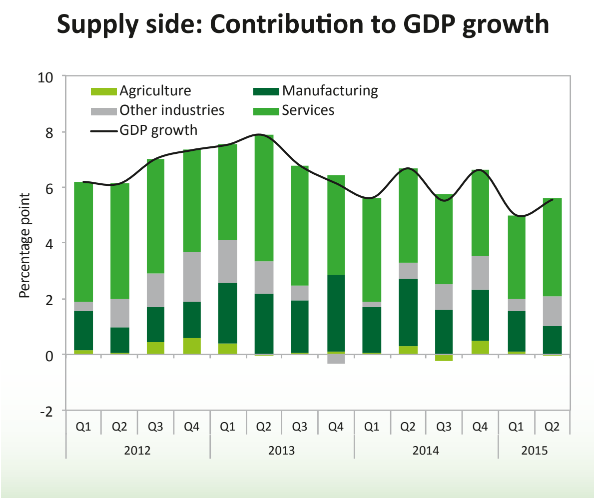
3. **Meanwhile, growth in services and industry was respectable, although manufacturing decelerated significantly.** The industry sector grew slower at 5.8 percent compared to 7.3 percent in the same period in 2014, brought down by the deceleration in manufacturing growth from 9 to 5.3 percent. Slower manufacturing growth, in turn, was driven by food manufacturing,[7] which grew by just 2.1 percent, reflecting lower agriculture production and contraction in food exports. Several other manufacturing sub-sectors also underperformed as exports to Japan (-7.5 percent) and China (-32 percent) fell.[8] On the other hand, the services sector grew at a slightly slower pace of 5.8 percent relative to a year ago, but continued to be the main driver of growth, accounting for 3.3 percentage points (ppt), given its dominant size. Expansion of most sub-sectors in services continued to remain strong at more than five percent. Government services was the exception, which contracted by 1.8 percent.

Figure 1. The Philippines remained among the stronger performers in the region.



Sources: CEIC, Reuters

Figure 2. On the supply side, services and industry continued to drive growth while agriculture stagnated.



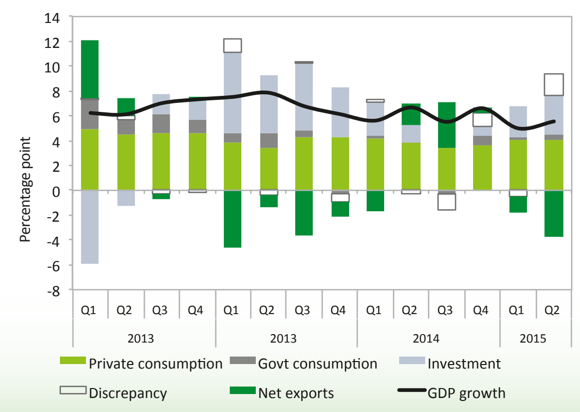
Source: Philippine Statistics Authority

[6] According to the Philippine Statistics Authority, water-intensive crops such as rice and corn were affected the most, contracting by 2.8 and 15.7 percent, respectively, in Q2. However, crops requiring less water such as pineapple, mango, abaca, *monggo* (mung beans), sweet potato, and cassava still grew due to hot weather conditions favorable to their production.

[7] Food manufacturing is the largest manufacturing sub-sector and typically comprises around 40 percent of total manufacturing output. The fast pace of population growth, at 1.9 percent, is a major driver.

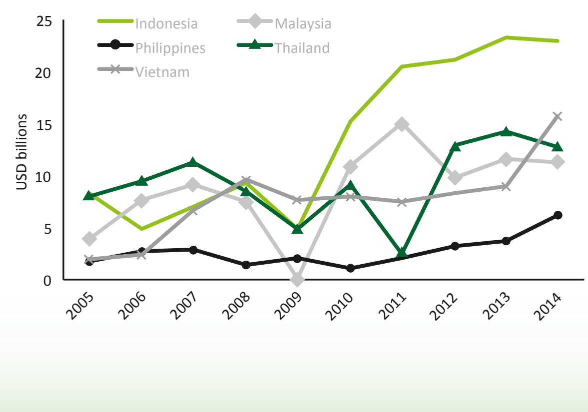
[8] Japan is the Philippines’ top export market, while China is the country’s third largest export market.

Figure 3. On the demand side, strong private consumption, in the midst of weak government spending and falling net exports, continued to drive growth.



Source: Philippine Statistics Authority

Figure 4. Although rising, the Philippines still attracts much less FDI compared to its ASEAN neighbors.



Source: World Development Indicators; Country statistics offices

4. **On the demand side, the strong performance of private domestic demand at 8.1 percent continued to drive growth**. Stronger growth of household consumption at 6.1 percent (Figure 3), was supported by low food inflation, the continued decline in fuel prices, and sustained increase in remittances. Stronger household consumption also suggests that more Filipinos are recovering from the effects of natural disasters such as Typhoon Yolanda. In addition, robust private fixed capital formation (11.2 percent growth) in both construction and durable equipment provided additional support. Stronger growth in durable equipment at 10.4 percent and the country's inclusion in the EU's Generalized Scheme of Preference Plus (GSP+)[9] in December 2014 suggest a near-term expansion of manufacturing.[10]

5. **Government spending, which had a slow start, began to recover in Q2.** Slow budget execution continued in Q1 2015, particularly for infrastructure, due to a number of execution bottlenecks. This resulted in the contraction of government spending by two percent, pulled down by a 24 percent decline in public construction in Q1. Government spending recovered in Q2 by 6.9 percent as public construction bounced back by 20.4 percent. This brought government spending growth to three percent in H1 and contributing only 0.4 ppt to GDP

[9] The GSP+ grants duty free access to a number of Philippine exports. These include marine products (fisheries), processed fruit, prepared food, animal and vegetable fats and oils, textiles, garments, and chemicals. The government estimates that it can generate 200,000 jobs and raise exports to the EU by 11 percent (source: Department of Trade and Industry).

[10] Despite its slowdown in H1 2015, optimism for the country's manufacturing sector remains. The government continues to support the manufacturing sector through its Manufacturing Resurgence Program (MRP), which aims to increase the contribution of manufacturing to 30 percent of GDP and 15 percent of employment by 2025.

growth. The fiscal policy section discusses the reasons for slow government spending in more detail.

6. **In addition, a weaker global economy reversed the performance of merchandise exports, while imports continued to grow.** Stagnant merchandise export growth at 0.4 percent in H1 largely reflected weak global demand, specifically in Japan and China. In particular, exports of agricultural products (-31 percent) and electronics data processing (-14 percent) were the hardest hit. However, despite weak global demand, total electronics exports recovered by 16 percent as demand from the US improved. In addition, merchandise export growth was outpaced by merchandise import growth, which grew by 9.8 percent. As a result, net exports took away some 2.6 ppt from GDP growth. Growth in merchandise imports was driven by a 56 percent increase in electronic parts imports. Within this product group, components and devices for semiconductors grew by 82 percent. This development suggests that growth of electronics exports will be sustained in H2 as parts are typically assembled and shipped in a short time span. In addition, import of office, electrical, and telecommunications equipment was strong and supported the growth of private investment.

7. **Despite a growing trade deficit, the country's current account balance remained in strong surplus, as exports of services and remittances remained resilient.** In H1 2015, the current account balance yielded a surplus of USD 4.7 billion (3.3 percent of GDP) compared to USD 3.9 billion (2.9 percent of GDP) in H1 2014. This was fueled by the strong performance of services exports (growth of 9.7 percent), which is still being led by the country's fast-growing business process outsourcing (BPO) industry. In H1 2015, the industry generated USD 8.5 billion in revenues and is expected to create an additional 170,000 jobs this year. Despite concerns about a slowing global economy, cash remittances maintained its respectable growth of 5.6 percent. However, in recent months, households receive eight percent more in peso terms given the peso's depreciation. Remittance growth was robust across all regions except Europe, which contracted by eight percent, reflecting its easing economy. Despite much lower oil prices, cash remittances from the Middle East remained robust, growing by 6.8 percent in the same period as deployment of overseas Filipino workers to the region was sustained.

8. **After reaching a record high last year, net foreign direct investment (FDI) slowed in H1 2015.** The perennially low levels of FDI highlight the country's low level of capital accumulation relative to the region.[11] Through June 2015, the Philippines registered a net FDI inflow of USD 2 billion, which was 40 percent lower than the same period in 2014. Despite the sharp decline, net FDI inflows in H1 2015 was comparable to the average FDI achieved since 2010.[12] However, compared to its East Asian neighbors, FDI attraction still lags significantly behind (Figure 4), indicating much scope to improve the investment climate and open the economy to more foreign players (see the policy section for more discussion). For example, full liberalization of

[11] For a more detailed discussion on the Philippines' investment deficit, see the August 2014 edition of the PEU. This is available at: http://www.worldbank.org/en/country/philippines/publication/philippines-accelerating-public-investment-to-sustain-growth-that-benefits-the-poor.
[12] H1 net FDI inflows averaged PHP 1.9 billion from 2010 to 2014.

the Philippine banking industry in 2014 helped to attract USD 1.3 billion in FDI to the sector from an average of just USD 35 million since 2005. On the other hand, following heightened volatility in the global financial market, net portfolio investment reversed its trend starting Q2, resulting in a September year-to-date net outflow of USD 64 million (see the financial sector section for more discussion).

9. **With a strong current account and stable financial account, the balance of payments, which was in deficit in 2014, returned to a surplus in H1 2015.** As a result, the country's gross international reserves (GIR) recovered to USD 80.6 billion in June before falling slightly in August to USD 80.3 billion as the central bank intervened to lessen the peso's volatility. This level of GIR remains high, is still at comfortable levels, and well in excess of the IMF's suggested reserve adequacy. Reserves are enough to cover 10.3 months of imports or 4.5 times the value of the country's short-term external liability by residual maturity.[13]

10. **In Q3, available high frequency data suggest an improving economy.** The country's private sector is poised to continue its strong performance in Q3 2015. In particular, sustained growth of remittances in July, which grew by almost eight percent in peso terms (given the peso's four percent depreciation in recent months), and record low inflation in July and August are expected to drive consumption growth. In addition, the country continues to benefit from a vibrant tourism sector, which generated 16 percent more revenues and attracted 14 percent more tourists in July. Moreover, the public sector continues to recover. In July, government spending increased by 25 percent, the largest increase for the year, driven by a 93 percent increase in capital outlay. These gains are likely to offset further slowdown in external demand as the global economy eases, and in agriculture as El Niño intensifies.[14] In July, merchandise exports and manufacturing contracted slightly. However, the country's top export, semiconductors, grew strongly by 55 percent.

Employment and poverty

11. **Continued job gains in the industry and services sectors could not compensate for the substantial job losses in agriculture caused by El Niño.**[15] Based on the latest round of the Labor Force Survey (LFS) in July 2015, job generation continued to be led by the services sector, majority of which belonged to the informal services sector, followed by industry. In industry, the construction sector, not manufacturing, drove job creation. However, job generation in

[13] Short-term external liability by residual maturity, as defined by the central bank, refers to external debt with original maturity of one year or less, plus principal payments on medium and long-term loans of the public and private sectors due in one year or less.

[14] The Philippine Statistics Authority estimates that rice production may decrease by 14 percent in Q3 2015, while corn production is expected to remain the same compared to Q3 2014.

[15] This paragraph is based on government press release. Further breakdowns are not available as the July 2015 round of the Labor Force Survey (LFS) included Leyte Province while all 2014 LFS rounds excluded Leyte due to survey constraints caused by Typhoon Yolanda.

both services and industry were not enough to offset the substantial job losses in the agriculture sector, which lost some 877,000 jobs as production fell as a consequence of El Niño. In all, the country experienced a net loss of around 96,000[16] jobs between July 2014 and July 2015. (Figure 5).

12. **Moreover, underemployment increased significantly while the labor force participation rate fell.** Although the rate of unemployment fell to 6.5 percent in July 2015, the rate of underemployment increased by 2.5 ppt to 20.8 percent, indicating that the quality of jobs remains a challenge. High underemployment, in turn, reflects the high rate of informality, which covers over 75 percent of workers (see the medium-term reform section for more discussion). These workers are vulnerable to job losses or income shocks. At the same time, the labor force participation rate declined by 1.4 ppt. There are three possible reasons for the decline. First, the number of discouraged workers increased.[17] Second, there was an increase in other sources of income, such as remittances, thereby reducing the need to find work. And third, workers are going back to school to retool. All three reasons are valid but their respective magnitudes are difficult to gauge. On the one hand, the stark increase in underemployment and net job losses suggest that job opportunities are limited and may push up the number of discouraged workers. On the other hand, sustained growth of remittances and the peso's depreciation, have led to higher household income, which may reduce the need to find work. It may also create incentives to go back to school, especially in light of improving public education system, including vocational schooling.

13. **Since 2012, poverty is trending downwards, although recent data shows a slight uptick.** After declining by three ppt between H1 2012 and H1 2013, poverty incidence increased by around one ppt between H1 2013 and H1 2014.[18] The increase is attributed to Typhoon Yolanda and artificially high rice prices due to importation lags, which are believed to have offset income growth of the poor.[19] Even though poverty increased slightly, the overall downward trend still suggests that growth is becoming more inclusive. Apart from higher growth in recent years, the expansion of the conditional cash transfer (CCT) program in 2014 is credited for raising the poor's income. In fact, according to the APIS, the first three income deciles saw the largest growth in domestic transfers (Figure 6).[20]

[16] This is based on preliminary estimates and is subject to change.

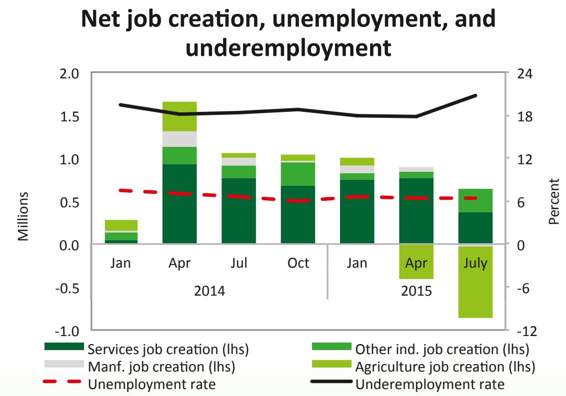
[17] Discouraged workers are those who are without a job and not seeking work because they are tired of looking for work or believe there is no work available. Discouraged workers who looked for a job in the six months prior to the interview date for the LFS were treated as unemployed.

[18] This is based on official poverty estimates from the 2014 Annual Poverty Indicators Survey (APIS).

[19] The tight supply of rice in H1 2014 led to a 12.2 percent increase in rice price, which could have effectively wiped out income growth of the poor.

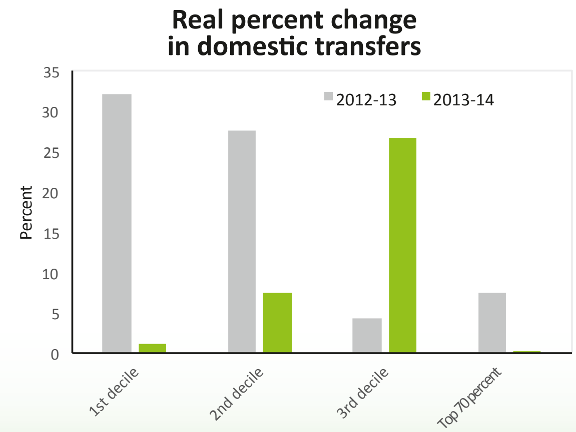
[20] In 2013, the first two income deciles experienced a 30 percent growth in domestic transfers, which includes transfers received from the government's CCT program. This slowed down to an average of four percent in 2014, as transfer income was broadly sustained. The large growth of transfer income in the third income decile suggests that the CCT program is reaching more poor Filipinos, as the CCT program expands.

Figure 5. Net job losses were recorded in July 2015, brought about by large job losses in the agriculture sector.



Source: Labor Force Survey
Note: Net job generation for July 2015 was computed using the distribution of employment by sector including the province of Leyte. Since Leyte makes up only 2.3 percent of the population, results would be broadly comparable.

Figure 6. The large increase in domestic transfers in the first three income deciles suggests that the government's CCT program is reaching more poor Filipinos.



Source: PSA, World Bank staff computations

Financial markets

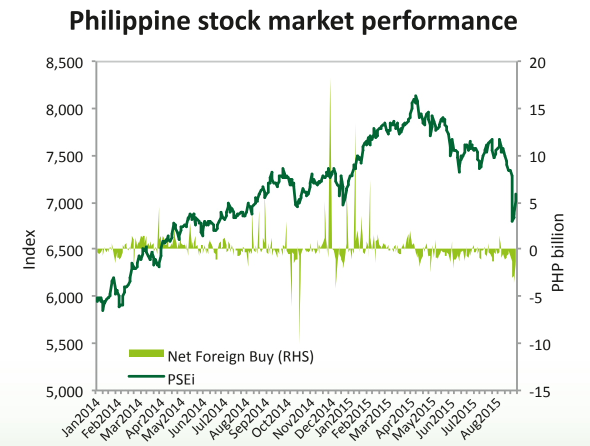
14. **Like the rest of the region, the domestic financial market experienced large volatilities in recent months but underlying fundamentals remain sound.** The Philippine Stock Exchange had a strong start in the year with its main index (PSEi) reaching a record high of 8,127 points in April 2015 or 12.4 percent higher compared to the start of the year (Figure 7). However, concerns brought about by the timing of the US Federal Reserve's interest rate hike have dampened expectations for the local equity market. More recently, the rapid decline of China's stock market, together with the depreciation of its currency and concerns about a more pronounced slowdown, contributed to a sell-off in the local stock market, which wiped out year-to-date gains. On August 24—the new "Black Monday"—the PSEi, contracted by 6.7 percent. This was the fourth largest decline since the global financial crisis of 2008.[21]

15. **However, the bond market saw prices rise.** Despite expectation of higher interest rates and the turmoil in the China, bond prices increased slightly as a result of the low inflation outlook and as investors rebalanced their asset holdings. For instance, bond prices of the benchmark ROP 2032 and 2034 (i.e., government external debt papers) increased from 146 to 156 and 156 to 163, respectively, since the start of the year (Figure 8).

[21] PHP 764 billion in total market value (six percent of GDP) was wiped out in a single day.

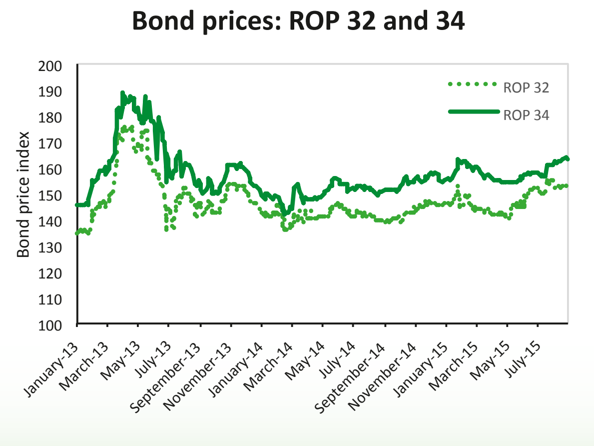
16. **Increased volatility in global financial markets have led to a sharp reversal in net foreign portfolio investments (FPI), leading to a net outflow in the first eight months of the year.** After posting net inflows of USD 1.8 billion in the first two months of 2015, consecutive net outflows since March led to a year-to-date net outflow of USD 64 million by September 2015. Capital outflow and regional currency depreciation led by the Chinese yuan have exerted pressure for the peso to depreciate against the US dollar by almost five percent as of September, resulting in its lowest value in five years. However, in real terms, the peso remained stable in recent months after appreciating for almost a decade now (Figure 9), making it one of the strongest currencies in the region in real terms. This has naturally led to concerns about the competitiveness of Philippine exports.[22]

Figure 7. The PSEi was not immune to volatility in global financial markets as year-to-date gains were wiped out.



Source: Philippine Stock Exchange

Figure 8. Recently, bond prices have increased given benign inflation outlook and as investors repositioned their asset holdings in the market.



Source: Bloomberg

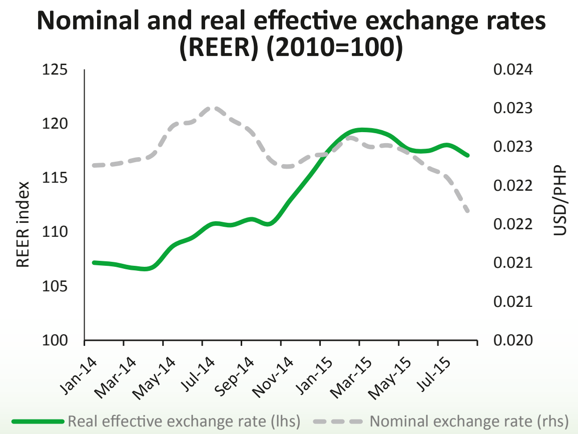
17. **The domestic financial market remains strong with a number of prudential measures in place to mitigate risks. However, careful monitoring is still needed given the possibility of more global volatility and certain data gaps.** Non-performing loans are very low at 2.4 percent of total loan portfolio (TLP) and the banking sector is well capitalized at more than twice the Basel standard of eight percent and higher than BSP's 10 percent standard, providing sufficient capital to absorb any possible shock on their credit exposures.[23] A number of macro-financial prudential measures are also in place to mitigate risks. In particular, lending to real estate is

[22] For a more detailed discussion on the movement of the peso, see the August 2014 edition of the PEU.

[23] Under BSP Circular 839, universal and commercial banks must meet the requirement of 10 percent capital adequacy ratio of qualifying capital. Their subsidiary thrift banks are also required to maintain a common equity tier one level of at least six percent of qualifying capital.

capped at 20 percent of TLP under a more conservative measure.[24] However, measuring the exposure of non-bank financial institutions to real estate credit suffers from data gaps.[25] Finally, the peso remains flexible and is broadly in line with market fundamentals, providing a cushion for large capital outflows.

Figure 9. Following significant real appreciation in the last decade, the peso has been relatively stable in the past few months, while it generally depreciated in nominal terms.



Note: Nominal exchange rate expressed in USD/PHP. An increase in the REER index, and the exchange rate in USD/PHP represents an appreciation.
Source: Bank for International Settlements, BSP

Prices and monetary policy

18. **CPI inflation continued to decelerate, averaging 1.7 percent in the first eight months of 2015, below the central bank's target of two to four percent for 2015.** Several supply side factors explain the slower rate of inflation, which reached 0.6 percent in August (Figure 10). Lower inflation was driven by the deceleration of food inflation to 1.2 percent in August from 8.3 percent a year ago as ample inventory[26] kept food supply sufficient despite lower agriculture output (Table 2). In particular, timely and adequate importation of rice kept prices from increasing as it did last year.[27] In addition, oil prices, which fell by 54 percent in August

[24] Under BSP's Memorandum No. M-2012-036, which supplements BSP Circular 600, the BSP lifted all exemptions in the computation of bank exposure to real estate and expanded them to cover funds channeled into securities of property firms. The guidelines under the memorandum provide a more comprehensive measure of banks' 20 percent cap on real estate exposure.

[25] For more discussion, please see the IMF Article IV consultation 2015, Policies for macroeconomic and financial sustainability. This is available at: http://www.imf.org/external/pubs/ft/scr/2015/cr15246.pdf

[26] For instance, rice inventory increased by 31 percent.

[27] The total volume of rice imports reached 1.8 million metric tons (mt) as of September 2015. This includes 500,000 mt imported in February, 250,000 mt in June, and 250,000 mt in September, all via the government-to-government procurement scheme. In addition, the private sector was contracted to import 787,000 mt under the minimum access volume (MAV) commitment for the year.

2015 compared to the same period in 2014,[28] also contributed to lower inflation given its pass through on electricity, transportation, and manufactured goods prices. On the other hand, core inflation, which excludes certain food and energy items to better capture underlying price volatilities, was higher at 2.2 percent year-to-date. This suggests that low inflation is largely driven by volatile goods and is transitory in nature, and is not indicative of the slowing economy.

Table 2. Breakdown of food inflation by commodity; total rice stocks

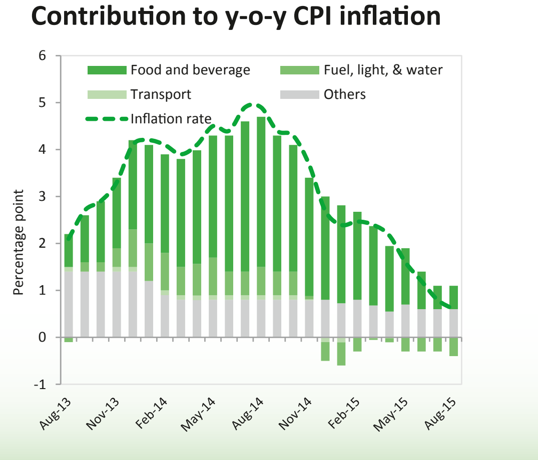
	2014			2015		
	Q1	Q2	Aug	Q1	Q2	Aug
Inflation (percent)						
Food and non-alcoholic beverages	**5.6**	**6.8**	**8.3**	**4.8**	**3.0**	**1.2**
Food	5.9	7.1	8.7	5.0	3.1	1.1
Bread and cereals	8.6	10.2	10.7	5.7	2.6	-0.5
Rice	10.8	12.9	13.2	7.2	3.3	-0.9
Corn	3.7	5.9	9.1	2.4	0.2	-0.7
Meat	2.7	4.0	5.9	4.2	1.3	0.3
Fish	4.1	5.4	6.4	5.1	5.3	3.1
Milk, cheese and eggs	2.2	2.8	4.2	4.4	3.3	1.8
Oils and fats	1.3	4.9	7.5	2.7	0.9	-0.3
Fruit	5.2	5.5	8.3	11.4	9.6	4.7
Vegetables	11.0	9.7	15.0	1.1	0.4	2.0
Sugar, jam and honey	2.5	4.8	7.5	3.8	4.2	2.9
Food products nec	4.1	8.7	9.6	4.8	4.6	4.3
Non-alcoholic beverages	**1.7**	**1.5**	**1.8**	**2.1**	**2.2**	**1.9**
Alcoholic beverages and tobacco	**9.6**	**4.0**	**3.5**	**4.0**	**3.8**	**3.7**
Rice Stock (millions metric tons)						
Total Rice Stock	1.8	2.3	1.7	2.3	3.0	2.2
NFA Rice Stock	0.5	0.5	0.4	0.6	0.6	0.8

Source: Philippine Statistics Authority (PSA), Bangko Sentral ng Pilipinas (BSP)

19. **Monetary policy remains supportive with room to respond to higher global interest rates.** Given the relatively stable inflation outlook, the Monetary Board kept policy rates steady, but announced that it was prepared to respond to developments in the global market. Since mid-September 2014, overnight borrowing and lending rates remained at four and six percent, respectively. The interest rate on special deposit accounts (SDA) also remained steady at 2.5 percent and the reserve requirement ratio was also left unchanged at 20 percent for universal and commercial banks and eight percent for thrift banks. These have helped keep money supply (M3) growth stable, growing by an average of nine percent through June 2015, compared to an average of 33 percent over the same period in 2014 (Figure 11).

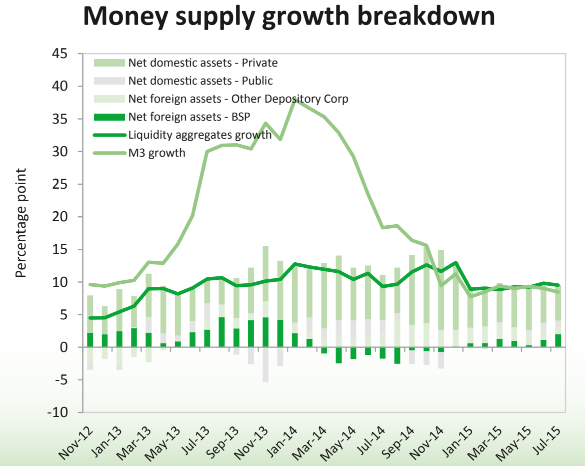
[28] Oil prices continued to decline on account of weaker global demand, stable production of oil, and more competition from natural gas.

Figure 10. Inflation reached its lowest level in 20 years as a result of deceleration in food prices and the continued decline in oil prices, bringing inflation down to 1.7 percent as of August (year to date).



Source: Bangko Sentral ng Pilipinas (BSP)

Figure 11. Money supply growth remained low and stable given appropriate monetary policy and prudential measures.



Source: BSP

Fiscal policy

20. **Continuous improvement in tax effort is helping build adequate fiscal space for the government to ramp up investment to accelerate growth.** Tax effort increased to 14.1 percent of GDP in H1 2015 from 13.7 percent of GDP in H1 2014. The Bureau of Internal Revenue (BIR), which accounts for around 80 percent of total tax revenues, collected 10 percent more taxes compared to the same period in 2014. In the absence of new tax policy, the BIR continues to rely on improved tax administration and higher private sector growth to meet its collection target. In contrast, collections by the Bureau of Customs (BOC) increased by only three percent in H1 2015, driven by the decline in oil prices over the past year.[29]

21. **However, gains from higher revenues and unprecedented increases in the budget have yet to translate into commensurate increases in government spending.** Since 2010, government budgets have increased by an average annual rate of 15 percent, with sharp increases coming in the latter years. Existing government systems and procedures face considerable difficulties expanding at this pace. From H1 2014 to H1 2015, while government budget increased by 18.5 percent, government expenditures only increased by 8.5 percent. This slow pace is most evident in Typhoon Yolanda reconstruction spending,[30] which indicates that

[29] The BOC estimates that it is likely to lose some PHP 40 billion (0.3 percent of GDP) in VAT revenues due to lower oil prices.

[30] As of June 30, 2015, only 53 percent of the total PHP 167 billion Yolanda rehabilitation fund was released to different agencies, more than a year and a half after the typhoon hit the country.

existing government systems are not designed to cope with large increases in the budget. According to the government, slow disbursement is largely the result of structural weaknesses within key departments and agencies, which includes i) poor planning, ii) weak program and project design, and iii) procurement difficulties such as frequent bid failures, weak capacity to procure, right-of-way-issues, difficulties in securing permits, and coordination problems. To address budget execution bottlenecks, the president issued Administrative Order (AO) No. 46 in March 2015 to improve spending efficiency and expedite the implementation of priority programs and projects under the 2015 budget.[31] Procurement units are also being strengthened, including provision of extra staff positions in the bids and awards committee. In addition, amendments to right of way acquisition are being discussed in congress to address procurement bottlenecks.

22. **In particular, public infrastructure spending contracted in Q1 2015 before rebounding in Q2.** In Q1, public infrastructure spending fell by 11 percent in nominal terms but recovered in Q2 by 37 percent, in line with the government's pronouncements to ramp up spending for the rest of the year. While not part of the budget, construction of much needed public infrastructure projects could see a boost from the government's public-private partnership (PPP) program. After much delay, the Muntinlupa-Cavite expressway, the country's first PPP road project, was opened in July 2015. Another project, the automatic fare collection system, which unites the ticketing and fare collection for the country's various railway lines, is currently undergoing public testing and is expected to be fully operational shortly. Following its completion, the government expects to see three more PPP projects completed by 2016 (Table 3). However, challenges still remain, as multiple hurdles such as right-of-way issues, bidding failures, and other legal complications have caused a number of PPP projects to fall behind schedule.

23. **The country's fiscal position is sustainable.** In H1 2015, the government recorded a budget surplus of 0.2 percent of GDP before returning to a year-to-date deficit of PHP 18.5 billion in July. Prudent fiscal management has resulted in better financing terms and sustained decline in its debt burden. The government continues to have a fully funded fiscal deficit with an efficient mix of local and foreign sources. Borrowing costs continue to decline, which has also allowed the government to swap old, high cost, short-term debt for newer, lower cost, long-term debt. For instance, the latest domestic debt swap enabled the government to save PHP 2.4 billion in interest expense. In H1 2015, the national government debt to GDP ratio improved to 44.9 percent of GDP, on track to meet the government's goal of 40 percent in the medium-term. Total external debt is also falling at a similar pace towards 20 percent in the medium-term from 25.7 percent of GDP in H1 2015.

[31] Under AO 46, agencies are required to complete the disaggregation of project listings and submit all documentary requirements for their allotment releases by end-April. They are also required to submit to the Department of Budget and Management and the Office of the Cabinet Secretary the implementation plans for programs and projects noted in the 2015 General Appropriations Act.

24. **Going forward, the government needs to review and improve budget planning and execution so that improved revenues can translate into better spending and improved public investment.** This calls for effectively addressing key bottlenecks including procurement issues, and reforming the public financial management system (see the prospects and policies sections for more discussion).

Table 3. Status of PPP projects

PPP projects in the pipeline	Project amount (PHP billion)	Bidding date/contract award/ construction start	Expected projected completion date	Status as of September 2015
Completed projects	**2.0**			
Muntinlupa-Cavite expressway (MCX)	2.0	May 2013	Jul 2015	Operational
Projects in the pipe line	**503.1**			
Contract awarded	**187.0**			
Automatic fare collection system project	1.7	Mar 2015	2015	Ongoing public testing
LRT line-1 Cavite extension project	64.9	Oct 2014	2019	Ongoing pre-construction
Cavite-Laguna expressway	55.5	Jul 2015	2017	Ongoing procurement of independent consultant (IC); contract signed on July 10, 2015.
PPP for school infrastructure projects (Phases I and II)	20.3	Sep 2013	2016	Phase I: 98.6 percent complete, phase II: 31.1 percent complete
Mactan-Cebu International Airport passenger terminal building	17.5	Nov 2014	2020	7.0 percent complete
NAIA expressway project (Phase II)	15.9	Jan 2014	2016	51.1 percent complete
Modernization of the Philippine Orthopedic Center	8.7	Oct 2014	2017	Ongoing procurement of independent consultant (IC) ; awaiting issuance of certificate of possession for the project site
Southwest integrated transport system	2.5	Jul 2015	2017	Ongoing pre-construction activities and IC procurement
Bidding stage/for bid submission	**220.1**			
Laguna lakeshore expressway dike project	122.8	Nov 2015	2021	For bid submission
Regional prison facilities	50.2	Sep 2015	2018	For bid submission
Bulacan bulk water supply project	24.4	Sep 2015	2017	For bid submission
New centennial water source - Kaliwa dam project	18.7	Jul 2015	2020	For bid invitation
Intergrated transport system - south terminal project	4.0	Jul 2015	2017	For issuance of notice of award
Other projects	**96.0**			
MRT line-7	69.3	2015	2018	Ongoing pre-construction
Metro Manila skyway (Phases I and II)	26.7	Apr 2014	2016	Phase I: 4.4 percent complete, phase II: 1.8 percent complete

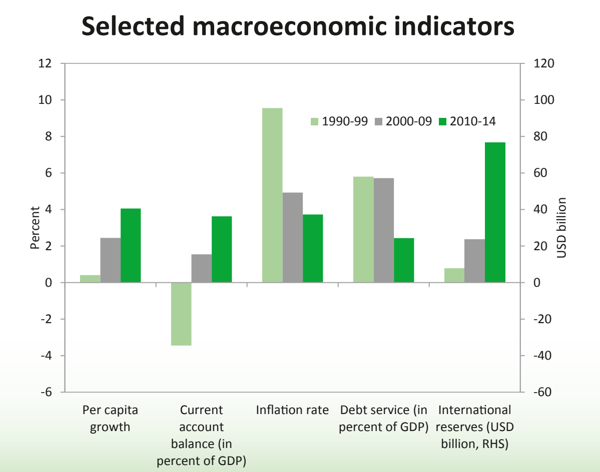
Source: PPP center

PROSPECTS, RISKS, AND POLICIES[32]

Prospects and risks

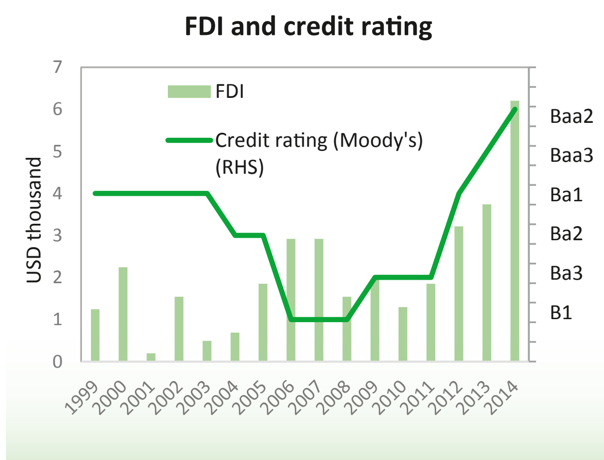
25. **The Philippines' strong macroeconomic fundamentals provide the necessary conditions for rapid, sustained, and inclusive growth.** The country is increasingly characterized by robust economic growth, low and stable inflation, healthy current account surplus, more-than-adequate international reserves, and a sustainable fiscal position (Figure 12)—a combination never seen in its history. Globally, this strong performance was recognized by all three major credit rating agencies with sovereign credit rating upgrades to two notches above investment grade and by a record high foreign direct investment inflows last year. With a solid macroeconomy that has proven to be resilient against shocks, the country can now focus its attention on implementing crucial structural reforms that can sustain growth, create more and better jobs, and eradicate extreme poverty.

Figure 12. Strong macroeconomic fundamentals underpinned growth in the last five years.



Source: PSA, BSP, World Bank staff computations

Figure 13. International recognition for the Philippines' good performance is seen in investment-grade credit ratings and record FDIs in 2014.



Source: BSP, Moody's investors service

26. **Near term economic growth will remain robust and is projected to improve from 5.8 percent in 2015 to 6.4 percent in 2016** (Table 4). Lower 2015 growth takes into account the relatively weak first half growth brought about by slow government spending, negative net exports, and the initial impact of El Niño. Second half growth is projected to improve as government spending catches up. In addition, accelerated implementation of public-private

[32] This section was prepared by Joseph Louie Limkin (Research Analyst), with inputs from Kevin Cruz (Research Analyst), and under the guidance of Karl Kendrick Chua (Senior Country Economist), all from the Macroeconomics and Fiscal Management Global Practice.

partnership (PPP) projects, valued at 0.6 percent of GDP in 2015, and the continuing effect of lower food inflation and declining oil prices can further support growth (see Box 1 for more discussion). Lower prices of oil and slower inflation of other commodities has enabled the central bank to keep key rates low to support growth. However, a stronger El Niño and weaker exports can pull down growth considerably.[33] In 2016, growth is expected to accelerate to 6.4 percent as the country recovers from the 2015 slowdown and as election spending lifts government spending[34] before tempering to 6.2 percent in 2017.

Table 4. Philippine, East Asia, and global growth projections

	2015	2016	2017
Philippines			
Revised	5.8	6.4	6.2
Previous	6.5	6.5	6.3
East Asia			
Revised	5.7	5.8	5.8
Previous	6.7	6.7	6.6
Global			
Revised	2.5	3.0	3.1
Previous	2.8	3.3	3.2

Source: World Bank staff estimates
Note: Previous projections refer to those reported in the June 2015 Global Economic Prospects

27. **Poverty reduction is expected to continue if the country is able to maintain relatively high economic growth and better job trends in recent years, despite recent shocks to agriculture.** Using full-year estimates from the 2012 Family Income and Expenditure Survey, poverty is estimated to have decreased from 11.2 percent in 2012 to 10.5 percent in 2014 and is projected to decrease further to 8.2 percent in 2017 (using the new international poverty line of USD 1.90/day purchasing power parity [PPP], new 2011 PPP prices, and the above growth assumptions). Although government spending was reduced overall in 2015, government transfers to poor households were not impacted and are being ramped-up. However, official poverty estimates are particularly sensitive to food price inflation. Even as the outlook for international prices is favorable, poverty results will also depend on how the government manages its food policy, and in particular, rice imports.

[33] The current El Niño is projected to be one of the strongest in history. The two strongest El Niño episodes in 1982-83 and 1997-98 led to a contraction in agriculture by four and seven percent, respectively.

[34] The May 2013 edition of the Philippine economic update (PEU) estimates that H1 GDP growth could be one percentage point (ppt) higher during a presidential election year, as election spending and transfers lift government spending. This is available at:
http://www.worldbank.org/content/dam/Worldbank/document/EAP/Philippines/Philippine_Economic_Update_May2013.pdf.

Box 1. Lower oil and rice prices: potential impact on growth and poverty

Over the past year and a half, oil prices have fallen significantly, and are likely to stay below USD 60 per barrel over the medium-term. Previous episodes of major oil price declines[35] were more transitory in nature (i.e., 1991 Gulf war, 1997 Asian financial crisis, 2001 September 11 attacks and the dot-com bubble, and 2008 global financial crisis). In contrast, the current decline in oil prices appears to be more prolonged due to both supply and demand factors: i) expansion of non-OPEC sources of oil such as shale, ii) change in OPEC policy stance from price targeting to market share protection, and iii) the global economic slowdown, led by China.

Given that the country is a major net importer of oil, the Philippine economy stands to benefit significantly. Lower oil prices will have direct and indirect effects on growth. Using the 2006 input-output table, the economy wide share of petroleum to total production cost is around eight percent. In industry, this is higher at almost 11 percent. This means that the halving of oil prices since 2014 could have reduced the cost of goods by roughly five percent, not including multiplier effects. All in all, through various transmission channels such as greater consumption and a lower import bill, the country is estimated to gain an additional one-half to one ppt in GDP growth in 2015.[36]

Lower oil prices and low food inflation also affect households positively, and more so among poor[37] households given that food accounts for 40 percent of their consumption basket. Households directly benefit from lower food and transportation costs, and indirectly from lower input costs for agriculture and lower manufactured goods prices. Even smallholder farmers can benefit from lower commodity prices, as most of them are net food buyers, even if they are involved in agricultural production.

While the precise impact of lower food and oil prices is difficult to measure, the household survey suggests that it can be significant. For instance, using the 2012 Family Income and Expenditure Survey, the average poor household can save around PHP 6,000 annually (equivalent to around 32 percent of the national poverty gap) from lower oil, transport, and rice prices.[38] Compared to the average price of oil in 2014, the poor have effectively gained PHP 4,400 year-to-date due to low oil prices. If oil prices fall further as projected and this is completely passed on to consumers, and rice prices stay at their current levels, the poor could save an additional PHP 1,600 for the rest of the year.[39] This is money that can be used to increase basic consumption and bring some households out of poverty.

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[35] An oil price decline is considered a major episode if the decrease in crude oil prices surpassed 30 percent over a six month period.

[36] See the East Asia and Pacific Update April 2015 edition for more discussion. This report is available at: http://www.worldbank.org/en/region/eap/publication/east-asia-pacific-economic-update

[37] In this box, the poor is defined as the bottom 30 percent of the population, roughly coinciding with the official poverty incidence.

[38] Together, these three items account for around 32 percent of the total consumption basket of the poor, compared to only 22 percent for the rest of the population.

[39] The consumption of oil and rice by the poor in 2014 is projected from the 2012 FIES by applying the historical growth rate of consumption compared to the 2009 FIES. The projected expenditure in 2014 is divided by the average prices in 2014 to get the quantity consumed. This quantity is then multiplied with the prevailing (lower) price, and the product is subtracted from the 2014 consumption to get potential savings in 2015, which could be used to increase other consumption and thus overall welfare.

Finally, the poor can benefit even further if excise taxes on petroleum products are increased and the revenue is redistributed in the form of better social services, including social protection. Raising excise taxes on petroleum products is equitable as consumption of petroleum products is highly skewed towards the rich (i.e., the richest 10 percent consumes almost 60 percent of total petroleum products).[40] Box 3 of the January 2015 edition of the Philippine economic update discusses an option to raise some PHP 20 billion in petroleum excise taxes that the government could use to help address poverty.

Box table 1.1. Impact of lower oil and rice prices on the poor

PHP	Projected consumption at 2014 average prices	Consumption at 2015 current prices (September)	Consumption if oil prices fall further as projected and rice prices stay the same
Oil and oil related expenditure	10,430	6,929	6,234
Rice	21,441	19,106	19,106
Total	31,871	26,035	25,340
Freed up money*		4,377	1,633

Source: PSA, WB staff estimates

*Freed up money is pro-rated from the start of the year up to the current month (September), while the potential gains if prices fall further are pro-rated from October up to the end of the year.

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28. **With private domestic demand growing by an average of 6.9 percent since 2010,[41] realizing the administration's end-term growth target of seven to eight percent will primarily hinge on its ability to significantly increase public spending to offset weak external demand.** This requires spending 95 percent of the primary budget instead of the average trend of 79.7 percent (see Box 2 for more discussion). In the short-term, meeting the 95 percent target requires more effectively addressing well known procurement bottleneck issues. In the long-term, significant reforms in the public financial management system are necessary to address limited absorptive capacity of the government in light of the growing fiscal space (see the policy section for more discussion).

[40] For a more detailed discussion on the manner and benefits of raising petroleum excise tax as prices fall, please see the PEU January 2015 edition.

[41] Since 2010, average growth of private domestic demand at 6.9 percent has been higher compared to average GDP growth of 6.2 percent.

Box 2. What if the government spent the budget as planned?

A simple static analysis (without multiplier effects) shows that if the government spent closer to the budget, growth would be higher, even reaching the administration's end-term target of seven to eight percent.[42] Despite the vibrant performance of the private sector, slow public spending of around 4.5 percent since 2010 has significantly limited economic growth. With an average spending-to-primary budget ratio[43] of 79.7 percent, GDP growth averaged 6.2 percent from 2010 to 2014, significantly lower than the eight percent high-end target by 2016. If the spending ratio had improved by five percentage points (ppt) each year to 85 percent, average GDP growth could have been 6.9 percent. With a 15 ppt a year improvement to 95 percent, average growth would reach 8.2 percent. However, this assumes that ramping up spending does not entail significant productivity and efficiency losses.

Box table 2.1. Summary of scenarios

Cases	2010	2011	2012	2013	2014	Average
Actual spending ratio*	83.7	73.6	80.7	82.7	78.0	79.7
Actual government spending growth	4.0	-6.2	15.7	6.7	2.4	4.5
Actual private domestic demand growth	8.9	6.2	3.9	10.1	5.4	6.9
Actual overall GDP growth	7.6	3.7	6.7	7.1	6.1	6.2
Spending ratio scenarios						
85 percent	7.6	4.5	7.5	7.8	6.9	6.9
90 percent	7.6	5.3	8.3	8.6	7.7	7.5
95 percent	7.6	6.1	9.1	9.4	8.5	8.2

Source: WB staff estimates
*Defined as the ratio between government spending, as measured in the national income accounts, and primary appropriations, as calculated using DBM data.

29. **The government has identified a number of executive and legislative measures to speed up public spending, especially on infrastructure.** These measures—reducing lump sums, more proactive management of procurement delays (as provided by AO 46), shift to bank processing of payments, amendments to the right-of-way acquisition and the build-operate-transfer law, and a new public financial management law—need to be fast-tracked if they are to make a difference on 2015 and 2016 growth.

30. **Efforts are also needed to fast-track bidding and implementation of the PPP program.** Currently, there are 15 projects worth PHP 503.1 billion (four percent of 2014 GDP) that are at least in the bidding stage, including 10 projects that were already awarded, have started construction, or nearing completion. With construction costs assumed to be spread equally over their projected duration, PPPs are projected to raise investments by 0.6 percent of GDP in 2015 and 0.8 percent of GDP in 2016. In addition, up to 18 more PPPs are expected to be approved by June 2016, including the biggest PPP in history, the North-South commuter rail,

[42] Growth of at least eight percent in a single year has not been achieved since the 1970s.

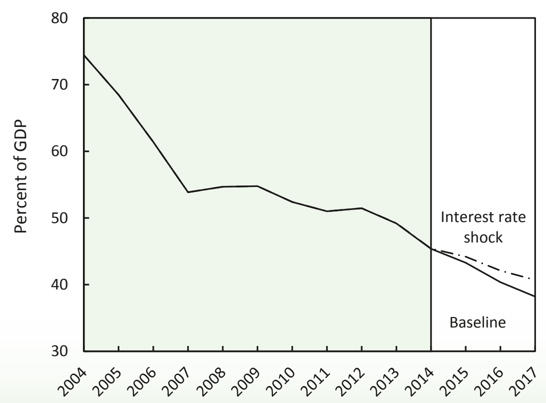
[43] Government spending is defined as the sum of government consumption and public construction from the national income accounts. Primary budget is equal to the sum of new appropriations, continuing appropriations, supplemental appropriations, and automatic appropriations less interest payment. Interest payment is deducted since it does not affect GDP.

worth around PHP 171 billion (1.4 percent of GDP). Fast-tracking would shift spending to earlier years and reap multiplier effects to spur growth in the coming years.

31. **Higher spending that is in line with budget targets will not increase the country's debt burden.** National government debt has gone down significantly from 75 percent of GDP a decade ago to just 45 percent of GDP in 2014. Debt service as share of revenues fell even more, from 85 percent in 2006 to just 27 percent in 2014, freeing up a lot of resources for an investment-led growth, which should be a priority given a falling output gap. With good fiscal management, the government can afford a deficit equivalent to two percent of GDP and still see its debt burden fall in the medium-term even with an interest rate or exchange rate shock (Figures 14 and 15). Raising fiscal space beyond moderate deficit spending requires new sources of tax revenues (see the policy section for more discussion).

Figure 14. National government debt will continue to fall over the medium-term even with an interest rate shock…

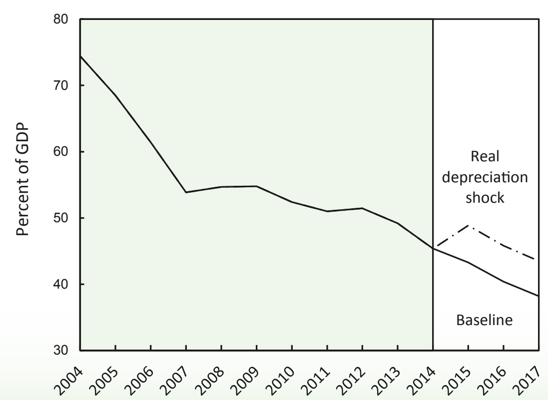
Interest rate shock (in percent)



Source: World Bank staff estimates
Note: The dotted line represents debt projections with a one standard deviation shock to interest rates.

Figure 15. … or an exchange rate shock.

Interest rate shock (in percent)



Source: World Bank staff estimates
Note: The dotted line represents a one-time, real exhange rate depreciation of 30 percent, with real depreciation defined as nominal depreciation minus inflation.

32. **Near-term growth projections are tilted towards the downside. Philippine external demand hinges primarily on the strength of recovery of the US, Euro, and Japanese economies.** These economies account for about half of Philippine exports, not including Chinese-assembled electronic products using Philippine-made parts. However, Philippine merchandise exports are not expected to return to pre-crisis growth rates as global trade remains sluggish in the medium-term. To raise external demand amidst slower trade and more global competition, the Philippines needs to start raising productivity to lower unit labor cost, especially in light of an appreciating peso in real terms. Increasing infrastructure, reducing non-tariff barriers, and improving logistics support are all needed.

33. **The upcoming increase in US policy rates may yet again disrupt the local financial market.** The long anticipated tightening of US monetary policy is likely to begin in Q4 2015. However, unlike the taper tantrum in 2013, the local markets have internalized the inevitable increase in interest rates, and as such, the impact on the financial market should be more

manageable. Capital outflow is still likely, but the country's strong fundamentals will cushion its transmission into the real sector. Moreover, room for domestic monetary policy tightening exists given improving growth prospects and manageable inflation.

34. **But the greater concern lies in its impact on the cost of financing, both for the public and private sectors.** The Philippine economy has benefited significantly over the years from the low interest rate environment. Lower borrowing costs have helped create significant fiscal space while allowing debt burden to fall substantially. It has also helped boost the construction and real estate sectors. All these are about to change as domestic interest rates rise in response to higher US policy rates, and this will have a more material impact on near-term growth as opposed to short-term capital outflow. Responding to this threat lies in both securing long-term fiscal space through revenue mobilization (see the policy section for more discussion) and macro-financial prudential measures to manage risk from increasing leverage.

35. **Closer to home, while the Chinese stock market volatility poses little risk for the Philippine financial sector, the effect of a Chinese slowdown could be more pronounced.**[44] Financial linkages between China and the Philippines are low, thus capital outflows stemming from the volatile Chinese financial market are manageable. However, Philippine exports to China comprise around 13 percent of total exports and thus could have some effect on growth. On the one hand, agricultural exports to China are rising (currently valued at USD 400 million) and could affect farmers' income.[45] On the other hand, as the bulk of exports to China are electronic parts, exports to China may not fall significantly as final demand for electronics comes predominantly from high-income countries, reflecting China's role as a global assembly hub for these products. Moreover, the Chinese yuan's depreciation can make its exports more competitive, thereby benefiting the Philippines as it is a key supplier of parts. China's slowdown could also have more pronounced effects on tourism, as China is fast becoming a major source of foreign tourists for the Philippines. Tourist arrivals from China have grown exponentially from just 15,000 in 2000 to almost half a million in 2014. The key response to slower external demand from China is to improve productivity on the goods side and improve tourism infrastructure and facilities on the services side.

36. **On the domestic side, El Niño is the main threat, not so much on GDP growth per se but on the quality of growth, as tens of millions of farmers' lives may be affected.** Current growth projections assume that agriculture will not expand in 2015 given the adverse effects of El Niño. However, a stronger El Niño could lead to a major contraction in agriculture, thereby pulling down GDP growth and more importantly farmers' income, while increasing inflation. Simulations show that if agriculture contracts by four percent, as in the 1983 El Niño, GDP growth in 2015 could drop to 5.4 percent, holding other factors constant. If agriculture

[44] For more discussion on the linkages between the two countries, see the January 2015 edition of the PEU. This is available at: http://www.worldbank.org/en/country/philippines/publication/philippine-economic-update january-2015.

[45] For instance, in 2012, the local banana industry suffered when exports to China were halted due to phyto-sanitary concerns.

contracts by seven percent, as in the 1998 El Niño, GDP growth could drop to as low as 5.1 percent.[46] With a fall in farm production, farm prices will inevitably lead to higher inflation, once the currently adequate food inventory is depleted. The combined effect of higher food prices and lower farm output will have significant impact on poverty (see Box 3 for more discussion on El Niño). The key response to El Niño in the immediate-term is to ensure adequate food stock, especially through timely importation of rice and other key food items. In the medium-term, reforms in food policy are essential (see the January 2015 edition of the Philippine economic update for more discussion).

Box 3. The likely consequences of El Niño and the government's response

Latest forecasts indicate that the current El Niño episode may rival the 1997-98 episode, which resulted in a large contraction in the country's agriculture sector. The strongest episode of El Niño was recorded in 1997-1998, causing a dry spell from June 1997 to August 1998.[47] As a result, the country's agriculture sector contracted by seven percent in 1998, with a negative contribution of one ppt to overall growth. The losses in agriculture were highlighted by double digit declines in output for the country's major crops such as rice, sugar, and yellow corn. The large contraction in output caused a significant increase in food prices, as food inflation rose to 8.3 percent in 1998 compared to 2.9 percent in 1997. Had the government not over-imported rice in 1998, food inflation could have been much higher.

As a consequence, the impact of El Niño on poverty was pronounced. Datt and Hoogeveen (2000) showed using the 1998 Annual Poverty Indicators Survey (APIS) that the combined effects of the financial crisis of 1997 and the 1997-98 episode of El Niño resulted in an increase in poverty incidence from 29.1 to 31.7 percent in 1998. The El Niño shock alone contributed about 46 percent to the increase in the poverty incidence.

The current episode of El Niño has begun to take its toll on the country's agriculture sector, albeit not yet as pronounced as the 1997-98 episode. In H1 2015, the country's agriculture sector grew by only 0.3 percent, with bleak outlook for the rest of the year as the government expects 70 out of the country's 81 provinces likely to be affected by drought by year end.[48] The Department of Agriculture (DA) estimates that the agriculture sector already incurred PHP 3.3 billion in production losses due to El Niño as of August. Despite the negative impact on output, food inflation is still low, in large part due to adequate and timely importation of rice, which has dampened the effects of lower farm output on prices.

[46] The fall in GDP growth as a result of agriculture contraction is likely to be less severe nowadays given that agriculture value-added now comprises just 11 percent of total value-added.

[47] As a comparison, the agriculture sector also experienced a contraction in the 1982-83 episode of El Niño—the second strongest in history—with agriculture contracting by four percent and food inflation rising to 8.6 percent.

[48] Based on statistical analysis by the Philippine Atmospheric, Geophysical, and Astronomical Services Administration (PAGASA) using historical and just-in-time rainfall data, provinces that are projected to be least affected by El Niño are: Agusan del Norte, Agusan del Sur, Surigao del Norte, Surigao del Sur, Compostela Valley, Davao del Norte, and Davao Occidental, all from eastern Mindanao; Benguet, Ifugao, and Mountain Province, all from the Luzon highlands; and Siquijor in Visayas.

For the rest of 2015 to early 2016, the effects of El Niño on farm output may pose an upside risk to inflation and poverty as the current bout of El Niño is expected to intensify in the last quarter of the year and persist until early 2016.[49] Indicative simulation shows that if food inflation increased to 8.3 percent similar to the 1998 episode, then poverty incidence could increase by around 0.8 ppt in 2016 compared to 2014.[50] As a response, the government is carefully monitoring the situation and planning the appropriate rice import quantity. In September 2015, the government bid out contracts to import 750,000 metric tons of rice to serve as buffer stock in case El Niño intensifies and adversely impacts domestic rice production. Furthermore, the DA has requested a supplemental budget of PHP 1.9 billion,[51] while the National Economic and Development Authority has created a task force to help mitigate the negative effects of El Niño. The government has indicated that it will continue to monitor the supply of rice and stands ready to import rice to keep prices stable.

Selected references

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Policies

37. **The remaining eight months of the Aquino Administration present an opportunity to clearly and practically define the unfinished business in the structural reform agenda.** These are challenging reforms, as they would reverse decades of policies which have undermined the economy's capacity to generate more and better jobs. They include i) institutionalizing current reforms to increase budget transparency and accountability, ii) crafting a simpler, more equitable, and more efficient tax system to finance an investment-led growth, iii) further opening up the economy to more competition by reducing the investment negative list, iv) securing property rights through land governance reforms, and v) unleashing the full potential

[49] The current bout of El Niño is expected to peak in November 2015 and will likely continue until March to April 2016.

[50] The 2014 APIS was used to run the simulation. To compute for poverty incidence in 2016, the following steps were taken: i) compute 2016 projected per capita income by using 2014 per capita income as base and income growth from 2012 to 2013 of 3.5 percent compounded for the bottom 50 percent (income growth from 2013 to 2014 is not used given the presence of exogenous shocks), ii) compute projected 2016 poverty threshold by adjusting the 2014 poverty threshold under the assumption of two percent overall inflation in 2015, 8.3 percent food inflation in 2016, and three percent non-food inflation in 2016, and iii) count the number of poor households whose income falls below the poverty threshold in 2016.

[51] The proposed supplemental budget is broken down into i) production support for rice, corn, high-value crops, livestock (PHP 804 million), ii) water management (PHP 989 million), iii) information and education campaign (PHP 73 million), and iv) project management (PHP 65 million).

of the private sector, in particular, small and micro firms, by re-engineering business regulations to make them simpler and far less costly. When sustained, these reforms can sustain high growth, accelerate good job creation, and eliminate extreme poverty.

38. **The Aquino Administration made substantial progress on improving the macroeconomy and governance, in particular, with respect to fighting corruption and increasing transparency.** This improved macro-governance climate provided an environment conducive to inclusive growth. In 2010, the reform-minded Aquino Administration commenced office with a strong governance agenda and commitment to strengthen macroeconomic stability. These efforts have borne fruit and are well recognized locally and globally. At home, according to a recent survey by the Social Weather Stations, 41 percent of Filipinos are satisfied with the government[52] even on its last year—a feat that no recent administration had achieved.[53] Globally, the country's rank in Transparency International's Corruption Perceptions Index improved by 49 places from 134 in 2010 to 85 in 2014. In addition, as discussed above, the country is now rated two notches above investment grade by all three major credit rating agencies—a testament to the country's strong macroeconomic fundamentals.

39. **The administration's focus on improving fiscal revenues and public financial management allowed a considerable ramping up of spending, including on programs which benefit the poor directly**. The proposed budget for 2016 is nearly double than that of 2010, implying an annual growth rate of about 12 percent. This is substantial by international standards. One fiscal management measure which paid off significantly was enabled by better creditworthiness of the country. In particular, it allowed the government to replace high-cost with low-cost debt. This caused debt servicing as a percentage of government revenues to decline from 53 percent in 2011 to 27 percent in 2014.

40. **The growing fiscal space was rightly targeted towards priority areas, led by social services**. The budget for education, health, and social protection grew by almost three times between 2010 and 2016. As a result, the country today has a world class conditional cash transfer (CCT) program that replaced a corrupt patronage system of subsidies. The public education system now provides 13 years of free schooling. Universal healthcare coverage is close to being achieved. A larger budget for community-driven development and bottom-up budgeting programs is giving the people direct voice in development interventions. Infrastructure spending, while progressing slower, has also been ramped-up, with the aim of reaching five percent of GDP by 2016. These spending reforms were made possible by better tax administration and the passage of the "sin tax" law, both of which created significant fiscal

[52] The net satisfaction rating is defined by the SWS as the difference between the percent of respondents who say they are satisfied with the president and the percent of respondents who say that they are unsatisfied with the president.

[53] In the third quarter preceding a presidential election, no other president among the last four surpassed a net satisfaction rating of 40 percent (i.e., C. Aquino: 10 percent, Ramos: 35 percent, Estrada: impeached, and Arroyo: negative 38 percent!).

space of around 1.9 percent of GDP, and by better transparency and accountability of public spending.

41. **On the structural reform agenda, the Aquino Administration has begun to address decades-long constraints that have held back the potential of the private sector.** These reforms include:

- **Passing an overarching competition policy law:** Under the competition law, economic agents can be charged with monopolistic behavior. The law has been decades in the making, as it was always successfully opposed by the large business conglomerates.

- **Allowing foreign transshipment of goods:** Cabotage liberalization was another long-awaited, but nonetheless welcome structural reform with the objective of increasing competition in order to bring down transportation costs and improve safety standards. The new law allows foreign ships to on and off-load foreign freight along domestic routes, instead of being forced to completely on and off-load in one international port. The reform is not a full liberalization, as foreign ships will not be allowed to take in domestic cargo, but it is a good start. In addition, implementing rules and regulation still need to be drafted.

- **Fully liberalizing the banking industry:** The banking sector liberalization opens up the banking sector to foreign competition—five foreign banks have already been approved for entry. Moreover, full liberalization in 2014 helped to attract USD 1.3 billion in FDI to the financial sector from an average of just USD 35 million since 2005.

- **Simplifying business registration:** Finally, progress was made on key aspects of the investment climate for SMEs, including business registration. However, the positive legal and regulatory reforms undertaken seem to need stronger coordination and enforcement on the ground to ensure that SMEs actually experience an improved investment climate.

Moreover, the push for the rationalization of fiscal incentives will likely attract rather than discourage both domestic and foreign investment, as the playing field will be leveled, compared to the current system in which incumbent firms are treated as “infants” with unfair incentives.

42. **Taken together, the administration’s governance and structural reforms led to a significant acceleration of economic growth since 2010**. However, it seems that the governance reforms—the reduction of corruption, the increased transparency, and the higher and improved spending patterns—contributed more to higher growth than the structural reforms per se, as many are awaiting concrete implementation and further reforms. A recent

growth decomposition by the IMF[54] suggests that the unexplained part of the growth—the growth increase which cannot be explained by the growth of capital and labor—was the most important contributor to growth. As it is unlikely that a sudden improvement in technology adoption—the usual explanation for the unexplained part—occurred across the economy, improved governance would be a strong candidate to explain the growth acceleration.

43. **The reforms are also beginning to translate into more and better job creation and faster poverty reduction.** As discussed above, but worth repeating, the 2013 Annual Poverty Indicator Survey (APIS) suggests that poverty fell strongly between 2012 and 2013. The 2013 data also suggest that real income of the bottom 20 percent grew much faster than the rest of the population, through a substantial 30 percent growth of domestic cash transfers to this quintile versus four percent for the rest of the population—confirming that the government's CCT program is well-targeted and reaching the poor. Moreover, underemployment among the poor significantly decreased in the same period. However, in 2014, the APIS data showed an increase in poverty, attributed to Typhoon Yolanda (a one time, unprecedented event) and artificially high rice prices (due to rice importation lags by the state monopoly), which offset the income growth of the poor. Nonetheless, poverty reduction is expected to continue if the country is able to maintain the speed and quality of growth achieved in recent years.

44. **The reforms undertaken by the Aquino Administration signal a break from the past.** What is now needed is to cement the gains in the last five years by institutionalizing the reforms made and clearly laying out the unfinished reform agenda, which would address the remaining structural issues that impede investment and thus the creation of more and better jobs. These reforms, covering the areas of public finance, competition, property rights, and business regulations, are well known and are discussed in depth in the Philippine development report "Creating more and better jobs,"[55] and in previous editions of the Philippine Economic Update.[56]

45. **This closing discussion highlights the key recommendations that the administration can consider as it ends its term:**

- **Institutionalize current public sector reforms to increase budget transparency and accountability, and spending efficiency:** The administration's well known transparency and accountability reforms can be institutionalized by passing the Freedom of Information Bill. This would help institutionalize "open data," which means making government data publicly available in user-friendly forms that can easily be analyzed

[54] For more discussion, please see the IMF article IV consultation 2015 selected issues. "Philippines: real and financial cycles."

[55] The 2013 Philippine development report "Creating more and better jobs" is available at: http://www.worldbank.org/content/dam/Worldbank/document/EAP/Philippines/PDRFullReport.pdf.

[56] The past editions of the PEU are available at: http://www.worldbank.org/en/country/philippines/publication/philippine-economic-updates

(i.e., in Excel format as opposed to PDFs or images).[57] Budget reporting reforms to allow the public and the government itself to track spending from appropriations to results on the ground can be institutionalized by adopting an automated and government-wide financial management and information system. These reforms can help the government fully utilize the growing fiscal space, which remains a challenge given limitations of the current public financial management system and the inclination of civil servants to still operate in the old mentality of rationalizing spending given severe cash constraints.[58]

- **Craft a simpler, more equitable, and more efficient tax system to sustainably finance an investment-led growth:**[59] Following the passage of the landmark sin tax law, the following measures can be considered: i) rationalize tax incentives by making them more targeted, transparent, performance-based, and temporary, including timely release of a tax expenditure statement, which enumerates all existing and proposed tax incentives and who benefits from them, and ii) index tax rates and valuations which have not kept up with inflation, such as petroleum excise taxes and property valuations. Rapidly falling oil prices provide an opportunity to adjust petroleum excise taxes to make the tax system more equitable. Only if new revenues are raised should reforms to reduce tax rates be considered. These could include i) lowering the top marginal income tax rate to 25 percent, ii) reducing the gap between regular and special corporate income tax rates, and iii) simplifying the tax regime for micro and small enterprises. For tax policy to be effective, improved tax administration is necessary. Relaxing the bank secrecy law when fraud is detected would help improve tax administration significantly.

- **Further open up the economy to more competition by reducing the investment negative list:**[60] Following the passage of the competition policy law, proper formulation of its implementing rules and regulations is needed. Moreover, further opening up priority sectors of the economy to international players is recommended by removing them from the foreign investment negative list. The following sectors are likely to have the largest gains in terms of competition, capital, and technology: telecoms,[61] shipping

[57] Compared to the open data initiative, the FOI has a larger scope as it seeks to give the public easier access to a wide range of public documents, such as complete statement of assets, liabilities, and net worth of elected officials, government project documents, and minutes of official proceedings (e.g., congressional debates).

[58] Using the 2014 budget as a frame of reference, the government's analysis showed that failure to meet the disbursement goal was a result of structural weaknesses within key departments and agencies, which includes poor planning, and program and project design, procurement difficulties, including frequent bid failures and weak capacity to procure; and other bottlenecks including right-of-way-issues, difficulties in securing permits, and coordination problems.

[59] For more discussion, please see the August 2014 edition of the PEU and the upcoming report "Tax policy for more inclusive growth."

[60] For more discussion, please see the January 2015 edition of the PEU.

[61] For instance, in its latest household download index, internet metrics provider Ookla (which owns the popular website speedtest.net), ranked the Philippines as 21st out of 22 countries in Asia in terms of average internet speed at 3.64 megabytes per second (mbps), behind Laos and Myanmar, and only ahead of Afghanistan. Comparing the Philippines to its neighbors, the country's average internet speed is dwarfed by Thailand at almost 20 mbps, and

construction, and rice. They are also the sectors likely to generate jobs, increase real income, and improve quality while lowering prices.

- **Secure property rights through land governance reforms:** Following the near completion of the cadastral survey,[62] and efforts to streamline land registration, the following reforms could be considered to address long standing issues in securing property rights: i) accelerate the systematic and administrative adjudication of property rights in rural and urban land, plot by plot, ii) adopt and strictly enforce zoning regulations in a systematic and consistent way, iii) implement the land reform program using a more community-driven and decentralized approach, and iv) improve land administration by passing an effective Land Administration Reform Act and National Land Use Act.

- **Overhaul business regulations to make them simpler and far less costly:** The private sector is the main contributor and beneficiary of economic growth. In H1 2015, private domestic demand grew by 8.1 percent compared to an economy-wide growth of 5.3 percent. The full potential of the private sector, in particular, small and micro firms, can be realized by re-engineering business regulations to make them simpler and far less costly. When sustained, these reforms can accelerate good job creation among micro and small firms and help eliminate extreme poverty by increasing their productivity and reducing informality. Being a major theme and recommendation of this report, the details are discussed in the medium-term reform section while the special focus looks in-depth at the total cost of starting and maintaining a business, and transaction costs in exporting—two areas with great potential to create more and better jobs when reformed substantially.

46. **A number of these recommendations are currently being addressed.** In his last state-of-the-nation address (SONA) in July 2015, President Aquino asked congress to pass the 2016 General Appropriations Act on time, as is the practice in the last five budgets, so that i) there would be no recurring funding for projects that are already completed, and ii) there would be no delay in the delivery of public services. In addition to the economic reform bills, such as the fiscal incentives rationalization bill, the president certified the passage of an anti-dynasty law as urgent—the first such high level directive to reform the country's political system,[63] and the

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even Vietnam at 18 mbps. As a reference, high-income economies like Singapore and Hong Kong both have average internet speeds of over 100 mbps. More glaringly, despite being particularly slow, internet costs in the Philippines are extremely expensive, costing around USD 18 per mbps against a global average of around USD 5 per mbps, as measured by Ookla.

[62] In 2015, the Department of Environment and Natural Resources reported that it completed field survey activities for the cadastral survey. This covers over 30 million hectares in all of the country's 1,634 cities and municipalities. However, 118 cities and municipalities in the Autonomous Region in Muslim Mindanao are still undergoing inspection and verification.

[63] Research from the Asian Institute of Management Policy Center suggests that Philippine provinces with the highest concentration of political dynasties also tend to have the highest poverty rates.

Bangsamoro Basic Law, which is expected to help sustain peace in Mindanao. Outside the SONA, the President has expressed support in securing the revenue base by not supporting the lowering of tax rates without the appropriate offsetting measures.

47. **To conclude, achieving inclusive growth is within reach, now more than in any previous period.** The government now needs to maximize the chances that the country will follow a more inclusive growth path by accelerating reforms to secure property rights, promote more competition, and simplify regulations to trigger more private investments by firms of all sizes, while sustainably ramping up public investments in infrastructure, education, health, and social protection.

MEDIUM-TERM REFORM AGENDA

Simplifying business regulations to enhance inclusive growth[64]

1. **Complex Philippine business regulations are major hindrances to inclusive growth.** They limit the growth of innovative entrepreneurship, contribute to large scale informality, and hence prevent the country from creating more and better jobs. To reduce poverty and share the benefits of higher growth more broadly, reforms to simplify business regulations are needed. Priority needs to be given to three major hindrances that affect the smallest businesses the most: starting and maintaining a business, paying taxes, and accessing finance.

A complex set of business regulations

2. **Philippine business regulations are complex and among the costliest in East Asia, undermining firms', especially micro and small firms' ability to create jobs.** Various measures of competitiveness show a big room for improvement. The Doing Business 2015 report ranks the Philippines at 95 among 189 economies in overall ease of doing business.[65] Among major economies in the ASEAN region, only Indonesia was ranked lower. For most indicators, the Philippines ranks in the bottom half of the world (Table MT1). Firms find starting a business to be among the costliest in the world, with a ranking of 161. Paying taxes and getting credit fare better, but still at the low end of the spectrum at 127 and 104, respectively. All other indicators except trading across borders and resolving insolvency, have rankings of 100 or higher (i.e., worse). In contrast, Malaysia and Thailand are among the easiest places to do business, with overall rankings of 18 and 26, respectively. Indonesia, despite falling behind the Philippines in recent Doing Business surveys, does a better job in protecting investors (ranked at 49 compared to the Philippines' 128). Even though the country's ranking improved from the 72nd percentile in 2007 to the 50th percentile in 2015, there is still much room for improvement.

Starting and maintaining a business

3. **Cumbersome regulations and procedures in starting and operating a business deter new firm entry and business expansion, especially among micro and small firms.** For example, using available data, the number of procedures required to start a corporate business in the

[64] This section draws from the Philippine development Report "Creating more and better Jobs" (World Bank 2013). It was prepared by Karl Kendrick Chua (Senior Country Economist, Macroeconomics and Fiscal Management [MFM] Global Practice) with inputs from Joseph Louie Limkin (Research Analyst, MFM), Hans Shrader (Senior Program Manager, Trade and Competitiveness Global Practice) and Griselda Santos (Operations Officer, Finance and Markets Global Practice).

[65] Rankings are from one (best) to 189 (worst).

Philippines, at 16, is substantially higher than in other countries in the region.[66] The average firm spends 34 days securing licenses required to start a business and spends around PHP 21,156 for these (equivalent to 16.6 percent of the country's per capita income)—an amount very high relative to the micro firm's startup capital. Firms in the Philippines also have to apply for licenses annually, more often than in other countries (Figure MT1). Up to 18 licenses, permits, and forms have to be approved before a business can commence. In many cases, firms report that they need to pay bribes or give gifts to obtain various permits and government services (Figure MT2).

Table MT1. Rank (and percentile rank)[1] in Doing Business 2015 and selected sub-indicators

Components	Philippines	Indonesia	Malaysia	Thailand	China	Vietnam	Singapore
Overall ease of doing business	**95 (50)**	**114 (60)**	**18 (10)**	**26 (14)**	**90 (48)**	**78 (41)**	**1 (1)**
Starting a business	**161 (85)**	**155 (82)**	**13 (7)**	**75 (40)**	**128 (68)**	**125 (66)**	**6 (3)**
Number of procedures	16	10	3	4	11	10	3
Number of days	34	53	6	28	31	34	3
Cost (percent of per capita income)	17	21	7	7	1	5	1
Dealing with construction permits	**124 (65)**	**153 (81)**	**28 (15)**	**6 (3)**	**179 (95)**	**22 (12)**	**2 (1)**
Employing workers[2]	**115 (63)**	**149 (81)**	**61 (33)**	**52 (28)**	**140 (77)**	**103 (56)**	**1 (1)**
Registering property	**108 (57)**	**117 (62)**	**75 (40)**	**28 (15)**	**37 (20)**	**33 (17)**	**24 (13)**
Number of procedures	9	5	8	2	4	4	4
Number of days	35	27	14	2	20	57	5
Cost (percent of property value)	4	11	3	6	4	1	3
Getting credit	**104 (55)**	**71 (38)**	**23 (12)**	**89 (47)**	**71 (38)**	**36 (19)**	**17 (9)**
Protecting investors	**154 (81)**	**43 (23)**	**5 (3)**	**25 (13)**	**132 (70)**	**117 (62)**	**3 (2)**
Paying taxes	**127 (67)**	**160 (85)**	**32 (17)**	**62 (33)**	**120 (63)**	**173 (92)**	**5 (3)**
Number of payments per year	36	65	13	22	7	32	5
Hours per year	193	254	133	264	261	872	82
Total tax rate (percent of profit)	43	31	39	27	65	41	18
Trading across borders	**65 (34)**	**62 (33)**	**11 (6)**	**36 (19)**	**98 (52)**	**75 (40)**	**1 (1)**
Enforcing contracts	**124 (66)**	**172 (91)**	**29 (15)**	**25 (13)**	**35 (19)**	**47 (25)**	**1 (1)**
Resolving insolvency	**50 (26)**	**75 (40)**	**36 (19)**	**45 (24)**	**53 (28)**	**104 (55)**	**19 (10)**

Source: Doing Business 2015 report (World Bank)

Notes: 1. Rankings and percentile ranks are given in boldface. Rankings are based on a total sample of 189 economies. Percentile ranks (1=best, 100=worst) are given in parentheses and are computed by WB staff.

2. "Employing workers" data are excluded in the 2015 rankings on the ease of doing business. "Employing workers" data shown here are from the Doing Business 2010 Report which covers 183 economies.

4. **The process for individuals seeking government licenses, permits, or clearances for employment purposes is also cumbersome.** For instance, workers spend anywhere from a few hours to several days traveling and securing police or National Bureau of Investigation clearances, registering vehicles and getting driver's licenses,[67] getting a community tax certificate, dealing with the Social Security System (SSS) (i.e., loans and retirement processing),[68] and getting an "exit clearance" from the Philippine Overseas Employment Administration (POEA) in the case of overseas Filipino workers. There is little use of the internet

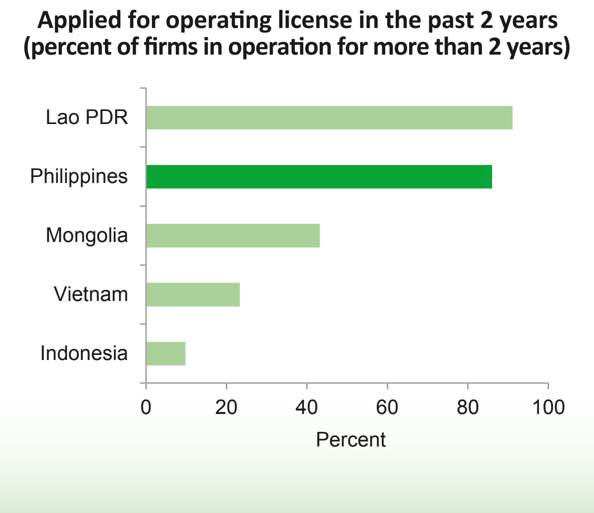
[66] In April 2015, reforms to reduce the cost of starting a business have been initiated. These reforms are currently being validated by the Doing Business team and will be released in the upcoming Doing Business report 2016.

[67] In recent years, this process has worsened due to significant backlogs in new license plates and drivers' license production. After paying, applicants wait for several months before they can get their renewals.

[68] In the case of SSS pension, pensioners must report annually to the SSS or their respective banks before pension benefits can continue. Failure to report means that pension is discontinued.

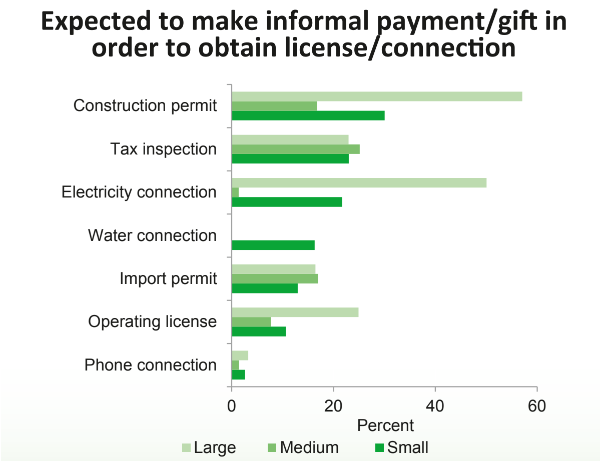
or other modern technology to reduce transaction costs, and efforts to reduce the number of personal appearances, steps, and requirements for routine transactions are lacking.

Figure MT1. Firms in the Philippines need to apply for licenses more often.



Source: Enterprise Survey 2009

Figure MT2. Firms report the need to pay bribes or give gifts to obtain permits.



Source: Enterprise Survey 2009
Note: In this figure, firm sizes are based on definitions used by the Enterprise Survey. Large firms have 100 or more workers. Medium firms have 20 to 99 workers. Small firms have 5 to 19 workers.

5. **Finally, a weak bankruptcy resolution regime makes it particularly difficult for inefficient or unprofitable firms to exit the market**. A new insolvency law was recently passed, bringing the recovery rate from an average of four cents to a dollar to an average of 21 cents to a dollar. However, this is still quite low compared to 42 cents in Thailand and more than 80 cents in Malaysia, causing potential firms to think twice before entering the market.

Paying taxes

6. **Paying taxes is also cumbersome in the Philippines.** According to the Doing Business 2015 report, the Philippines' rank in paying taxes, which focuses on administrative complexities of making various tax payments by enterprises, is among the worst in the ASEAN region and globally ranks at 127 among 189 economies. This weak performance is largely attributed to the country's high total tax rate,[69] equivalent to about 42.5 percent of profit—the highest among the three comparator countries—and the number of payments per year at 36, which is around three times higher than that in Malaysia, around double compared to Thailand, and even five payments more than that in Myanmar, the lowest overall ranked East Asian country. The

[69] The total tax rate measures the amount of taxes and mandatory contributions borne by the business in the second year of operation, expressed as a share of commercial profit. The Doing Business 2015 reports the total tax rate for calendar year 2013. The total amount of taxes borne is the sum of all the different taxes and contributions payable after accounting for allowable deductions and exemptions. The taxes withheld (such as personal income tax) or collected by the company and remitted to the tax authorities (such as value added tax, sales tax or goods and service tax) but not borne by the company are excluded (source: Doing Business 2015).

Philippines performed better only in the number of hours to comply with tax requirements[70] at 193 hours, compared to 264 in Thailand and 254 in Indonesia. In Malaysia, compliance takes only 133 hours. However, these figures do not adequately measure the full compliance costs faced by Filipino taxpayers, given alleged systemic corruption in the tax system.

Accessing finance

7. **Another key constraint to firm entry and expansion in the Philippines is limited access to finance.** This issue weighs heavily on micro, small, and medium-size enterprises (MSMEs),[71] preventing the majority of micro and small rural enterprises from growing. It is also a main obstacle to rural development. A large number of these enterprises are involved in adding value to primary crops but they are constrained by low-productivity technologies that hardly meet the emerging standards for quality and food safety required by the domestic market and foreign importers. Only about a fourth of these enterprises have access to reliable sources of credit such as rural banks, credit unions, cooperatives, and non-profit microfinance institutions. Because they often lack acceptable forms of collateral and transparent accounting practices, small rural enterprises are considered risky and are often turned down.

8. **A 2007 study by the International Finance Corporation (IFC)[72] suggests that the annual unmet demand for SME loans ranged from PHP 67 billion to PHP 180 billion.** The government has tried to address this problem by imposing a minimum amount on bank lending to SMEs. However, instead of encouraging SME development, the requirement has led to re-labeling or re-categorizing of loans by banks, in order to comply with the requirement without venturing into new SME markets or taking new SME clients. This appears to be a common practice among banks in the Philippines.[73]

9. **Limitations in bank regulation and supervision framework have also affected credit growth for SMEs.** Lack of legal protections for bank supervisors and an inadequate bank resolution framework result in an overly conservative stance of the regulators in setting guidelines for credit operations. Addressing this issue would facilitate the shift toward a more

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[70] The indicator on hours per year for paying taxes "measures the time taken to prepare, file, and pay three major types of taxes and contributions: the corporate income tax, value-added or sales tax, and labor taxes, including payroll taxes and social contributions" (Source: Doing Business 2015 report).

[71] *Updated Bangko Sentral ng Pilipinas* figures show that between 2008 and 2013, total nominal lending volume to MSMEs rose from PHP 311 billion to PHP 386 billion, accounting for just 12 percent of the net loan portfolio of the Philippine banking sector, and representing an average increase of only 4 percent per year. Moreover, according to the United Parcel Service, Inc. (UPS) Asia Business Monitor Report (2009), access to funding is the second most important factor limiting the competitiveness of Philippine SMEs (as mentioned by 67 percent of respondents), next to lack of government support at 74 percent.

[72] See Vaillancourt (2007) for more discussion.

[73] Enforcement of mandatory lending targets relies on self-reporting and on the regulator's capacity to supervise, which is usually overstretched. Moreover, lending to microfinance institutions also counts toward meeting the mandatory minimum SME target — a common loophole that results in little or no additional SME lending.

risk-based approach to supervision and would lead to the development of a more dynamic financial sector by enabling a more effective and less costly mechanism for weaker firms to exit.

10. **Access to credit is also hampered by a relatively high credit repayment risk.** SME access to loans is inversely related to the average time it takes to complete bankruptcy proceedings and bankruptcy costs, and positively related to the expected creditor recovery rate on bad loans. It is therefore unsurprising that the share of SMEs with bank loans (less than 10 percent[74]) is so low, considering that the bankruptcy process is extremely slow (i.e., it takes around 6 years to complete a bankruptcy case), bankruptcy administration costs are high (38 percent of assets), and expected creditor recoveries are much lower at around four cents to a dollar, as mentioned earlier. Moreover, bankruptcy procedures are so inefficient that creditors hardly ever use it.[75] These factors make SME financing a very risky exercise in the Philippines.

11. **The previous lack of accessible information on payment histories added further to creditor risks.** The ability of financial institutions to provide cost-effective services depends largely on the availability of information necessary to assess the creditworthiness of their clients. The scope, accessibility, and quality of credit information through public or private bureaus in the Philippines are very low. Through Republic Act 9510, also known as the "Credit Information System Act," a centralized credit bureau, the Credit Information Corporation, was finally created in 2015 after much delay. However, its effectiveness has yet to be proven, partly because of its age.

12. **Moreover, the land registration and titling system is fragmented into different registries, making debtor searches and financing difficult, and property rights insecure.** The current system for registering land titles is inadequate. The data are not centrally filed and are not available online. The absence of reliable cadastral surveys until this year leaves large tracts of land without enforceable titles. Uncertainties surrounding land ownership in rural areas brought about by delays in the agrarian reform program and restrictions on the transfer of land further discourage investments in agriculture.

13. **Finally, significant deficiencies also abound in the registration of moveable collateral (i.e., chattel).** This is often the only type of collateral available to small and medium-size enterprises. Information in the various Registry of Deeds offices is not centralized, registration of chattel is often extremely time-consuming and costly, and financial institutions often cannot verify if a particular chattel is registered.

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[74] World Bank Enterprise Survey Data (2011 Survey year).

[75] An up-to-date bankruptcy framework, Republic Act 10142 "Financial Rehabilitation and Insolvency Act," which aims for a faster and more orderly rehabilitation or liquidation of financially distressed companies and individuals was passed in 2010. Implementation, however, was delayed to 2013 when the supreme court through A.M. No. 12-12-11-SC approved and promulgated the Financial Rehabilitation Rules of Procedures (2013) to govern the proceedings that could be brought under Republic Act No. 10142.

Informality and weak entrepreneurship as consequence

Large-scale informality

14. **Informality is one of the major consequences of costly business regulations.** The informal services sector has become the dominant source of employment for the majority of Filipinos who cannot find work in formal services and manufacturing. While not all of informal services are equivalent to bad jobs, its correlation to poverty and vulnerability is high and there are strong indications that the majority of informal services workers do not have the opportunity to move up the job ladder. Many end up in informal and subsistence micro-enterprises with no plans to grow, innovate, and create jobs.

15. **The Philippine labor market is characterized by high levels of informality.** Around 75 percent of Filipino workers are informally employed.[76] Informal workers are operationally defined to include all self-employed workers (not including employers), unpaid family workers, and wage workers with no written contract, social insurance, or protection from dismissal using the 2008 Informal Sector Survey (ISS)[77] of the Philippine Statistics Authority (PSA). The PSA and the Department of Trade and Industry (DTI) estimate that around 90 percent of Filipinos work in micro, small, and medium-size enterprises (MSME)[78] or on own-account, and more than 60 percent are found in the informal sector.[79] According to the ISS, around 70 percent of self-employed workers are not registered with any government authority. A majority of their workers are working under informal arrangements.

16. **In the past 15 years, the share of vulnerable workers, which include own-account and unpaid family workers — an indicator of informality — have decreased but their magnitude is still high.** Wage and salaried workers accounted for about 57 percent of total employment in 2012, 6 percentage points higher than in 1997 (Figure MT3). Three fast-growing industries contributed to this growth: BPO, electronics, and tourism. The remaining 43 percent are either own-account (32 percent) or unpaid workers in family micro-enterprises (11 percent).

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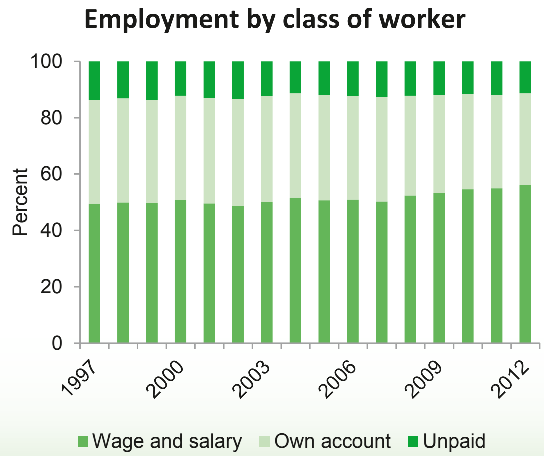
[76] This estimate is not far from the estimate of the Employers Confederation of the Philippines, which put the number of informal workers at 77 percent of total employment (Ortiz-Luis 2008).

[77] The ISS largely follows the recommendations of the International Labor Organization (ILO) 15th and 17th International Conferences of Labor Statisticians (ICLS). They recommend the following criteria for informal enterprises: i) non-registration of enterprise, ii) small employment size, and iii) non-registration of employees of the enterprise. On the other hand, it recommends two criteria for informal employment: i) workers in informal sector enterprises and households and ii) contributing family workers in formal sector enterprises.

[78] Following government definitions, micro firms are firms with fewer than 10 employees, small firms are firms with 10 to 99 employees, medium firms are firms with 100 to 199 employees, and large firms are firms with 200 or more employees.

[79] The informal sector is broadly defined to include enterprises that fall outside the purview of government regulations. Operationally, the informal sector includes the agriculture and informal services sectors. The informal services sector is operationally defined to include the following subsectors: i) wholesale and retail trade, and ii) transportation, communication, and storage (TCS).

Figure MT3. The composition of employment has moved toward wage workers but vulnerability remains high.



Source: LFS

17. **Vulnerable workers are susceptible to job or income losses.** While non-wage work does not necessary mean a bad job, it is less desirable in most cases because workers in this category are less likely to have formal work arrangements, access to benefits and social security, and protection from income shocks or job losses. In fact, vulnerable employment is widespread in the agriculture and services sectors (Table MT2), and is highly correlated with poverty incidence (Figure MT4).

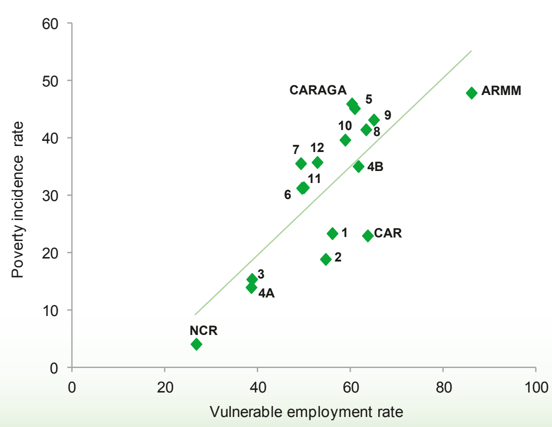
Table MT2. Agriculture and the informal services sectors have the highest rates of vulnerability.

Composition of employment by sector

Industry	Wage and salary	Own account	Unpaid	Total
Agriculture	29.1	46.0	24.9	100
Industry	81.8	14.6	3.6	100
Manufacturing	73.6	20.3	6.1	100
Others	92.2	7.4	0.4	100
Services	63.6	30.4	5.9	100
Formal	90.1	7.9	2.1	100
Informal	50.7	41.5	7.8	100

Source: LFS 2011

Figure MT4. Vulnerable employment is highly correlated with poverty incidence at the regional level in 2009.



Source: LFS 2009, PSA

18. **Even among wage workers, many are informal workers.** Many wage workers do not receive adequate protection from the Labor Code. The Labor Code *de facto* protects only about

a third of wage workers. The majority of wage earners face a high degree of income insecurity and a low degree of social protection (Table MT3). Data from the ISS show that 63 percent of workers in 2008 had no written contracts and 62 percent had no social insurances. Such attributes significantly increase the probability that workers are subjected to labor abuse. They also expose workers to sudden income shocks when they lose their jobs. Protection from and compensation for dismissal are also limited. Almost 60 percent of wage workers reported that they can be terminated without advance notice, and an even larger share of workers (70 percent) did not receive termination pay. Agricultural workers exhibit the highest degree of informality, with more than 90 percent of workers exposed to low protection and a high level of income insecurity. The level of informality is lower in industry and services but employment is still mostly informal in these sectors (64 and 52 percent, respectively).

Table MT3. Measures of informality for wage workers

	Written	Verbal	None
Type of contract	36.7	40.1	23.2
	Yes	**No**	
Social Insurance (Social Security System or Government Service Insurance System)	38.1	61.9	
Protection from dismissal	41.4	58.6	
Compensation in case of dismissal	29.8	70.2	
Leave benefits			
Paid leave	28.0	72.0	
Sick leave	28.9	71.1	
Maternity/paternity leave	27.3	72.7	

Source: ISS 2008

Weak entrepreneurship

19. **Apart from large-scale informality of workers, the other major consequence of costly business regulation is the slow growth of entrepreneurship, which has resulted in limited job creation for the poor.** This is evident in a number of indicators such as the small size of firms, lack of registration, necessity as main intention for starting a business, low productivity, and limited options.

20. **A huge majority of Philippine firms are small and remain small over the years**. Micro, small, and medium-size enterprises (MSMEs) account for 99 percent of all enterprises in the Philippines,[80] and a majority of workers are found in micro-enterprises.[81] The 2009 Enterprise Survey (latest available survey),[82] which covers registered firms, shows that after three years,

[80] Source: Micro, Small, and Medium Enterprise Development Council (2011)

[81] Source: WB staff estimates based on DTI, NSO, and WB data

[82] The 2009 Enterprise Survey covers registered firms in manufacturing and services with 5 or more employees. To be consistent with the official definition, the definition for firm size in the Enterprise Survey was adjusted accordingly.

91 percent of small firms remained small and only one percent moved to the medium-size category. The biggest movement was in the medium-size category, where 17 percent of firms moved to the large-size category. However, a larger share reverted to the small-size category (21 percent) (Table MT4). The lack of growth among micro and small firms has contributed to the "missing middle" phenomenon in the Philippines.

Table MT4. Transition between firm size (in percent of total firms)

Size category (2006)	Size category (2009)				
	Micro	Small	Medium	Large	Total
Micro	85	15	0	0	100
Small	7	91	1	1	100
Medium	0	21	62	17	100
Large	0	6	3	91	100

Source: Enterprise Survey 2009

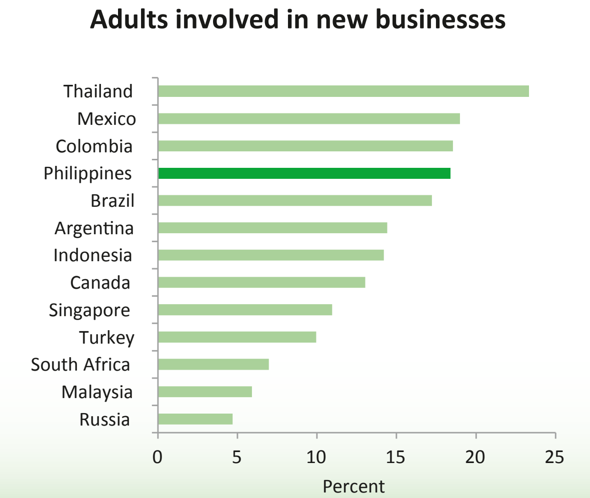
21. **The number of registered MSMEs is very low.** A comparison between the Global Entrepreneurship Monitor (GEM) survey[83] and the World Development Indicators (WDI) of the World Bank on the number of newly registered enterprises suggests that a large number of Philippine MSMEs are not registered. For instance, in 2014, 18.4 percent of GEM respondents in the Philippines stated that they were either owners or the owner/manager of a new business,[84] higher than in most other countries (Figure MT5). However, according to the data collected by the WDI, in 2012, the density of newly registered firms is lower than in other countries at only two registrations per 10,000 adults (Figure MT6).[85]

[83] GEM is an annual assessment of entrepreneurial activity. It is based on a survey conducted in over 85 countries and covers around 2,000 adults per country. The GEM survey for the Philippines was last conducted in 2014 (see http://www.gemconsortium.org/).

[84] In the GEM methodology, this is defined as the percent of the adult population who are either an entrepreneur or owner-manager of a new business.

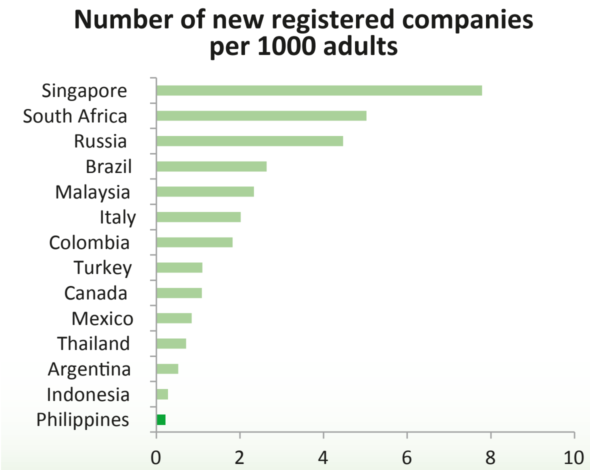
[85] These two statistics are not expected to match closely as new attempts to start a business are not always successful. But for countries with low levels of informality, these 2 statistics are much closer. In Canada, for example, six percent of respondents state that they are involved in a new business and business registrations are at 75 per 10,000 adults. In countries with higher levels of informality, such as Indonesia and Thailand, the high share of entrepreneurs is accompanied by lower new firm registration density.

Figure MT5. The share of Filipinos involved in starting a business is one of the highest.



Source: Global Entrepreneurship Monitor (GEM)

Figure MT6. But few businesses are formally registered.

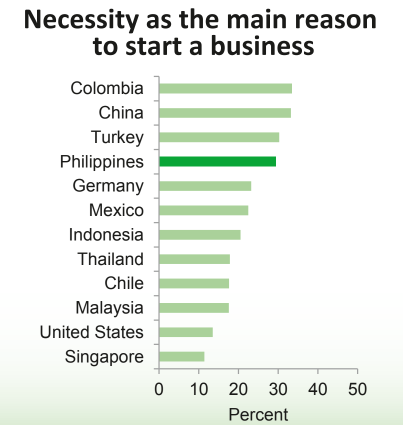


Source: WDI

22. **The share of Filipinos involved in starting a business is one of the highest in the world, but new businesses are often started out of necessity, and while many introduce innovations, few intend to grow**. According to the GEM survey, although 18.4 percent of Filipinos are involved in setting up or running a new business, about a third half of them cite necessity as the main reason, more often than in other countries (Figure MT7a). Though Filipino entrepreneurs are more likely to introduce a product or market innovation than in most other countries (Figure MT7b), they also do not expect to create more than five jobs in the next five years (Figure MT7c). While this showcases the creativity of Filipinos in spite of challenging market conditions and business regulations, these statistics indicate that a vast majority of new businesses are subsistence or stagnant in nature, reflecting the lack of jobs in the domestic economy.

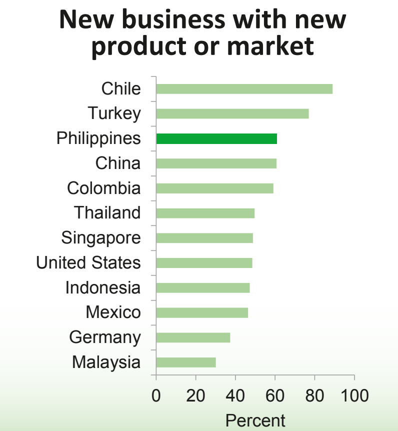
Figure MT7. About a third of new firms cite necessity as the main reason for starting a business and very few introduce innovation or plan to add five or more jobs over five years.

a



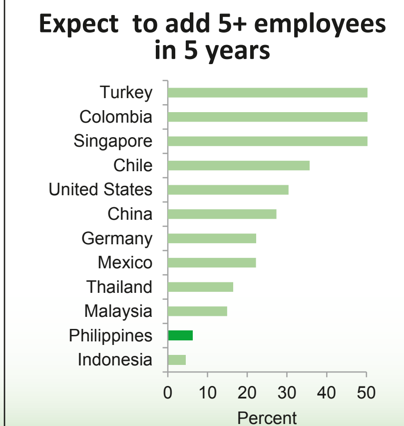
Source: GEM

b



Source: GEM

c

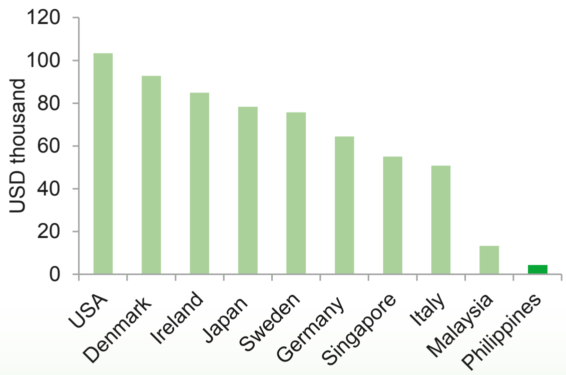


Source: GEM

23. **The average productivity of MSMEs in the Philippines is very low**. The labor productivity of MSMEs in the Philippines is one-third that in Malaysia and one-twentieth those in high-income countries (Figure MT8).[86] Also, Philippine MSMEs' contribution to GDP is small compared to their share of employment. They account for 60 percent of establishment employment but contribute only 36 percent of establishments' gross value-added (Figure MT9).

Figure MT8. Labor productivity of smaller firms in Philippines is much lower than in other countries.

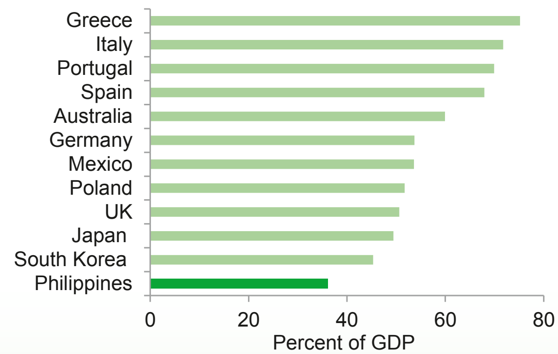
Average MSME labor productivity



Sources: European Commission, US SME Characteristics and Performance, Singapore Department of Statistics, Singapore, SME Corp. Malaysia, Micro, Small, and Medium Enterprise Development Council (2011)

Figure MT9. MSME contribution to GDP is small relative to its employment share.

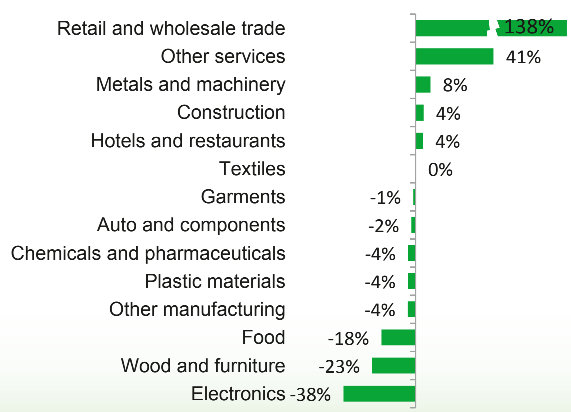
Share of value-added of MSMEs



Sources: OECD Structural and Demographic Business Statistics (SDBS) Database, NSO (2008), Micro, Small, and Medium Enterprise Development Council (2011)

Figure MT10. The retail trade sector accounts for majority of new job creation.

Net job creation by sector as a share to total job creation



Source: Enterprise Survey 2009

24. **More than 50 percent of new businesses cluster in retail trade, given few options elsewhere** (Figure MT10). This share is much larger than in other countries. Countries such as

[86] Not all country estimates in Figure MT9 cover micro firms and have the same definition of firm size. For instance, the USA estimate covers only firms with less than 500 US-based employees.

China, Indonesia, and Malaysia have higher rates of business creation in other sectors. Consequently, majority of jobs are also created in the retail trade sector in the form of *sari-sari* stores (i.e., informal retailing), street vending, and commission-based jobs, such as selling insurance or real estate.

Reforms to simplify business regulations

25. **Simplifying business regulations are needed to encourage the rapid growth of businesses of all sizes and encourage movement of small firms to the formal sector, and in the process create more and better jobs.** The copious amount of red tape and convoluted procedures not only hinders investment and entrepreneurship, they also provide fertile ground for rent-seeking and corruption, which are detrimental to businesses of all sizes. Priority should be given to addressing three concerns in the Doing Business Report that affect micro and small enterprises the most: i) starting and maintaining a business, ii) paying taxes, and iii) accessing finance. This section discusses general reform directions while the special focus on doing business discusses these reforms in detail.

- *Simplify and automate key business registration and licensing processes to reduce transaction costs*

26. **Starting a business can be simplified by harmonizing and streamlining procedures through a process re-engineering.** The Philippines' business regulatory system currently requires 16 procedures to start a business. As a testament to this tedious process, firms are required by law to post in public view up to 18 different permits and licenses. To put the Philippines on par with other EAP countries, steps to register would need to be reduced from 16 to 7. This reform could include i) harmonizing and streamlining procedures among national government agencies and LGUs to avoid overlaps and redundancies (e.g., harmonizing the city and *barangay* business permits into one permit), ii) removing steps that can be verified by government offices at the back end (the recent policy directive that no longer requires a Social Security System (SSS) clearance when renewing business permits is a good example[87]), and iii) reducing requirements whose purposes are not fully justified. The latter includes a) reducing or abolishing the paid-in minimum capital requirement, b) making the use of notaries and lawyers optional for company startups, c) moving toward a fixed registration fee that covers only administrative costs, and d) removing antiquated mandatory practices of having the Bureau of Internal Revenue (BIR) stamp the company's invoice and account books. Some of these proposals would require a comprehensive review of all national and local laws, and their implementing rules and regulations.

[87] Under the Joint Memorandum Circular No. 1 series of 2012 (December 2012) of SSS and the Department of Interior and Local Government, businesses no longer need to secure SSS clearance before renewing business permits. Instead, the SSS will transmit to the LGUs a list of delinquent employers. Businesses on the list will be barred from renewing their business permits.

27. **Automating and completely implementing the Philippine Business Registry (PBR) and the Business Permit and Licensing System (BPLS) thorough the RS4LGU program (discussed in special focus 1) are also needed.** Automation and complete implementation of the PBR and the BPLS would not only reduce the cost of doing business but also enhance transparency and accountability across agencies and authorities involved, and eliminate opportunities for corruption. Complete implementation of the PBR as the single online portal for processing all national level registration and licensing requirements for sole proprietors should be given high priority. This "one-stop shop" system would significantly reduce transaction costs associated with having to interact with various agencies, like the Business Permits and Licensing Office, and the BIR. Implementation of the PBR would need to be followed by streamlining registration, automating the BPLS, and rolling it out to all LGUs. To improve incentives for LGUs to implement the BPLS, access of LGUs to the Performance Challenge Fund can be linked to compliance with BPLS monitoring indicators.

28. **Greater transparency of business regulations can help improve understanding of the registration, licensing, and taxation processes (especially among incipient firms) and help reduce transaction costs.** This can be done by mandating the prominent display of easy-to-understand process flowcharts and service standards in all government offices. This would involve creating a step-by-step guide, with a list of required documents and steps showing which offices to visit, when to visit and with what documents, and listing the addresses, working hours, and contact number of each office. A first step in this direction has been taken with the Anti-Red Tape Act of 2007 (Republic Act 9485), which brought about the Citizen's Charter flowcharts now displayed in various government offices. This could be improved further in terms of completeness, accuracy, and accessibility. Developing a more efficient online or mobile registration system with no human intervention would be the next step in making information more accessible and the system more transparent and accountable, saving valuable time for both businesses and government officials. More importantly, reducing the need for direct interaction with different officials would minimize the potential for under-the-table transactions.

29. **The process for individuals seeking government licenses, permits, and clearances for employment purposes also needs to be simplified.** This includes simplifying procedures and rationalizing fees in government offices such as the SSS, Land Transportation Office[88], National Bureau of Investigation, Philippine Overseas Employment Administration, and various city and municipal offices, so that workers can spend less time queuing up to pay for and secure these documents, and more time on their work. The current effort to have a one-stop shop for some

[88] For instance, renewing a driver's license requires paying the following fees: PHP 350 for processing fee, PHP 67 for computer fee, PHP 100 for change in address in some cases, PHP 100 for medical checkup, and PHP 50 for computer fee for medical checkup, for a total of PHP 667. Reforms could include reducing fees for items that are fully not justified (e.g., computer and change in address fees) and extending the validity of licenses from three to five years, as is the practice in other countries.

of these government services in malls is welcome. Further improving this initiative, such as using online resources, would need to follow.

- *Simplify tax regime for micro and small taxpayers*

30. **Moving toward a simplified tax regime for micro and small businesses is warranted to reduce compliance costs and encourage movement of firms to the formal sector.** The administrative complexity of complying with tax obligations is among the top complaints voiced by MSMEs and a frequent excuse for remaining in the informal sector. A simplified system could include i) using simplified tax forms, registration requirements, and payment processes, ii) mandating fewer requirements for bookkeeping and financial reporting, iii) integrating the tax filing and payment systems of the national and local government units so that taxpayers need to file and pay only once, and iv) combining the value-added tax (VAT), percentage tax, and income tax into a single business tax on turnover for micro and small enterprises. Reforming a very entrenched system with large bureaucratic interest will likely be a challenging endeavor. Resistance to reform can be mitigated by piloting the reform in a few agencies and LGUs, and then expanding it when public support has increased. By reducing compliance burden through a simplified tax regime, the government stands to raise more taxes and reduce corruption in the tax system, while also promoting entrepreneurship and job creation in the formal sector.

- *Facilitate greater access to finance, especially for micro and small enterprises*

31. **The public repository of credit information is now underway.** Currently, there is no centralized comprehensive credit information system in the Philippines to house information on all borrowers of financial institutions. Financial sector groups within the banking industry have set up their own private credit bureaus. These credit bureaus are, however, mutually independent with limited capacity to share data across different banking groups and data are generally only for negative credit performance records. The fragmented nature of the credit information industry prevents lenders from obtaining reliable and complete credit history on existing and potential borrowers. In 2008, the "Credit Information System Act" (Republic Act 9510) was passed. The law created the Credit Information Corporation (CIC), whose purpose is to establish the comprehensive and centralized credit information system. This centralized repository of credit information will enable financial institutions to make more informed decisions in lending based on both positive and negative credit information. Development of the system is now underway. A pilot of the system is now being developed in a phased approach to be launched by June 2016.

32. **The mandated system of lending to small and medium enterprises (SMEs) needs to be replaced by a system of credit guarantees.** Mandatory bank allocations for SME lending may have played a role in encouraging growth in the volume of SME lending initially, but they no longer suffice to meet the financing needs of Philippine SMEs and have proven to be counter-

productive. A system of guarantees that seeks to encourage financial institutions to lend to SMEs stands a better chance of succeeding than the current system that seeks to coerce the banking system into making loans that are perceived to be unprofitable or overly risky.

33. **Strengthening the Philippine collateral system can improve access to finance.** The cadastral titling of all lands in the country needs to be completed and a central registry for land titles established. This implies reforming the land administration procedures, which are overly complex, centralized, and lengthy. There is a need to establish a modern, unified, and easily accessible registration system. It would need to have searchable registries for all collateral across registries.

34. **Increasing lending secured by non-real property or movable assets can further improve access to finance.** This entails i) improving the legal and regulatory framework for secured transactions, ii) implementing a modern, centralized electronic registry for security interests in movable assets, and iii) enhancing the capacities of local financial institutions in lending based on movable assets. With better access to finance, more SMEs would grow and create jobs.

35. **The role of cooperatives in accessing finance needs to be enhanced.** Cooperatives provide savings and credit services to over seven million members in the Philippines and can play a crucial role in improving access of microenterprises and farmers, especially in poor and remote communities, to financial services. Lack of adequate regulation and standards has often led to poor financial performance of cooperatives. Credit and multipurpose cooperatives are recognized as potentially important channels for reaching poor and remote areas with financial services. Yet lack of adequate supervision, weak governance, poor financial management skills, and a lack of necessary information and governance systems often contribute to the poor performance or failure of cooperatives. Participation of cooperatives in providing access to finance can be enhanced by i) improving the regulatory capacity of the Cooperative Development Authority (CDA), ii) developing an effective apex structure to enhance financial viability of cooperatives and widen their reach, and iii) amending the Financial Rehabilitation and Insolvency Act to include cooperatives. Recent legal reforms provide a basis for improving regulation of credit cooperatives and introducing clear performance standards. Implementing adequate standards for governance, accounting, and financial management, and enforcing these standards effectively are critical to the sustainable development of cooperatives.

- *Ensure a coherent strategy for MSME development and measure impact of programs*

36. **International experience shows that effective implementation is the key to ensuring the success of strategies, plans, and programs for MSME development**.[89] The Philippines, like

[89] The need to enhance growth in the MSME sector is recognized in the MSME Development Plan 2011-2016. The plan sets a target for SME value-added contribution to GDP at 40 percent (from about 35 percent in 2008) and increase in the number of SME jobs by two million. The plan addresses the key constraint areas and comprises four pillars: i) business environment, ii) access to finance, iii) access to markets, and iv) productivity and efficiency. It also covers crosscutting dimensions, including regional and local economic development, gender mainstreaming, migration, and climate change.

most other countries, has a wide range of MSME support programs being implemented by various departments and agencies.[90] Improving coordination is an important first step in enhancing the effectiveness of the overall efforts to support SME development. This can be followed by improving the collection of program outcome data to allow the government to conduct evidence-based evaluation of programs to deliver maximum impact.

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[90] The Micro, Small, and Medium Enterprise Development (MSMED) Council coordinates the MSME support programs. It is chaired by the Secretary of Trade and Industry and comprises key government departments and agencies as well as private sector representatives.

SPECIAL FOCUS 1

The real cost of starting and maintaining a business[91]

Introduction

1. **Micro, small, and medium enterprises (MSMEs)[92] are important contributors and beneficiaries of economic growth.** In 2012,[93] MSMEs accounted for 99.6 percent of businesses in the Philippines, comprised around 90 percent of total employment, and contributed 36 percent of total value-added (DTI 2014). Furthermore, 89 percent of MSME employees work in micro and small businesses. Given these, creating an environment that helps MSMEs grow is essential in advancing inclusive growth.

2. **However, business regulations have long been a cumbersome process in the Philippines, posing obstacles to the development of MSMEs and hence job creation.** While the Philippines registered notable gains in its overall ranking in the 2015 Doing Business Report (95th out of 189 countries, slightly below the 50th percentile), its ranking in the starting a business indicator barely improved (Table 1.1). By comparison, in the East Asia region, Singapore and Malaysia are among the easiest countries to start a business, with world rankings of 6 and 13, respectively. Similarly, MSMEs in the Philippines also find maintaining a business to be costly. These have led to i) low registration rate, ii) necessity as a key reason for starting a business, iii) stagnant business growth, iv) low productivity, and v) large scale informality affecting over three quarters of the labor force (see the medium-term reform section for more discussion).

3. **Of particular concern is the high overall cost imposed on MSMEs in starting and maintaining a business.** They not only have to pay for legitimate fees equivalent to 17 to 36

[91] This special focus section was prepared by Justin Chan (Research Assistant), Joseph Louie Limkin (Research Analyst), Karl Kendrick Chua (Senior Country Economist), all from the Macroeconomics and Fiscal Management (MFM) Global Practice (GP), and Roberto Galang (Operations Officer), Beatrice Tanjangco (Research Assistant), and Teresita Lacerna (Legal Adviser), with inputs from Jonathon Kirby (Consultant) and Marieta Patag (Consultant), all from the Trade and Competitiveness (T&C) GP. The team thanks Hans Shrader (Senior Operations Officer) and Marianne Anderson (Results Measurement Specialist), both from T&C, for reviewing the special focus, and to officials of the Department of Trade and Industry, National Competitiveness Council, and the Quezon City Business Permit Licensing Office and Communications Coordination Center for their comments.

[92] Republic Act 9501 defines MSMEs as businesses with assets not more than PHP 100 million or employment not exceeding 199 employees. This is broken down into the following categories: i) micro businesses have assets not exceeding PHP three million, or employs less than 10 workers, ii) small businesses have assets between PHP three and 15 million, or employs 10 to 99 workers, and iii) medium businesses have assets between PHP 15 and 100 million, or employs 100 to 199 workers. The employment criteria takes precedence over the asset criteria in case of double classification.

[93] 2012 is the year with latest available data.

percent of per capita income (PHP 21,000 to 45,000[94]), they also spend a considerable amount of time moving from one agency to another and waiting in line to process their documents, often resulting in significant loss of productive time and income. In some instances, businesses report that they need to pay bribes or give gifts to obtain various permits and government services. Simplifying and streamlining business registration process in the Philippines would therefore not only support job creation, but also improve transparency and accountability in the government.

4. **To complement the discussion in the medium-term section, this special focus analyzes the direct and opportunity costs of starting and maintaining a business, and argues that reforms to reduce overall cost would free up substantial resources to make growth more inclusive.** It begins with an overview of the procedures and direct cost in starting and maintaining a business, followed by an analysis of the opportunity costs, and ends with a discussion of current and recommended reforms to reduce the cost of business start-ups and maintenance.

Table 1.1. Progress in starting a business indicator

Philippines	2005	2010	2015
Starting a business rank	102 out of 145	162 out of 183	161 out of 189
Number of procedures	17	18	16
Number of days	49	42	34
Cost (as a percent of per capita income)[95]	24.1	21.6	16.6
Cost (in current pesos)	14,587	18,918	21,156

Source: World Bank's Doing Business in the Philippines (http://www.doingbusiness.org/data/exploreeconomies/philippines)

Direct costs

5. **In the Philippines, the complexity of starting a business reflects the decentralized manner of securing various permits and licenses.** An entrepreneur needs to visit the local government (and its various offices), five other national government agencies, and several private offices (e.g., bank, bookstore, print shop, notary) to secure various licenses, permits, and forms before his business can commence. To maintain a business, he has to update all clearances required during start-up, as well as a zoning permit. There are variations in the required steps and corresponding cost depending on the type of business (i.e., corporation or sole proprietor) and the local government unit.

[94] As a point of comparison, PHP 19,000 is the average monthly income of a worker in the 9th income decile and monthly minimum wage is in Metro Manila is around PHP 12,000.

[95] The per capita income used in the respective reference years are: PHP 60,528 for 2005, PHP 87,582 for 2010, and PHP 127,438 for 2015.

6. **For a corporation registering in Quezon City,[96] it takes 16 steps and 34 days to complete all government requirements and costs around PHP 19,638.** Table 1.2 outlines the steps and the corresponding direct cost involved.

Table 1.2. Procedures for starting a corporation with average cost and time consumed

Steps	Days	Cost (PHP)
1. Verify and reserve the company name with the Securities and Exchange Commission (SEC).	1	40
2. Deposit the paid-in minimum capital at the bank.	1	0
3. Notarize articles of incorporation and treasurer's affidavit at the notary.	1	500
4. Register the company with SEC and receive a pre-registered taxpayer identification number (TIN).	2	3,065*
5. Obtain a *barangay* (village) clearance.	1	500
6. Pay the annual community tax and obtain the community tax certificate (CTC) from the City Treasurer's Office (CTO).[97]	1	500
7. Obtain the mayor's business permit to operate from the Business Permit Licensing Office (BPLO).[98]	6	5,353*[99]
8. Buy special books of account at bookstore.	1	400
9. Apply for Certificate of Registration (COR) and TIN at the Bureau of Internal Revenue (BIR).	1	115
10. Pay the registration fee and documentary stamp taxes (DST) at the authorized agent bank (AAB).	1	5,665*
11. Obtain the authority to print receipts and invoices from the BIR.	1	0
12. Print receipts and invoices at the print shop.	7	3,500
13. Have books of accounts and Printer's Certificate of Delivery (PCD) stamped by the BIR.	1	0
14. Register with the Social Security System (SSS).	7	0
15. Register with the Philippine Health Insurance Corporation (PhilHealth).	1	0
16. Register with Home Development Mutual Fund (Pag-ibig).	1	0
Total	**34**	**19,638**

Source: Doing Business 2015
*See Doing Business 2015 methodology for details, found in http://www.doingbusiness.org/data/exploreeconomies/philippines/starting-a-business

[96] Quezon City is largest city in terms of population and is consequently used as the benchmark in the Doing Business Report.
[97] According to the Quezon City Business Permit Licensing Office, this step has ceased to be a separate step since 2012. For the past three years, business registration applicants were not required to present the CTC when they register their business. The fee of PHP 500 is simply included in the one-time assessment of all fees and charges.
[98] Before a business permit is issued, the applicant must secure several clearances such as engineering, fire safety, and sanitation. Under the regulatory simplification program (discussed in Box 1.2), the time needed to complete LGU-managed processes were reduced to one day by moving requirement to post-licensing.
[99] According to the Quezon City Business Permit Licensing Office, the cost depends on the declared capitalization of the business. The smallest fee is PHP 2,400.

7. **Sole proprietors follow a slightly different track, which has been simplified in recent years.**[100] The general steps and direct cost for Quezon City are outlined in Table 1.3. In 2010, the Department of Trade and Industry (DTI) launched the Philippine Business Registry (PBR) in Quezon City.[101] The PBR is an online registration platform for sole proprietors that covers registering a business name, obtaining a TIN, and registering with SSS, PhilHealth, and Pag-IBIG. By merging several steps, step 1 can, in theory, be completed in just one day. In practice, however, system delays, can lead to more days. At the local level, step three has become easier with the Business One Stop Shop (BOSS) that allows minimally regulated businesses to obtain their local permits within the day.

Table 1.3. Procedures for starting a sole proprietor in Quezon City with average cost and time consumed

	Steps	Days	Cost (PHP)
1.	Register business name with DTI through the Philippine Business Registry (PBR).	1	PHP 15 documentary stamp tax and PHP 200 to 2,000 depending on scope.
2.	Obtain a barangay clearance.	1	PHP 300 to 1000 depending on barangay
3.	Go to the Business One Stop Shop (BOSS) and bring i) PBR number (registration with DTI), ii) barangay clearance, iii) contract of lease (if renting) or title to property (if owner of business area), and iv) location plan/site map.	1 (for steps 3 to 5)	*Depends on capitalization, scope, and type of business
4.	Pay taxes and fees at the City Treasurer's Office.		
5.	Present official receipt to the BOSS and the BOSS personnel releases the mayor's permit and business license plate.		
6.	Comply with other necessary requirements[102] within 90 days (not applicable for all).		
	Total	**3**	**PHP 515 to 3,015**

Sources: Quezon City Communication Center, Business Processing and Licensing Office, and Business One Stop Shop Brochure.

[100] The information in this paragraph is based on interviews with the Communications Center and Business Process and Licensing Office of Quezon City.
[101] The Quezon City Government tested the PBR in 2009 and launched it in 2010, while PBR II was launched in 2012.
[102] These include i) fire safety and inspection certificate, ii) sanitary permit,iii) certificate of electrical inspection, iv) mechanical permit, and v) other clearances or certificates required, depending on the type of business.

8. **After a business commences, numerous annual regulatory requirements are needed to maintain the business, which can take several days to fulfill.**[103] The primary step is the annual renewal of the mayor's business permit. Renewal of the mayor's business permit necessitates renewing the same permits and clearances required the year before as well as payment of business taxes based on gross sales. Permits vary depending on business type, and include the fire safety inspection certificate from the Bureau of Fire Protection, a sanitary permit from the City Health Department, and a certificate of electrical inspection from the Local Building Official.[104] These are provided by different local government offices and require time and effort given the bureaucracy. After the business owner complies with the requirements, documentary proof of gross sales such as audited financial statements and VAT payments must be presented and assessed. While these requirements may serve important purposes**,** they appear to be cumbersome, considering that businesses in the Philippines need to apply for licenses more often than in neighboring countries (for instance, see Figure MT1 in the medium-term reform agenda section).

9. **Moreover, there are tax and contribution payments that have to be paid frequently within the year.** For instance, for a corporation, there are 36 regular tax and contribution payments needed every year (some required monthly and some quarterly), which takes 193 hours to comply with (Table 1.4). As the online system is not always functional, payments have to be made in person in some cases.

Table 1.4. Number of regular tax and contribution payments by a medium-sized company

Steps	Number of Payments	Hours
1. Local tax payment.	1	..
2. Real property tax payment.	1	..
3. SSS, Pag-ibig, PhilHealth, and other payments.	25	38
4. National tax payment (income tax and VAT)	2	155
5. Other tax payments	7	..
Total	**36**	**193**

Source: Doing Business 2015
Note: .. means no data available.

10. **These tax and contribution requirements make no concession to business size.** Micro and small firms face very high cost of compliance as the same tax regime is applied to them

[103] The process of business permit renewal varies depending on the LGU. Quezon City was used as a reference to remain consistent with the Doing Business Report.
[104] For example, a law office would only need a fire inspection certificate, but a *carinderia* (small eatery) will also need a sanitary inspection, and a drugstore/clinic would need to present a certificate from the Department of Health.

without regard to business size or their capacity to comply (e.g., they often do not have the resources to employ accountants or to maintain full accounts required by the tax agency). This deters many of them from entering or staying in the formal sector. In fact, it may be easier to leave the system completely than to comply without sufficient knowledge of the law and be subjected to audits and penalties. Moreover, maintaining a formal status can be much more expensive than the original cost of business registration.

Opportunity costs

11. **Apart from legally-mandated direct cost, corruption adds to the cost of starting and maintaining a business.** While the peso value is difficult to determine given the clandestine nature of these transactions, the significant number of businesses reporting the need to pay bribes or give gifts suggest that the practice may be systemic in some agencies. For instance, in the 2009 Enterprise Survey, around 11, 8, and 25 percent of small, medium, and large firms, respectively, reported paying bribes or giving gifts to obtain an operating license (see Figure MT2 in the medium-term reform section). The results are even worse for securing a construction permit and getting an electricity connection. A more recent survey by the Social Weather Stations (SWS) in 2015 confirms earlier results. It finds that 25 percent of firms paid bribes in order to obtain a local license, while 21 percent paid bribes in order to obtain a national license.

12. **More importantly, considerable opportunity cost arises from missing productive days of work, and thus lost income, in order to comply with government requirements.** For most micro or small businesses, the owner himself has to personally travel from one government agency to another and fall in long lines instead of doing more productive work.[105] These lost productive days lead to lost income. If an agent or worker is deputized, that typically comes at a high cost relative to the business's capitalization. Estimating the impact of lost productive days on income is subject to a number of assumptions and considerations, and thus also not easy to measure, but indicative estimates show that this can also be very large.

13. **Using parameters from the previous section, total opportunity cost from productive days lost can easily reach more than PHP 100 billion annually.[106]** The following gives the breakdown: For businesses, this comes from lost income opportunities (by PHP 11.9 billion). For the government, this comes from lost tax and contribution revenues due to lower income (by PHP 9.7 billion). Finally, for the economy, it manifests in lower aggregate spending (by PHP 133.8 billion). Table 1.5 summarizes these opportunity costs while Box 1.1 explains the (conservative) methodology used.

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[105] Transacting with a government agency does not usually take eight full hours, but considering the worsening traffic condition, time spent travelling from one agency to another can easily take the whole day.

[106] Understandably, the bulk of the opportunity cost comes from maintaining a business, given the requirement to renew and pay annually (or more frequently). However, if all the opportunity costs in starting a business since the beginning are added up, this can easily rival the opportunity cost of maintaining a business.

14. **Moreover, opportunity cost can also arise from discouraged Filipinos who could have started a business if only the cost was reasonable.** While this type of opportunity cost is more difficult to measure, it nevertheless is not hard to grasp. For instance, households receiving substantial remittances of at least PHP 200,000 per year and have a working age member who is not employed (i.e., unemployed or out of the labor force) could better use this money to start a business,[107] yet many don't. The 2012 Family Income and Expenditure Survey (FIES) estimates that 117,782 households fit this description, with average annual remittances of PHP 374,000. However, due to income underreporting, actual remittances received may be closer to PHP 602,140.[108] In the central bank's survey of overseas Filipino worker (OFW) households, in the past five years, only 6.5 percent of households reported that they use remittances for investments, while 42 percent use the remittances for savings. The difference of 35.5 percent[109] may represent the untapped potential investors, of which around half are assume to be risk-neutral and thus will invest. Assuming that these households invest the entire remittance amount,[110] this gives rise to forgone investment of around PHP 12.6 billion. At a return of investment of 15 percent, this translates into forgone annual income of PHP 1.9 billion and forgone tax revenues of around PHP 1.5 billion. Finally, taking the economy-wide multiplier of 1.8, the impact on the economy is PHP 21.2 billion. And if each business creates two jobs in addition to the owner, then total job generation would be 62,179, or about five percent of the number of entrants to the labor force every year. This is a significant number of jobs forgone.

15. **These indicative estimates suggest that high cost of doing business is clearly a toll on the country's inclusive growth agenda.** When taking all other Doing Business indicators into account (e.g., securing construction permit, getting electricity, trading externally), the overall cost of doing business, both direct cost and opportunity cost, could be several times higher.

[107] This analysis considers only remittance-receiving households as a potential source of new businesses. It uses remittances from the household surveys, which are lower than the remittances reported by the central bank. This means that the estimates are conservative estimates, even when risk aversion is considered (i.e., some households will not start a business because they are simply risk averse).

[108] FIES income components, including remittances, suffer from significant underreporting, thus they need to be adjusted. A simple way to adjust FIES remittance is to raise it by the ratio of total BOP cash remittances to FIES remittance. Since BOP cash remittance was around PHP 903.7 billion and FIES remittance was PHP 560.2, the ratio is around 1.61.

[109] This may represent the ceiling of remittance receiving households who could have invested, as investing involves risk, and not all households have a high risk appetite.

[110] This assumption is reasonable as these households belong to the top two percent of the income percentile with a marginal propensity to consume of 0.68, much lower than the national average of 0.83.

Table 1.5. Annual opportunity costs in billions of PHP					
	Forgone investment	**Forgone business net income**	**Forgone tax and contribution revenues**	**Forgone aggregate spending**	**Forgone employment**
Loss to corruption	*Significant but very difficult to measure*				
Starting a business		0.13[111]	0.11[112]	1.50[113]	
Maintaining a business		11.77[114]	9.57[115]	132.28[116]	
Total direct opportunity cost		**11.90**	**9.68**	**133.78**	
Indirect opportunity cost from forgone investment	**12.59**[117] For the first year only	**1.89**[118]	**1.54**[119]	**21.23**[120]	**62,179**
Grand total	**12.59**	**13.79**	**11.22**	**155.01**	**62,179**

Source: WB staff calculations based on government statistics.

Box 1.1. Methodology for estimating the opportunity cost of lost productive days and discouraged potential investors

To estimate the opportunity cost in starting a business, a proxy for income is multiplied by the number of days spent in complying with various government requirements and the number of new businesses that enter the market annually. To be conservative, the minimum wage rate of the National Capital Region is used as a proxy for net income. The number of new businesses that enter the market annually is extrapolated from the Department of Trade and Industry's annual estimate of MSMEs for 2008 and 2012. In 2008 and 2012, respectively, DTI estimated around 758,436 and 940,802 MSMEs. These numbers represent an average annual entry of 45,592 MSMEs into the market. This is further broken

[111] This is computed as (34 days x PHP 481 per day x 4,559 new corporations) + (3 days x PHP 481 per day x 41,033 new sole proprietors). The addends are PHP 74.6 million and PHP 59.2 million.

[112] This is computed as (PHP 133.8 million x 42.5 percent_ + (PHP 969.34 million x 5.36 percent) [the effective VAT rate on sales assuming 50 percent is exempt]. Revenues are computed from profit using the following profit to cost ratio: 13.8 to 86.2. The addends are PHP 56.87 million and PHP 51.96 million.

[113] This is computed as PHP 835.57 million x 1.8 (the economy-wide multiplier).

[114] This is computed as 26 days x PHP 481 per day x 940,802 existing MSMEs. 26 days is derived from 193 hours required to pay taxes plus an estimated two days to renew licenses.

[115] This is computed as (PHP 11.77 billion x 42.5 percent) + (PHP 85.26 billion x 5.36 percent). The addends are PHP 5 billion and PHP 4.57 billion.

[116] This is computed as PHP 73.49 billion x 1.8.

[117] This is computed as 117,782 households x adjusted average remittance of PHP 602,140 x half of the 35.5 percent OFW households who are risk neutral and could have invested.

[118] This is computed as PHP 12.59 billion x 15 percent return on investment.

[119] This is computed as (PHP 1.89 billion x 42.5 percent) + (PHP 13.68 billion x 5.36 percent). The addends are PHP 0.81 billion and PHP 0.73 billion.

[120] This is computed as PHP 11.79 billion x 1.8.

down into an estimated 4,559 (10 percent) corporations and 41,033 (90 percent) sole proprietors. To estimate the opportunity cost for existing businesses, the DTI estimate of MSME stock as of 2012 is used as the proxy. These parameters are lower bound and thus give a conservative estimate of opportunity cost.

To estimate the impact on government tax and contribution revenues, lost income is multiplied by the average tax and contribution rate of 42.5 percent of profit, taken from the Doing Business Report. In addition, the VAT rate of 12 percent is applied to the derived business sales. To be conservative, it is assumed that 50 percent of cost is non-VATable. Finally, the profit and cost share of 13.8 and 86.2, respectively, is based on the economy-wide average from the Census of Philippine Business and Industry.

To estimate the impact on aggregate spending (and hence GDP), total business cost is multiplied by the average economy-wide multiplier of 1.8, sourced from the 2006 input-output table.

Finally, there are many ways to estimate forgone investment due to high cost of entry. One method is to scan the household survey for households receiving substantial remittances and have at least one member outside the labor force who could start a business using the remittances. Supplemented with the BSP's survey on the use of OFW remittances, the number of untapped households can be estimated. Details are discussed in the main text.

Reforms to reduce the cost of starting and maintaining a business

16. **Recognizing the adverse impact on the economy of costly business start-up, the government has begun to address a number of doing business constraints.** At the national level, four landmark memoranda of agreement (MOAs) were signed by nine national government agencies and a local government unit on April 14, 2015.[121] This major collaboration among several government agencies is a response to the complexity created by the country's decentralized manner of starting a business. If implemented fully, the number of days needed to start a corporate business in Quezon City is expected to fall from 34 to 8 and the number of steps from 16 to 6. Successful implementation can then be rolled-out in other areas.

17. **The new process in registering a corporation involves a re-engineering of existing processes and the creation of an integrated business registration system.** Many steps from the previous regime are either eliminated or merged to reduce the number of steps and days needed (Figure 1.1). Among the steps retained are the preparation of supporting documents, securing a *barangay* clearance, and obtaining the business permit from the Business Permits and Licensing Office (BPLO). Steps removed or merged are i) bank deposit of paid in capital, ii)

[121] These agencies are: National Competitiveness Council (NCC), Department of Finance (DOF), Department of Trade and Industry (DTI), Department of the Interior and Local Government (DILG), Securities and Exchange Commission (SEC), Bureau of Internal Revenue (BIR), Social Security System (SSS), Home Development Mutual Fund (Pag-IBIG), Philippine Health Insurance Corporation (PhilHealth), and the local government of Quezon City.

purchase of special books of accounts, and iii) individually registering with a) SSS, b) PhilHealth, and c) Pag-Ibig. These former requirements are removed as SEC adopts an integrated business registration system similar to PBR, which will create a unified registration system for SEC, SSS, PhilHealth, and Pag-IBIG registrations and for obtaining a TIN from BIR. Furthermore, efficiency are being introduced at the LGU level by reducing the average processing time for obtaining a business permit to operate from six days to around two to three days, including the step to pay the annual community tax and payment of necessary fees. BIR is also enhancing its system by combining the process of securing a certificate of registration and the registration of book of accounts into one. Likewise, acquiring authority to print and printing receipts/invoices are being simplified.

Figure 1.1. Newly simplified approach to corporate business registration.

18. **If fully implemented, this reform can also result in time and cost savings.** For each day of reduction, at least PHP 2 million in lost income can be saved. Moreover, PHP 68 million in lost income can be saved if the 2015-2016 goal of the National Competitiveness Council (NCC) to reduce business start-up to three steps and three days is achieved. While these appear small, its second round effects on the economy can be substantial. Furthermore, another PHP 9 billion in lost income can be saved annually if the days spent to pay taxes is reduced to 13 payments and 36 hours. In addition to these savings, gains to the economy can come from new business entry (e.g., 24 percent spike in registration rate when procedures were simplified in the key cities of Manila, Quezon, Marikina, and Mandaluyong) as a result of faster, easier, and more transparent registration process and business regulations.

19. **At the local level, 25 cities[122] have also taken initiatives to reduce business start-up costs.** In the Philippines, cities, municipalities, and *barangays* (villages) play a big role in the business registration process. In fact, about one-third of the registration steps are in the domain of the local government. To support business entry reform at the city level, the Department of Interior and Local Government (DILG) initiated a program called RS4LGU (Regulatory Simplification for LGUs) that support cities to reform their business registration systems (see Box 1.2). Since 2010, 25 cities have passed executive orders (EOs) codifying reforms to simplify their respective business permit licensing systems. Cities that have passed EOs reduced registration steps from an average of 45 to 3 and registration days from an average of 30 to 1. More successes are expected to follow as DILG rolls out the program to other LGUs.

Box 1.2. Regulatory simplification program for business permit renewal in the Philippines

Initiated in 2008, the regulatory simplification program targeted and removed system inefficiencies, and regulatory redundancies to make starting a business easier.[123] The regulatory simplification program aimed to i) help local governments units (LGUs) lower administrative barriers, and ii) reduce transaction costs for opening a business in terms of time, cost, and procedures. The program used a bottom-up approach to involve LGUs in the reform. A diagnostic tool developed by the International Finance Corporation (IFC) was used to help cities methodically analyze and target steps for elimination in business registration. A legal analysis guidance tool was created to help them determine which licensing steps can be eliminated or moved. It also helped cities realize that several steps could be deferred to post-licensing, such as a firm's enrollment with social security agencies and securing a fire permit. This made a two-step and one-day business permit process for LGU-controlled procedures possible.

[122] The cities that have started reforms to reduce business start-up costs are the following: in Luzon: Urdaneta, Kabugao, San Fernando, Santiago, Cauayan, La Trinidad, Legazpi, Tabuk, Baguio, Laoag, Tanauan, Vigan, Ilagan, and Kawit; in Visayas: Bogo, Calbayog, Catbalogan, Tacloban, Ormoc, Danao, and Lapu-lapu; and in Mindanao: Surigao, Tacurong, Samal, and Tagum.

[123] The program was supported by the International Finance Corporation of the World Bank Group.

The success of four pilot cities in Metro Manila caught the national government's attention and generated interest for its roll out in other LGUs. The project began in Quezon City, Marikina City, Mandaluyong City, and Manila City in 2009. The time to complete business entry in the four cities was reduced from an average of 13 days to just 1. In the succeeding years, the project was expanded to Tuguegarao City, Puerto Princesa City, and Pasig City. During the final 1.5 years of the project, 15 more cities adopted the program as the Department of Interior and Local Government (DILG) formally took ownership of the program and hired its own coaches to replicate the earlier successes of the reform. A particularly successful LGU is La Trinidad in Benguet Province.

Business registration requirements in La Trinidad were reduced significantly after the reform. La Trinidad officially adopted the regulatory simplification program in March 2014. Before introducing the program, registration required eight signatures and 18 steps, and took two to five days for the Business Permit Licensing Office (BPLO) to process an application. All in all, it took around 14 days to complete the 18 steps. After the program was implemented, registration was reduced to three signatures, three steps, and one hour for the office to process. The simplified three steps are i) unified submission of form and obtainment of barangay clearance, ii) one-time assessment and payment (previously multiple payments that went through various departments), and iii) release of permit. In addition, like other LGUs in the program, it adopted a unified form that further simplified the process.

As a result, the number of new registrants and renewals increased significantly in the first year of implementation and businesses benefited through annual cost savings. La Trinidad saw the number of new registrants and renewals increase from 5,568 in 2013 to 6,717 in 2014 (a 21 percent increase), driven by first time registrants. Moreover, businesses benefited from an estimated PHP 83 million in annual cost compliance savings (information derived from focus group discussion).

20. **While the above reforms are laudable and should make a significant impact, more can be done to unleash the full potential of MSMEs both as contributor and beneficiary of economic growth.** The thematic recommendations to reduce the cost of doing business are discussed in the medium-term section on simplifying regulations. This concluding section discuss in detail those recommendations specifically pertaining to business startup and operations. The "Go Negosyo Act" discussed in Box 1.3 is an important initiative that addresses some of these recommendations.

- **Further simplify and automate key business registration steps through process re-engineering** such as i) harmonizing and streamlining remaining procedures among national government agencies and LGUs to avoid overlaps and redundancies, ii) removing steps that can be verified by government offices at the back end, and iii) reducing requirements whose purposes are not fully justified. Some of these would require a comprehensive review of all national and local laws, and their implementing rules and regulations.

- **Fully implement the Philippine Business Registry (PBR) at the national level and the RS4LGU program at the local government level.** The simplification of steps due to the PBR and the RS4LGU can help reduce transaction costs and enhance transparency and accountability across involved agencies. In addition, training personnel on implementing these rules effectively is needed to ensure adequate compliance.

- **Introduce alternative payment systems such as online and mobile payments.** This would eliminate the need to visit government offices or local banks to complete the processing. This would also reduce the potential for under-the-table payment. Quezon City is expected to roll out an online payment system for business taxes by end-2015. Other LGUs can move to implement similar programs.

Box 1.3. NEGOSYO centers: Easing the way for MSMEs to do business

The 2014 "Go Negosyo Act" is an important legislation that supports the state's policy of fostering broad-based growth of MSMEs. One provision of the act is the establishment of go negosyo centers by the Department of Trade and Industry (DTI) in several cities and municipalities to facilitate business start-up and operations by MSMEs. DTI has allocated PHP 92.7 million to set up these centers, which are mandated to promote ease of doing business by MSMEs through i) business registration assistance, ii) business advisory services, iii) business information and advocacy, and iv) monitoring and evaluation of business processes for MSMEs.

Go negosyo centers serve as a support sharing facility and a one-stop shop for MSME services. Through these centers, MSMEs can start and do business without going to different government agencies, thereby bypassing lengthy and complex procedures. The centers assist in facilitating business registration and providing assistance on compliance. Moreover, the centers also offer advisory services on product development and investment promotion, as well as facilitate market linkages and access to technology, financing, and management training. MSMEs also receive advice and assistance on how to comply with these requirements.

To date, 89 go negosyo centers have been established across the country and MSMEs have begun to use their services. Around 29,615 MSMEs have availed of the centers' services of which 46 percent availed registration or renewal service, and 33 percent availed of business advisory services on product development (4 percent), access to markets (5 percent), access to finance (5 percent), investment promotion (3 percent), business management training (12 percent), and business information (25 percent).

- **Reduce the frequency of renewals of government licenses, permits, and clearances for employment purposes.** For instance, licenses can be renewed every three years instead of yearly, and risk-based audits can be used by the government to check on compliance instead of subjecting the whole population to *de facto* audits every time they renew their licenses. Local business tax revenues can be maintained by increasing the tax to cover multiple years. At any rate, for the business, this is still reduced total cost given the time savings.

- **Consider adopting a risk-based approach for business permitting purposes.** The idea of risk based audits can be extended to licensing, permitting, and other regulatory requirements. Under this approach, instruments used for regulation and control will be based on the level of risk (see Box 1.4 for more discussion).

- **Simplify the tax regime for micro and small businesses to reduce compliance costs and encourage movement of firms to the formal sector.** A simplified system could include i) using simplified tax forms, registration requirements, and payment processes, ii) mandating fewer requirements for bookkeeping and financial reporting, iii) integrating the tax filing and payment systems of the national and local government units so that taxpayers need to file and pay only once, and iv) combining the value-added tax (VAT), percentage tax, and income tax into a single business tax on turnover for micro and small enterprises, say at six percent of gross sales. By reducing compliance burden through a simplified tax regime, the government stands to raise more taxes and reduce corruption in the tax system, while also promoting entrepreneurship and job creation in the formal sector.

Box 1.4. Introducing a risk-based approach to regulate business licensing

Adopting a risk-based approach can simplify key regulatory processes that govern business activities, thereby saving and allocating scarce resources. A risk-based approach involves moving from inspections, licensing, permitting, and other regulatory requirements that cover all businesses uniformly to an approach that tailors the instruments used for regulation and control based on the level of risk. The higher the potential risk posed by a specific business activity, the stricter the control and the greater the need for licensing or permitting and more frequent inspections. For low-risk activities, a license or permit should generally not be required, and inspections should be rare.

Risk matrices are the primary tool used to conduct risk classification. The format is relatively simple: one axis represents severity and the other probability. Regulatory responses (e.g., licensing, permitting) are adapted based on the matrix. Only parameters that are easily known about the business are included. If risk matrices are too long and complex, they become very difficult to use. A typical risk matrix would be less than one page, including at least the following factors (and possibly others that are country or regulator-specific):

- Sector of activity
- Type of process (if manufacturing, what products are involved and are hazardous substances used or stored?) or type of activity (if non-manufacturing, do people reside permanently and/or sleep in the facility?)
- Number of people present in the establishment during normal operation and/or maximum number of people that are present
- Location in the case of hazardous industrial facilities (surrounded or not by inhabited area or close to sensitive object from an environmental perspective, such as a water source)
- Specific aspects of the building, such as underground parts and/or high-rise (i.e., difficulties in evacuation)
- Specific hazardous machinery being used in the building

To sufficiently assess the likelihood of compliance in each establishment, an adequate information system is needed by regulators. In most cases, the assessment of risks is based on prior records. Efficiently using them requires a computerized system to make full use of risk matrices.

Aggregate classifications of establishments can mitigate concerns about inadequate information. Because of inadequate information, some preliminary division of establishments based on their inherent characteristics (e.g., sector, size, and type of activity) is already a considerable improvement in terms of risk management compared to treating all establishments as identical. Thus, governments that do not have such information systems in place can start implementing risk-based approaches to classification and planning.

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SPECIAL FOCUS 2

Export transaction costs in the Philippines[124]

Introduction

1. **Philippine merchandise exports have been steadily increasing, but at a slower pace compared with regional peers.** The country's exports have increased by 42 percent since 2000,[125] driven by increasing integration into the global electronic supply chain, increasing demand for other local products, such as agricultural produce, and positive effects of trade liberalization stemming from the 1993 ASEAN Free Trade Agreement. However, export growth of regional peers has been significantly higher. For instance, Indonesia's exports in the same period increased by 180 percent and Thailand's by more than 200 percent (Figure 2.1).

2. **Philippine export performance has been uneven and is concentrated in a few firms, which are mostly large enterprises.** The performance of Philippine exports relative to the world has alternating periods of robust growth in the mid-2000s, loss of market share during 2011-2012, and a return to growth afterwards. This volatility is expected but appears to be more pronounced compared to its neighbors like Indonesia, Thailand, and Malaysia (Figure 2.3). The country's volatility in export shares has been largely driven by changes in global market trends for electronics, which represent around 50 percent of the country's total exports. Periods of strong growth have benefited a small segment of the economy as Philippine exports are concentrated in a few firms, estimated at between 1,420 and 3,579 companies, with only a few small and medium enterprises (SMEs).[126]

3. **Less robust export growth may have slowed the pace of job creation.** Since 2001, growth of the total wage bill in the export sector has been slower than that of the economy.

[124] This special focus section was prepared by Justin Chan (Research Assistant), Joseph Louie Limkin (Research Analyst), Karl Kendrick Chua (Senior Country Economist), all from the Macroeconomics and Fiscal Management Global Practice (GP), and Roberto Galang (Operations Officer), Marcin Piatkowski (Senior Financial Economist), Jean Francois Arvis (Senior Transport Economist), Daria Taglioni (Senior Trade Economist), Gerard McLinden (Lead Specialist), Christina Busch (Consultant), Claire Hollweg (Consultant), and Guillermo Arenas (Consultant), all from the Trade and Competitiveness GP. This special focus benefited from the Export Development Council's (EDC) cost of exporting survey and interviews with i) EDC, ii) Royal Cargo, iii) current and former officials of the Bureau of Customs (BOC), iv) e-Konek Pilipinas, and v) Department of Trade and Industry. The Chamber of Customs Brokers was not available for interview despite repeated attempts. The report team is very grateful for their time, and in particular, to the EDC for sharing the survey results.

[125] This is sourced from the World Development Indicators' value of exports index, which is derived from the national income accounts.

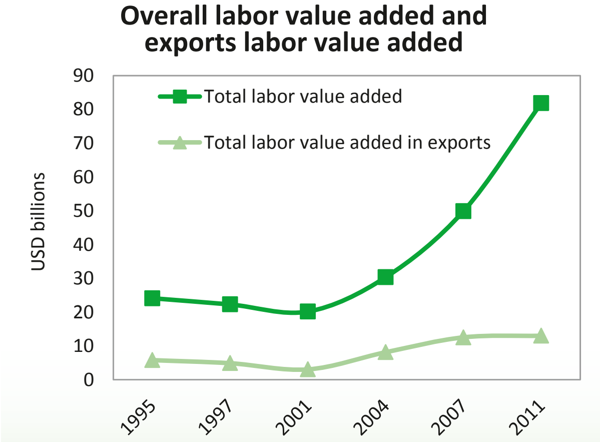
[126] The number of exporters varies across data sources: i) 1,420 exporters according to *Bangko Sentral ng Pilipinas* Directory of Philippine Merchandise Exporters 2012, ii) 1,284 PEZA-registered exporters as of January 31, 2014, and iii) 2,295 registered exporters in PhilExport (SMEs are likely to be counted in this list). The latter two are largely mutually exclusive.

Moreover, between 2001 and 2011, labor value-added of exports (both direct and indirect) increased slower than total labor value-added (Figure 2.2). In fact, labor value-added of exports declined from 25 percent of total labor value-added in 1995 to 15 percent in 2011. This divergence occurred primarily between 2007 and 2011 when total labor value-added grew significantly but total labor value-added of exports stagnated. The slower growth in the labor content of exports relative to total production suggests that the export sector is creating less jobs, both direct and indirect, than the non-export sector, or that the returns per labor unit may be growing faster in the non-export sector.

Figure 2.1. Philippine value of exports grew much slower compared to its neighbors.

Source: WDI

Figure 2.2. Labor value-added of exports is also growing much slower than total labor value-added of the economy.



Source: WB staff calculations based on the World Bank dataset on the labor content of exports (LACEX).

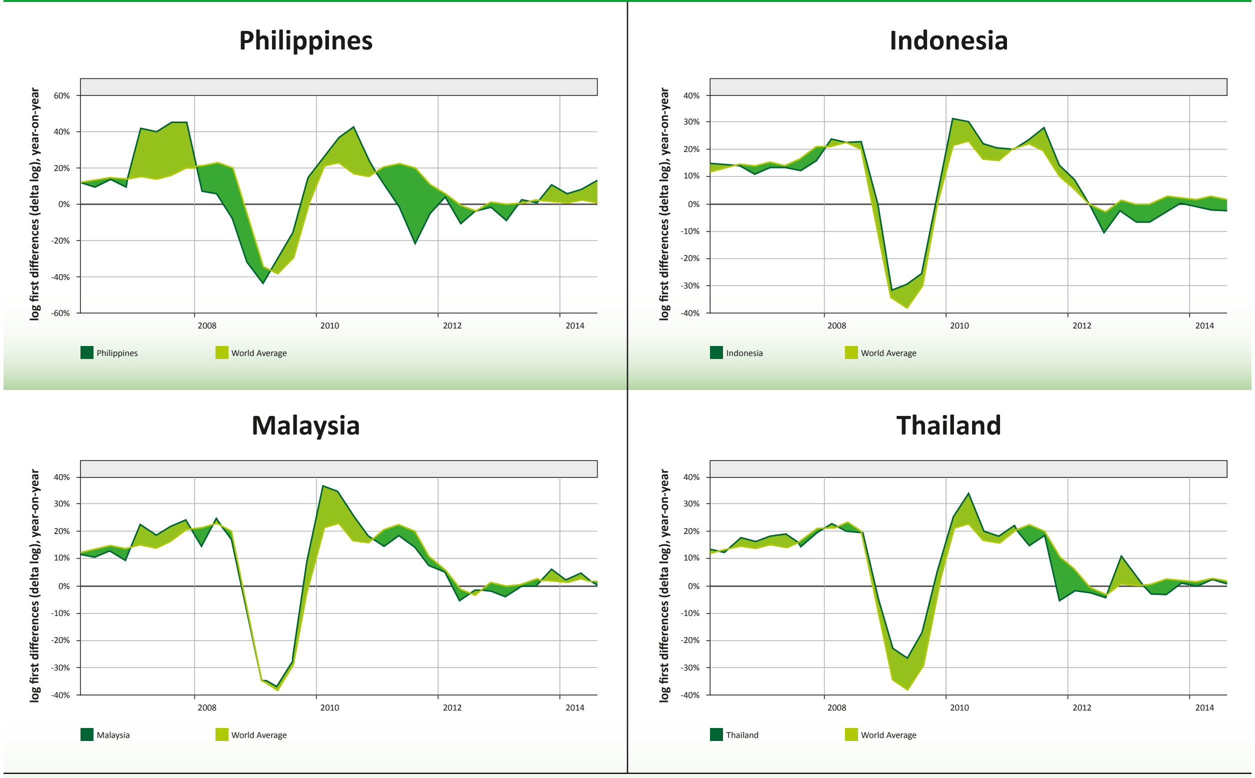
4. **Several reasons are behind the country's subpar growth of exports.** These include i) rising global competition, ii) declining growth of its key export products, particularly electronics, iii) a strong real exchange rate, and iv) high bilateral trade costs, in particular, high export transaction costs. This special focus discusses high export transaction costs, which affects SMEs the most. Aside from high domestic export transaction costs, other bilateral trade costs also affects SMEs and are discussed in Annex 2.1.

5. **The Philippines has higher export transaction costs relative to its neighbors.** In the 2015 Doing Business Report,[127] the Philippines' overall performance in trading across borders is generally poorer compared to Indonesia, Malaysia, Thailand, and Vietnam. Even though it ranks ahead of Indonesia and Vietnam in terms of processing time, it ranks last among neighboring countries in terms of number of documents required and more so in the cost to export (Table 2.1). To export a 20-foot container, companies operating outside the Philippine Economic Zone

[127] See World Bank Doing Business 2015. This is available at http://www.doingbusiness.org/reports/global-reports/doing-business-2015.

Authority (PEZA) need to prepare six documents, wait for 15 days (including two days of domestic transportation and handling), and pay around USD 755 (PHP 34,000) (including domestic logistics costs).

Figure 2.3. Philippine export growth alternated from strong to weak, thereby affecting its global market share. In contrast, neighboring countries experienced lesser volatility.



Note: Percentage point difference is equal to country growth minus global growth. The shaded areas represent the gain (green) or loss (red) of market share in percentage points (i.e., the difference between country and global growth).
Source: World Bank measuring export competitiveness database

Table 2.1. Cross-country comparison of exporting procedures

Country	Documents Needed to export (number)	Time to export (days)	Cost to export* (USD per container)
Singapore	3	6	460
Malaysia	4	11	525
Indonesia	4	17	572
Hong Kong	3	6	590
Thailand	5	14	595
Vietnam	5	21	610
Philippines	**6**	**15**	**755**

Source: World Bank Doing Business 2015
Note: *Cost to export includes inland transportation and handling

6. **High export transaction costs affect SMEs the most.** Not only is de jure cost high, de facto cost is often higher. In practice, exporters often face longer processing time and have to pay grease money to stay in schedule.[128] Often, high transaction costs can dissuade SMEs from entering the market altogether. To help get around the tedious process, firms that still find it profitable to export employ customs brokers and/or freight forwarders. However, availing these services represents additional costs to exporters and are often beyond the financial capacity of small exporters. Given this, there is huge scope in simplifying export procedures to enhance participation of small firms, which would help create more and better jobs and make growth more inclusive.

7. **This special focus analyzes Philippine exporting procedures and costs for a typical non-PEZA small exporter (for goods shipped through sea), and recommends how these procedures can be further simplified.** It begins by giving an overview of the *de jure* export procedures and costs. This is followed by an analysis of *de facto* costs based on survey results, and ends by suggesting some recommendations to reduce export transaction costs.

Export procedures and de jure cost[129]

8. **For a first time non-PEZA exporter, exporting goods involves eight general steps consisting of both manual and automated processes.**[130] These are: i) accreditation with the government or with the exporter confederation, ii) system registration with the Bureau of Customs (BOC) (the first two steps apply only to first time exporters), iii) submission of export declaration (ED) form and supporting documents to the BOC, iv) application for export commodity clearance for regulated products, v) document processing by BOC and issuance of the authority to load (AL), vi) payment of wharfage and arrastre charges,[131] vii) inspection of regulated cargo by BOC, and viii) application for certificate of origin and/or certificate of shipment, if needed (see Figure 2.4 for a summary flowchart). While efforts are being made to automate each step of the export process, several steps still involve a physical or manual process.

9. **For a first time exporter, the first step is to secure an exporter accreditation either from government agencies or the Philippine Exporters Confederation (PhilExport).** Government agencies that grant accreditation include the Board of Investments (BOI), various

[128] Examples of grease money are those paid to hasten processing time, minimize intentional delays, and prevent physical inspection of cargo.
[129] The sources for the de jure export procedures include the Export Development Council survey on export cost, the Bureau of Customs, PhilExport, Philippine Ports Authority, and Doing Business 2015.
[130] In contrast, PEZA exporters typically go through a much simplified export procedure. They deal mainly with PEZA rather than the Bureau of Customs. Once their electronically-filed export declaration is approved, they can proceed with the shipping.
[131] Wharfage is charged for the use of port facilities while arrastre is charged for cargo handling.

investment promotion agencies (IPA),[132] and the Export Marketing Bureau (EMB) of the Department of Trade and Industry (DTI). Firms that are not registered with a particular government agency can get accreditation from PhilExport. Accreditation from government agencies is free of charge. However, accreditation from PhilExport costs PHP 4,000 annually for member companies and PHP 5,000 for non-member companies. PhilExport offers a PHP 3,000 discounted price for *barangay* micro business enterprises.[133] This step involves physical submission of forms and payment of fees while registration is approved online with a subsequent confirmation receipt sent via email.

10. **The second step for first time exporters is to register with the client profile registration system (CPRS) of the electronic to mobile system (E2M) of the BOC.** This is done electronically through any of the accredited value-added service providers (VASP).[134] This step is free of charge. Once an exporter has an accreditation and has registered in CPRS, it does not have to redo the first two steps in future transactions, unless filing for an annual renewal of PhilExport accreditation.

11. **The third step is to file an ED form, which is also done electronically in E2M via a VASP.** Registered exporters can lodge their EDs into E2M through the VASP they registered with. De jure costs include the VASP fee of PHP 45 per ED, documentary stamp tax (DST) of PHP 115, and bank charge of PHP 300, for a total of PHP 460.[135] De jure processing time is four minutes. Payment for lodging an ED is automatically debited from the registered bank account of the exporter.

12. **The fourth step is to acquire an export commodity clearance (ECC) for regulated products.** This step only applies to goods which are regulated such as copper concentrates, live animals, shells, and plants.[136] An exporter of regulated goods needs to acquire an ECC from the respective government agency regulating the specific good. These agencies may charge a fee for the ECC depending on the type of good. Fees may be charged on a fixed cost per transaction or weight basis, or a combination of both. Fees are paid manually at the cashier of the concerned regulating agency.

[132] The IPAs include i) Subic Bay Metropolitan Authority, ii) Clark Development Corporation, iii) Poro Point Management Corporation, iv) Cagayan Economic Zone Authority, v) Aurora Pacific Economic Zone and Freeport Authority, and vi) Authority of the Freeport Area of Bataan.

[133] Under RA 9178, *barangay* micro business enterprises are defined as any business entity or enterprise engaged in the production, processing or manufacturing of products or commodities, including agro-processing, trading and services, whose total assets including those arising from loans but exclusive of the land on which the particular business entity's office, plant and equipment are situated, shall not be more than PHP 3 Million.

[134] The three accredited value-added service providers (VASP) are Cargo Data Exchange Center, e-Konek Pilipinas, and InterCommerce Network Services. VASPs handle BOC's client-facing ICT processes, such as inputting export declarations into the system.

[135] Bank charge is necessary since the documentary stamp tax is paid via electronic fund transfer.

[136] A list of all prohibited and regulated products for export can be found in http://www.dti.gov.ph/emb/index.php/exporting-essentials-2/list-of-prohibited-and-regulated-products.

13. **The fifth step is document processing by the BOC and the issuance of the AL.** Once the ED is approved, the exporter must submit a printed copy of the ED together with supporting documents to the BOC Export Division for processing and release of AL. This step is free of charge. De jure processing time usually takes 10 minutes for green lane exports if all documentary requirements are complete while red lane exports usually take at least a day. The clearance of the ED and issuance of the AL are usually done manually.

14. **The sixth step is payment of wharfage and arrastre fees.** The fees are set by the Philippine Ports Authority (PPA). Wharfage fees are paid manually to PPA collecting officers. For non-containerized cargo, the fee is PHP 20.55 per metric ton or PHP 17.08 per cubic meter, whichever is higher. For containerized cargo, it is charged per container and is based on the size of the container: PHP 290.86 for 20 footers, PHP 369.54 for 35 footers, PHP 437.98 for 40 footers, and PHP 513.24 for 45 footers. Arrastre fees are paid manually at the port operator's cashier. The charges for a full container load (FCL) are also based on the size of the container: PHP 3,408.16 for 20 footers, and PHP 7,827.68 for 40 and 45 footers. All charges are inclusive of the 12 percent value-added tax.

15. **The seventh step is submission of the ED and AL to concerned BOC divisions and subsequent cargo inspection.** This step is free of charge and takes about a day. If cargo is containerized, the exporter submits the documents to the Customs Container Control Division (CCCD), which verifies the lodged ED against the submitted ED and supervises cargo loading. If cargo is non-containerized, the exporter deals with the Piers and Inspection Division. EDs of exports tagged as green are automatically approved and cargo does not undergo inspection. Those tagged as yellow go through document check, while those tagged as red undergo physical inspection. According to Portcalls, around 70, 20, and 10 percent are tagged as green, yellow, and red, respectively.[137] Currently, as provided by Executive Order 230, only exporters in the top 1,000 corporations are qualified to take advantage of the green lane.[138]

16. **The eighth and final step is securing a certificate of origin and/or certificate of shipment from BOC.[139]** This step is only followed if required by the importing country. An exporter submits a written request and supporting documents and pays a documentary stamp tax of PHP 115 for each requested document. According to BOC, the application for the certificate of origin takes five days, two hours, and 25 minutes. The application for the certificate of shipment takes one day and 14 minutes. As a response to the ASEAN integration, the BOC has begun to automate the process of filing for a certificate of origin and is currently under pilot testing.

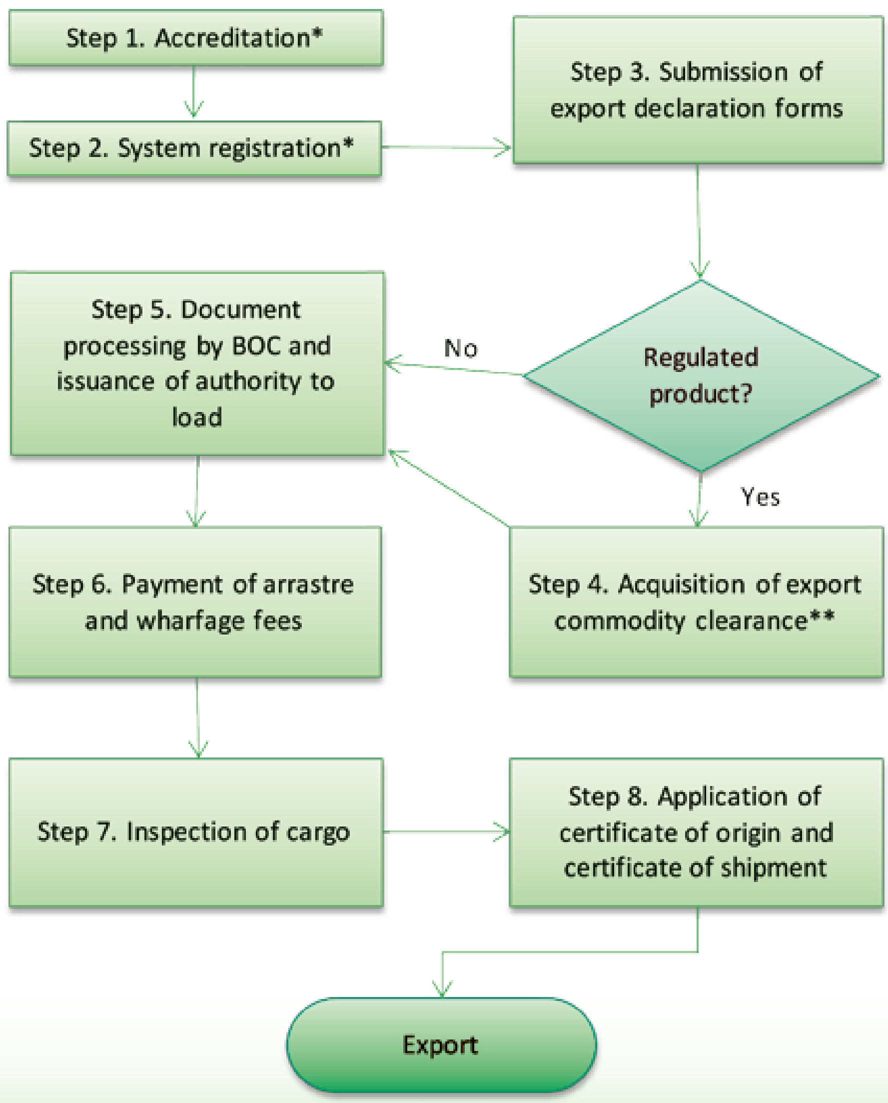
[137] Source: http://www.portcalls.com/ph-customs-activates-green-lane-for-exports.

[138] Under Executive Order 230, "Authorizing the Establishment and Maintenance of a 'Super Green Lane Facility' at the Bureau of Customs," only the top 1,000 corporations in the country are qualified for the SGL program.

[139] The certificate of origin is a document that officially states that the exported goods are originating or manufactured in the said country of origin. This document is usually needed to claim benefits under free trade agreements. The certificate of shipment contains the nature of the shipment and is usually used to declare whether a shipment represents a full or partial shipment when it reaches the country of destination.

17. **To minimize transaction cost, exporters often use the services of customs brokers or freight forwarders, who usually charge based on the value of the goods.** Customs brokers can handle most exporting steps. Large exporters usually deal directly with freight forwarders which employ their own customs brokers and provide additional logistics support.

Figure 2.4. Summary of export procedures



*Applies only for a first time exporter, as this is done only once.
**Applicable only for regulated products.

De facto cost of exporting

18. **In practice, exporters say that they pay more than the de jure cost to speed up the process.** In 2014, the Export Development Council (EDC) conducted a survey on the cost of exporting (see Box 2.1 for a background of the survey). The survey finds that while corruption is minimal, exporters have to pay grease money to facilitate faster transactions, especially if the delay can lead to offloading of cargo or missing a shipment schedule (see Table 2.2 for a summary of the various costs for exporting a 20-foot container). As prescribed, it takes anywhere from seven days and 28 minutes to eight days, two hours, and 53 minutes to fulfill all the export requirements. However, in reality, respondents report that it takes anywhere from six days, three hours, and 30 minutes to seven days, eight hours, and 24 minutes. However, this shorter processing time comes at higher cost. *De jure* costs total PHP 4,389 while total *de facto* cost can go as high as PHP 4,833. These findings are corroborated by anecdotal evidence.

Box 2.1. The Export Development Council's (EDC) survey of export cost of compliance

In 2014, the EDC conducted a survey on export compliance costs. Its main objective was to determine whether exporters pay more than the legally-mandated fees and how long it really takes to export. The findings were intended to help policymakers lower the costs of export (both de jure and de facto), and standardize export costs and procedures across ports. The survey covered steps three to seven. It asked respondents on the actual duration and costs incurred (for both official and un-receipted), together with any comments they may have on each step.

The survey's 41 respondents had the following attributes: 38 of them were non-PEZA exporters that went through the manual or E2M route, 28 exported their products through the Manila International Container Terminal or the Port of Manila, 16 used brokers, while 20 used representatives (including their own staff).

The following observations are noteworthy:

· Only two respondents indicated that they went through the export procedure themselves. All others had representatives or used the services of a customs broker. This may suggest that small exporters were underrepresented in the survey.

· Respondents appear to be more concerned about cost rather than time given the higher response rate for cost (around 50 percent) compared to time (around 25 percent).

· Even though the survey results show substantial differences between *de jure* and *de facto* costs, only two respondents directly indicated that there were additional un-receipted costs.

19. **Steps one, two, and three de jure and de facto costs are generally similar, and registration is usually approved in a week, but actual time spent can be longer than expected.** In step 3, the de facto cost is usually PHP 460 as well, although the survey reported several

cases where exporters paid less (between PHP 445 to 485) to avoid paying the documentary stamp tax. In contrast, the de jure processing time of four minutes is not typically followed. Processing time typically ranges between three and 20 minutes, but one exporter reported that it took him one day to complete the step. The common problem cited by respondents is difficulty logging into the system, especially during peak hours.[140]

20. **In step 5, although free of charge, informal fees are allegedly paid to speed up document processing.** Based on the survey, a number of respondents mentioned that they pay PHP 70 to PHP 175 per document. Other respondents claim to pay as high as PHP 500. However, BOC maintains that there are no such informal fees. Though small in value, these could sum up to large amounts over repeated transactions. Per the survey, the actual time needed to complete this process ranges from five minutes to two hours.

21. **In step 6, port officials allegedly allow exporters to pay lower fees if an official receipt is not issued.** Some respondents pay a reduced wharfage fee of PHP 150 per FCL for 20 footers and PHP 200 for 40 footers if an official receipt is not issued. Although the difference between formal and informal fees is relatively small at around PHP 100 to 200, this still represents a substantial loss in government revenues if the practice is widespread.[141] Furthermore, some exporters claim that port personnel ask for grease money to processing. The average time needed to complete this step ranges from 30 minutes to three hours.

22. **In step 7, additional un-receipted costs are also observed in cargo inspection.** This step does not involve de jure fees. However, survey respondents say that total informal fees paid range from PHP 300 to 425 per container. The de facto time needed to complete this step ranges from 13 minutes to two hours and 45 minutes.

[140] This is also supported by several anecdotal evidences. For instance, Mindanao exporters find the new E2M automated export declaration system expensive and time consuming. They often find themselves repeating the filing processing two to three times for each export transaction because export declarations use estimates of volume and weight, and final verification only occurs immediately prior to shipment. Discrepancies between actual and estimated volume and weight require a new declaration and the whole filing process needs to be repeated. Each filing would cost an exporter PHP 500 to 600 for document processing plus a PHP 45 IT fee.

[141] For instance, if 20 percent of all exporters choose to pay the informal fees for each container, then this will cost the government at least PHP 80 million annually. This assumes container traffic of 1.5 million TEU.

Table 2.2 Indicative de jure and de facto costs of exporting a 20-foot container using one transaction (for regular steps)

Procedure	Cost (in PHP) *De jure*	Cost (in PHP) *De facto*	Time *De jure*	Time *De facto*
3. Submission of export declaration	460	445 to 485	4 minutes	3 minutes to 1 day
5. Document processing and issuance of authority to load	0	70 to 500	10 minutes to 1 day	5 minutes to 2 hours
6. Payment of wharfage and arrastre	3,699[142]	3,193	..	30 minutes to 3 hours
7. Inspection of cargo	0	300 to 425	1 day	13 minutes to 2 hours and 45 minutes
8a. Application for certificate of origin	115	115	Initial application: 5 days, 2 hours, and 8 minutes Processing: 17 minutes	Same as de jure
8b. Application for certificate of shipment	115	115	1 day and 14 minutes	Same as de jure
Total	**4,389**	**4,238 to 4,833**	**7 days and 54 minutes to 8 days, 2 hours, and 53 minutes**	**6 days, 3 hours, and 30 minutes to 7 days, 8 hours, and 24 minutes**

Sources: Export Development Council survey, Bureau of Customs, PhilExport, Philippine Ports Authority, and Doing Business 2015.
Note: .. means no data available.

Recommendations

23. **The potential of Philippine exports can be harnessed by reducing the export transaction costs.** With a dynamic private sector, exporters, in particular, small exporters can contribute and benefit more from higher growth. Realizing this requires a number of reforms to reduce export transaction costs. Some of these recommendations are already in progress, and would complement reforms in reducing non-tariff barriers, enhancing logistics support, and improving productivity of key export products.

[142] This is computed by adding the prescribed wharfage and arrastre fees for 20 footers, which are PHP 290.86 and 3,408.16, respectively.

24. **First, the government needs to enhance and implement the National Single Window (NSW) automated system.** In 2007, the Philippine government started using the NSW, an internet-based system that helps traders access information and submit documents through a single entry point to fulfil all import, export, and transit-related regulatory requirements. However, implementation is lacking, especially for small exporters. In addition, further enhancement of the NSW should facilitate multiple clearances by concerned government agencies (which number around 30) via a single gateway/website, as well as the full integration of the system with the BOC's declaration processing system. The government can also explore extending the risk management functionality in the BOC IT system to other agencies.[143]

25. **Second, information on all export procedures, processes, fees, rules, and regulations as well as agreed performance standards needs to be clear, monitored, and published in a single website.** As of publication, the BOC website does not appear to have detailed information on export procedures.[144] Without these information, monitoring the actual cost of exporting will be difficult. Addressing this requires online publication of detailed procedures and the corresponding cost and time standards, as well as regular monitoring of actual performance. Moreover, creating a simple, user-friendly trade portal similar to what has been set-up in Laos, and now being rolled out in Cambodia and Myanmar, would benefit exporters.

26. **Finally, redundant steps need to be eliminated.** For instance, exporters file an ED online but have to submit a printed copy of the ED to various BOC divisions. Instead of having the exporter submit these documents, the BOC's system needs to be enhanced so that any BOC division will have access to the EDs once they are filed online. This will help reduce transaction costs as well as opportunities for corrupt practices.

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[143] As the NSW is not yet fully functional, some functionalities that would normally be expected to be managed by the NSW are currently handled by VASPs. However, in a single window environment, information should be able to reach all parties without the need for a private intermediary. When this happens, VASPs can adapt and provide complementary functions such as providing value added services to the private sector or IT support to individual industries.

[144] The DTI's Export Marketing Bureau has a general "Guide to Philippine exporting procedures" (http://www.dti.gov.ph/emb/index.php/exporting-essentials-2/export-procedures). However, like the BOC website, this guide does not contain any cost or time standards.

Selected references

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Annex 2.1. Lowering bilateral trade costs to raise exports

1. **Bilateral trade costs are important factors that determine a country's competitiveness.** This Annex benchmarks the Philippines in terms of bilateral trade costs, including logistics and connectivity, and discusses reforms the government has undertaken to reduce them.

2. **The Philippines has high bilateral trade costs.**[145] As an archipelago with no immediate neighbors, slightly higher trade costs are to be expected when compared to countries with land borders. Yet trade costs between the Philippines and its immediate maritime neighbors (i.e., Vietnam, Malaysia, and Indonesia) are generally higher compared to trade costs between these countries (Annex Table 2.1). For instance, the Philippines' trade costs with Indonesia are almost twice the trade costs between Indonesia and Malaysia. Trade costs between Vietnam and Malaysia are the lowest among the six pairings.

3. **In particular, trade costs with China are high**. China is the country's third largest export market with 14 percent share in total exports in 2014. Compared with its closest ASEAN neighbors, only Indonesia (which is farther from China) has trade costs with China that are comparable to the Philippines, while costs for other countries are 20 to 40 percent lower. In general, the Philippines is a more costly partner. Using Australia as a baseline, the Philippines is the most costly (i.e., Philippine value of 136 compared to 107 for Indonesia, 97 for Vietnam, and 75 for Malaysia).

Annex Table 2.1. Bilateral trade costs in the region: Total trade in 2010

	Philippines	Indonesia	Malaysia	Vietnam	Thailand	China	Australia
Philippines		130	86	90	84	103	136
Indonesia	130		68	97	89	104	107
Malaysia	86	68		62	47	62	75
Vietnam	90	97	62		72	72	97
Thailand	84	89	47	72		81	74
China	103	104	62	72	82		91
Australia	136	107	75	97	74	91	

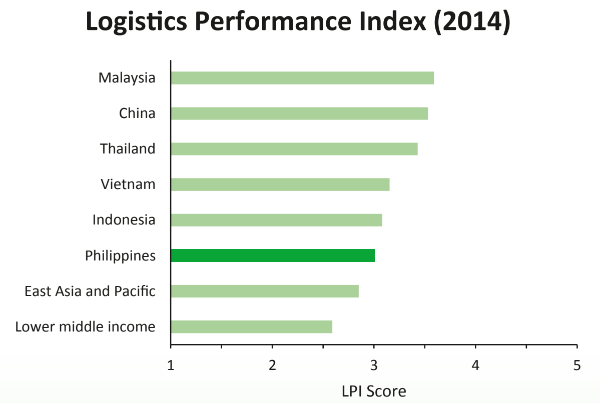
Source: World Bank trade costs database
Note: Trade costs are percentage ad valorem

[145] Bilateral trade costs capture the added costs that producers face when selling their products internationally and is driven by the distance between the partners, logistics facilities, existence of regular maritime and air transport services, customs and other procedures, tariffs, quotas, standards, and other non-tariff restrictions. Higher bilateral trade costs result in smaller bilateral trade flows.

4. **The logistics performance index (LPI)[146] also implies high trade costs for the Philippines.** While caution must be exercised in interpreting small differences in LPI scores, data from 2014 suggest that the Philippines fares the worst on overall logistics performance compared to the major economies in the region (Annex Figure 2.1). More detailed dimensions of the LPI reveal that the country is weak on trade and transport-related infrastructure, which exacerbates the country's connectivity challenges.

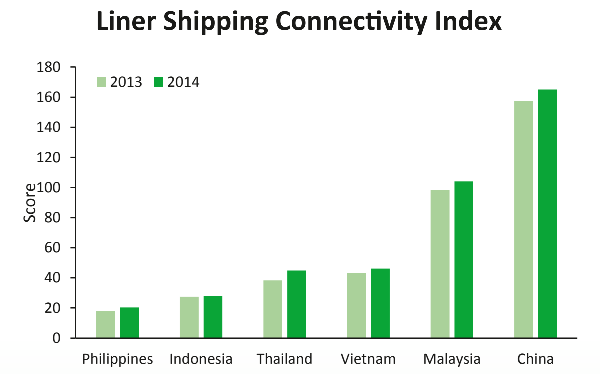
5. **The Philippines is also affected by low connectivity.** Data from the liner shipping connectivity index (LSCI)[147] shows that the Philippines' score of 20.3 is less than half of Vietnam or Thailand, one fifth of Malaysia, and only one ninth of China (Annex Figure 2.2). The poor performance is largely explained by lack of diversity of connections and low volume. For example, in 2014, deadweight tonnage (dwt) handled in Malaysia was 16.8 million, 15.5 million in Indonesia, 6.8 million in Thailand, but only 3 million in the Philippines.[148]

Annex Figure 2.1. Among major economies in the region, the Philippines has the lowest performance in logistics…



Source: World Bank

Annex Figure 2.2. ...exacerbating the country's poor connectivity



Source: World Bank

6. **The government recognizes the issue of high trade costs and has taken steps to lower them.** In 2014, the Maritime Industry Authority (MARINA) lowered entry barriers and streamlined the licensing processes for vessels, allowing shipping companies to get their licenses in nine days compared to 52 days previously, leading to savings of up to PHP 30 million for large vessels. In July 2015, congress passed the "Foreign Co-loading Act" that allowed foreign vessels to transship imported and exported goods across multiple ports in the Philippines. In addition, the Philippine Ports Authority (PPA) initiated a public-private partnership (PPP) project to modernize the Davao Sasa Port. Four more ports will follow: Iloilo,

[146] The logistics performance index (LPI), developed by the World Bank, is based on a survey of logistics professionals and scores countries on several dimensions, including trade and transport related infrastructure, logistics services, and customs procedures.

[147] The LSCI aggregates information such as volumes of containers for the economy relative to its size, number of shipping lines, and maximum boat size serving the country.

[148] See UNCTAD, Review of Maritime Transport (2014).

Zamboanga, General Santos, and Cagayan de Oro. In aviation, the Mactan-Cebu International Airport PPP project was awarded in June 2015. Further PPPs are planned for other regional airports such as Davao, Laguindingan, Iloilo, and Bacolod. Finally, since 2013, the Department of Agriculture has implemented a risk management program for quarantine clearances to facilitate the movement of low risk agricultural products. Efficient and timely implementation of these projects will be key to lowering trade costs and thereby raising exports.

DATA APPENDIX

Table A.1. Key economic indicators (2013 to 2017)

	2013	2014	2015	2016	2017
	Actual		Projections		
Growth and inflation	(in percent of GDP, unless otherwise indicated)				
Gross domestic product (percent change)	7.1	6.1	5.8	6.4	6.2
Inflation (period average)	3.0	4.1	2.0	3.0	3.5
Savings and investment					
Gross national savings	24.7	24.6	25.2	26.1	26.6
Gross domestic investment	20.5	20.8	21.7	23.0	23.7
Public sector					
National government balance (GFS basis)1/	-1.5	-0.7	-1.2	-2.1	-2.1
National government balance (gov't definition)	-1.4	-0.6	-1.1	-2.0	-2.0
Total revenue (government definition)	14.9	15.1	15.3	15.5	15.8
Tax revenue	13.3	13.6	13.8	14.0	14.4
Total spending (government definition)	16.3	15.7	16.4	17.5	17.8
National government debt	49.2	45.4	43.6	41.7	39.8
Balance of payments					
Merchandise exports (percent change)	-3.6	7.3	2.0	6.5	8.5
Merchandise imports (percent change)	-3.1	2.2	2.5	7.5	8.0
Remittances (percent change of USD remittance)	7.4	5.9	5.5	5.5	5.4
Current account balance	4.2	3.8	3.5	3.1	2.9
Foreign direct investment (billions of dollars)	3.9	6.2	3.0	3.5	4.0
Portfolio Investment (billions of dollars)	0.4	-0.3	0.5	1.0	2.0
International reserves					
Gross official reserves2/ (billions of dollars)	83.2	79.5	81.5	82.7	84.0
Gross official reserves (months of imports)3/	11.5	10.2	10.0	9.5	8.9
External debt4/	28.0	27.5	26.8	26.0	25.5

Sources: Government of the Philippines for historical and World Bank for projections.
1/ Excludes privatization receipts and includes CB-BOL restructuring revenues and expenditures (in accordance with GFSM)
2/ Includes gold
3/ Defined as the total of goods and merchandise exports
4/ World Bank definition

Table A.2. National government cash accounts (GFS basis) (2013 to 2015)

	2013	2014	2015
	Actual		Budget
Revenue and grant	14.9	15.1	16.5
Tax revenue	13.3	13.6	15.5
Net income and profits	6.2	6.2	7.3
Excise tax	1.0	1.1	1.1
Sales taxes and licenses	2.7	2.7	3.2
Others	0.7	0.6	1.0
Collection from Customs	2.6	2.9	2.9
Nontax revenue 1/	1.6	1.5	1.0
Grant	0.0	0.0	0.0
Total expenditure	16.3	15.7	18.5
Current expenditures	13.3	12.8	13.9
Personnel services	5.0	4.8	5.4
MOOE	2.5	2.4	3.1
Allotment to LGUs 2/	2.1	2.2	2.2
Subsidies	0.6	0.6	0.4
Tax expenditures	0.2	0.2	0.2
Interest payment	2.9	2.5	2.6
Capital outlays	2.9	2.8	4.4
Net lending	0.1	0.1	0.2
Balance (GFS definition)	-1.5	-0.7	-2.1
Balance (GOP definition)	-1.4	-0.6	-2.0
Primary Balance (GFS)	1.4	1.9	0.5
Memorandum items			
Privatization receipts (PHP billions)	2.9	1.9	2.0
Nominal GDP (PHP trillion)	11.5	12.6	13.9

Sources: Department of Finance, Bureau of Treasury, and Department of Budget and Management

1/ Excludes privatization receipts (these are treated as financing items in accordance with GFSM).

2/ Allocation to local government units (LGUs) excludes capital transfers, which are included in capital outlays.

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