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Philippines: Private Sector Development
Challenges and Possible Ways to Go

Aziz Haydarov

No. 5 | August 2011

Asian Development Bank

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This working paper was prepared by Aziz Haydarov, country economist at the Philippines Country Office of the Asian Development Bank (ADB). The author thanks reviewers from ADB, whose feedback on earlier drafts helped improve the paper. All possible shortcomings in substance and form are the exclusive responsibility of the author. The analyses, views, and opinions presented in the paper are those of the author and should not be represented as those of ADB.

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CURRENCY EQUIVALENTS

(as of 30 June 2011)

Currency Unit	–	peso (P)
P1.00	=	$0.023
$1.00	=	P43.405

ABBREVIATIONS

ADB	–	Asian Development Bank
ASEAN	–	Association of Southeast Asian Nations
BOT	–	build–operate–transfer
BPO	–	business process outsourcing
BSP	–	Bangko Sentral ng Pilipinas (Central Bank of the Philippines)
CAPE	–	country assistance program evaluation
CPS	–	country partnership strategy
FDI	–	foreign direct investment
GDP	–	gross domestic product
LGU	–	local government unit
NEDA	–	National Economic Development Authority
PEZA	–	Philippine Economic Zone Authority
PPP	–	public–private partnership
PSOD	–	Private Sector Operations Department
PSD	–	private sector development
RORO	–	roll on and roll off
SDA	–	special deposit account
SMEs	–	small and medium-sized enterprises

NOTE

In this report, "$" refers to US dollars.

EXECUTIVE SUMMARY

This paper's objective is to inform the next Philippines country partnership strategy, 2010–2016 of the Asian Development Bank (ADB), given the strategic focus on private sector development (PSD) and private sector operations as a major driver of change under Strategy 2020. The paper builds on the ADB private sector assessment published in May 2005, whose analysis and recommendations have remained largely valid.

The private sector generates 93% of the gross domestic product (GDP) of the Philippines and employs more than 92% of the workforce. However, despite its significant role in the economy, the private sector's potential as a driver of inclusive economic growth remains largely unutilized. The Philippine economy suffers from underinvestment. Total investments have fallen from 21.2% of the GDP in 2000 to 14.0% in 2009 and are lower than those of Indonesia, Malaysia, Thailand, and Viet Nam. Domestic private investments have fallen from 14.0% in 2000 to just 10.5% of GDP in 2009. In 2010, due to improved investor confidence, total domestic investment increased to 15.6%, and private investments went up to 11.7% of GDP. These investment levels, however, still remain low by regional standards. Similarly, foreign direct investment (FDI) was lower than in neighboring countries.

The Philippines is characterized by a weak investment climate. Overall, competitiveness rankings and other investment climate diagnostics show that the major constraints to private sector growth continue to be inadequate infrastructure, corruption, cumbersome business procedures, poor tax and customs administration, barriers to market entry and competition, weak property rights, high energy costs, and lack of equitable and effective regulation and enforcement. These conditions persist despite repeated reform efforts.

However, there have been positive signs in the business process outsourcing (BPO) industry. Since 2004, the industry's revenues have grown so strongly that in 2009, the Philippines became the third-largest BPO destination in the world, with only India and the People's Republic of China ahead. Currently, the BPO industry employs about 544,000 people, of which 344,000 work at call centers. BPO is also a source of indirect employment for some 1.3 million people, and its share in the country's GDP is 4.8%.

Despite all odds, public–private partnerships (PPPs) remain a promising area in PSD.[1] However, following the Asian Financial Crisis in 1997/98, the pace of PPPs dropped dramatically and never fully recovered. From a peak of 15.5% of GDP in 1997, private infrastructure commitments have declined to an average of 2.1% in 2000–2009. The Philippines has had successful experience with PPPs in the power sector;[2] yet due to weak governance, successful private investment in other infrastructure sectors has been rather limited. There have been high-profile failures, most notably the build–operate–transfer (BOT) contract for the Ninoy Aquino International Airport's terminal III. Well-known, successful PPPs include the rehabilitate–operate–transfer arrangements for the North Luzon Expressway Project and the BOT contract for the Manila Water Company.

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1 Other sectors showing significant growth potential include a wide range of service-related industries, agribusiness and food processing, construction and property development, tourism, and electronics assembly.

2 Of the 103 PPP projects that reached financial closure in 1990–2009, 72 were in the energy sector. Of these, most were in power generation, which is less prone to the overall governance environment due to relative physical insulation of power-generation facilities and long-term power purchase agreements.

The new government has shown strong commitment to moving the PPP agenda forward, through, for example, reorganization of the BOT Center into the PPP Center, and revitalization of the Project Development Facility as the Project Development and Monitoring Facility to help implementing agencies structure, prepare, and competitively tender bankable PPP projects. In addition, the government is in the process of developing an interim scheme to provide access to long-term financing for PPP projects until a dedicated infrastructure finance facility can be established. The government presented its agenda to foster PPPs at an international PPP investment conference at which a list of 10 PPP projects for rollout in 2011 and a substantial number of projects for rollout over the medium term were presented.

Overall, the government's support to PSD has had three broad directions. First, microbusinesses and small and medium-sized enterprises (SMEs) have been supported through a range of dedicated programs, which have been mainstreamed into national development plans. In his State of the Nation Address of 26 July 2010, President Benigno Aquino III also focused on development of micro and SMEs. Support to micro and SMEs is one of 10 strategic support areas under the competitive industry and services sector theme of the Philippines Development Plan, 2011–2016, which sets the objective of generating 2 million jobs through micro and SME expansion by 2016 and increasing the micro and SME share in gross value added to 40.0% from the current level of 35.7%.

Second, PPPs have been fostered given the government's constraint to invest sufficiently in infrastructure itself. During the 1990s, the Philippines was a global leader among developing countries in implementing PPP infrastructure projects. It was one of the first developing countries with a BOT law and a dedicated BOT center. In his State of the Nation Address, President Aquino also indicated that PPPs are considered by the government to be the solution in funding immense infrastructure investment needs. The government intends to speed up development of PPP projects in transport (e.g., expressways), agriculture-related facilities (e.g., grain terminals, refrigeration facilities, road networks, and post-harvest facilities), railways, and education. In addition, according to the development plan, promotion of PPPs is a major government effort toward fostering a better business environment and improving productivity and efficiency under the more competitive industry and services sector theme.

Third, FDI has been facilitated with a focus on big projects, for which there has been a lack of domestic financial resources and know-how. The government's intention to streamline fiscal incentives was indicated by President Aquino in his State of the Nation Address; he mentioned that the government would reevaluate fiscal incentives to identify those that should be eliminated. Improvement of investment promotion areas is one of the 10 strategic support areas under the Philippine development plan's competitive industry and services sector themes with the objective of achieving, by 2016, some P3,800 billion in cumulative investments approved by government agencies dealing with investment facilitation and economic zones.

In this paper and on the basis of discussions with key stakeholders, PSD constraints in the Philippines are grouped under inefficient state systems and an inadequate business environment. The first group covers issues related to poor governance (including insufficient institutional and legal frameworks), which increases the risk of corruption. Within the second group, the inadequate infrastructure and insufficient SME access to finance are the most prominent factors affecting the environment in which businesses operate.

To address inefficient state processes, the Philippines should (i) adopt legislation on freedom of information; (ii) intensify implementation of anti-red tape legislation; (iii) institutionalize and capacitate the function of regulatory impact analyses; (iv) improve

coordination with local government units (LGUs) during preparation of investment projects, and streamline national legislation and the Local Government Code; (v) update labor legislation, and improve the minimum wage determination system; (vi) adopt and institutionalize an anti-monopoly framework; (vii) institutionalize the judiciary–business link, and streamline the mechanism for implementation of arbitration awards; (viii) reduce the number of business registration procedures, and fully operationalize the Philippines Business Registry; (ix) simplify taxation of small businesses (including considering exempting small businesses from income taxes during the first 3 years of operation); (x) operationalize financial rehabilitation and insolvency legislation; (xi) complete cadastral titling of land, and establish a central registry for land titles; and (xii) strengthen the National Competitiveness Council to become the main public–private mechanism for PSD policy coordination and consultation.

To address the inadequate business environment, the Philippines should (i) increase public investments in infrastructure to at least 5% of GDP; (ii) facilitate private investment commitment in infrastructure through PPPs to reach 4% of GDP through improving PPP policy, legal, and regulatory frameworks; streamlining the government's institutional setup and capacity to promote and implement PPP projects; strengthening systems and capacity to prepare bankable PPP projects; and making long-term financing and risk guarantee mechanisms for the PPP projects available; (iii) develop long-term integrated transport infrastructure master plans for Luzon, Mindanao, and Visayas; (iv) further strengthen roll-on and roll-off infrastructure; (v) consider gradually easing the country's cabotage restrictions; (vi) enhance SME access to finance through operationalization of the Central Credit Information Corporation as well as provision of guarantees for SME loans; (vii) consider establishing an agribusiness investment facility to facilitate synergy between small and large firms; (viii) develop a sustainable mechanism for providing the private sector, including SMEs, with research and development support to foster innovation and technology development; and (ix) consider setting up, with government funding, a venture capital fund to foster growth of innovation-oriented SMEs.

Overall, ADB support to PSD through supporting public sector projects in public sector management, finance, energy, and transport sectors has been successful. In 2007–2010, ADB's major support to investment climate-related reforms was through the Development Policy Support Program cluster, which helped lower transaction costs for business start-ups through supporting, on a programmatic basis, government efforts toward simplification of regulations, establishment of an enterprise registration system, and development of a handbook on good practices in enterprise registration by LGUs. While the 2008 country assistance program evaluation (CAPE) rated ADB public sector support in the finance and energy sectors *successful*, performance of the transport sector operations was assessed as *partly successful*. The major cause for this poor performance was slow progress in procurement and problems with land acquisition and resettlement. In 2006–2009, the SME Development Support Project provided dedicated support to PSD, which has been successful in improving SME access to finance.

Support through private sector operations has been relevant. From 1995 to 2009, there were 14 private sector operations approved for a total of $1,143 million. The number and amount of approved private sector transactions declined in 2001–2007, when only four projects materialized. The largest shares among the approved operations were in the finance (26%) and energy (46%) sectors. About $655 million or 57% of these operations were canceled due to financial problems of the companies as well as implementation and operational disputes between the project sponsors and the government. Despite being small in amount and number, the CAPE indicated that private sector operations in LGUs and housing finance proved complementary with the overall PSD-related work of ADB and were in line with the government

and ADB strategies. Private sector operations also supported privatization and rehabilitation of generation plants under the 2001 Electric Power Industry Reform Act, which contributed to the enhanced efficiency of the power sector. Another important example of private sector operation relevance is the financing of the North Luzon Expressway, which helped significantly reduce transport costs and time, as well as traffic congestion, in the northern provinces of Luzon.

Under the next country partnership strategy, the overall objective of ADB private sector support should be increased private sector investment, perhaps back to its 1990s level of 20% of GDP, through supporting reforms and projects aimed at lowering the cost of doing business. Investment operations should be aimed at physical, capital, and infrastructure enhancement and capacity development, especially in PPP-related areas. Necessary regulatory and institutional reforms at the central and local government levels could be supported through programmatic development policy operations. Support could be also provided to facilitate long-term financing for infrastructure projects via currency swaps and establishing a dedicated infrastructure financing facility. Technical assistance could support preparation and implementation of PSD-related reforms, in particular those on improving PPP rules and procedures to facilitate more entry of the private sector into PPP projects at the national and subnational levels. In parallel, the government's capacity must be improved to develop well-structured, bankable PPP projects. Further, the Philippines Country Office's capacity enhancement should be considered to ensure country-level coordination and implementation of the country partnership strategy's PSD agenda.

Private sector operations will continue to be responsive to the needs of the private sector and oriented by the priorities of the government. At the same time, the Private Sector Operations Department (PSOD) and the Southeast Asia Department (SERD) should closely collaborate and, if needed, suitably augment each other's operations to magnify the development impact of their support to the private and public sectors. There can be operational emphasis on the development of critical national and local infrastructure projects in (i) energy; (ii) water and sanitation; (iii) transport (including toll roads, ports, and mass transit systems); (iv) education and health; (v) infrastructure finance; and (vi) well-targeted, innovatively designed, and market-driven financing for micro and SMEs. Where appropriate, PSOD could provide technical assistance to facilitate infrastructure project development, address entry barriers, improve governance, and assist with capacity development. PSOD could also support clean energy projects through its investments in private equity funds operating in the Philippines. Special attention can be paid to supporting PPP opportunities across all operations in the Philippines, also through joint project and knowledge work with SERD.

I. INTRODUCTION

1. With a rapidly growing population as well as greater competition in the external environment, private sector development (PSD) in the Philippines is key to the country's overall development. The country strategy and program, 2005–2007 of the Asian Development Bank (ADB) focused ADB support to the Philippines on investment climate improvement, along with fiscal consolidation and accelerated Millennium Development Goal attainment (ADB 2005a). The country strategy and program was critically informed by a private sector assessment also published in 2005, and its analysis and recommendations have remained largely valid (ADB 2005e). In 2008, ADB adopted a long-term framework known as Strategy 2020, which also emphasizes PSD and private sector operations at the institutional level (ADB 2008c).[1] ADB is currently in the process of developing a new country partnership strategy (CPS), 2010–2016, for the Philippines, which will be aligned with the next Philippine Development Plan, 2011–2016 (GOP, NEDA 2011).

2. This paper aims to inform the preparation of the CPS given ADB's strategic focus on PSD and private sector operations as a major driver of change. This paper examines the PSD agenda of the new government, where, for example, support for public–private partnerships (PPPs) to improve the country's infrastructure is emphasized. The paper also looks into ways of fostering innovation, research, and development within the private sector.

3. This paper draws on consultations with PSD stakeholders (i.e., the private sector, academe, government, and development partners) that occurred throughout the country, as well as a private sector assessment conducted by Cayetano Paderanga of the University of the Philippines School of Economics in 2009–2010 (ADB forthcoming). The paper also benefits from various discussions with the private sector conducted during CPS consultations in Metro Manila and Cebu. Publications of development partners also informed this paper.[2]

4. The paper was prepared by Aziz Haydarov, country economist, Philippines Country Office. Valuable advice and comments were provided by the Southeast Asia Regional Department (SERD, including Kelly Bird, senior economist; R. Bolt, advisor; Claudia Buentjen, principal country specialist; Jon Lindborg, advisor for PPPs; and Joel Mangahas, country specialist); as well as the Private Sector Operations Department (PSOD, including Mary Abad, investment specialist; Elsie Louise Araneta, principal operations coordination specialist; and Christine Genalin C. Uy, investment specialist). Overall leadership and strategic advice were provided by Neeraj Jain, country director, Philippines Country Office.

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[1] The strategy sets ADB goals in fulfilling its vision of an Asia–Pacific region free of poverty by 2020. Its three critical strategic agendas are inclusive growth, environmentally sustainable growth, and regional integration. The strategy aims to promote such drivers of change as PSD, good governance, gender equity, knowledge solutions, and partnerships.

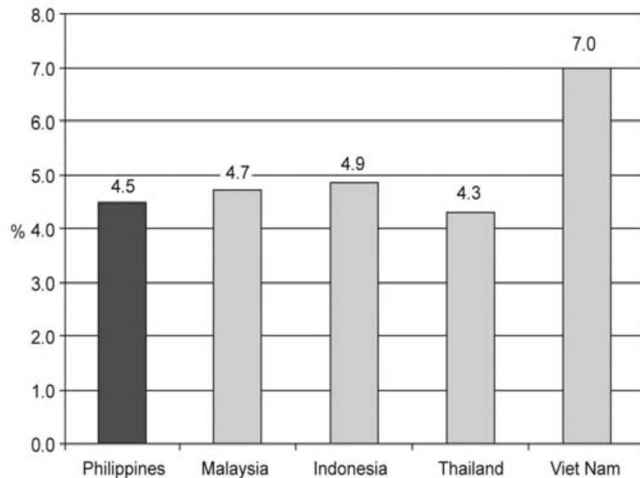
[2] Including Joint Foreign Chambers of the Philippines (2010), which was prepared with the support of the United States Agency for International Development, as well as a series of policy notes prepared by the World Bank in 2010.

II. MACROECONOMIC PERSPECTIVE

5. **Philippines economic growth has been jobless…** In 2000–2009, the economy in the Philippines grew on average by 4.5% annually, which was at par with the economic performance of its neighbors, except Viet Nam, which grew by 7.0% in that period (Figure 1). In the first half of 2010, growth in the Philippines was at an impressive 7.9%, largely due to the interplay of a strong rebound in exports, the government's fiscal stimulus measures, and election-related expenditures. However, this growth has not translated into more jobs. Unemployment in the Philippines has been stubbornly high in comparison to the country's neighbors, being 7.5%–8.0% since 2006 (Figure 2).

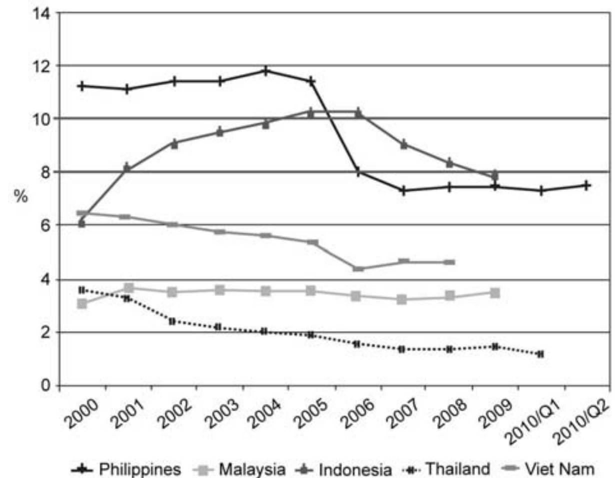
6. This poor growth–unemployment performance does not seem to have been caused by labor force growth, which in 2000–2008 grew on average by 2.3% annually, similar to the rates of Indonesia (1.9%), Malaysia (2.4%), and Viet Nam (2.4%).[3] It also seems not to be the result of the inflation–unemployment trade-off. In 2000–2009, consumer prices rose on average by 5.2% annually in the Philippines, higher than in Malaysia (2.2%) and Thailand (2.4%), and slightly lower than in Viet Nam (6.5%). All of these countries display, however, significantly lower unemployment rates than the Philippines.[4]

Figure 1: Average Annual Growth in Selected Southeast Asian Economies, 2000–2009



Source: BSP.

Figure 2: Unemployment in Selected Southeast Asian Economies, 2000–2009



Q = quarter.
Note: For the Philippines unemployment time series, the structural break in 2006 was due to the methodology change.
Source: BSP.

7. **… due to underperformance of the private sector, despite its dominant role in the economy.** The private sector generates 93% of the gross domestic product (GDP) of the

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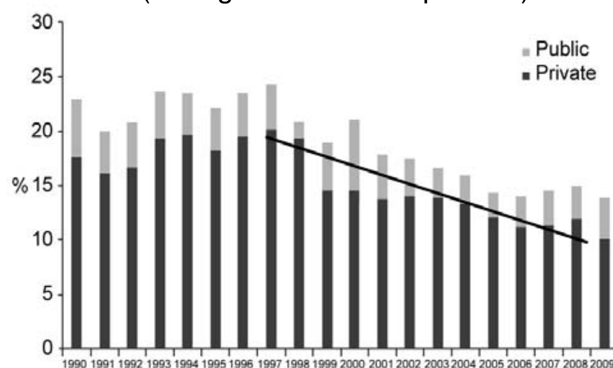
[3] The only country with a significantly lower labor force growth—an average of 1.5% annually—is Thailand.

[4] The highest average annual inflation in 2000–2009 was in Indonesia at 8.4%, where unemployment was, contrary to expectations, rising in 2000–2006, but then went down to almost the same level as in the Philippines. According to Aldaba and Hermoso (2009), the Philippines needs to generate at least 1.2–2.0 million jobs annually to achieve unemployment rates of 2%–6%. If a 10% reduction in underemployment is added as an objective, then an additional 7.3 million good-quality jobs should be created (p. 6).

Philippines, employs 92% of the workforce, and makes 85% of investments. However, despite this significant role in the economy, the private sector performed below its potential, as capacity utilization of firms is, on average, 77% (World Bank and IFC 2009). This is reconfirmed for the manufacturing industry, whose average capacity utilization, based on monthly integrated surveys of selected industries conducted by the National Statistics Office, has never gone beyond 85% since 2005, despite record-high growth of 7.1% in 2007.

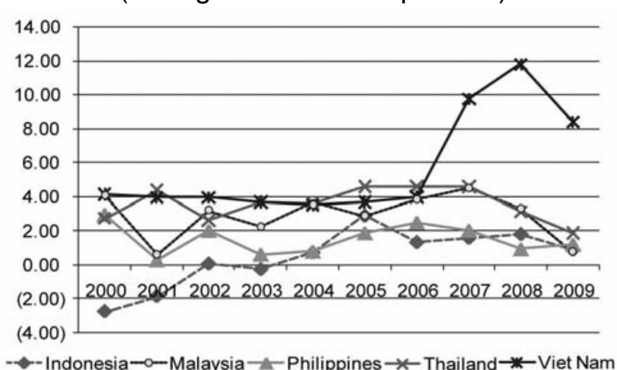
8. **The underperformance of the Philippine private sector can be seen more clearly from its poor private investment dynamics.** The Philippine economy suffers from underinvestment (Park et al. 2009). Total domestic public and private investments have fallen from 20%–25% of GDP in the mid-1990s to 14% in 2009, lower than the rates of Indonesia, Malaysia, Thailand, and Viet Nam. Private investments have fallen from 14.0% in 2000 to just 10.5% of GDP in 2009 (Figure 3). In 2010, due to improved investor confidence, total domestic investment increased to 15.6%, and private investments went up to 11.7% of GDP.[5] These investment levels, however, still remain low in regional comparisons.[6] The country has not been perceived as an attractive investment destination by foreign businesses, either. Foreign direct investment (FDI) as a percentage of the GDP was lower in 2000–2009 than in the neighboring countries (Figure 4). On average in 2000–2009, the FDI level in the Philippines was 1.5% of GDP, while that of Malaysia was 2.9%, Thailand was 3.6%, and Viet Nam was 5.7%.

Figure 3: Public and Private Investment in the Philippines
(% of gross domestic product)



Source: Joint Foreign Chambers of the Philippines (2010).

Figure 4: Net Foreign Direct Investment in Selected Southeast Asian Countries
(% of gross domestic product)

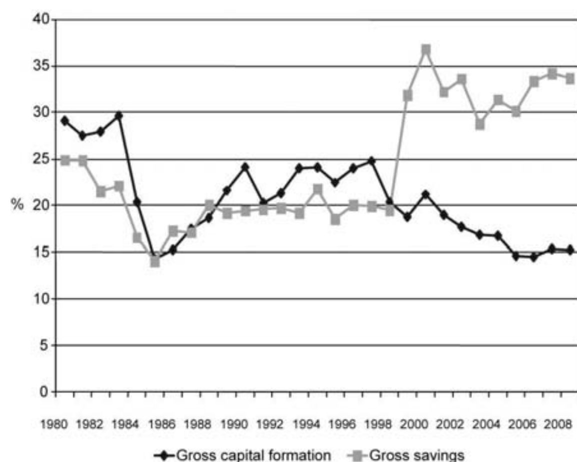


Source: BSP.

9. **Due to workers' remittances from abroad, savings were abundant…** Since 2000, savings have, on average, exceeded investments by 16% of GDP (Figure 5). This was the direct effect of the rocketing inflow of remittances from overseas Filipino workers, which grew from 9.0% of GDP in 2000 to almost 14.0% in 2005, and then slightly decreased to about 11.2% in 2008 (Figure 6). In terms of remittances, the Philippines has by far outpaced its neighbors, except for Viet Nam, which, on average, received remittances of about 7.4% of GDP in 2001–2008.

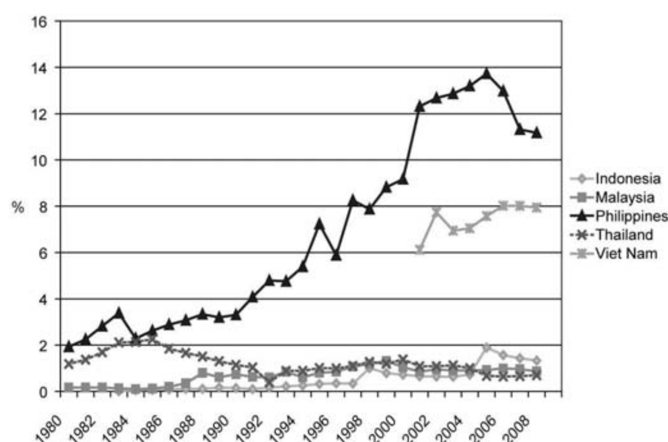
5 Private investment is derived at by subtracting public construction from gross fixed capital formation.
6 In 2010, the average investment–GDP ratio for Indonesia, Malaysia, and Thailand was 26.6% (Asian Development Outlook Database).

Figure 5: Savings and Investments in the Philippines
(% of gross domestic product)



Source: World Development Indicators.

Figure 6: Workers' Remittances in Selected Southeast Asian Countries
(% of gross domestic product)



Source: World Development Indicators.

10. **… but did not find their way into investment.** Despite fast-rising savings, domestic credit to the private sector fell from more than 60% of GDP in 1998 to below 30% in 2008 (Figure 7). This decline in private sector credit was not accompanied by the respective increase in the real interest rate,[7] which ranged from 4.0% to 5.8% in 2000–2007, and even fell to 1.1% in 2008 due to high inflation caused by food and oil price shocks (Figure 8). Such negative dynamics in private sector credit seem to be caused by the low demand of the private sector itself due to a weak investment climate and the banking sector's preference to lend money to the government[8] (on average about 15% of GDP since the early 1990s) or to invest abroad, as can be seen from the sharply increasing net foreign assets, which went up from 10% in late 1990s to some 25% of GDP in 2008.

11. **Banks have been increasingly parking liquidity with the Central Bank of the Philippines (BSP) instead of channeling it as loans to the private sector.** The amount of funds deposited by the population, through the financial sector and by the financial sector itself at BSP in the form of special deposit accounts (SDAs), reached P1.16 trillion in November 2010.[9] The share of SDAs in overall deposits held at BSP rose from 0% in 2002 to over 50% in June 2010 (Figure 9). Interest rates on SDAs have been higher than those offered by banks, hence the motivation of the public and, in fact, the banks themselves to deposit money with BSP using the risk-free SDA facility (Figure 10).

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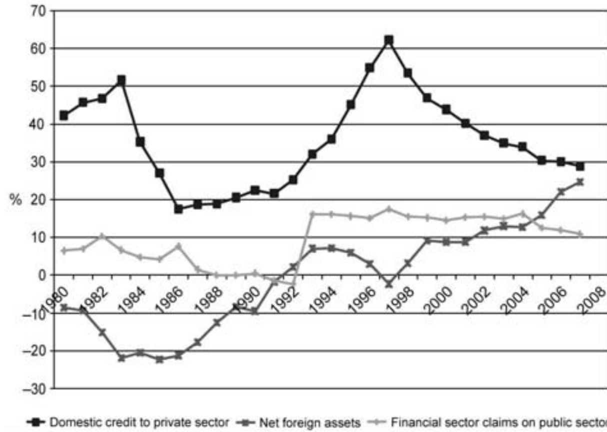
[7] The real interest rate is the lending interest rate adjusted for the GDP deflator inflation. The lending interest rate is the average rate charged by banks on loans to prime customers.

[8] According to the International Monetary Fund (2010), securities make up one-fourth of Philippine bank assets. Among the largest 10 banks, 60% of the securities that they hold are government bonds.

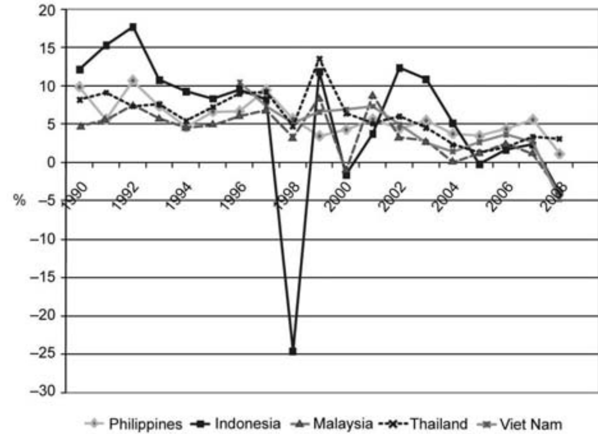
[9] The risk-free SDA facility consists of fixed-term deposits by banks and trust entities of banks and nonbank financial institutions with BSP. It was introduced in November 1998 to enable BSP to expand its tool kit in liquidity management. In April 2007, BSP expanded access to the SDA facility by allowing trust entities to deposit in the SDA facility to better manage liquidity in the face of strong foreign exchange inflows.

Figure 7: Credit to the Private Sector, Net Foreign Assets, and Claims on the Public Sector in the Philippines
(% of gross domestic product)



Source: World Development Indicators.

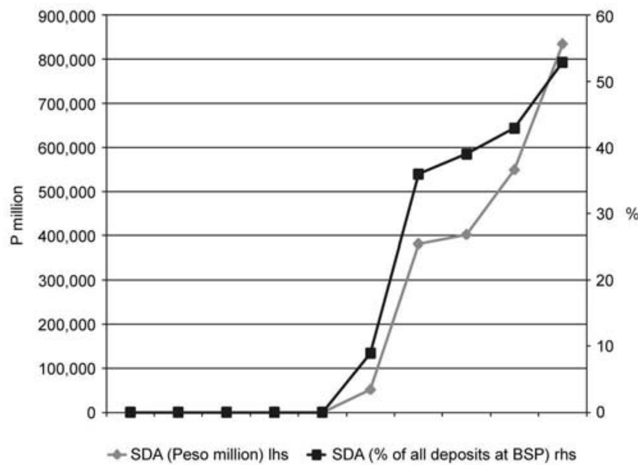
Figure 8: Real Interest Rate Dynamics in Selected Southeast Asian Countries



Source: World Development Indicators.

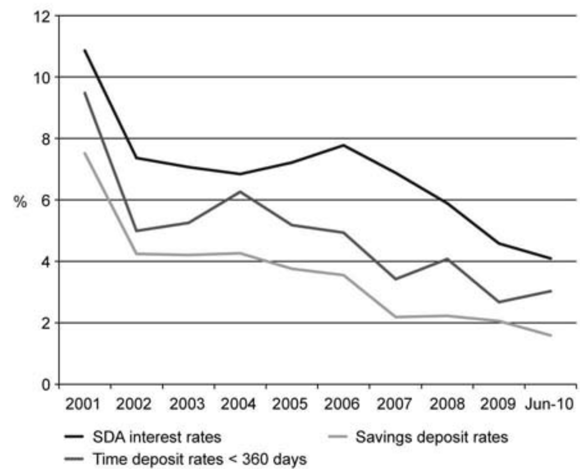
12. Having such large resources that are not used for investment purposes is not in the best interest of the country. Given the inadequacy of infrastructure, these funds could be gradually channeled for productive purposes (i.e., without significant inflation impact) to infrastructure projects using various PPP schemes.

Figure 9: Special Deposit Account Dynamics



lhs = left-hand side, rhs = right-hand side, SDA = special deposit account.
Source: BSP.

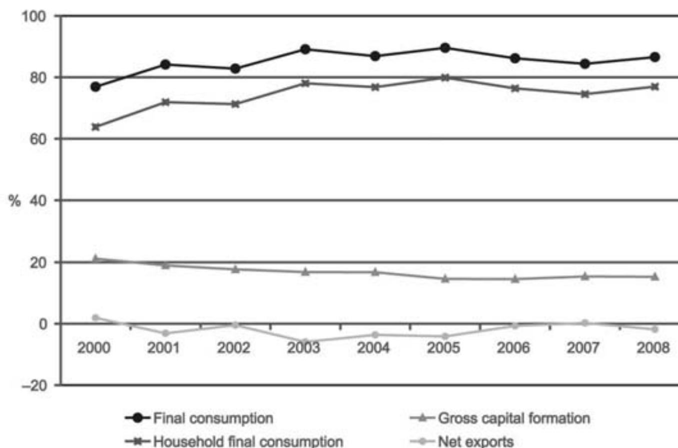
Figure 10: Selected Deposit Interest Rates



SDA = special deposit account.
Note: Special deposit account rates are weighted average in percent per year. Savings deposit rates refer to the annual percentage equivalent of commercial banks' actual monthly interest expenses on peso savings deposits to the total outstanding levels of these deposits.
Source: BSP.

13. **Overall, the Philippine private sector has been only mildly affected by the global economic crisis…** Due to strong private consumption, fueled by the growing remittances from overseas Filipino workers accounting for almost 80% of GDP (Figure 11) and robust public spending, the economy grew by 0.9% in 2009. The private sector's demand-side response to the crisis was a 10% contraction in investments in 2009, which was also compounded by uncertainties related to the May 2010 national elections. On the supply side, the most crisis-hit were companies related to electronics and semiconductors, automobiles, consumer electronic products in the export-processing zones, and furniture manufacturing (Balisacan et al. 2010). The impact of the Ondoy and Pepeng typhoons that hit the country in September and October 2009 was far more adverse on the agricultural sector (especially rice production) than the global economic crisis. The services sector—and business process outsourcing (BPO) industry in particular—has shown significant resilience. Despite the global economic crisis, the BPO industry continued to hire new staff members, and its revenues grew by double digits (World Bank 2009b).

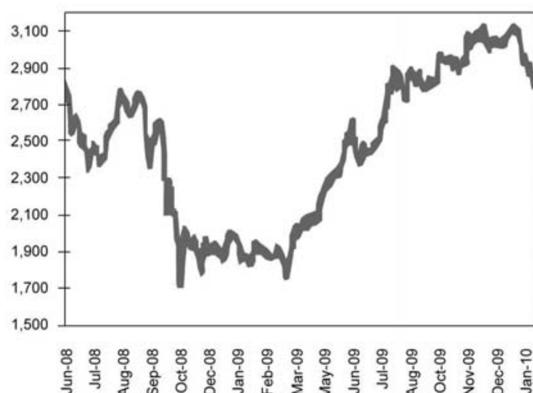
Figure 11: Demand Side of the Philippine Economy: Consumption, Investment, and Net Exports



Source: World Development Indicators.

14. **… as the stock exchange and corporate sector profitability dynamics show.** The companies listed on the Philippine Stock Exchange, due to their concentration in selected sectors, do not represent the overall corporate sector of the country. However, the dynamics of their performance on the stock exchange and regarding profitability still provide useful hints and qualitative patterns on the private sector's overall condition in the Philippines. The Philippine Stock Exchange index, after having plummeted around October 2008, has not only strongly recovered its loss but has actually grown beyond where it was before the "hard times" hit (Figure 12). Overall profitability of the listed companies grew by almost 80% in 2009, with the mining and oil sector being the only sector posting negative profitability growth of –33.6% (Table 1). In fact, the global economic crisis motivated many large, locally owned companies to switch their businesses to working more in nontradable sectors such as power generation, transport infrastructure, and oil refining.

Figure 12: Philippine Stock Exchange Index



Source: World Bank (2010).

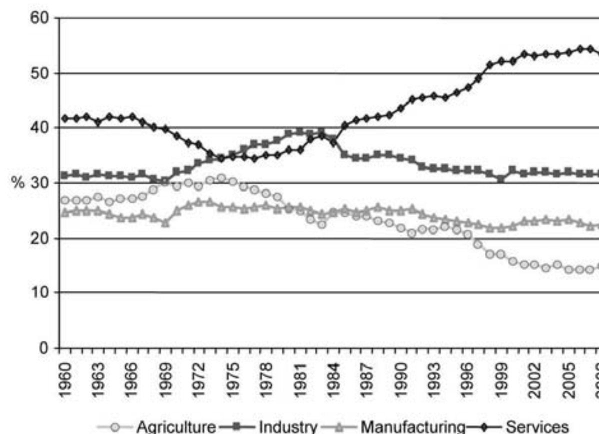
Table 1: Profitability of Companies Listed on the Philippine Stock Exchange

	Net Income			Revenues		
	2007	2008	2009	2007	2008	2009
Levels (P billion)						
PSEi	190.9	155.3	240.6	1,606.5	1,502.1	1,615.5
Financial Sector	46.2	27.5	44.2	289.7	278.5	313.1
Industrial Sector	57.3	49.1	126.8	1,067.9	1,241.1	1,232.6
Holding Firms Sector	62.0	37.2	70.9	439.3	509.0	576.3
Property Sector	26.7	25.7	28.8	108.8	119.7	123.1
Services Sector	82.4	55.1	84.0	432.3	433.6	432.4
Mining and Oil Sector	6.9	4.6	3.1	31.5	33.6	38.5
SMEs	0.0	0.0	0.0	0.1	0.1	0.1
Total	**281.5**	**199.2**	**357.8**	**2,369.5**	**2,615.5**	**2,716.1**
Total Nonfinancial	**235.4**	**171.8**	**313.6**	**2,079.9**	**2,337.0**	**2,403.0**
Growth Rate						
PSEi	…	(18.6)	54.9	…	(6.5)	7.6
Financial Sector	…	(40.5)	61.0	…	(3.9)	12.4
Industrial Sector	…	(14.3)	158.3	…	16.2	(0.7)
Holding Firms Sector	…	(40.0)	90.7	…	15.9	13.2
Property Sector	…	(3.6)	11.8	…	10.0	2.8
Services Sector	…	(33.1)	52.4	…	0.3	(0.3)
Mining and Oil Sector	…	(33.2)	(33.6)	…	6.7	14.6
SMEs	…	(54.3)	111.5	…	40.9	25.1
Total	…	**(29.2)**	**79.6**	…	**10.4**	**3.8**
Total Nonfinancial	…	**(27.0)**	**82.6**	…	**12.4**	**2.8**

… = data not available, ( ) = negative, PSEi = Philippine Stock Exchange index, SMEs = small and medium-sized enterprises.
Source: World Bank (2010).

15. **Despite growing domestic demand, the private sector in the Philippines either does not want or does not need to invest.**[10] Several major sectors of the economy, such as agriculture (i.e., corn, rice, and sugar), power, maritime and air transport, and banking, depict strong oligopolistic or even monopolistic features.[11] On one hand, capital-intensive large conglomerates, which have strong backward and forward links in the economy, are comfortable with how much they invest, as this produces good rents for them anyway. On the other hand, such oligopolistic situations result in expensive inputs, which are produced by these large conglomerates and used by firms down the value-addition chain. This hardly motivates firms to invest, as it lowers the return on investment. Therefore, the capital-intensive part of the private sector (i.e., large conglomerates and the firms using their output and input) does not wish to invest. Further, the less capital-intensive part of the private sector, such as the services sector (e.g., telecommunications and BPO), does not need to invest much to maintain rapid growth. In fact, the stagnating share of industry and rapidly growing share of services in the aggregate output in the last 3 decades confirm this (Figure 13).

Figure 13: Philippine Economic Sectors
(% of gross domestic product)



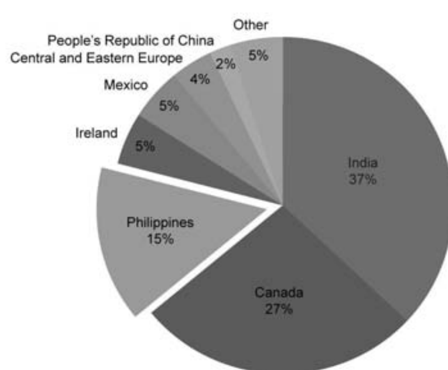
Source: World Development Indicators.

16. In the services sector, the BPO industry has grown impressively. In fact, since 2004, BPO revenues grew so strongly that in 2009, the Philippines became the third-largest BPO destination in the world (Figure 14). In 2004–2009, the industry's employment grew by a

[10] The discussion in this paragraph is largely based on Bocchi (2008).
[11] An extensive discussion on competition in the Philippines can be found in Aldaba (2008).

staggering 34.5% and its revenues by 37.0% annually (Figure 15). It is estimated that without the BPO industry, Philippine growth would have been 0.2 percentage point lower in 2004–2007. Then, the BPO industry kept growing at 19% in 2009 despite the global economic crisis, and its expected growth for 2010 is 26% (Trestle Group Consulting 2010). The industry is, however, moving away from voice-based services (e.g., call centers) toward knowledge-based businesses (e.g., software development and accounting). Currently, there are over 600 information technology BPO companies employing about 442,000 people in the country. Their direct contribution to the country's gross value addition is estimated at 5.3% (World Bank 2010f, p. 123).

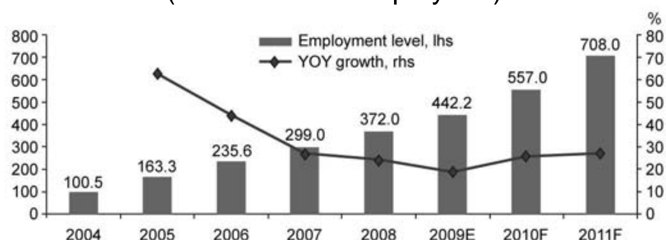
Figure 14: Philippines in the Global Business Process Outsourcing Market



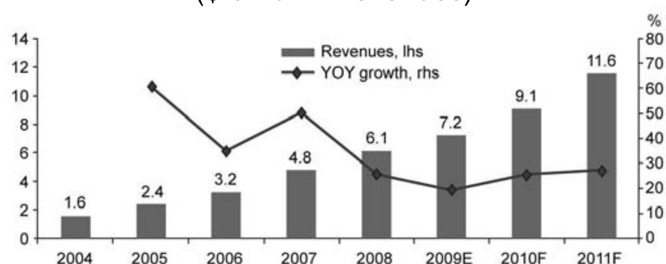
Source: ADB (Forthcoming).

Figure 15: Philippine Business Process Outsourcing Industry Growth

(thousands of employees)



($ billion in revenues)



E = estimated, F = forecast, lhs = left-hand side, rhs = right-hand side, YOY = year on year.
Source: BPAP as cited in Joint Foreign Chambers of the Philippines (2010).

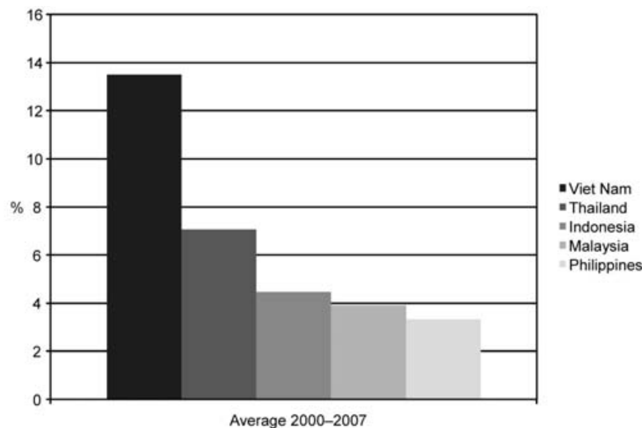
17. **The BPO industry's success is a function of reform and the country's comparative advantage.**[12] The BPO industry's "miracle" in the Philippines is a logical consequence of the liberalization of the telecommunications sector in 1993 magnified by the country's comparative advantage in terms of availability of adequately educated English-speaking labor and an improved power supply after energy sector reforms. In fact, the BPO industry's emergence as a new, nontraditional, and nonelite-captured sector with well-established political and economic frameworks is an example of a successful structural change induced by a reform impulse.

[12] A good discussion on this can be found in World Bank (2010f, p. 123).

III. MICROECONOMIC PERSPECTIVE

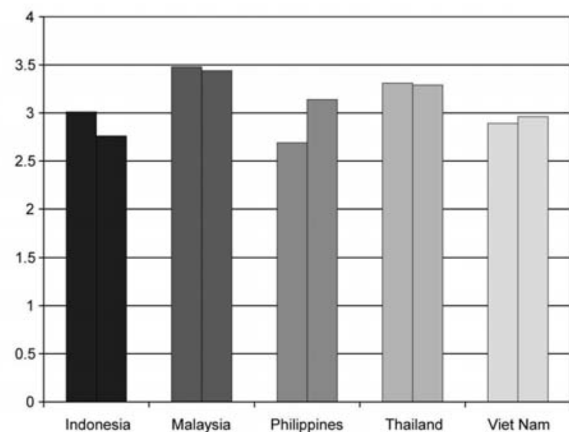
18. **The country's borders do not constrain business activities.** The Philippines has had a liberal trade regime since the mid-1980s. In fact, import tariffs are well below its regional comparators—in 2000–2007, on average, the import tariff rate was about 3.3% (Figure 16).[13] The Philippines is also viewed favorably in terms of logistics for trade. The Logistics Performance Index score improved from 2.69 in 2007 (ranking it 65 of 150 countries) to 3.14 in 2010 (ranking it 44 of 155 countries). This is now higher than the scores of Indonesia and Viet Nam (Figure 17).[14] Flow of capital in and out of the country is also not a problem.

Figure 16: Applied Tariff Rate on Imports in Selected Southeast Asian Economies
(average 2000–2007)



Note: The weighted mean applied tariff is the average of effectively applied rates weighted by the product import shares corresponding to each partner country.
Source: World Development Indicators.

Figure 17: Logistics Performance Index of Selected Southeast Asian Economies, 2007 and 2009



Note: The Logistics Performance Index score is between 1 and 5, with 1 being the lowest (i.e., worst in terms of logistics) and 5 the highest (i.e., best in terms of logistics).
Source: World Development Indicators.

19. **Behind-the-border constraints[15] are, however, pervasive and affect PSD.** The Philippines is characterized by a weak, deteriorating investment climate, which can be seen not only from low, decreasing private sector investments, but also from the dynamics of the country's ratings and rankings in various assessments and surveys such as the International Finance Corporation and World Bank's Doing Business reports, World Economic Forum's Global Competitiveness reports, and World Bank's Enterprise surveys. What follows is a brief review of the performance of the Philippines in some of the most commonly referred to and recent assessments and surveys.

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[13] If nontariff barriers (e.g., quotas, customs procedures, and standard requirements) to trade are also considered, the country's openness seems to be lower. There is, however, little up-to-date data on these nontariff barriers.

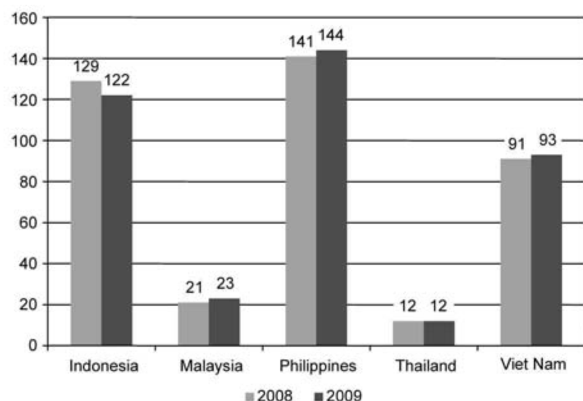
[14] In such subcategories of the Logistics Performance Index as efficiency of the customs clearance process and quality of trade- and transport-related infrastructure, the Philippines is at par with Indonesia and Viet Nam.

[15] Behind-the-border constraints are aspects of domestic investment climate such as inadequate property rights, inflexible labor markets, poorly designed taxes, barriers to competition, and poor governance and regulation. These constraints deter both foreign and domestic investment, which, in fact, should play a leading role in achieving and sustaining inclusive economic growth.

A. Doing Business Reports

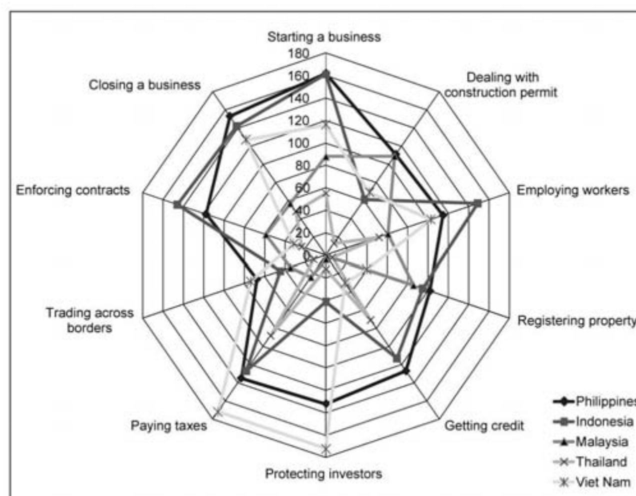
20. **The Philippines scores poorly in terms of ease of doing business** (World Bank 2009a). The country went further down from its low rating in the Doing Business Report, from 141st place in 2009 to 144th in 2010 out of 183 countries (Figure 18). Moreover, it performed worse than the countries in the comparator group. In fact, in the Southeast Asian subregion, the Philippines is ahead of only Cambodia and the Lao People's Democratic Republic. Major deterioration occurred in the areas of paying taxes (a drop in rank by nine places), starting a business (a drop in rank by seven places), and dealing with construction permits and dealing with investors (a drop in rank by five places each). The country's openness is also confirmed by its 68th-rank on trading across borders, which is better than that of Viet Nam (Figure 19). Particularly worrying is its rank for starting a business (162), getting credit (127), protecting investors (132), enforcing contracts (118), and closing a business (153).

Figure 18: Ease of Doing Business Ranking of Selected Southeast Asian Countries



Note: The higher the rank, the more difficult it is to do business in the country. A total of 183 countries were surveyed.
Source: World Bank (2009a).

Figure 19: 2010 Ease of Doing Business Ranking of Selected Southeast Asian Countries



Note: The closer to the radar's center, the better it is in terms of each indicator.
Source: World Bank (2009a).

21. **Overall, it is costly and difficult to do business in the Philippines** (Table 2). It takes a long time (52 days), and it is rather expensive (almost 30% of income per person). Access to credit is significantly hampered by the lack of information on creditworthiness of businesses despite the abundant liquidity of the banking sector. In fact, the country has the lowest credit information index in the comparator countries group. Insufficient investor confidence is also well reflected in the Investor Protection Index for the Philippines, which is lower than in all comparator countries except Viet Nam. However, more striking is the "achievement" in time required to enforce contracts (i.e., 2.3 years) and to close businesses (i.e., 5.7 years) in the Philippines—in this respect, the country is ahead of its neighbors. Yet if a company becomes bankrupt in the Philippines, an average creditor can expect to get back only 4.4 cents on each invested dollar, which is 3.1 times lower than in Indonesia, the country with the second-lowest recovery rate.

Table 2: Selected Indicators of 2010 Doing Business

	Starting a Business		Getting Credit	Protecting Investors	Enforcing Contracts		Closing a Business	
Country	**Time** (days)	**Cost** (% of income per capita)	**Credit Information Index**[a]	**Investor Protection Index**[b]	**Time**[c] (days)	**Cost** (% of claim)	**Time**[d] (years)	**Recovery Rate**[e] (cents on $)
Indonesia	60	26.0	4	6.0	570	122.7	5.5	13.7
Malaysia	11	11.9	6	8.7	585	27.5	2.3	38.6
Philippines	52	28.2	3	4.0	842	26.0	5.7	4.4
Thailand	32	6.3	5	7.7	479	12.3	2.7	42.4
Viet Nam	50	13.3	4	2.7	295	28.5	5.0	18.0

[a] Measures the scope, access, and quality of credit information available through public registries or private bureaus. It ranges from 0 to 6, with higher values indicating that more credit information is available from a public registry or private bureau.
[b] Varies between 0 and 10, with higher values indicating greater investor protection.
[c] In calendar days, counted from the moment that the plaintiff files the lawsuit in court until payment.
[d] The time required to resolve bankruptcy.
[e] Measures how many cents per dollar claimants recover from the insolvent firm.
Source: World Bank (2009a).

22. **There are, however, success stories regarding doing business at the local level.** There is significant space for maneuvering with local government units (LGUs) on starting businesses, dealing with licenses, and registering property. Of the many procedures to start a business, only 11 are national-level requirements. In Taguig, it takes only 27 days to start a business, against the national average of 52 days, and in Lapu-Lapu, it costs just 17.0% of per capita income to start a business versus 28.2% of income reported for the Philippines as a whole (Table 3). The number of procedures to start a business also varies among cities; while Manila, Marikina, and Taguig stand out with 15 procedures only (although this is still too many in comparison with other countries), other places, like Davao, report 23, while Pasig reports 22 procedures.

23. **LGUs clearly benefit economically from easing their bureaucratic requirements for businesses.** Iloilo City, in Panay Province, was able to reduce the number of days from 7 to 4 and steps to get business permits, licenses, or license renewals from 18 to 8 (Table 4). Apart

Table 3: Best Practices of Doing Business Environments in Selected Philippine Cities

Indicator	Global ranking (178 economies)
Days to Deal with Licenses Tanauan (58 days)	6
Days to Register Property Mandaluyong (21 days)	35
Cost to Register Property Mandaue (3.3% of property value)	54
Cost to Deal with Licenses Makati, Manila (102.4% of income per capita)	61
Days to Start a Business Taguig (27 days)	76
Cost to Start a Business Lapu-Lapu (17.0% of income per capita)	79
Number of Procedures to Register Property All cities (8 procedures)	124
Number of Procedures to Deal with Licenses Taguig (23 procedures)	142
Number of Procedures to Start a Business Manila, Marikina, Taguig (15 procedures)	168

Source: World Bank (2008).

Table 4: Improvements in Business Permit and Licensing Systems in Iloilo, Panay Province, Visayas Region

Indicators	2007	2008	Efficiency gain (%)
Number of Days (or the average total processing time)	7	4	43
Number of Steps	18	8	56
Number of Forms	12	8	33
Number of Signatures	30	12	60
Average Total Bureaucratic Costs (P)	4,600.00	1,700.00	63
Customer Satisfaction	very low	average	…
Number of Business Permits Renewed (during the business permit renewal period in January)	2,970	4,550	53
Total Revenues from the Business Permits (for January in P)	67,758,274,228.00	95,754,315,210.50	57

… = data not available.
Source: Templonuevo (2008).

from improved LGU customer satisfaction, such measures resulted in a reduction of associated LGU costs by 63% and an increase in revenues from business permits by 57%, which can be largely attributed to the increased number of business permits renewed (up by 53%).

B. Global Competitiveness Report

24. **The Philippines is perceived, in general, as poorly competitive.** The 2010–2011 World Economic Forum's Global Competitiveness Index ranks the Philippines 85 out of 139 countries, two places above its 2009 rating (WEF 2010). This seems to be the result of the inclusion of six more countries into the sample, as movements of Malaysia and Thailand resemble that of the Philippines. Noticeable, however, are the improvements of Indonesia (+10) and Viet Nam (+16).

25. Overall, over the past 5 years, the Global Competitiveness Index for the Philippines has both worsened and remained below that of its neighbors. In particular, a significant dip occurred in 2009, when the country went down by 16 places to the 87th rank (Table 5). In fact, of the country's neighbors, only Cambodia was placed lower in 2009 and 2008.

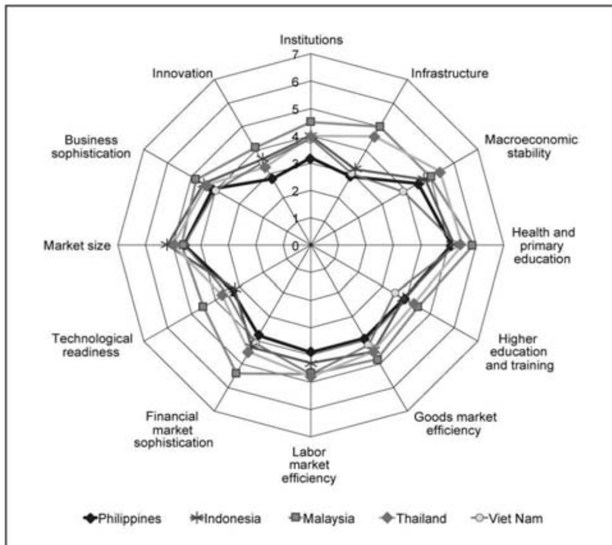
Table 5: Global Competitiveness Index of Selected Southeast Asian Countries

	2010	2009	2008	2007	2006
Sample size	*139*	*133*	*134*	*131*	*121*
Philippines	**85**	**87**	**71**	**71**	**75**
Indonesia	44	54	55	54	54
Malaysia	26	24	21	21	19
Thailand	38	36	34	28	28
Viet Nam	59	75	70	68	64

Note: The higher the rank, the less competitive the country.
Source: World Economic Forum (2009 and 2010).

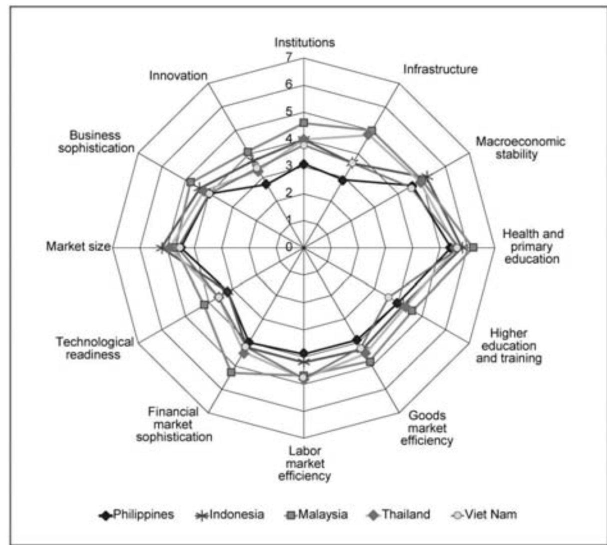
26. **Of specific concern is the lack of institutions, infrastructure, technological readiness, and innovation in the Philippines** (Figures 20 and 21). While the country's Global Competitiveness Index indicators have been lower than those of its neighbors, it is striking how weakly the country's institutions, infrastructure, technological readiness, and innovation are assessed. In terms of institutions, the country's ratings (among 139 assessed in 2010) are particularly low in diversion of public funds (135th rank), public trust of politicians (134), irregular payments and bribes (128), favoritism in decisions of government officials (131), transparency of government policy making (123), burden of government regulation (126), business cost of terrorism (126), and ethical behavior of firms (129). In terms of infrastructure, the low quality of roads (114th rank), ports (131), air transport (112), and electricity supply (101) are the most problematic areas. For technological readiness, the country has fewer internet users (112th rank) and poor internet bandwidth (101). Innovation is affected by the poor quality of scientific research institutions (108th rank), lack of government procurement of advanced technology products (129), and lack of scientists and engineers (96).

Figure 20: Global Competitiveness Index Indicators of Selected Southeast Asian Countries, 2009



Note: Scores are from 1 to 7. The higher the score, the better it is.
Source: World Economic Forum (2009).

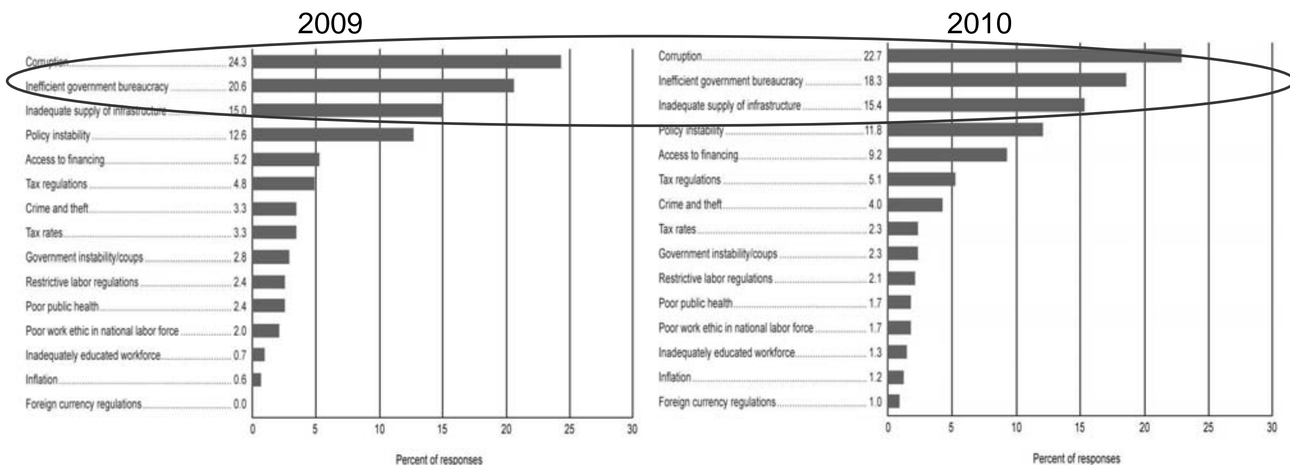
Figure 21: Global Competitiveness Index Indicators of Selected Southeast Asian Countries, 2010



Note: Scores are from 1 to 7. The higher the score, the better it is.
Source: World Economic Forum (2010).

27. **Corruption, weak governance in the public sector, and poor infrastructure are among the most prominent factors affecting businesses in the Philippines.** While the weights of corruption and inefficient government bureaucracy went down in 2010 (Figure 22), these two issues preserved their ranks as the top two problematic factors. In contrast to corruption and government bureaucracy, assessment of the inadequacy of infrastructure changed very little in 2010, maintaining its third place. Interestingly, despite the smooth, relatively peaceful national elections in May 2010, businesses still perceive the country as politically unstable, as political instability's fourth rank shows. Somewhat bewildering is the

Figure 22: Most Problematic Factors for Doing Business



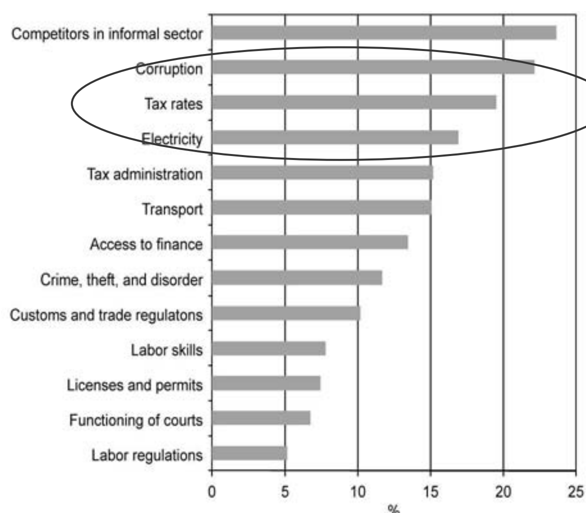
Source: World Economic Forum (2009) and (2010).

decrease in access to finance's rank from fifth place in 2009 to 10th place. Tax regulations have, in fact, become a more prominent problematic factor. In 2010, the gap in rank between the fifth (i.e., tax regulations) and sixth (i.e., tax rates) factors is 4.1, significantly higher than the gap of 0.4 between the fifth-ranked (i.e., access to finance) and the sixth-ranked (i.e., tax regulations) factors in 2009.

C. Enterprise Survey

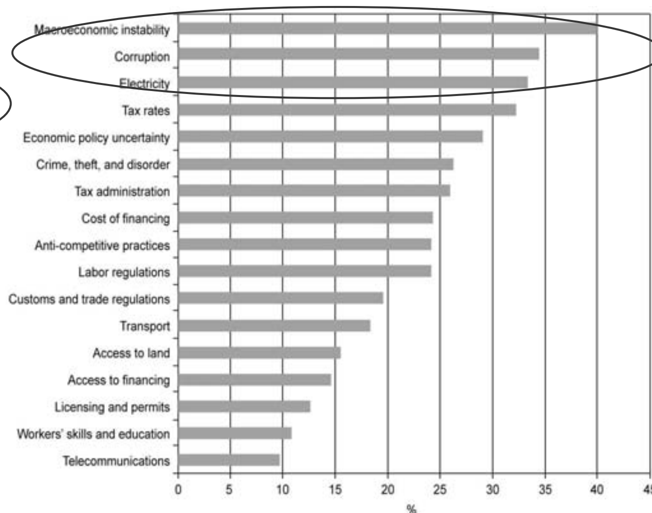
28. **Corruption, electricity, and tax rates seem to have persistently constrained business activity.** In 2009, the most prominent constraint in the World Bank's Enterprise Survey was the practices of competitors in the informal sector, with almost a quarter of the firms indicating this as a major constraint (Figure 23, World Bank 2009b).[16] Corruption was second, with 22% of firms' responses, tax rates were third (17%), and electricity was fourth (16%). A similar ranking pattern can be traced back to the results of a 2003 survey conducted by ADB (ADB 2005): corruption was second, electricity was third, and tax rates were the fourth major constraints (Figure 24).[17]

Figure 23: Major Constraints Identified by Firms in 2009



Source: World Bank (2009b).

Figure 24: Major Constraints Identified by Firms in 2003



Source: ADB (2005e).

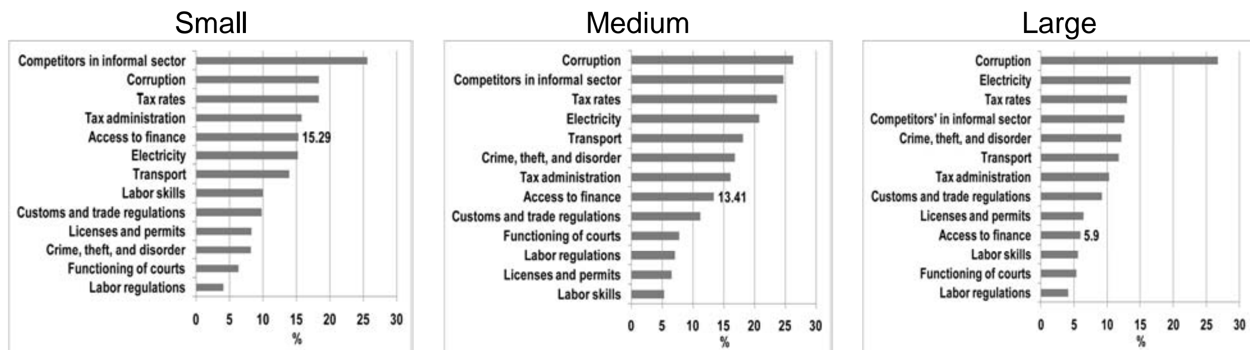
29. **Access to finance seems to be mostly a small and medium-sized enterprise (SME) problem.** Interestingly, 15.3% of small firms (ranking it fifth) and 13.4% of medium-sized enterprises (ranking it eighth) identify access to credit as a major constraint, while only about 6.0% (ranking it 10th) of large firms feel seriously constrained because of lack of access to finance (Figure 25). In fact, one can see the decline in the importance of the access to finance

[16] Domingo (2004) estimated the size of the nonobserved economy in the Philippines to be as big as 44% of GDP. This is similar to the estimation of Schneider and Enste (2000) of 50% of GDP.

[17] At that time, macroeconomic instability was ranked first, as severe fiscal problems increased the overall macro environment's uncertainty; the national government's budget deficit was –5.3% of GDP in 2002 and –4.2% in 2003. Due to a favorable external environment and some structural improvements, the situation improved as the deficit fell to –0.2% in 2007 and –0.9% in 2008. However, the deficit jumped to –3.9% of GDP in 2009 due to the countercyclical fiscal measures that the government adopted to mitigate the impact of the global economic crisis.

with the increase of firm size. Only 5.8% of small firms use bank finance for investment purposes, which is significantly lower than the 14.6% of medium and 18.0% of large firms. Another recent survey shows that 45% of micro and SMEs, especially smaller enterprises, do not use credit from financial institutions nor have seen any improvement in access to credit (GOP, Department of Trade and Industry 2010). Also, firms (regardless of the size) have put labor skills and regulations at the end of their constraint priority list, implying their overall satisfaction with the quality of labor and existing flexibility in the use of labor.

Figure 25: Major Constraints to Enterprises
(by firm size)



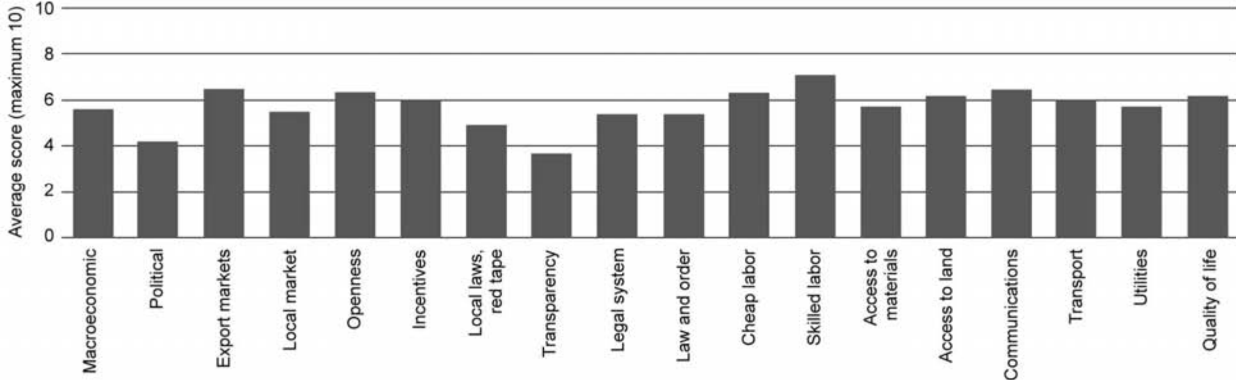
Source: World Bank (2009b).

D. Investor Survey[18]

30. **Investors have a negative view of public sector governance in the Philippines…** Transparency in decision making and absence of corruption have the lowest rating, with a score below 4 (Figure 26). Political stability, local laws and red tape, legal system and enforcement of contracts, and law and order are considered problematic by investors. The relatively good score of infrastructure-related factors seems to be due to the fact that a minimum necessary level of infrastructure should already be available where firms, which apply to the Board of Investments and the Philippine Economic Zone Authority (PEZA) for investment incentives, intend to start or expand businesses. Investors seem satisfied with workers' skills and education, the price of labor, the country's access to export markets, and the degree of the country's openness. This supports findings of the previous surveys. In addition, investors seem to be, overall, satisfied with the offered investment incentives. However, given the country's special focus on such incentives, this particular factor should score better in comparison with other factors.

[18] For this survey by ADB, 188 investors registered with the Board of Investments and Philippine Economic Zone Authority (PEZA) were surveyed to identify their opinion on the country's existing investment incentive regime and the importance of offered incentives in deciding to invest in the country (ADB 2010d). Countries offer investment incentives to compensate for their poor location (i.e., expensive and unreliable infrastructure, high production costs, low-quality labor, and political or economic instability). In the Philippines, investment incentives offered are income tax holidays, concessional company tax rates (only in special economic zones), value-added tax and import duty exemptions, tax credits, and additional deductions from taxable income.

Figure 26: Investor Rating of the Philippines Based on Location Offer Factors



Note: There are 18 factors influencing an investor's location decision: (i) macroeconomic stability of the country; (ii) political stability of the country; (iii) access to regional and other export markets; (iv) size, nature, and purchasing power of local market; (v) openness to trade and investment; (vi) size of investment incentives provided; (vii) transparency in decision making and absence of corruption; (viii) local laws and regulations and red tape; (ix) legal system and enforcement of contracts; (x) law and order; (xi) access to cheap labor; (xii) access to labor with necessary skills and/or education; (xiii) access to cheap raw materials and production inputs; (xiv) access to land and/or property; (xv) access to adequate transport at acceptable costs; (xvi) access to adequate communications at acceptable costs; (xvii) access to adequate utilities (e.g., power and water) at acceptable costs; and (xviii) environmental and quality of life factors.
Source: ADB (2010d, p. 47).

31. **… and about half of them, in fact, seem not to need tax incentives to invest.** Based on comparison of the rates of return before and after tax investment incentives with the target rates of return, it was estimated that 52% of the investor before-incentive rates of return was already higher than the target rates of return. The breakdown by the type of incentives shows that, on average, 28% of firms receiving income tax holidays do not need this incentive to make investments. In respect to tax and duty exemptions, the redundancy rate is 45%; for tax credits, 50%; and for lower corporate tax after income tax holidays, 48%.

IV. CONSTRAINTS TO PRIVATE SECTOR DEVELOPMENT

32. Based on the previous discussion, PSD constraints seem to belong to two major groups: inefficient state systems and an inadequate business environment. The first group covers issues related to poor governance, including insufficient institutional and legal frameworks, which increases the risk of corruption.[19] Within the second group, inadequate infrastructure and insufficient SME access to finance are the most prominent factors affecting the environment in which businesses operate.

A. Inefficient State Systems

33. **The situation with governance worsened during 1998–2008.** If compared with 1998, none of the Worldwide Governance Indicators[20] have improved in the last decade (Figure 27). Of particular concern is the deterioration of such important factors for PSD as political stability, regulatory quality, rule of law, and control of corruption. In 2008, the country was perceived to be the least politically stable among the comparator group of neighboring countries. In terms of the rule of law, Malaysia, Thailand, and Viet Nam were assessed higher; in controlling corruption, Indonesia, Malaysia, and Thailand performed better (Figure 28). It is noticeable that in none of the years did the Philippines rank in the upper 100–75 percentile.

34. **Political stability is likely to improve, but unresolved armed conflicts keep affecting businesses.** The country had national elections on 10 May 2010, which were relatively peaceful, and transition from the old to the new government was smooth. President Benigno Aquino III enjoys very strong popular support—88% of adult Filipinos have much trust in him in contrast to his predecessor's –35% satisfaction rating in 2009 (Social Weather Stations www.sws.org/ph). Thus, the government is very unlikely to become unstable in the short to medium term. However, occurrence of domestic terrorism and violence, especially in the Mindanao island group, is still likely due to the ongoing conflict with armed separatist groups.[21] Apart from contributing to the overall uncertainty for doing business and investing in the country, violence and terrorism have a clear economic implication on operating firms in the form of "special taxes" that uncontrolled armed groups impose. Some estimates show that one armed group collected P100 million from firms in Mindanao from these special taxes (Pacific Strategies

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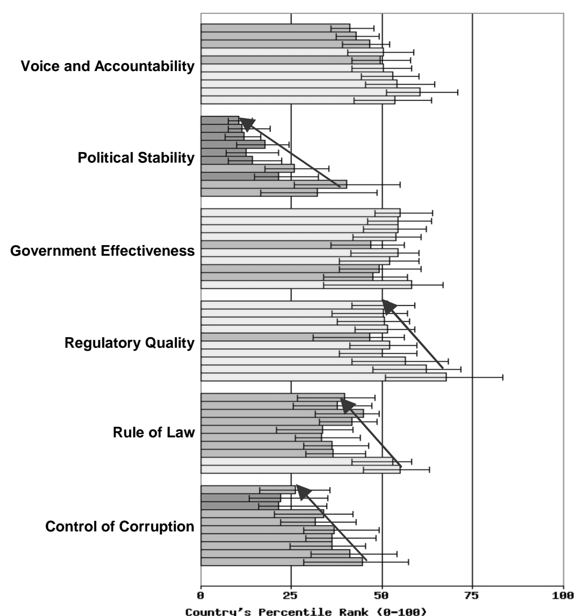
[19] ADB's definition of governance is used as presented in ADB (1995, p. 3). According to it, governance is "the manner in which power is exercised in the management of a country's economic and social resources for development." The concept of governance encompasses the functioning and capability of the public sector, as well as the rules and institutions that create the framework for the conduct of both public and private business, including accountability for economic and financial performance, and regulatory frameworks relating to companies, corporations, and partnerships. According to ADB (1998, pp. 9–10), "corruption involves behavior on the part of officials in the public and private sectors, in which they improperly and unlawfully enrich themselves and/or those close to them, or induce others to do so, by misusing the position in which they are placed."

[20] These measure governance in six dimensions: (i) voice and accountability (i.e., extent to which a country's citizens are able to participate in selecting their government, as well as freedom of expression, freedom of association, and a free media), (ii) political stability and absence of violence and/or terrorism (i.e., perceptions of the likelihood that the government will be destabilized or overthrown by unconstitutional or violent means, including domestic terrorism and violence), (iii) government effectiveness (i.e., quality of public services, quality of the civil service and degree of its independence from political pressures, quality of policy formulation and implementation, and credibility of the government's commitment to such policies), (iv) regulatory quality (i.e., ability of the government to formulate and implement sound policies and regulations that permit and promote PSD), (v) rule of law (i.e., extent to which agents have confidence in and abide by the rules of society, in particular quality of contract enforcement, police, and courts, as well as the likelihood of crime and violence), and (vi) control of corruption (i.e., extent to which public power is exercised for private gain, including petty and grand forms of corruption, as well as capture of the state by elites and private interests). Source: World Bank (2010h).

[21] A good analysis of the issue can be found in World Bank (2010e).

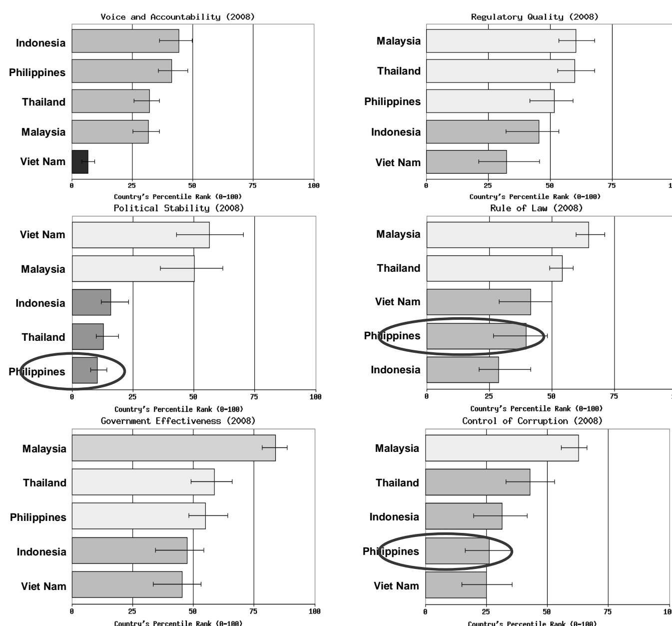
and Assessments 2011). Moreover, these taxes have shown the tendency to increase. For mining firms, such taxes are reported to have increased from P15 million per firm in 2010 to P25 million in 2011.

Figure 27: Dynamics of Governance Indicators in the Philippines, 1996–2008



Note: Comparison between 2008, 2007, 2006, 2005, 2004, 2003, 2002, 2000, 1998, and 1996 are in a top to bottom order. The country's percentile rank indicates the rank of the country among all countries in the world; 0 corresponds to the lowest rank, while 100 to the highest rank.
Source: World Bank (2010h).

Figure 28: Governance Indicators in Selected Southeast Asian Countries, 2008



Note: The country's percentile rank indicates the rank of the country among all countries in the world; 0 corresponds to the lowest rank, while 100 to the highest rank.
Source: World Bank (2010h).

35. **Regulatory quality is challenging, especially at the LGU level.** Interference by local government officials into private sector activities through issuances of controversial ordinances has been adding to the overall uncertain environment in which the private sector operates. Two recent cases are the nearly canceled $2 billion shipyard investment project in Misamis Oriental in 2008 and an under-threat $5 billion gold and copper mining project in South Cotabato (Box 1). It is no wonder that investors have preferred to locate in special economic zones, as there they interface only with one national government-level agency, usually PEZA.[22] It is, however, impossible to ring-fence all private investment projects in such zones, implying the need to improve the regulatory environment at the local government level to make it more investor friendly.

[22] Another factor that contributes to the businesses' preference of working with PEZA is the efficiency of its staff members. This seems to be caused by PEZA's ability to attract and maintain a professional cadre who is paid salaries that are close to market rates. This became possible after PEZA had been exempted from the salary standardization law prescribing civil servant salaries based on a salary schedule.

Box 1: Challenges at the Local Government Unit Level—Shipyard Project in Misamis Oriental and Tampakan Copper–Gold Project in South Cotabato

Shipyard Project in Misamis Oriental

In April 2008, a Republic of Korea firm, Hanjin Heavy Industries and Construction, decided to withdraw its $2 billion shipyard project from Misamis Oriental Province largely due to difficulties in dealing with two town governments. The shipyard facility, located in Tagoloan and Villanueva cities and covering 441 hectares, was expected to employ about 45,000 people (e.g., engineers, welders, fabricators, and administrative personnel) after becoming fully operational. At the time, the project was assessed to be the largest foreign direct investment-financed project in the Philippines, which was also to become the world's second-largest ship-building facility.

However, the mayor of Tagoloan issued an executive order that sought to stop the construction of the shipyard. The basis for this construction stop was the firm's failure to obtain a municipal building permit and an environmental clearance certificate from the Department of Environment and Natural Resources. Although the certificate was issued, this was only done when the firm announced its withdrawal intentions. Among other issues that the firm faced were problems with right-of-way, a dispute with the National Power Corporation on billing conditions, land-ownership issues, and intentions in the Senate to summon the firm's managers over environmental concerns. There were also safety concerns regarding the firm's employees.

To salvage this strategically important project, the national government's direct involvement became necessary. The dispute with the local government officials delayed the project by 1 year and exposed the inability of local governments to resolve issues in a systematic, business friendly manner, implying the importance of ad-hoc and stand-alone solutions coming from the national government.

Tampakan Copper–Gold Project in South Cotabato

Sagittarius Mines, which is controlled by Xstrata Copper (the world's fourth-largest copper producer), is expected to invest around $5 billion into the Tampakan copper–gold project in South Cotabato Province. Under the project, 2.4 billion tons of minerals are expected to be processed, including 13.5 million tons of copper and 15.8 million ounces of gold. The project is to employ up to 9,000 people during construction and up to 2,000 people during operations. It aims to start actual mining in 2016, using an open-pit mining method, which is permitted by the Philippine Mining Act (Republic Act No. 7942).

However, at the end of June 2010, 2 days before the expiration of its term, the provincial government of South Cotabato adopted the province's new environment code, which effectively banned open-pit mining. This was justified by the lack of assurance that the tribal communities at the mining sites would benefit from the project, risk of pollution, and drying up of a major river crucial for irrigation. The provincial government also based its decision on the failure of the relevant national government agencies (e.g., the Mines and Geosciences Bureau and the Department of Environment and Natural Resources) to convince the provincial government that there were sufficient safety nets to cushion the impact of open-pit mining in the province.

There are different views of the ban from the legal perspective. Sagittarius Mines opines that a local law cannot supersede a national law (i.e., the Mining Act does not ban open-pit or any other mining method). The provincial government has, however, expressed its view that the passage of the environment code is part of the exercise of autonomy by local government units.

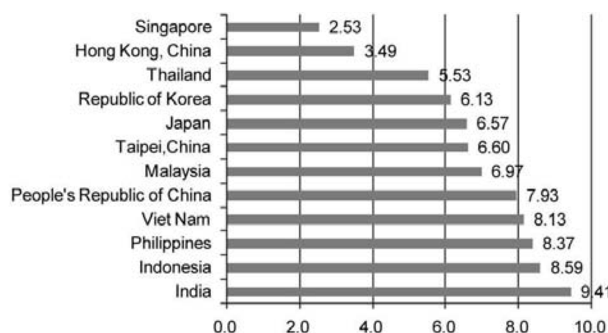
The decision on the open-pit mining at the local level has raised concerns among mining executives, who are noting the lack of cohesion between the national and local governments on mining policies. If the uncertainty in this issue holds for too long, it could jeopardize the plans for the next 2 years to attract $13.5 billion of investments into the mining sector.

Sources: GMA News Online (2008), Go (2010), Gomez and Pales (2008), Olchondra (2010), Sabillo (2010), Sarmiento (2010), and Yap (2010).

36. **Contradictions in the interpretation of the taxation-related regulatory framework at the LGU level have also created uncomfortable situations.** The 1991 Local Government Code empowered LGUs to levy certain taxes, including a real property tax and local business tax. At the same time, national laws (e.g., Republic Act No. 8756 regulating requirements for establishing the regional headquarters of multinational companies) and/or agreements between the national government and private companies can provide exemption from local taxes. LGUs, however, guide themselves in dealing with the businesses located in their territories by the Local Government Code's taxation provisions. This often leads to disputes, which require court decisions or involvement of national government authorities. Apart from taking time and incurring additional costs, such issues raise uncertainty and significantly affect the decisions of those who intend to open businesses in the country. Among the cases related to LGU taxation are the attempt of Makati and Quezon cities to impose local taxes on members of the Philippine Association of Multinational Regional Headquarters (Joint Foreign Chambers of the Philippines 2010); levying of real estate taxes by the Nueva Vizcaya and Nueva Ecija provinces on the California Energy Casecnan Water and Energy Company (Galvez 2009); and a court dispute between the Palawan provincial government and the consortium of Shell Philippines Exploration, Chevron Malampaya, and PNOC Exploration Corporation that jointly implements the Malampaya Deepwater Gas-to-Power Project on allegedly delinquent real property payments (PNOC Exploration Corporation 2009).

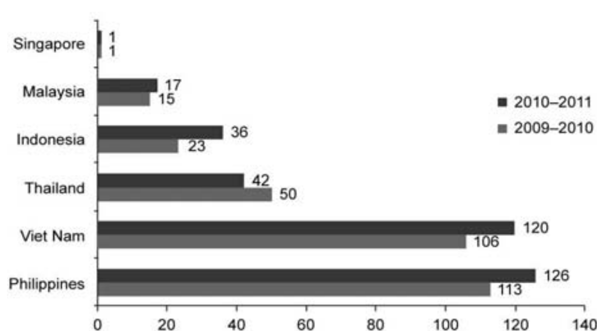
37. **Despite good initiatives, red tape further poses a significant problem.** Establishment of the Anti-Red Tape Task Force in 2006 and adoption of the Anti-Red Tape Law and its implementing rules and regulations have been the right steps in the right direction.[23] However, implementation of the existing anti-red tape legal framework remains weak, as the results of various surveys show. The Hong Kong, China–based consultancy firm, Political and Economic Risk Consultancy, has rated the efficiency of the Philippine bureaucracy lower than those of Malaysia, Thailand, and Viet Nam, although marginally higher than that of Indonesia (Figure 29). According to the World Economic Forum's ranking of the burden of government regulation, the Philippines has maintained the lowest rank among its neighbors in both the 2009–2010 and 2010–2011 surveys (Figure 30).

Figure 29: Efficiency of Bureaucracy in Selected Asian Countries, 2010



Note: 1 = the best; 10 = the worst.
Source: Political and Economic Risk Consultancy.

Figure 30: Burden of Government Regulation in Selected Asian Countries



In the 2009–2010 and 2010–2011 surveys, 133 and 139 countries were evaluated, respectively.
Source: World Economic Forum (2009 and 2010).

[23] The Anti-Red Tape Task Force was established by Executive Order No. 557 dated 8 August 2006. The Anti-Red Tape Act is Republic Act No. 9485 dated 2 June 2007. The Anti-Red Tape Act's implementing rules and regulations are in the Memorandum Circular of the Civil Service Commission No. 12 series of 2008 dated 24 July 2008.

38. **The labor regulatory framework needs streamlining.** Minimum wages in the Philippines are high in comparison with its regional comparators, undermining the country's competitiveness outlook (Table 6).[24] High labor costs are reported to be among the factors that contributed to the decline of such labor-intensive industries as the footwear and garment industries. The situation with the minimum wages is aggravated by the high number (21 in 2010) of paid holiday days off (Figure 31), which adds to business costs and negatively affects the country's competitiveness in comparison with its neighbors, where both the minimum wages are lower and there are fewer paid nonworking days.

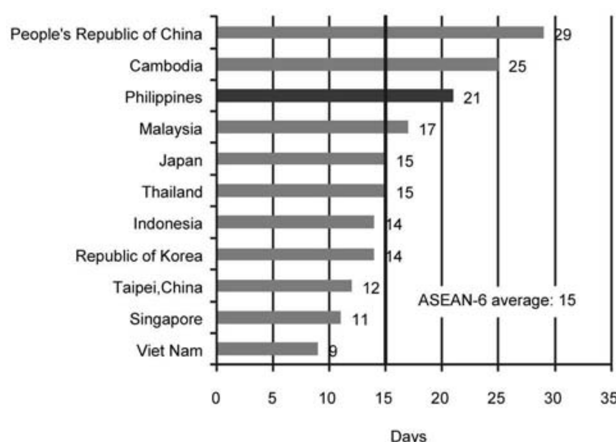
39. Overall, the Philippines Labor Code, adopted in 1974,[25] would benefit from being better aligned with the developments in the country's internal and external environments. One such development is the ongoing shift of production facilities due to rising wages and shortage of workers from the People's Republic of China's coastal areas to inland or to other Asian countries, where the Philippines could be a possible destination.[26]

Table 6: Daily Minimum Wages in Selected Asian Countries and Areas
($ per day)

Country and/or City	Minimum	Maximum
Viet Nam	1.39	1.74
Cambodia	1.67	1.67
Jakarta, Indonesia	2.00	3.73
Bangkok, Thailand	4.55	6.24
Delhi, India	4.45	4.93
Shenzhen, PRC	5.37	5.37
Guangzhou, PRC	5.43	5.43
Malaysia	7.56	16.20
NCR, Philippines	*8.80*	*8.80*
Taipei,China	17.96	17.96
Singapore	19.23	68.15
Republic of Korea	26.53	26.53
Japan	56.31	70.82

NCR = National Capital Region, PRC = People's Republic of China.
Note: There is no legislated minimum wage in Singapore. Only several sectors in Malaysia are subject to minimum wage regulation.
Source: National Wages and Productivity Commission as cited Joint Foreign Chambers of the Philippines (2010).

Figure 31: Nonworking Paid Holidays per Year in Selected Asian Countries, 2010



ASEAN-6 = Indonesia, Malaysia, Philippines, Singapore, Thailand, and Viet Nam.
Note: In the People's Republic of China, workers are required to compensate some of the holiday days off either before or after the holiday. This results in the net number of nonworking paid holidays equaling 23.
Source: Joint Foreign Chambers of the Philippines (2010).

[24] Minimum wages are set for each of the 16 regions of the country and the Autonomous Region in Muslim Mindanao on the basis of consultations among representatives of the government, employees, and employers appointed by regional tripartite wages and productivity boards. The National Wages and Productivity Commission, which is an agency of the Department of Labor and Employment, formulates policies and guidelines on wages, incomes, and productivity and exercises technical and administrative supervision over these boards.
[25] Presidential Decree No. 442 dated 1 May 1974.
[26] It is reported that salary levels in population-intensive inland areas are up to 70% less than the salaries paid to workers in the People's Republic of China's manufacturing centers, and moving the factories inland could save 30% of costs. It is also reported that some textile plants have been already moved from the People's Republic of China to countries such as Bangladesh and Kazakhstan.

40. **Competition framework is weak.** Trade liberalization and the subsequent openness to imports as a result of the country's accession to the World Trade Organization in 1994 brought greater contestability to the domestic markets. However, there are still significant barriers to competition in a few sectors of the Philippine economy (Table 7). Constraints to competition and/or entry of new firms are usually traced back to either structural constraints or collusive behavior. Competition in several sectors is promoted by sector- and/or industry-specific laws; there are also regulatory arrangements to manage natural monopolies.[27] Obviously, such a fragmented competition, promotion, and anti-trust framework cannot provide a comprehensive response to existing and emerging competition issues. In addition, insufficient separation between regulators and those whom they regulate (e.g., the Philippines Port Authority, which both regulates and owns ports) creates oligopolistic practices and conflicts of interest. There is also lack of a single institution to supervise or to enforce implementation of competition and anti-trust legislation across sectors, independently advise policy makers on competition and anti-trust issues, and keep the legal and regulatory framework up to date for the benefit of the whole economy.

Table 7: Selected Sectors with Barriers to Entry and Competition

Sector	Source of Barrier to Entry
Rice	Import licenses or tariff quotas
Corn and sugar	Cartel behavior by dominant producers
Agribusiness	Restrictions on foreign land ownership and restrictive land-use policies
Downstream oil	Cartel behavior by oligopolistic producers and large capital requirements
Pharmaceuticals	Licensing and registration restrictions and cartel behavior by dominant firms
Cement	Cartel behavior by oligopolistic producers and large capital requirements
Electricity distribution	Monopoly and limited regulatory capacity
Water	Local monopoly and multiple fragmented and overlapping administrations
Drugstores	Economies of scale and scope
Telecommunications	Congressional franchise and limited regulatory capacity
Ports	Monopoly and limited regulatory capacity
Water transport	Cabotage law and cartel behavior by local oligopolies
Air transport	Cabotage law, congressional franchise, and limited regulatory capacity

Source: Aldaba (2008).

41. **Rule of law remains of concern.** In particular, of concern are the issues related to weak contract enforcement, controversial judicial decisions, and varying interpretation of the

[27] Competition in the telecommunications sector is regulated by Executive Order No. 109 from 1993 creating an opportunity for new firms to enter the industry through, for instance, allowing foreign investment up to 40%. This resulted in significant improvement to the quality of services and a dramatic fall in prices. In the insurance sector, Department of Finance Order No. 100-94 from 1994 allowed wholly owned foreign insurance and reinsurance companies to operate in the country either as branches, newly incorporated subsidiaries, or through the acquisition of existing domestic firms. The civil aviation sector was liberalized in 1995 through Executive Order No. 219 that ended the monopoly of Philippine Airlines and enabled entry of privately owned airlines into the market. The 1998 Oil Industry Liberalization Act (Republic Act No. 8479) increased competition in the petroleum products market by allowing new entrants, including foreign oil retail firms, in the downstream oil industry (i.e., importing, refining, storing, and distributing petroleum products). The 2000 General Banking Law (Republic Act No. 8791) further liberalized the banking industry by allowing foreign banks to acquire up to 100% equity of a local commercial or thrift bank within a given period. The electricity sector was liberalized in 2001 with adoption of the Electric Power Industry Reform Act (Republic Act No. 9136), which provided for the restructuring of the electric power industry and required privatization of most government-owned generation assets as well as independent power producer contract administration and transmission lines. Further, examples of regulatory agencies dealing with natural monopolies are the Civil Aeronautics Board, Energy Regulatory Commission, Land Transportation Franchising and Regulatory Board, Maritime Industry Authority, National Food Authority, National Telecommunications Commission, Philippine Ports Authority, Sugar Regulatory Administration, and Toll Regulatory Board.

law. Perhaps the most prominent case of contract enforcement is the Ninoy Aquino International Airport's terminal III, where the build–operate–transfer (BOT) contract, which was signed in 1997, was canceled in 2002 after construction of the terminal was almost entirely completed. This and other cases of the government's revision of existing contracts and controversial judicial decisions (Box 2) have significantly affected the country's investment climate as the dynamics of the country's competitiveness ratings show.

Box 2: Selected Amended Contracts in the Philippines

Ninoy Aquino International Airport's terminal III is a $640-million, modern facility designed to serve 13 million passengers per year. The winning bid for the contract, PairCargo and its partner Fraport AG of Germany, contracted the Philippine International Air Terminals Corporation (PIATCO) to undertake the construction and subsequent operation of the terminal.

The concession agreement, signed in 1997, was amended and/or supplemented in 1999, 2000, and 2001. It originally required PairCargo and Fraport to construct and subsequently operate the international airport within a 25-year cooperation period. After 25 years of operation, the terminal would be sold to the Government of the Philippines for $400 million. However, the build–operate–transfer contract was abrogated by the government in 2003, which was later confirmed by the Philippine Supreme Court. This decision was based on (i) the absence of the requisite financial capacity of the PairCargo Consortium, which is required under build–operate–transfer law; (ii) material and substantial amendments to the 1997 concession agreement, which deviated from the original contract bid; and (iii) amendments to the 1997 concession agreement providing for a direct government guarantee, which is prohibited by the build–operate–transfer regulatory framework in the case of an unsolicited proposal.

In December 2004, terminal III was expropriated by the government through an order of the Pasay City Regional Trial Court subject to payment of an initial amount of P3 billion to PIATCO. This amount was paid to PIATCO by the government in September 2006. PIATCO and Fraport also filed compensation claims against the government before (i) the Singapore-based International Chamber of Commerce Court (ICC) of Arbitration for $565 million; and (ii) the World Bank's International Center for the Settlement of Investment Disputes (ICSID) in Washington, DC for $425 million. Both cases were basically decided in favor of the government—first in July 2010 by the ICC, and then in August 2007, when the ICSID dismissed the claim, stating that it had no jurisdiction over the matter. At that time, it was estimated that the terminal was 98% complete, requiring only $6 million to be fully ready. However, in December 2010, the ICSID, after another appeal by Fraport, overturned its August 2007 decision, allowing Fraport to sue the government again for the reimbursement of its $425 million investment in terminal III. In May 2011, the Pasay City Regional Trial Court ordered the government to pay PIATCO $175.8 million as just compensation for the takeover of terminal III. This amount is significantly lower the equivalent of $842.8 million claimed by PIATCO, which expressed its intention to contest the decision of the Pasay City Regional Trial Court. Obviously, these developments and the still-uncertain environment around terminal III will affect (in terms of time and price) the government's intention for bidding out to the private sector the operation and management of this terminal.

Nevertheless, the terminal officially opened to selected domestic flights in July 2008 (initially Cebu Pacific only, then Philippine Airlines subsidiaries, Air Philippines and PAL Express). Cebu Pacific international flights have been conducted from the terminal since August 2008. All international flights (except for those from Philippine Airlines) should operate from the terminal in the future. However, international carriers still operate from outdated terminal I, as they are unwilling to move to terminal III unless the ownership issue is completely resolved.

Other cases of problems with contract enforcement and business unfriendly judicial decisions:

- **Privatization of the Manila Hotel in 1995.** The Supreme Court overturned the winning bid by the Malaysian Renong Group, as the hotel was said to be part of Philippine heritage and should therefore be offered first to a Philippine bid, even at a lower cost.

continued on next page

Box 2: Selected Amended Contracts in the Philippines *(continued)*

- **Keppel Subic Shipyard in 2001.** The Supreme Court declared JG Summit as the bid winner 5 years after Keppel won the project, indicating that shipyards are a public utility and should be at least 60% owned by Filipinos. However, shipyards are not on the Foreign Investment Negative List. Although the decision was later reversed, it affected the country's investment image.
- **Renegotiation of contracts with independent power producers in 2001.** The government initiated the renegotiation of independent power producer contracts in response to the public demand for lower electricity rates. This also involved renegotiating the state guarantees offered to these producers in the early 1990s when the country faced serious power shortages. Several contracts were resolved, resulting in about $1 billion savings for the government, but implying $1 billion less-than-expected revenues for the producers.
- **Waste-to-energy project with Jancom Environmental in 2002.** In response to the demands of various groups, the government canceled this project 5 years after its approval.
- **Camp John Hay redevelopment in 2003.** The Supreme Court voided tax incentives granted to Camp John Hay locators.
- **Western Mining in 2004.** The Supreme Court voided the financial and technical assistance agreement between the government and Western Mining, a 100% foreign-owned firm, for a mining project in Mindanao, declaring the financial and technical assistance agreement unconstitutional. Although this decision was later reversed, Western Mining eventually left the Philippines.
- **Clark incentives in 2005.** The Supreme Court nullified fiscal incentives granted to some 300 investors in the Clark Economic Zone.
- **Pandacan terminal local government unit spot zoning in 2008.** The Supreme Court sustained a local government unit decision rezoning an oil storage area from industrial to commercial and forcing its relocation.
- **Manulife case in 2008.** The Supreme Court ruled that an agent of a life insurance company was an employee and not an independent contractor, which is the standard practice internationally. Upon the motion for reconsideration by Manulife, the court changed its decision.

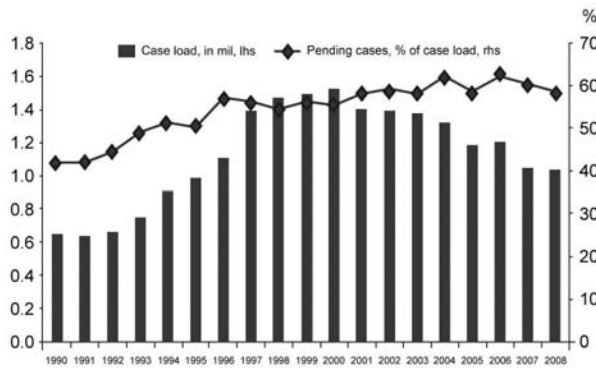
Sources: Joint Foreign Chambers of the Philippines (2010), Llanto (2008), Wallace (2006), and Wikipedia (2010).

42. **Despite visible progress in judicial reform and the availability of a good legal framework, efficiency of the judicial system is still low.** Vacancy rates among judges fell from 29.5% in 2005 to 22.7% in 2008, and the budget of the judiciary increased by 34% in real terms between 2004 and 2009, although it was still below the aim of 2% of the national budget (World Bank 2010c). The arbitrary use of temporary restraining orders in business cases has also decreased.

43. Furthermore, court caseloads have been decreasing since 2000 (Figure 32), and, after adoption of the Alternative Dispute Resolution Act in 2004, the use of arbitration in dispute resolution is more frequent. However, the country is still ranked very low in terms of efficiency of its dispute settlement legal framework (Figure 33). One of the reasons is low judicial assistance to arbitration, as courts tend to decide on arbitration cases themselves, resulting in long delays. On average, it takes around 135 weeks to enforce an arbitration award rendered in the Philippines, from filing an application to a writ of execution attaching assets, assuming that there is no appeal, and 126 weeks for a foreign award.[28]

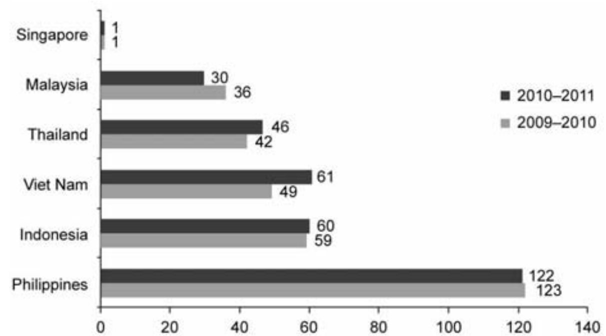
[28] As compared to 22 weeks in Indonesia, 24 weeks in Malaysia, 54 weeks in Thailand, and 13 weeks for a local case and 17 weeks for one rendered abroad in Viet Nam.

Figure 32: Caseload of Courts in the Philippines



lhs = left-hand side, rhs = right-hand side.
Source: Supreme Court of the Philippines and National Statistical Coordination Board as cited in Joint Chambers of the Philippines (2010).

Figure 33: Efficiency of Legal Framework in Settling Disputes



Note: In the 2009–2010 survey, 133 countries were evaluated, and in 2010–2011, 139 were evaluated.
Source: World Economic Forum (2009 and 2010).

44. **At the local level, decisions by courts can slow down implementation of national government policies.** Decisions by local courts have suspended implementation of government policy aimed at development of domestic automobile production through eliminating importation of used cars to the Philippines (Box 3). Apart from affecting the country's investment climate and the government's capacity to conduct economic reforms, such decisions have also had an impact on the domestic automobile manufacturing industry's profitability and employment-generation capacity.

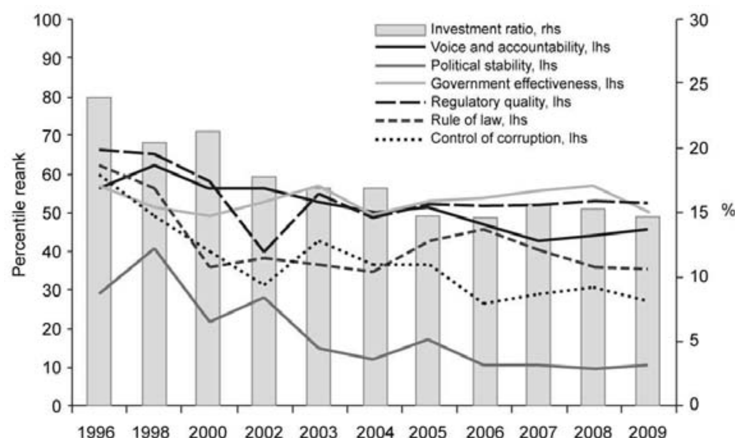
Box 3: Controversial Decisions of Local Courts

Used vehicle auction firms in the Subic Bay Freeport Zone obtained a temporary restraining order from the Olangapo Regional Trial Court against enforcement of Executive Order No. 156 from 12 December 2002. In response to this, the government appealed first to the Court of Appeals and later to the Supreme Court, which eventually affirmed the validity of the executive order. However, during the legal proceedings, about 150,000 vehicles were imported, converted to right-hand drive, and auctioned, depressing the domestic market both for new and used cars and leading to large job losses at auto-manufacturing factories, which operated far below capacity.

After issuance of Executive Order No. 156, several used car auction firms at Subic relocated to the Cagayan Special Economic Zone and Freeport. There, they continued to import and sell 4,000–7,000 used cars annually. Before starting their businesses at the new location, these firms received the decision of the Aparri Regional Trial Court, which basically exempted these firms from the executive order. It took about 2 years for the solicitor general to decide that Executive Order No. 156 also applied to Cagayan Freeport. After that, in September 2010, the Regional Trial Court finally ordered the Cagayan Special Economic Zone to stop issuing gate passes for used cars to exit the freeport.

45. **Weak governance and corruption seriously affect public coffers and the economy as a whole.** Corruption, based on the estimate of Transparency International, consumes 20% of the country's budget (GOP, Department of Budget and Management 2010). The Parliamentary Committee in the Philippines calculated that in 2002, corruption cost the government $1.9 billion annually—twice the size of the national education budget or almost 2.5% of GDP in 2002 (Poroznuk 2006). Despite the Run after Smugglers Program of the Bureau of Customs, smuggling of diesel and avturbo fuel might be costing the budget a loss of up to P30 billion in revenues annually; it is estimated that about one-third of government procurement is wasted because of corruption (Joint Foreign Chambers of the Philippines 2010, p. 293).[29] Overall, since 1996, there seems to be a relationship between investments as share of GDP and governance indicators, as both show similar declining dynamics (Figure 34).

Figure 34: Investment and Governance Indicators in the Philippines



lhs = left-hand side, rhs = right-hand side.
Source: National Statistics Coordination Board and World Bank as cited in Joint Foreign Chambers of the Philippines (2010).

B. Inadequate Business Environment

46. **Inadequate infrastructure is a major development constraint in the Philippines** (ADB 2007b). Infrastructure development has not kept pace with continued population growth of, on average, 2.3% annually in the last 2 decades as well as increasing urbanization. Over the past decade, the total infrastructure investment in the Philippines has averaged 2.9% of GDP, well below the recommended 5.0% benchmark (World Bank 2005). This indicates an annual financing gap of over 2.0% of GDP, or about $3.2 billion based on the GDP of $161.0 billion in 2009. The public sector's ability to invest, operate, and maintain infrastructure has remained constrained due to limited fiscal space.

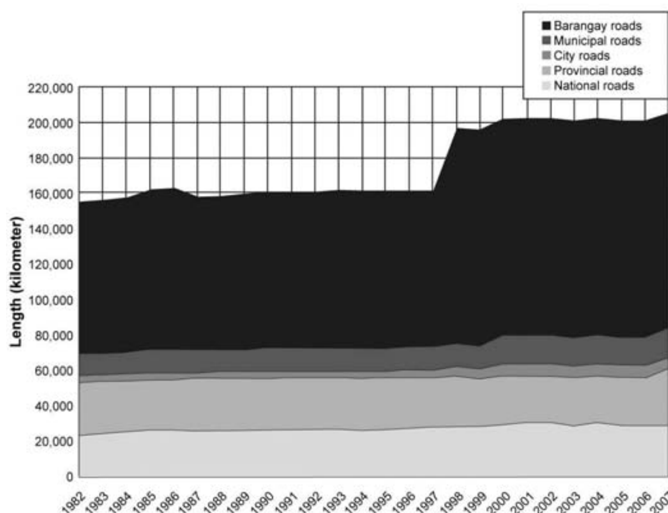
47. **Further, the enhancement of road infrastructure has been insufficient to serve the needs of the expanding economy.** The length of national roads, which are critical for interprovincial trade and economic convergence, has not increased in the last decades (Figure 35) with *barangay* (neighborhood) roads receiving most of the new stock.[30] More importantly, the quality of roads is low, as only 22% of roads are paved. The population density of paved roads is also very high—almost 2,000 people per 1 kilometer of paved road, which compares with the country's neighbors very unfavorably (Table 8). It is estimated that severe

[29] The same source indicates that the number of legally imported and manufactured vehicles is considerably lower than the number of vehicles registered every year in the Philippines. Philippine statistics on imports from the People's Republic of China are lower by several times than the People's Republic of China's statistics on exports to the Philippines.

[30] This is attributed to the fact that *barangay* roads are the usual recipients of the so-called Countryside Development Funds received by each congressperson (P70 million) and senator (P200 million). The total fund budget is about P250 billion each year. Countryside Development Fund-financed investments are not well integrated with government investment priorities and programs.

traffic in Metro Manila might cost the economy more than P100 billion (in 1996 prices) annually (Sigua and Toglao 2007). In addition, the Department of Transportation and Communications estimates that traffic congestion causes up to P140 billion every year in direct and indirect economic losses (Pinoy Dad http://pinoydad.com/metro-manila-traffic-costs/).

Figure 35: Total Road Length in the Philippines



Source: Department of Public Works and Highways as cited in Joint Foreign Chambers of the Philippines (2010).

Table 8: Road Quality and Density in Selected Southeast Asian Countries

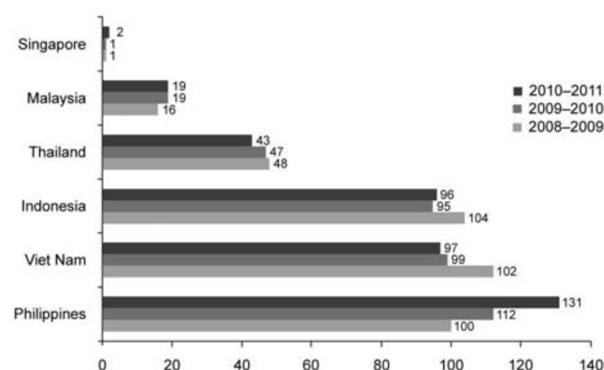
Country	Total Road Network ('000 km)	Paved Roads as % of Total Road Network	Population per km of Road	Population per km of Paved Road
Indonesia	437.8	59.1	521	882
Malaysia	122.7	79.9	220	275
Philippines	200.8	22.2	426	1,913
Singapore	3.3	100.0	1,455	1,455
Thailand	98.1	99.9	683	684

km = kilometer.
Source: Joint Foreign Chambers of the Philippines (2010).

48. **The maritime transport infrastructure quality is low, and its services are expensive.** The country ranks poorly in terms of quality of seaport infrastructure (Figure 36), despite the obvious critical importance of seaports for the national economy given the archipelagic nature of the Philippines. The cost of exporting a container from the Philippines is high in comparison with the country's neighbors (Table 9). It is, in fact, more expensive to ship goods from Manila to Davao than from Manila to, for example, Jakarta (Table 10). This is reported to be the effect of the country's cabotage regulations, which prohibit foreign flag vessels from picking up local cargo for delivery to another port within the Philippines.[31] This arrangement limits the contestability of goods and passenger shipping to domestic shipping companies, which are reported to breed oligopolistic behavior in the sector. Most adversely affected by the cabotage law is Mindanao and, among businesses, micro and SMEs.

[31] The cabotage-related provisions are reflected in the Tariff and Customs Code of the Philippines. For details see Lorenzo (1998).

Figure 36: Quality of Port Infrastructure in Selected Asian Countries



Note: In 2008–2009, 134 countries were evaluated; in 2009–2010, 133; and in 2010–2011, 139.
Source: World Economic Forum (2009 and 2010).

Table 9: Container Exporting Cost in Selected Southeast Asian Countries
($)

Item	Philippines	Thailand	Indonesia	Viet Nam
Terminal handling charge[a]	96	74	95	60
Cargo handling[b]	52	37	34	79
Port charges and/or wharfage	6	22	0	1.6
Customs and security fee	45	37	23	50
Documentation	42	16	20	13
Trucking	100	126	100	138
Total	**341**	**312**	**272**	**341.6**

[a] The reported terminal handling charge refers to inter-Asia trade. The average terminal handling cost of a 20-foot container from Asia to the United States or Europe is $104.
[b] For the Philippines, this figure reflects only the cost of arrastre. The stevedoring cost is embedded in the terminal handling charge.
Source: Joint Foreign Chambers of the Philippines (2010).

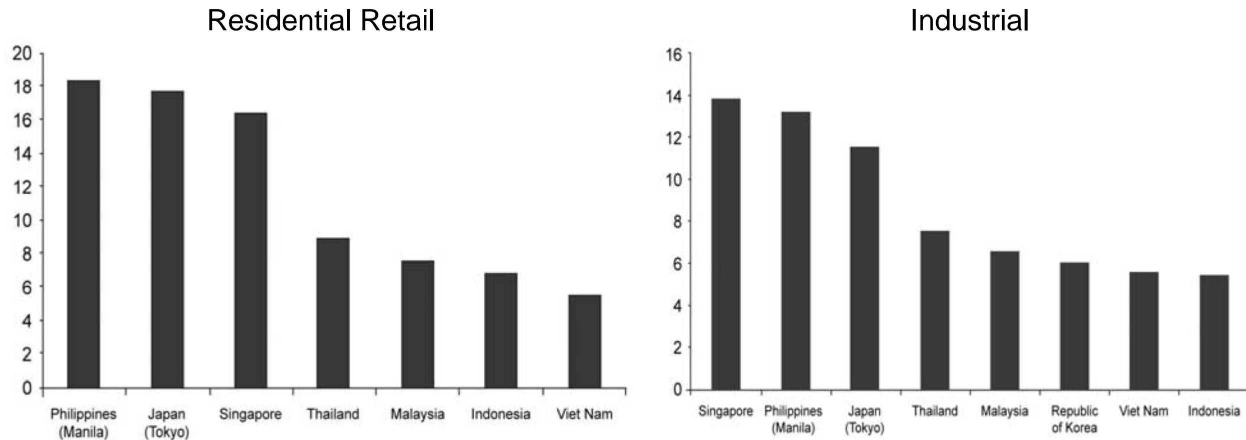
Table 10: Ocean Freight Rates from Manila to Selected Ports

Route	Distance (nautical miles)	Freight[a] ($)	Rate ($/nautical mile)
Manila–Kaohsiung	547	300.00	0.55
Manila–Hong Kong, China	633	250.00	0.39
Manila–Singapore	1,308	350.00	0.27
Singapore–Manila	1,308	350.00	0.27
Manila–Bangkok	1,485	600.00	0.40
Manila–Jakarta	1,308	650.00	0.41
Jakarta–Manila	1,308	650.00	0.41
Manila–Davao	*829*	*1,047.14*[b]	*0.97*

[a] Excludes terminal handling fee of P3,220.00 and documentation fee of $20.00.
[b] Includes local arrastre at ports of origin and destination, wharfage, and documentation stamps.
Sources: Commission on Audit, Philippine Shippers' Bureau, Domestic Shipowners' Association.

49. **Electricity cost is high, and interruptions in its supply cause significant losses to enterprises.** Residential and industry electricity tariffs in the Philippines are among the highest in Asia (Figure 37) reaching $0.20 per kilowatt-hour. On average, firms in the country lose some 4% of their sales due to power outages, with large firms' losses being closer to 6%. This compares the Philippines unfavorably with the average loss of 3% of sales in East Asia and the Pacific (World Bank and IFC 2009). Overall, electricity has been among the top constraints to business in the last years. Due to the high cost of electricity in the Philippines and frequent supply disruptions, some firms prefer to generate electricity on their own (i.e., off-grid) with savings in the range of P2–P3 per kilowatt-hour (ADB 2010d).

Figure 37: Electricity Tariffs in Selected Asian Economies in 2010
(cents per kilowatt-hour)



Source: Joint Foreign Chambers of the Philippines (2010).

50. **SMEs have insufficient access to finance...** Overall, only about 33% of Philippine firms have lines of credit from financial institutions, a figure below the region's average of 40% (World Bank and IFC 2009). Similarly, only 22% of firms finance investment needs using banks, although the average number for the region is 28%. The value of collateral needed to get a loan from a Philippine bank represents about 240% of the aspired loan, which is also significantly higher the region's average of 171%. Access to finance is even more problematic if the SME sector, which employs 31% of workers, is considered. For example, in the case of small enterprises, only 20% have lines of credit, 15% use bank loans for investment purposes, and the collateral–loan ratio is more than 300%.[32] A survey conducted by GTZ in 2009 found that 45% of all micro and SMEs, particularly smaller enterprises, did not use credit from financial institutions. The same survey found that there was little improvement over time in micro and SME access to credit (Small and Medium Enterprise Development for Sustainable Employment Program www.smedsep.ph).

51. **… largely due to lack of information.** The 2008 Magna Carta for Micro and SMEs (Republic Act No. 6977) requires that banks have at least 8% of their lending portfolio in loans to micro and small enterprises and at least 2% in loans to medium-sized enterprises. This requirement has been, in fact, surpassed with the average reported bank lending more than 20% to SMEs. Yet anecdotal evidence, supported by various surveys, suggests the opposite. Financial institutions' adverse attitude to SME lending is caused by (i) insufficient collateral, (ii) limited credit histories and banking experience, (iii) inadequate financial records and business plans due to the lack of accounting knowledge, and (iv) high interest rates charged by lenders to cover perceived high SME default risks and costs of servicing such small-yield clients as SMEs.[33] Insufficient information on SMEs for lending decisions can be seen in Table 11, which implies that there is little to no credit history coverage of bank clients in the country.

[32] According to the World Bank (2010a), the annual unmet demand for SME loans was between P67 billion and P180 billion. In 2000–2006, nominal lending to micro and SMEs rose on average by 3.7% annually, lower than the inflation rate.

[33] Banks normally prefer real estate as collateral. Some banks are reported to accept chattel mortgages, joint and several securities, and other forms of collateral. Overall, banks tend to rely more on collateral, giving less weight to business profitability, viability, or credit history of the borrowing SME. Many SMEs are reported to very seldom avail of banks' nonlending services, such as deposit and payroll services.

A good development in improving financial records of SMEs was the adoption of International Financial Reporting Standards for SMEs in the Philippines in January 2010 (Box 4).

Table 11: Credit Bureau Coverage in Selected Southeast Asian Countries

	Indonesia	Malaysia	Philippines	Thailand	Viet Nam
Public registry coverage of adult population (% of adults)	25.0	62.0	0.0	0.0	26.4
Private bureau coverage of adult population (% of adults)	0.0	100.0	7.4	35.7	0.0

Source: World Bank (www.doingbusiness.org).

Box 4: International Financial Reporting Standards in the Philippines

International financial reporting standards for small and medium-sized enterprises (SMEs) were developed by the International Accounting Standards Board to assist SMEs in reporting high-quality financial information in a consistent manner, while acknowledging the need to be simple and cost-effective. The standards, with 230 pages and organized by topic, stand alone from full international financial reporting standards, which are 3,000 pages long. The international financial reporting standards for SMEs reflect user needs for information about cash flows, liquidity, and solvency as well as actual SME capabilities and costs of preparation.

SMEs want to adopt these standards because of (i) improved access to capital, (ii) improved comparability, (iii) improved quality of reporting as compared to existing national generally accepted accounting principles, (iv) less burden for SMEs in jurisdictions where full international financial reporting standards or full national generally accepted accounting principles are now required, and (v) their streamlined structure.

The standards were adopted in the Philippines on 1 January 2010 and are known as the Philippine Financial Reporting Standards (PFRSs) for SMEs. Listed companies, large unlisted companies, financial institutions, and public utilities are required to use full PFRSs, which are nearly identical to full international financial reporting standards. The PFRSs for SMEs must be used by any other entity that has total assets of between P3 million and P350 million ($70,000 to $8,000,000) or total liabilities of between P3 million and P250 million ($70,000 to $5,500,000). Entities below those thresholds (i.e., micro entities) may use the PFRS for SMEs or another acceptable basis of accounting.

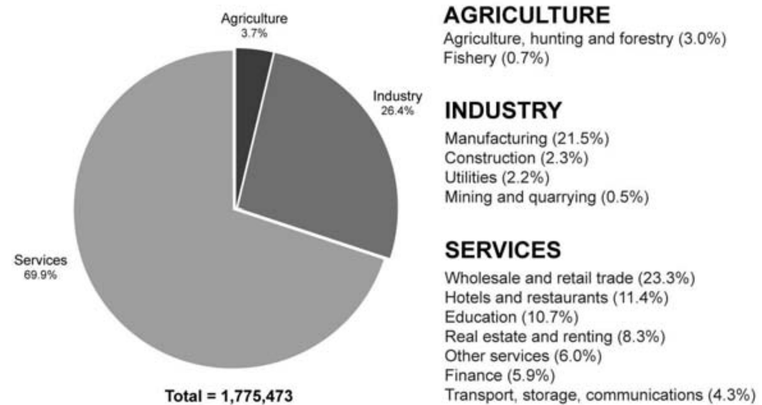
52. **There is lack of synergy between SMEs and large firms, especially in agribusiness.** Small farmers' efficiency is low due to their small scale,[34] and they face increasing competition from abroad as the Association of Southeast Asian Nations (ASEAN) free trade agreements with other countries, including the People's Republic of China and India, are gradually rolled out with the relevant tariffs to be either significantly reduced or eliminated. There were good examples of integration of small farmers into large agribusiness enterprises, such as with production of bananas, cassava, coffee, and jatropha, in Luzon and Mindanao, including the Autonomous Region in Muslim Mindanao.[35] Factors of success provided by large enterprises were guaranteed floor prices, facilitated access to bank financing, technical support, and treatment of the small farmers as partners.

[34] One of the factors for this is the provision in the Comprehensive Agrarian Reform Program that its beneficiaries cannot sell nor mortgage their land for 10 years.

[35] For more details see Joint Foreign Chambers of the Philippines (2010, pp. 65–66).

53. **Overall, manufacturing SMEs in the Philippines do not produce technology and are not innovation-oriented.** Manufacturing SMEs represent about 20% of total SMEs; the majority of SMEs is in the services sector (Figure 38). Within manufacturing, SMEs are concentrated in fairly traditional product groups: the food industry, organic and marine groups, wearable industries (i.e., garments, fine and costume jewelry, footwear, and accessories), leather goods, crafts and home furnishings (i.e., gifts, toys, housewares, and handicrafts), furniture and building materials, micro-electronics, and automotive and machine parts and components (GOP, Department of Trade and Industry 2006). In micro-electronics and automotive and machine parts, SMEs are largely involved in the assembly of imported inputs for either export or domestic consumption. Manufacturing SMEs, therefore, are not engaged in producing machines that make other things unlike the SMEs in, for example, Germany (*Economist* 2011).[36] This makes the Philippine SMEs largely users of the technology, rather than producers, thus limiting SME productivity growth to a low-technology trajectory. More importantly, from the long-term development perspective, the Philippines needs to start moving toward an innovation-producing and -intensive economy given the experiences of Japan, the Republic of Korea, and Taipei,China.

Figure 38: Composition of Small and Medium-Sized Enterprises in the Philippines by Sector



Source: Institute for Development and Econometric Analysis and BayanBusiness (2010).

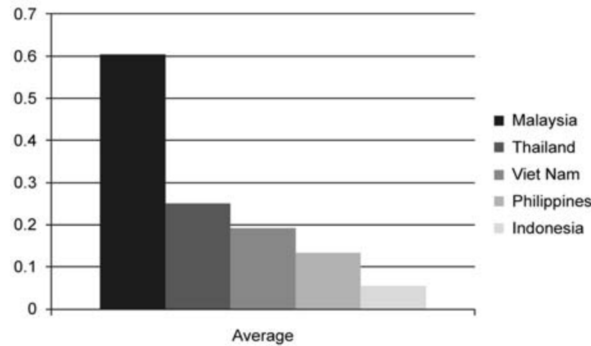
54. **Low research and development spending is, to a significant extent, the cause of slow technological progress and lack of homegrown innovations.** The country's spending of 0.11% of GDP on research and development is among the lowest in the world. Among its neighbors, only Indonesia spends less (Figure 39), while Malaysia spends 0.60% of its GDP; Thailand, 0.25%; and Viet Nam 0.20%. In terms of density of researchers, the Philippines is behind all of its neighbors with only 76 researchers per 1 million population, while the next country, Viet Nam, has 40 researchers more per 1 million (Figure 40).

55. Further, the Philippines is among the 10 countries in the world with the lowest public expenditure on higher education. In 2005–2007, the country spend only 11% of GDP per capita on higher education, while Malaysia spent 60%, Thailand 18%, and the average spending in East Asia was 24% of GDP per capita (World Bank 2010b, p. 3). This surely has contributed to the very low ranking of the country's universities in a global comparison. The Ateneo de Manila University was ranked 307th and the University of the Philippines was ranked 314th in 2010 (QS Top Universities www.topuniversities.com). However, there was no Philippine university

[36] The SMEs in Germany are normally referred to as *mittelschtand*, which is reported to be the motor of German growth and the country's "hidden champion." The *mittelschtand* is characterized by a mixture of engineering, technology, and service that has allowed German SMEs to increase their share of world markets by excelling in areas that demand constant, incremental innovation. The clients of German SMEs value not only the technical specifications of the specialized machines produced by the SMEs, but also—and this might be even more important than the machines themselves—the reliability, support, and services provided by the SMEs with their products.

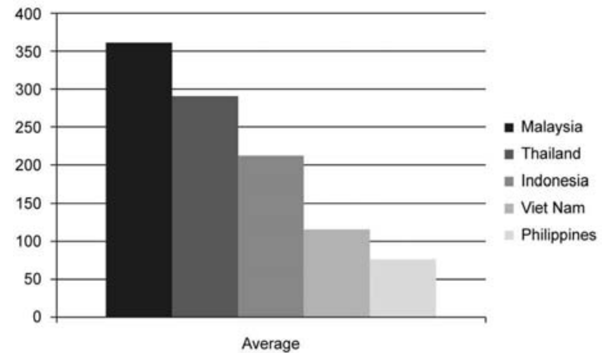
included in Shanghai Jiaotong University's 2010 Academic Ranking of World Universities (www.arwu.org/).

Figure 39: Research and Development Spending in Selected Southeast Asian Counties
(% of gross domestic product)



Note: Averages: Malaysia, 2000, 2002, 2004, 2006; Thailand, 2000–2006; Viet Nam, only 2002 data were available; Philippines, 2002, 2003, and 2005; Indonesia, 2000, 2001, and 2005.
Source: World Development Indicators.

Figure 40: Researchers in Research and Development in Selected Southeast Asian Counties
(per million people)



Note: Averages: Malaysia, 2000, 2002, 2004, 2006; Thailand, 2000–2006; Indonesia, 2000–2001; Viet Nam, only 2002 data were available; and Philippines, 2003 and 2005.
Source: World Development Indicators.

V. GOVERNMENT PRIVATE SECTOR DEVELOPMENT SUPPORT

56. Retrospectively, government PSD support can be grouped into three broad areas: support to micro and SMEs, fostering PPPs, and facilitation of FDI.

A. Support to Micro, Small, and Medium-Sized Enterprises

57. SMEs have been the focus of the government's economic policy since 1970, with the most recent SME development strategic framework being the 2003 National SME Agenda (Figure 41). A landmark step in SME development was adoption of the Magna Carta for SMEs (Republic Act No. 6977) in 1991, whose salient features were creation of the SME Development Council, provision for mandatory allocation of bank funds for lending to SMEs, and establishment of the Small Business Guarantee and Finance Corporation.[37]

Figure 41: Selected Small and Medium-Sized Development Milestones, 1972–2009

BMBE = Barangay Micro Business Enterprises, DRIVE = Developing Rural Industries and Village Enterprises, SE = small enterprises, SMEs = small and medium-sized enterprises, SULONG = SME Unified Lending Opportunities for National Growth.
Source: Institute for Development and Econometric Analysis (2010).

58. The SME Development Plan, 2004–2010 is the road map adopted by the government to implement the national SME agenda (GOP, Department of Trade and Industry 2006). Support to micro and SMEs was also the focus of the Medium-Term Philippines Development Plan, 2004–2010 (GOP, NEDA 2004), which aimed to create, by 2010, 6 million jobs through enhancing entrepreneurship opportunities, tripling the amount of lending to SMEs, and developing 1 million–2 million hectares of land for agricultural business. Attainment of these objectives has been supported through the SME Unified Lending Opportunities for National Growth and Microfinance Program, 2008 Magna Carta for Micro and SMEs, and 2003 Barangay Microbusiness Enterprise Law.

59. For example, in 1997–2006, financing institutions had, on average, 19% of their total loan portfolios in micro and SME lending, based on the requirements of the 2008 Magna Carta

[37] The SME Development Council was later reformed into the Micro and SME Development Council through adoption of 2008 Magna Carta for Micro and SMEs (Republic Act No. 9501). Its mandate is to spur the growth and development of micro and SMEs by facilitating and closely coordinating national efforts to promote their viability and growth, including assisting relevant agencies in tapping local and foreign funds for micro and SME development, promoting the use of existing programs, and seeking ways to maximize the use of labor resources. The Bureau of Micro, Small, and Medium Enterprise Development of the Department of Trade and Industry serves as the secretariat of the council. Further, after the merger of the Small Business Guarantee and Finance Corporation with the Guarantee Fund for Small and Medium Enterprises in November 2001, its name was changed to the Small Business Corporation.

for Micro and SMEs. Under the SME Unified Lending Opportunities for National Growth and Microfinance Program, which was funded by the Small Business Guarantee and Finance Corporation and six other government financial institutions,[38] lending to SMEs increased from P24 billion in 2004 to P36 billion in 2008. As of December 2009, it is reported that a total of P187.3 billion in loans to 166,355 SMEs were provided, which sustained 2.8 million persons. There were also several SME-centered capacity-building initiatives, such as the Small Enterprise Technology Upgrading Program of the Department of Science and Technology to foster technological innovations and knowledge transfer, and the ISTIV Productivity Awareness Program of the National Wages and Productivity Commission to make SMEs more productive through efficiency gains.[39] However, despite all of these efforts, the intention of the SME development plan to make the SMEs sector a key factor in Philippine economic growth remains unrealized.

60. President Aquino, in his State of the Nation Address of 26 July 2010, emphasized micro and SME development. He indicated that the government will take measures to reduce the time to register business names from 4–8 hours to 15 minutes, reduce the number of documents in the checklist for business opening from 36 to 6, shorten the application for business registration form 8 pages to 1 page, and adopt an anti-trust law to foster SME development. Support to micro and SMEs is one of 10 strategic support areas under the competitive industry and services sector theme of the Philippines Development Plan, 2011–2016, which sets the objective of generating 6 million jobs in general, and 2 million through micro and SME expansion specifically, by 2016.[40] The plan also aims to increase the micro and SME share in gross value added to 40.0% from the current level of 35.7% (GOP, NEDA 2011).

B. Fostering Public–Private Partnerships

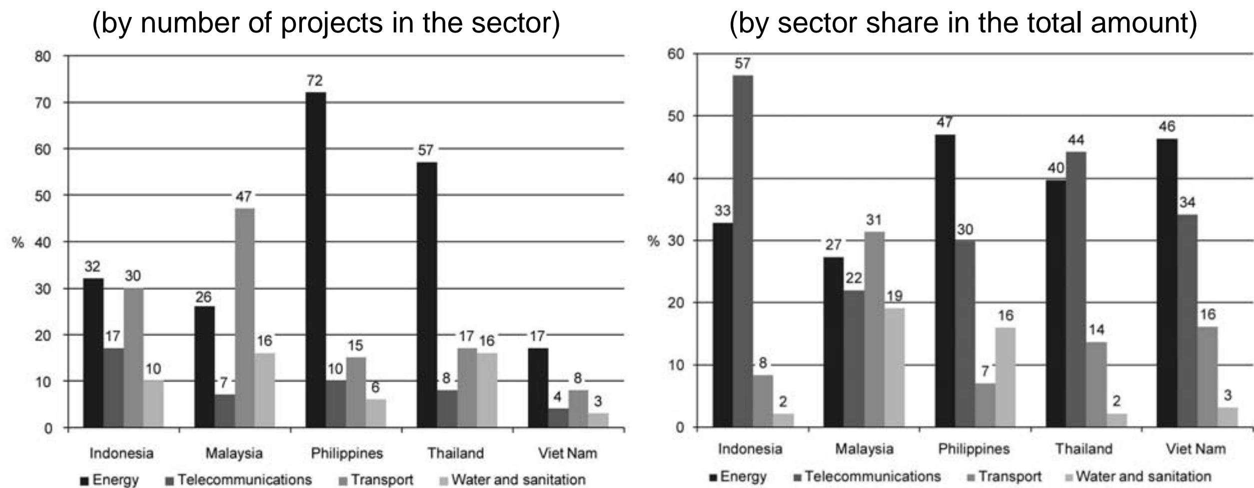
61. The Philippines was one of the first developing countries with a BOT law[41] and a dedicated BOT center. The Philippines has had a successful experience with PPPs in the power sector; of the 103 PPP projects that reached financial closure during 1990–2009, 72 were in the energy sector, or 47% of the total amount of financially closed PPP projects (Figure 42). Of these, most were in power generation that is less prone to the overall governance environment due to the relative physical insulation of power-generation facilities and long-term power purchase agreements (World Bank http://ppi.worldbank.org). However, due to weak governance and despite abundant savings,[42] successful private investment in other infrastructure sectors has been rather limited, with the North Luzon Expressway Project and Manila Water being the most known examples of successful PPPs. High-profile failures include the BOT contract for Ninoy Aquino International Airport's terminal III (Box 1). This partly explains why private infrastructure investment commitments declined from a peak of 15.5% of GDP in 1997 to an average of 2.1% during 1998–2009 (World Bank http://ppi.worldbank.org).

62. Over the last decade, unsolicited proposals have markedly increased. Of the 14 transport PPP projects that have been operational since 1993, 11 were from unsolicited

[38] The Land Bank of the Philippines plays a leading role, followed by the Development Bank of the Philippines, National Livelihood Development Corporation, Quedan Rural Credit and Guarantee Corporation, Philippine Export and Import Credit Agency, Small Business Corporation, and Social Security System.
[39] "I" stands for industrious, "S" for systematic, "T" for time-conscious, "I" for innovative, and "V" for value for work.
[40] The plan's overall employment generation target is 6 million.
[41] An Act Authorizing the Financing, Construction, Operation and Maintenance of Infrastructure Projects by the Private Sector and for Other Purposes (Republic Act No. 6957 as amended by Republic Act No. 7718)
[42] In 2000–2009, the average gross savings exceeded gross capital formation by about 9.2% of GDP (World Development Indicators).

proposals (Basilio, Hernandez, and Rosales 2010). Moreover, transparency in PPPs has deteriorated with the adoption of joint venture guidelines by the National Economic Development Authority (NEDA) in April 2008 that enables government-owned and -controlled corporations and government corporate entities to sign a joint venture agreement with a private proponent without being subject to the normal review and approval process through the Investment Coordination Committee of the NEDA Board.

Figure 42: Sector Distribution of Financially Closed Public–Private Partnership Projects in Selected Southeast Asian Countries



Source: World Bank (http://ppi.worldbank.org).

63. Yet the government has shown strong commitment to moving its PPP agenda forward. The BOT Center has been reorganized as the PPP Center and attached to NEDA. The Project Development Facility has been revitalized as the Project Development and Monitoring Facility managed by the PPP Center as a revolving fund, which has been allocated P300 million to help implementing agencies structure, prepare, and competitively tender bankable PPP projects.[43] Separately, significant funding has been provided to selected line departments for PPP project preparation and implementation purposes. In addition, the government is in the process of developing an interim scheme to provide access to long-term financing for PPP projects until a dedicated infrastructure finance facility can be established. In 2010, NEDA initiated a review of the BOT Law and its implementing rules and regulations. The government also presented its agenda to foster PPPs at an international PPP investment conference held in Manila from 18 to 19 November 2010 (GOP 2010), at which a list of 10 PPP projects for rollout in 2011 and a substantial number of projects for rollout over the medium term were presented.

64. The focus on PPPs was also specifically mentioned in President Aquino's 26 July 2010 State of the Nation Address. He indicated that PPPs are considered the solution to the problem of immense infrastructure investment needs and scarcity of government funds. The government intends to speed up development of PPP projects in transport (i.e., expressways), agriculture-related facilities (i.e., grain terminals, refrigeration facilities, road networks, and post-harvest facilities), railways, and education. He also stated that the government will reduce the review of a submitted BOT project proposal to 6 months, and these projects will be bid on in a transparent, competitive manner.

[43] Executive Order No. 8 dated 9 September 2010.

65. According to the Philippines development plan, promotion of PPPs is a major element of the government efforts toward a better business environment and improved productivity and efficiency under the more competitive industry and services sector theme. The plan indicates that the government's infrastructure initiatives will be pursued through PPPs, and the government will ensure transparent bidding of PPP projects in 2011–2014. The plan also indicates that the Philippines Infrastructure Development Fund will be established to provide a long-term fund structure to sustain and promote PPPs in the country. Legal and procedural reforms to revive the PPP programs are also on the plan's agenda.

C. Facilitating Foreign Direct Investment

66. The government has undertaken series of reforms to attract FDI to the country. These reforms have focused on streamlining and simplifying legislation as well as creating institutions specializing in investment facilitation, including FDI. One such landmark reform was adoption of the Omnibus Investments Code in 1987, creating the Board of Investments, institutionalizing an annual investment priority plan, allowing up to 100% foreign equity in export enterprises, and providing fiscal incentives such as income tax holidays of up to 6 years.

67. Another important step was adoption of the Foreign Investment Act in 1991, which liberalized the entry of foreign investments by opening the domestic market to 100% foreign investment projects (except in areas or sectors identified on the Foreign Investment Negative List) and allowing 100% foreign ownership in domestic market activities if the foreign investor invests at least $100,000 (with advanced technology or employment of 50 direct employees). Since adoption of this law, the number of exceptions to foreign ownership in domestic companies has gone down significantly but is still considered restrictive in comparison with other countries (Box 5).

68. Foreign investment in the export industry has been specifically supported by the government. For example, the Export Development Act of 1994 was adopted to develop the export sector by granting incentives, such as tax credits and exemption from duties for imported inputs and raw materials used in production. The Special Economic Zone Act adopted in 1995, which created PEZA, provided a framework for establishment and regulation of public and private sector economic zones for export of goods and services.[44] According to this act, enterprises located in the economic zones may import free of duty and taxes, and their income is subject to a 5% gross receipt tax, shared between national and local governments. This approach has largely targeted FDI for big projects, for which domestic financial resources and know-how were lacking.

[44] Apart from PEZA and the Board of Investments, there are two other investment promotion agencies: the Clark Development Corporation and the Subic Bay Metropolitan Authority. These manage the Clark and Subic special economic zones, which represent separate customs territories ensuring free flow or movement of goods and capital within, into, and out (for export) of the two economic zones. Enterprises working in these zones are also offered fiscal incentives such as a 5% tax on gross income earned.

Box 5: Foreign Equity Ownership Restrictions in the Philippines

"Among the 87 countries covered in Investing Across Sectors indicators, the Philippines imposes foreign equity ownership restrictions on more sectors than most other countries. The country imposes ownership limitations on many industries, in particular on the primary and service sectors. Foreign capital participation in the mining and oil and gas industries, for example, is limited to a maximum share of 40% by the Philippine Constitution. Foreign ownership in those sectors, however, may be allowed up to 100% if the investor enters into a financial or technical assistance agreement with the government. Such agreements are granted for a 25-year term and require a minimum investment of $50,000,000. In the service sectors, the Constitution limits foreign capital participation in public utilities (telecommunications, electricity, and transportation) to a maximum of 40%. The media industries (newspaper publishing and television broadcasting) and publishing sector are closed to foreign equity ownership."

Foreign Equity Ownership Index in Selected Southeast Asian Countries

Region or Economy	Mining, Oil, and Gas	Agriculture Forestry	Light Manufacturing	Telecommunications	Electricity	Banking	Insurance	Transport	Media	Construction, Tourism, and Retail	Health Care and Waste Management
Indonesia	97.5	72.0	68.8	57.0	95.0	99.0	80.0	49.0	5.0	85.0	82.5
Malaysia	70.0	85.0	100.0	39.5	30.0	49.0	49.0	100.0	65.0	90.0	65.0
Philippines	40.0	40.0	75.0	40.0	65.7	60.0	100.0	40.0	0.0	100.0	100.0
Singapore	100.0	100.0	100.0	100.0	100.0	100.0	100.0	47.4	27.0	100.0	100.0
Thailand	49.0	49.0	87.3	49.0	49.0	49.0	49.0	49.0	27.5	66.0	49.0
Viet Nam	50.0	100.0	75.0	50.0	71.4	65.0	100.0	69.4	0.0	100.0	75.5
East Asia and Pacific	**75.7**	**82.9**	**86.8**	**64.9**	**75.8**	**76.1**	**80.9**	**63.7**	**36.1**	**91.6**	**84.1**
World	**92.0**	**95.9**	**96.6**	**88.0**	**87.6**	**91.0**	**91.2**	**78.5**	**68.0**	**98.1**	**96.0**

Note: An index value of 100 means that full foreign ownership is allowed. An index value of 0 means no foreign ownership is allowed.
Source: World Bank (http://iab.worldbank.org).

69. The government's intention to streamline fiscal incentives was indicated by President Aquino in his State of the Nation Address as well. He mentioned that the government would reevaluate fiscal incentives to identify those that can be eliminated. Improvement of investment promotion areas is one of 10 strategic support areas under the Philippine development plan's competitive industry and services sector theme, with the objective of achieving, by 2016, some P3,800 billion in cumulative investments approved by government agencies (e.g., the Board of Investments and PEZA) dealing with investment facilitation and economic zones.

VI. POSSIBLE WAYS TO GO

70. To unleash the full potential of the private sector in the Philippines, state processes and the business environment need to be improved. The country's economy needs to grow faster than it has in the past to catch up with its rapidly growing neighbors and to remain competitive in and benefit from globalization. The private sector's role is crucial, as it is the major investor and employer in the country. Thus, the current trend of decreasing private investment needs to be reversed, and its level should return to where it was in mid-1990s—about 20% of GDP. Increased private sector investment will enhance employment and reduce underemployment, two issues of importance for poverty reduction.

71. As shown in section II, it is not the lack of capital that prevents the private sector from investment. A conducive environment must be created to unlock the abundantly available capital so that it can be invested productively. This unlocking of capital will occur if there is improvement in the efficiency of state processes, and if investors and entrepreneurs perceive the business environment as adequate.

A. Addressing Inefficient State Processes

72. **Adopt a freedom of information act.** There is information asymmetry in private–public sector relations: the public sector creates, changes, and enforces the rules with which the private sector should comply. Therefore, for the private sector to develop, it is important to be aware (at low or no cost) of frequently changing information on government policies and procedures. In the Philippines, the mechanism of accessing government-generated information needs streamlining and institutionalization to reduce direct and indirect transaction costs for the private sector. A freedom of information act and its implementing rules and regulations would address this issue, sending an important signal both to domestic and foreign investors on the continuous commitment of the government to improve governance. There were several initiatives to pass such an act; however, due to various reasons, the relevant bills were not approved.

73. **Intensify implementation of Anti-Red Tape Act.** The implementing rules and regulations of the Anti-Red Tape Act were adopted in July 2008. This act is seen as having potential to reform the country's government bureaucracy. However, the business community is still largely unaware of the act. Thus, it is important to assign to a capable government agency the responsibility of developing and implementing a national campaign to inform the public and business community of the act and its implementing rules and regulations. Other immediate actions could be development and disclosure in the relevant government agencies of easy-to-understand, step-by-step flowcharts on the registration, licensing, taxation, and other government processes pertaining to doing business, especially for business opening. To minimize direct interaction with different government officials, agency websites need to be kept updated with clearly perceivable and visually attractive information. The government may engage the services of an information technology firm with proven expertise in website design of major agencies in charge of business regulations.

74. **Institutionalize and capacitate the function of regulatory impact analysis.** As indicated above, it is important to have an efficient mechanism enabling low-cost access of the private sector to government-generated information. However, it is equally important to ensure that government-generated information (i.e., legislation and the regulatory framework) is relevant. This refers both to the flow (i.e., new regulations or amendments) and stock (i.e., the

existing regulatory framework) of government-generated information. Therefore, it is critical to ensure that creation of regulations is actually targeting the improvement of the quality of the regulatory framework as well as reduction of red tape. This is ensured through a regulatory impact analysis that takes into account economic, social, and environmental benefits and costs of proposed regulatory changes or new regulations on different groups such as consumers, businesses, the government, and society as a whole. A regulatory impact analysis is an important function that needs institutionalization through adoption of relevant legislation, creation of a dedicated structure to perform this function, and provision of capacity building to this structure. In some countries, there is an office of best regulatory practices, which conducts regulatory impact analyses that have shown significant positive impact on PSD.[45]

75. **Improve coordination with local government units during discussions on investment projects, and amend the Local Government Code.** It is important that LGUs respect investment incentives, including those on local taxes, agreed to by the investors and the relevant government agency on the basis of national legislation. To make this happen, a coordination mechanism should be set up that ensures consultations on and commitment of LGUs to the investment projects implemented in their territories. Government investment promotion agencies and relevant departments (e.g., the Department of Trade and Industry and Department of Interior and Local Governments) are most suited to consider the legal and institutional requirements for such a mechanism. In addition, the Local Government Code needs to be amended to synchronize it with national legislation on investment promotion and to ensure that no legal conflict exists between contracts with investors and the Local Government Code. Specific attention needs to be paid to LGU environmental clearances, regulatory frameworks, and local taxes as well.

76. **Update labor legislation, and improve the minimum wage determination system.** The Labor Code may need an update to ensure that the Philippines remains an attractive destination for FDI in terms of affordable, mobile labor. Consideration should be given to making rules on labor contracting and dismissal more flexible, introducing flexible work arrangements,[46] making provisions for nondiminution of wages and benefits more flexible, and allowing women to work at night. Another area for streamlining involves the number of holidays not exceeding the ASEAN average of 15 paid days off. The system of minimum wage determination also needs to become more flexible to take into account sector specifics as well as inflation and productivity. Consideration should be given to using smaller family size with more than one earner for minimum wage determination.

77. **Adopt and institutionalize an anti-monopoly and anti-trust framework.** A holistic anti-monopoly law and implementing rules and regulations are needed that would help systemically address existing noncompetitive behavior in several sectors as well as prevent emergence of such behavior.[47] Here, capacity building must be provided to a new, independent anti-monopoly institution to perform this function. This body could also address conflicts of interest with respect to regulators in selected sectors to ensure that sector regulation and

[45] An analysis of the options for creation of an office of best regulatory practices in the Philippines can be found in ADB (2010a). This report suggests, among other issues, that such an office can be established through an executive order and that it can be set up at NEDA.
[46] Flexible work arrangements have been allowed by the Department of Labor and Employment (Department Advisory No. 2, series of 2009) on a temporary basis to accommodate difficulties, which employers faced during the height of the global economic crisis in 2009. This was welcomed by employers that appreciated the fact that they could keep their permanent and high-value employees on the payroll during the crisis by using flexible work arrangements. Overall, this helped preserve many jobs.
[47] An anti-trust act was passed by the Senate in 2009 (Senate Bill No. 3197).

commercial activities are separated. Good international practices on competition policy in an emerging economy suggest the following core principles for competition legislation: (i) the law should be descriptive rather than prescriptive about the kinds of behavior that are prohibited, except for the most unambiguously prohibited behavior such as cartels; (ii) anti-competitive practices of state-owned enterprises should not be excluded from the legislation; (iii) the competition commission responsible for enforcing legislation should be fiscally and administratively autonomous, well funded, and subject to rules of transparency in its decision making, such as posting reports on its website; and (iv) the competition agency should not be excluded from reviewing the impact on competition of proposed regulations.

78. **Establish a mechanism to provide the judiciary with the investment climate impact perspective of relevant cases, and streamline the mechanism for implementation of arbitration awards.** Judicial decisions could benefit from being provided with an investment climate effect and significance perspective on business- and investment-related cases. Such a perspective can be provided through "friends of the court," a pool of respected business and economic experts whom judges could approach to hear their perspective on the case and its possible impact on the region, country, and/or province's investment climate. Courts also need to be motivated to direct and advise businesses to make greater use of alternative dispute resolution and arbitration mechanisms, such as court-annexed mediation and arbitration for civil disputes. Finally, a detailed mechanism needs to be developed, with the lead of the Supreme Court, to minimize the time that courts take to confirm arbitration awards. It is important that cases are reopened only when there is clear proof of the arbiters' negligence or unprofessionalism.

79. **Reduce the number of business registration procedures, and fully operationalize the Philippine Business Registry.** There are, on average, 18 procedures to process business applications and permits in the Philippines.[48] These can be reduced to six and made available online through the Philippine Business Registry to lessen the formal and informal costs of starting business.[49] The web-based Philippine Business Registry has two objectives: (i) provide unified registration and licensing procedures, and (ii) provide business development information to entrepreneurs. Although not fully operational, it has been linked to the registration systems of 18 central government agencies and 30 LGUs, which are considered critical to the success of the Philippine Business Registry. It is important to make the registry fully operational as soon as

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[48] These procedures are (i) verifying the availability of the company name with the Securities and Exchange Commission; (ii) obtaining a bank certificate of deposit of the paid-in capital from the authorized agent bank; (iii) registering the company with the Securities and Exchange Commission, and receiving a preregistered taxpayer's identification number; (iv) obtaining a community tax certificate from the City Treasurer's Office; (v) obtaining *barangay* clearance; (vi) notarizing the business permit and locational clearance application forms; (vii) obtaining locational clearance at the Urban Development–Zoning Administration Division; (viii) receiving an inspection for the locational clearance from the Urban Development–Zoning Administration Division; (ix) obtaining the business permit to operate at the Business Permits Office; (x) presenting the official receipt at the relevant LGU health department for the issuance of the sanitary permit; (xi) purchasing special books of accounts; (xii) registering for value-added tax at the Bureau of Internal Revenue; (xiii) paying for the documentary stamp taxes; (xiv) obtaining the authority to print receipts and invoices from the Bureau of Internal Revenue; (xv) printing receipts and invoices; (xvi) stamping receipts, invoices, and books of accounts by the Bureau of Internal Revenue; (xvii) registering with the Social Security System; and (xviii) registering with the Philippines Health Insurance Company.

[49] The proposed six procedures can be done through (i) reducing extra government layers (i.e., abolishing regional offices and strengthening provincial offices), and implementing coding in registration of business names to decentralize processing; (ii) decentralizing access to registration and processing as well as making the process of approval more transparent; (iii) abolishing outdated accounting requirements (e.g., legalization of books and receipts); and (iv) having up to four of the six procedures done online (e.g., company name verification, registration, and payment of fees). Further, ADB provided technical assistance to the government to develop the Philippine Business Registry, which can be accessed at http://www.business.ph.gov. See also ADB (2005b).

possible by adopting a time-bound action plan to be implemented by the responsible government agency.

80. **Simplify taxation of small businesses.** Surveys and anecdotal evidence suggest that compliance with tax regulations is burdensome to small businesses, and the bureaucratic complexity of taxation is reported to be among the major reasons for small businesses languishing in the shadow economy. This, in turn, has a negative budget revenue effect. Therefore, two major options should be considered, either exempting small businesses from income taxes in the first 3 years of operation or developing a simple tax regime specifically for small businesses. The argument in favor of former is that most small businesses exit the market in the first year of operation anyway, and by the third year, only a few really competitive small enterprises survive. The argument in favor of the latter is that there might be an increase in taxation revenue to the budget, as small firms that are partly in the informal sector will find it more beneficial to become fully legalized. Regardless of the option, it is important to simplify the small business taxation regime.

81. **Operationalize the Financial Rehabilitation and Insolvency Act.** The Financial Rehabilitation and Insolvency Act (Republic Act No. 10142) became effective in August 2010.[50] It will open up the opportunity to those entrepreneurs who failed to start a new business but are not discouraged by bureaucratic procedures or losing market and operational knowledge. It is important, however, to adopt implementing rules and regulations to this act, which would pay specific attention to low-cost, quick SME insolvency and rehabilitation procedures.

82. **Complete cadastral titling of land, and establish a central registry for land titles.** This will enable establishment of a modern, unified system for registration of secured transactions with the option to conduct searches of collateral among all registries. This will also help value land received by beneficiary farms under the Comprehensive Agrarian Reform Program, which will improve their access to credit from formal sources of financing. Establishment of such a system could lead to more investment in land as ownership will be certain, and this increased investment in land will foster private sector development in rural areas.

83. **Strengthen the National Competitiveness Council to become the main public–private mechanism in private sector development policy coordination and consultation.** The National Competitiveness Council, created in 2006, has missed its target of improving the country's competitiveness ranking from the bottom third to the top third by 2010. Among the reasons for its worse-than-expected performance have been its limited resources (from the government and from the private sector) and authority to direct government agencies to implement its suggestions aimed at competitiveness improvement. It is important to preserve and strengthen the council as a platform for government-private sector policy dialogue and coordination. To improve its effectiveness, a critical review of its structure and mandate is required to make it operational and to direct government agencies to take actions to improve competitiveness. After this review, the council needs to be provided with adequate resources to conduct dedicated research and coordination activities. A possible deliverable could be an annual statement on the nation's competitiveness to be submitted to the President and Congress for consideration and follow-up actions.

[50] This act provides a better basis for rehabilitation of troubled businesses. Specifically, it makes available three modes of rehabilitation: court-supervised rehabilitation, prenegotiated rehabilitation, and out-of-court or informal restructuring agreements or rehabilitation plans.

B. Addressing the Inadequate Business Environment

84. **Gradually increase public investments in infrastructure to at least 5% of the gross domestic product**. Government spending on infrastructure as a percentage of GDP has been constantly below that of its neighbors (Table 12). In fact, the already-low average annual government spending went down by 0.6% of GDP in the last decade as compared to its average level in the 1990s. In the mid-2000s, the government intended to increase annual public infrastructure spending to at least 5%, which would have brought the Philippines to the regional average of infrastructure spending (World Bank 2005). However, largely due to fiscal pressures, this intention did materialize. With the budget revenue reform gaining momentum, it seems that the government can start gradually increasing its infrastructure expenditures, which could reach the aspired 5% of GDP level over the next 3–4 years.[51]

Table 12: Central Government Capital Expenditure
(average annual % of gross domestic product)

	1990–1999	2000–2009
Indonesia	7.5	3.1
Malaysia	5.8	7.1
Philippines	*2.6*	*2.0*
Thailand	4.5	2.3
Viet Nam	5.7	8.7
Average	**5.2**	**4.7**

Note: For the Philippines, data for 2001–2009 are from the Department of Budget and Management.
Source: ADB Statistical Database.

85. **Facilitate private investment commitment in infrastructure through public–private partnerships to reach 4% of the gross domestic product...**[52] While the Philippines also experienced an overall decline in PPP projects after the 1997/98 Asian financial crisis, the decline in PPPs in the Philippines was much more prominent than in neighboring countries, except for Malaysia (Table 13). In Viet Nam, the private sector's commitment to infrastructure investment increased by almost 1.0% of GDP in total PPPs, and by 0.4% of GDP in nonenergy PPPs. For the country to unleash its potential and to address inadequate infrastructure,[53] which is one of its major development constraints, the Philippines must have the private sector return to infrastructure investments and even to go beyond its past investment levels. This would mean that overall PPP commitments of the private sector need gradually to reach some 4% of GDP per year, while commitments under nonenergy PPP contracts need to reach at least 2% of GDP, its average level in 1990.

[51] Total infrastructure investment in the Philippines averaged 3% of GDP in the last 7 years, below what the country's neighbors spent on infrastructure. The Philippines should invest at least 5% of GDP (both from public and private sources) into infrastructure to keep up with economic and demographic growth needs. See also ADB (2007b, p. 25).
[52] Private investment commitment in infrastructure refers to the total of financially closed PPP contracts, as reported in the World Bank's Private Participation in Infrastructure Database.
[53] The 2009–2010 Global Competitiveness Report ranked the Philippines 98th out of 133 countries surveyed regarding infrastructure, behind Singapore (4), Malaysia (26), Thailand (40), Indonesia (84), Viet Nam (94), and Cambodia (95, WEF 2009).

Table 13: Public–Private Partnership Infrastructure Projects in Selected Southeast Asian Countries
(period average, % of gross domestic product)

All Public–Private Partnerships

	1990–1999	2000–2009	Decline
Indonesia	1.3	0.7	0.5
Malaysia	3.7	2.2	1.5
Philippines	*3.6*	*2.1*	*1.5*
Thailand	1.4	1.1	0.4
Viet Nam	0.3	1.2	(0.9)

Nonenergy Public–Private Partnerships

	1990–1999	2000–2009	Decline
Indonesia	0.8	0.6	0.2
Malaysia	2.6	1.5	1.1
Philippines	*2.0*	*1.1*	*0.9*
Thailand	1.0	0.7	0.3
Viet Nam	0.2	0.5	(0.4)

( ) = negative.
Note: Project amounts reflect private sector financing commitments based on the public–private partnership contract.
Source: World Bank (http://ppi.worldbank.org)

86. …**through improving PPP policy, legal and regulatory frameworks...** As previously stated, the Philippines was one of the first developing countries with a BOT law and a dedicated BOT center. However, the enabling policy and legal and regulatory frameworks are unclear or inconsistently applied. Furthermore, many infrastructure projects have not been competitively tendered as PPPs, and the financial viability of several PPP projects has been undermined by the unwillingness or inability of the government to carry out its contractual agreements. Right-of-way acquisition processes and the lack of an adequate government budget for land acquisition have also severely hindered the implementation of PPP projects. Similarly, the inability of the government to grant an automatic franchise has resulted in a high degree of uncertainty for private sector project proponents.[54] Further issues include (i) the lack of schemes for viability gap financing for PPP projects with substantial economic benefits but limited commercial viability, and (ii) a lack of credible mechanisms for guaranteeing risks, particularly for regulatory-related risks. All of these policy and legal and regulatory framework issues need to be addressed through amendments to relevant laws and their implementing rules and regulations, and, if needed, adoption of new legislation.[55]

87. **… streamlining government's institutional setup and capacity to effectively promote and implement PPP projects…** In September 2010, the BOT Center was reorganized as the PPP Center and attached to NEDA. However, it lacks the necessary technical capacity to perform its role as the government's central PPP unit. Attaching the PPP Center to NEDA seems to be consistent with NEDA's role as the government's key socioeconomic planning and policy development and public investment programming and monitoring agency. However, in some aspects (e.g., PPP policy formulation, updating PPP legal and regulatory frameworks, and expert advice to other government agencies on PPP projects), there seems to be lack of clarity in delineation of responsibilities between the PPP Center and NEDA's BOT Group. The delineation of responsibilities between the PPP Center and government agencies both at the central and local levels is also unclear.

[54] The problem becomes even more apparent with the Toll Regulatory Board, which can refuse to grant a franchise to winning proponents of toll road projects.
[55] The government has already initiated a review of the BOT Law and its implementing rules and regulations. Among the issues being examined are the automatic grant of franchise, inclusion of joint venture arrangements as a variant of PPPs, and government guarantees and incentives to foster private sector interest in PPP projects.

88. Further, the technical capacity and budgets of government agencies in general, and the PPP Center in particular, are insufficient to design, develop, and competitively tender infrastructure projects. The PPP Center lacks ready-to-use tool kits and model PPP agreements for use by various line departments and LGUs. Sector-specific guidelines are also missing to consider the varying nuances of PPP viabilities (e.g., risk-sharing arrangements and appropriate contractual mechanisms) across sectors. Therefore, comprehensive capacity-building support to the PPP Center and other PPP stakeholders is required, accompanied by the streamlining of the government's PPP institutional setup.

89. **… strengthening systems and capacity to prepare bankable PPP projects…** Several agencies received substantial budget allocations in 2011 for preparation of PPP projects.[56] However, other agencies still lack sufficient resources and skills to move their PPP agendas forward. Overall, government agencies have insufficient project preparation capacity to address the wide range of complex economic, financial, technological, institutional, social, environmental, legal, and risk-sharing issues associated with large-scale infrastructure projects. Further, the risk of obtaining suboptimal consultancy advice for PPP project preparation is high given the nationality restrictions and price pressures arising from the government's consultant selection policies and procedures.[57] The Project Development Facility set up at the BOT Center in 1999 with donor funding had become essentially nonoperational until it was reorganized as the Project Development and Monitoring Facility in September 2010. It is, therefore, important to ensure that this facility's management systems and budget support are strengthened to safeguard the availability of a sustainable financing mechanism for preparing well-structured, bankable PPP projects.

90. **… and making long-term financing and risk guarantee mechanisms for the PPP projects available.** As previously stated, (i) banks in the Philippines dominate the country's financial system and are reluctant to provide long-term loans (beyond 10 years) for infrastructure projects; (ii) consortium lending, while growing, is uncommon among domestic lenders; (iii) the nonbank financial subsector is relatively weak and underdeveloped; (iv) the corporate debt market remains small relative to other countries in the region; (v) equity markets have not been very active in supplying risk capital for infrastructure; and (vi) pension funds and insurance companies are relatively small and face structural and performance issues that limit their ability to invest in infrastructure. Although the government is in the process of developing an interim scheme to provide access to long-term financing for PPP projects until a dedicated infrastructure finance facility can be established, the government needs to develop the regulatory and institutional frameworks for an infrastructure investment financing facility to operate on a sustainable basis.[58] It also needs to develop a credible risk guarantee mechanism,

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[56] For example, the Department of Public Works and Highways is allocated P5 billion in 2011 for PPP projects, of which some P639 million is for preparation of feasibility studies for new PPP projects. The Department of Transportation and Communications also received P5 billion in 2011 for PPP projects, of which P250 million is for PPP project preparation activities. The Department of Agriculture was allocated P2.5 billion for PPP projects in 2011.

[57] Government Procurement Reform Act (Republic Act No. 9184) and its implementing rules and regulations dated 22 July 2009.

[58] As an option for this scheme, infrastructure bonds for P200 billion to be floated by the state-owned National Development Corporation are being considered. The subscription of these bonds would be limited to the four government financial institutions: Development Bank of the Philippines, Government Service Insurance System, Land Bank of the Philippines, and Social Security System. Each of the institutions is expected to purchase at least P50 billion, which would be made available as loans to companies sponsoring PPP projects. Proceeds of the bonds will also finance land acquisition costs and other predevelopment needs as the government's counterpart initiative to attract private investors. Further, ideally, the dedicated infrastructure finance facility would be managed by professional fund managers and operated on private sector principles as a nonbank financial institution. ADB supported the establishment of similar entities in India and Indonesia (Appendix).

which could be in the form of a separate organization or embodied in the facility, to decrease the overall high level of uncertainty for the private sector regarding the implementation of PPP projects.

91. **Develop long-term integrated transport infrastructure master plans for Luzon, Mindanao, and Visayas.** Transport infrastructure expansion should conform to patterns of the country's long-term economic (e.g., growth centers, sectors driving growth, and domestic and international shipping demand) and social (e.g., demography and internal and external migration) development. It is important to have an integrated strategic vision for the next 30–40 years and midterm implementation plans for optimal utilization and development of the major seaports, airports, roads, and railway infrastructure in Luzon, Mindanao, and Visayas. This vision and these midterm plans should provide a holistic picture and link together the development of seaports and airports with the growth of cities and bigger urban centers, such as Metro Manila, Metro Cebu, and Metro Davao, as well as take into account the capacity of adjacent road networks. These plans would also guide decisions on the allocation of public resources for transport infrastructure development or whether to pursue them by attracting private sector investments through PPPs. The overall objective is to develop a seamless, integrated intermodal transport system to serve on a long-term basis the needs of an economically and demographically expanding country.

92. **Further strengthen roll-on and roll-off infrastructure.[59]** Introduction of roll-on and roll-off (RORO) policy in 2003[60] has contributed to a significant—20% to 68%—reduction in transport costs (Table 14). The principal sources of savings have been the elimination of cargo-handling charges and wharfage fees. Additionally, RORO has transformed the structure and operations of domestic shipping, as the logistics operations and strategies of both small and large firms have been altered. In one case, the national distribution network was reduced from 36 to 3 since the introduction of RORO. RORO has also spurred the economic development of local communities, tourism, regional trade, and agricultural productivity, and created new business opportunities.[61]

Table 14: Comparison of Transport Costs

Type of Commodity	Traditional Shipping	RORO Shipping	Savings (%)
Beer	30,400	13,000	57
Dry goods	50,000	40,000	20
Medical kits	10,000	4,000	60
Live cattle	90,465	51,500	43
Liquid CO_2	225,000	71,664	68
Assorted fish	32,000	23,360	27

CO_2 = carbon dioxide, RORO = roll-on and roll-off.
Source: ADB and Asia Foundation (2010).

93. To further maximize economic impact of RORO, chassis RORO should be included into the RORO regulatory framework, which currently limits RORO services to self-driven rolling cargoes.[62] The chassis RORO policy would reduce the domestic transshipment costs of both domestic and foreign containerized cargoes. Additionally, it might

[59] This is a system designed to carry rolling stock cargo that does not require cranes to be loaded or offloaded. Because this eliminates cargo-handling labor and equipment and reduces the amount of time required to be in a port, reductions in sea transport costs can be considerable.
[60] Executive Order No. 170, dated 22 January 2003, mended by Executive Order No. 170-A and 170-B dated 9 June 2003 and 19 September 2005, respectively. The Philippine RORO network is also known as the Strong Republic Nautical Highways. It has three major routes (i.e., Western, Central, and Eastern) and a series of east–west lateral connections.
[61] Detailed case studies on these are provided in ADB and Asia Foundation (2010).
[62] Cargo-handling operators indicate that the tractor heads (i.e., prime movers) must accompany the containers on chassis. While this is economically feasible for short hauls, it is inefficient and expensive for long hauls.

be useful to consider assigning all roads forming part of the RORO network as national roads. Institutionally, this will place these roads under the Department of Public Works and Highways that would manage the development and maintenance of the RORO road network ensuring intermodal connectivity between the non-RORO and RORO road network.

94. **Consider gradually easing the cabotage restrictions.** As shown above, domestic shipping costs are high. Liberalizing the cabotage provisions to allow foreign vessels to operate in the coastwise trade in the Philippines has been proposed.[63] This would expose interisland shipping to the pressures of international competition, which is considered advantageous to the country in the long run, as it will force all local industry players to increase their efficiency to survive the competition.[64] On the other hand, the domestic shipping industry argues that almost every country imposes cabotage, so the Philippines should have cabotage restrictions as well. These can be lifted on the principal of reciprocity. Given these arguments, an independent review of the cabotage issue should be conducted, including a sector- and country-level cost–benefit analysis. This review, which could be conducted by NEDA, should provide implementable recommendations on how to move forward with gradual liberalization of the domestic shipping industry with the ultimate objective of improving the country's competitiveness.

95. **Enhance small and medium-sized enterprise access to finance through operationalization of the Central Credit Information Corporation...** It is important to have a system in place that collects and disseminates fair and accurate information about the track record of borrowers and the credit activities of all entities participating in the financial system. In the Philippines, the legal and regulatory framework for a centralized credit information system through the Central Credit Information Corporation is in place but not yet operational.[65] The government, represented by the Securities and Exchange Commission and BSP, is expected to purchase 60% of the equity of the corporation, and the remaining 40% will be purchased by qualified investors, such as industry associations of banks, quasi-banks, and other credit-related associations including consumer associations.[66] It is vital that the Central Credit Information Corporation become operational as soon as possible, and that its staff members are provided with relevant capacity building to meet the expectations of the financial sector and its clients, especially SMEs.

96. **… and enhancing provision of guarantees for SME loans.** Pricing of wholesale or retail loans to SMEs is related to the risk assessment of SMEs by banks as well as the availability of risk-sharing mechanisms, such as guarantees. The government, through the Credit Guarantee Program of the Small Business Corporation, has been attempting to improve the access of SMEs to bank finance through provision of credit risk sharing and credit supplementation to banks that lend to SMEs. However, this program has not been particularly effective, especially in comparison with its wholesale microfinance lending operations (Figures 43 and 44). This declining dynamic of the Small Business Corporation's guarantee operations seems to be due to the unattractiveness of the guarantees to private financial institutions, which need to accept 100% risk weight. If the guarantees had sovereign status, this could result in a 0% risk weight, significantly lowering the pricing of bank loans to SMEs.

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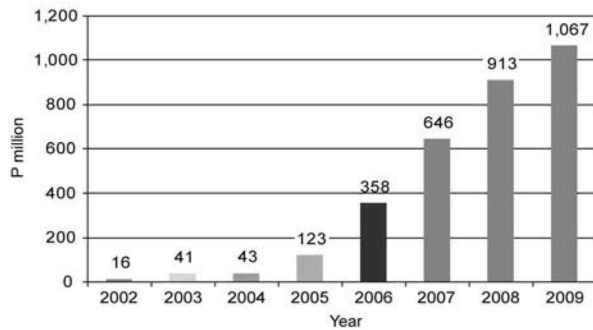
[63] "Coastwise trade" is defined as the transport of passengers or goods from one Philippine port to another Philippine port, where the passengers and/or goods are loaded at one port and unloaded at the other port.

[64] For example, see Austria (2003).

[65] The Credit Information System Act was adopted in October 2008 (Republic Act No. 9510), and its implementing rules and regulations were adopted in May 2009.

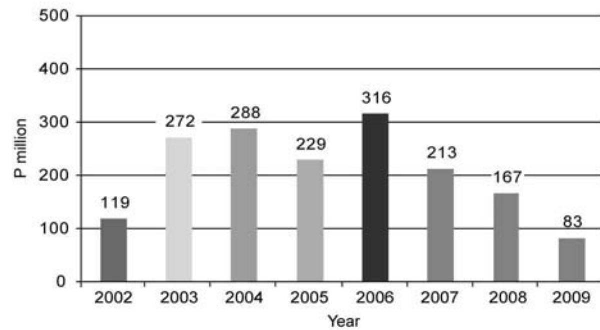
[66] Such restricted ownership precluded a $1 million equity investment by ADB in the Central Credit Information Corporation.

Figure 43: Small Business Corporation Wholesale Microfinance Lending



Source: ADB (2010b).

Figure 44: Small Business Corporation Guarantee Operations

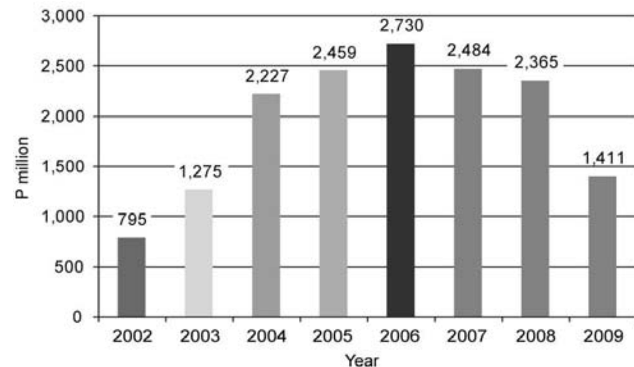


Source: ADB (2010b).

97. Alternatively, Small Business Corporation guarantees could become more attractive if these were backed by guarantees of a AAA financial institution such as ADB. In this case, the risk weight under bank lending to SMEs with Small Business Corporation guarantees could be 20% or lower, resulting in significant savings in terms of loan–loss provisions. Therefore, the regulatory framework of the Small Business Corporation should be reviewed to make its guarantee products more attractive to private financial institutions and to facilitate partnerships with AAA financial institutions. The Small Business Corporation would also benefit from revision of its guarantee products and processes to make them less complex and streamlined in accordance with international best practices.

98. The Small Business Corporation's wholesale lending performance has not been impressive in recent years. The decline in 2007–2009 can be traced back to the increase in the size and the decrease of the interest rate of the BSP rediscounting facility, which effectively provided additional liquidity to the banking system on terms more advantageous than the wholesale lending available from the Small Business Corporation.[67] This resulted in a sharp drop in the Small Business Corporation's wholesale lending, from almost P2.4 billion in 2008 to P1.4 billion in 2009 (Figure 45). It might be useful for the Small Business Corporation to review its wholesale lending prospects given the abundant liquidity in the banking system and at BSP. One option could be to shift, in the medium term, the focus of its operations from wholesale or retail SME lending to SME loan guarantees.

Figure 45: Small Business Corporation Wholesale Small and Medium-Sized Enterprise Lending



Source: ADB (2010b).

[67] BSP's rediscounting facility of P40 billion was activated in November 2008 to cope with possible adverse effects of the global economic crisis on the economy. The BSP rediscounting facility's overnight reverse repurchase rate has been lower than the Small Business Corporation's wholesale lending prime rate. As the initial amount allocated to the facility has been almost fully utilized by the banking system, its size was increased to P60 billion in March 2009. It decreased to P40 billion in February 2010 and P20 billion in May 2010 amid possible signs of inflationary economic expansion.

99. **Consider establishing an agribusiness investment facility to facilitate synergy between small and large firms.** It might be worthwhile to consider establishing a facility specializing in investments that would stimulate agribusiness development and promote synergies between agricultural SMEs with large corporations. To ensure market orientation of the facility, efficiency, and economy of scale, it should be managed by a large private financial institution, whose contribution could be augmented by the government or government financial institutions to make the terms of financing favorable to agricultural SMEs. One of the geographical target areas for the facility could be Mindanao, and the facility could also provide loans based on the principles of the Islamic finance. To motivate contributions by other private financial institutions, an amendment to the Agri-Agra Law[68] should be considered to make the facility an eligible investment for private financial institutions. Based on the assumption that an average P100,000 is required to create one job, a P50 billion agribusiness investment facility could create 500,000 jobs (Joint Foreign Chambers of the Philippines 2010).

100. **Develop a sustainable mechanism for providing the private sector, including small and medium-sized enterprises, with research and development support to foster innovation and technology development.** As shown previously, research and development expenditures in the Philippines are very low, and SMEs are not innovation-oriented. Obviously, it is rather expensive for the SMEs to finance research alone; hence, there is a need for intervention from the government. This was, for example, done in Germany when the government helped with financing of research in industries (i.e., green energy, security, and biotechnology) considered important for long-term growth. It has supported an extensive research infrastructure that small and medium-sized firms can tap into when they need help, thus lowering the barriers to innovation. One well-recognized and successful model is the Fraunhofer Society, whose 80 research units spend about €1.65 billion[69] ($2.39 billion) a year and employ more than 18,000 qualified scientists and engineers (Box 6).

101. In the Philippines, there is also a lack of coordination among educational institutions to provide innovative advice and technology development and testing services to domestic and foreign clients. The government also fails to fund research, development, and innovation for sectors that can drive the productivity-based economic growth in the long term. Therefore, it might be useful to consider options for setting up a sustainable and independent model for supporting research, development, and innovation projects and the needs of the private sector through domestic potential, with support, if required, from abroad. Basically, a Philippine Fraunhofer Model could be developed that could initially be composed of qualified universities and faculties able to provide, individually or collectively, research and development and innovation services to the private sector and the government. Once this model is established, it can be the major recipient of increased government spending on research and development.

[68] Republic Act. No. 10000, dated 23 February 2010. It requires banks to allocate 25% of their loanable funds to the agriculture sector: 10% for loans to agrarian reform beneficiaries and 15% for agriculture credit. Among the alternative forms to comply with the law are investments in or wholesale lending to accredited rural financial institutions, loans for agriculture infrastructure, and investments in government bonds. Such mandated lending could expose banks to credit risks, especially when there is, as reported, little demand from the agricultural enterprises for loans from the bank due to high pricing of such loans.

[69] Of this sum, €1.40 billion is generated through contract research.

Box 6: The Fraunhofer Society Model

The Fraunhofer Society (Fraunhofer-Gesellschaft zur Förderung der angewandten Forschung e. V.)—an independent, self-managed, nonprofit organization comprising 60 research institutes that belong to 20 independent member research centers—was founded in Munich on 26 March 1949 by representatives of industry and academia, the Bavaria state government, and the Government of Germany. It promotes and undertakes applied research of direct utility to private and public enterprises and of benefit to society. It also develops technological innovations and novel system solutions for its customers.

Under its business model, the Fraunhofer Society earns about 60% of its income through contracts with industry or specific government projects, with the remaining 40% sourced (9:1) from federal and state government grants for basic research.

The society develops products and processes up to technical or commercial maturity, including development of individual solutions in direct contact with the client. If necessary, several Fraunhofer institutes work together to produce more complex system solutions. Some of the services offered are (i) product development and optimization through to prototype manufacturing; (ii) development and optimization of technologies and production processes; (iii) support with the introduction of new technologies; (iv) technology assessment support; (v) advice on sources of funding, especially for small and medium-sized enterprises; and (vi) accredited test services, including issuing of test certificates.

One of the probably best-known inventions done by the Fraunhofer Society is the MP3 compression algorithm, which was patented by the Fraunhofer Institute for Integrated Circuits. Its license revenues generated about €100 million in revenue for the society in 2005.

Source: Fraunhofer (www.fraunhofer.de/).

102. **Consider setting up, with government funding, a venture capital fund to foster growth of innovation-oriented small and medium-sized enterprises.** For start-up companies that want to enter the market with new technology or products, it is normally difficult to obtain funding in the Philippines. Many such start-ups fail, but there are also some that succeed and become drivers of growth for the country, region, or sectors. An example of successful support to high-technology sector is the venture capital support program in Israel, which was launched in 1993 and was named Yozma, which means “initiative” in Hebrew (Senor and Singer 2009). Under the Yozma Program, attractive tax incentives were offered to foreign venture capital investments in Israel along with the Government of Israel’s doubling of any investment in such funds. As a result, in 1991–2000, Israel’s annual venture capital outlays, nearly all private, rose nearly 60-fold, from $58.0 million to $3.3 billion; companies launched by Israeli venture funds rose from 100 to 800; Israel’s information technology revenues rose from $1.6 billion to $12.5 billion; and it led the world in the share of its growth attributable to high-technology ventures at 70% (Wikipedia 2011). It might be, therefore, worthwhile to consider developing a comprehensive government program to foster venture capital funds that would provide financing to firms in the selected strategic priority sectors of the economy in the Philippines. This program could not only support setting up a venture capital fund with government equity (similar to the first Yozma fund in Israel), but also provide tax incentives or guarantees to stimulate the private sector’s interest in establishing new or investing in existing venture capital funds.

VII. ADB PRIVATE SECTOR DEVELOPMENT SUPPORT

103. **Private sector development has been constantly the focus of ADB support to the Philippines.** In the late 1990s, PSD was supported primarily through infrastructure-related operations. Under the 2001–2003 country strategy (ADB 2000), ADB provided support for private sector financing of infrastructure projects; financial intermediation, including capital market development and financial infrastructure; and in assisting the government in deregulation of industry, trade and investment, privatization of selected government-owned and -controlled corporations, and improving systems and capacity for PPPs. The country strategy and program, 2005–2007 (ADB 2005a) emphasized competition strengthening, fighting corruption through legal framework improvement (e.g., procurement reform), and strengthening the judiciary in terms of PSD-related support areas.

104. Overall, ADB has supported PSD in the Philippines through (i) public sector operations that emphasized improvements in the private sector-enabling environment via fostering reforms in public sector management as well as the finance, energy, and transport sectors, and providing financing for SME credit; and (ii) private sector operations through providing equity financing, credits, and guarantees for various private sector projects, including those in the financial sector and infrastructure.

A. Public Sector Support

105. **Overall, ADB support to improving the investment climate through support to public sector management reforms has been successful.** Adequately functioning public sector management systems are a critical factor for PSD and the overall investment climate. Hence, in 2007–2010, ADB supported public sector management reforms related to the investment climate on a programmatic basis through the Development Policy Support Program Cluster, which, among other objectives, aimed to improve the investment climate and rural development by (i) clarifying and strengthening the legal and regulatory framework for investment and trade, (ii) facilitating infrastructure development through more PPPs and greater coordination of public infrastructure investments, and (iii) improving rural–urban connectivity (ADB 2007c).[70] The program was accompanied by comprehensive technical assistance support that reviewed and provided recommendations on institutional options for addressing red tape, competition policy, reform of investment incentives, farmer supply chains, and youth employment. The 2008 country assistance program evaluation (CAPE) assessed ADB's support to public sector management *relevant, highly efficient, effective,* and *likely sustainable* (ADB 2008a). The overall rating was *successful.* Further, the Development Policy Support Program Cluster project completion report indicated that "fiscal consolidation, the simplification of regulations, the establishment of the enterprise registration system, and the handbook on good practices in enterprise registration by LGUs, all helped lower transaction costs for business start-ups" (ADB 2010c). It rated the Development Policy Support Program *relevant, effective, efficient,* and *likely sustainable*. The overall rating was *successful.*

106. **ADB support to the finance sector in the Philippines also has been successful.** ADB assisted in developing the nonbank finance subsector to support economic growth. For instance, ADB helped advance reforms and institutions in the Philippine Stock Exchange, government and corporate bond markets, mutual funds, and microfinance-related regulation and governance issues including the Securities and Exchange Commission. The CAPE rated ADB

[70] Under the cluster there were three subprograms each amounting to $250 million. The subprograms were in 2007, 2008, and 2009.

support to finance *highly relevant, effective, efficient,* and *likely sustainable*. Overall ADB support to the finance sector was *successful.* The CAPE recommended that ADB continue participation in developing nonbank financial institutions, the capital market, and microfinance subsector. It also stressed the need for a credit information bureau, which would help unlock bank financing for SMEs. In 2005–2010, finance sector development received $550 million (about 17% of the total new lending in this period[71]) through development policy loans for under for the Microfinance Development Program, Financial Market Regulation and Intermediation Program—Subprogram 1, and Financial Market Regulation and Intermediation Program—Subprogram 2 (ADB 2005f, 2006a, 2010e).

107. **Furthermore, ADB support to the energy sector has been successful.** According to the CAPE, ADB assistance resulted in (i) a power subsector that has been restructured and exhibits improved financial viability, a stronger sector regulatory framework, greater private sector participation in power generation and transmission, and enhanced consumer welfare and protection; (ii) a working wholesale electricity spot market using the market management system; (iii) improved awareness among rural communities of the importance of community and cooperative activities in support of rural electrification using new and renewable energy resources; and (iv) accelerated progress in power subsector privatization. The CAPE rated ADB support in the energy sector *highly relevant, effective, efficient,* and *likely sustainable*. Overall ADB support to the sector was *successful*. The CAPE indicated, however, that energy sector reform has yet to translate into markedly lower tariffs. It also indicated that private sector investors need reassurance of the government commitment to sector reforms, independence and transparency of the regulatory regime, effective operation of the spot market, and existence of a competitive market. In 2005–2010, the energy sector received $481.1 million (15% of new lending), of which $450.0 million was directed to support structural reforms in the power sector and $31.1 million for energy efficiency improvement (ADB 2006b, 2009a).

108. **ADB support to the transport sector has been partly successful.** ADB provided support for developing provincial and regional transport and communication infrastructure. Performance of transport sector operations was assessed by the CAPE as *less effective* and *less efficient* resulting, despite likely sustainability, in a *partly successful* rating. A major cause for this poor performance was slow progress in procurement and land acquisition and resettlement in the Sixth Road Project and the Third Airports Development Project (ADB 2008d, 2008e). Despite these operational issues, the CAPE nevertheless emphasized that transport infrastructure is a key constraint to PSD and growth and that ADB needs to continue to address areas such as transport policy; transparent procurement; and improving the prospects for PPPs, including those focused on mass transit in Metro Manila and RORO ferry systems to promote trade through and beyond the archipelago. In 2005–2010, there was no new ADB lending to the transport sector.[72]

109. A good example of a successful joint venture between public and private sector operations in the Philippines is the SME Development Support Project (ADB 2005g). This project, which closed in 2009, aimed to enhance SME access to credit through provision of a (i) $25.0 million credit line to the Small Business Corporation (i.e., liquidity enhancement), (ii) $18.4 million partial credit guarantee facility for the Security Bank Corporation without a government counterguarantee (i.e., risk reduction), and (iii) $1.0 million equity to the credit

[71] Total new lending in 2005–2010 was $3,185 million. This excludes $500 million under a loan provided to the government is support of its measures to mitigate the impact of the global economic crisis on the Philippines.

[72] The $500 million multitranche financing facility for the Road Sector Institutional Development and Investment Program is ready for approval by ADB in 2011 and is awaiting endorsement by the Cabinet Committee of the Government's Investment Coordination Committee.

information bureau (i.e., reduction of information asymmetry).[73] While the $25.0 million credit line was provided through ADB public sector operations, the partial credit guarantee facility and equity investment were provided through ADB private sector operations. The project completion report rated it *relevant, effective, highly efficient* (the project closed 2 years ahead of schedule with full loan amount having been utilized), and *likely sustainable,* resulting in an overall rating of *successful* (ADB 2010b). The CAPE, however, questioned whether the tool of an onlending facility can be relevant for future operations given the high domestic liquidity and low market rates.

B. Private Sector Operations

110. **Most direct support to the private sector took place through ADB support to the private sector in power, road, and finance sector projects.** ADB's private sector operations in the Philippines began in 1986. As of 30 December 2010, cumulative approvals in 26 projects amounted to $768.1 million. The largest shares among the approved operations were in the finance (25%) and energy sectors (45%). ADB's private sector operations in the Philippines have included financing for power plants and toll roads, as well as investments in securitizations, banks, venture capital, and private equity funds. One of the most known ADB-supported private sector toll road projects is the North Luzon Expressway Rehabilitation and Expansion Project, where ADB's direct $45 million loan and a complementary $25 million loan to Manila North Tollways Corporation in 2000 helped renovate an 83.7-kilometer section of the road, including construction or rehabilitation of 14 interchanges, 24 bridges, and 31 overpasses from Manila to the Clark Special Economic Zone in Pampanga Province. This project was rated *highly successful* by its extended annual review report (ADB 2008b).

111. **In 2001–2007, the number and amount of approved private sector transactions declined.** In this period, there were only four projects: (i) an equity investment of $2 million in the LGU Guarantee Corporation, which is a credit guarantee company that protects investors or lenders against borrower payment default; (ii) a loan of up to $33 million to Balikatan Housing Finance, a special purpose entity created to acquire highly delinquent mortgage loans from the National Home Mortgage Finance Corporation; (iii) an equity investment of up to $1 million in Bahay Financial Services established to service, manage, and administer mortgage loans acquired by Balikatan Housing Finance; and (iv) a $5 million local currency loan to a special purpose vehicle to finance the purchase of a portfolio of nonperforming loans and nonperforming assets from Equitable PCI Bank and Equitable Savings Bank.

112. **Significant support was provided for private sector power projects in 2008–2009.** In 2008, a $200 million loan was approved and disbursed for the acquisition, rehabilitation, and operation of the existing 600-megawatt Masinloc coal-fired thermal power plant in Zambales Province by Masinloc Power Partners. In 2009, a loan for up to $120 million was approved for KEPCO SPC Power Corporation for the construction, operation, and maintenance of a new coal-fired power plant in the Visayas region using circulating fluidized bed technology. By supporting private sector investments in power, both projects are helping further power sector reforms aimed at increasing efficiency and reducing costs.

113. ADB's Trade Finance Facilitation Program now covers the Philippines as well. The program expanded to the Philippines in early 2010 and now supports the trade finance business

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[73] The $1 million equity investment (through ADB private sector operations) in the credit information bureau did not materialize due to the restrictions in the credit information bureau's ownership according to the Credit Information System Act and its implementing rules and regulations.

of eight local banks. Participation will help banks provide more funding to exporters and importers that span all sectors of the economy. This will, in turn, spur growth and create jobs across the country.

114. **However, a significant share of approved private sector projects did not materialize,** and several large private sector projects were canceled after approval (ADB 2007a). For example, the $165 million Maynilad Water Services Project did not reach financial closure due to the financial difficulties experienced by the Maynilad Water Services Company. The $80 million investment in Philippine International Air Terminals Corporation responsible for the construction and subsequent operation of Ninoy Aquino International Airport's terminal III was canceled, as implementation and operational disputes emerged between the sponsors and the government before commissioning of the completed terminal. The government canceled the $200 million Peso Swap and Financing Project, which may have been caused by the perception that sufficient foreign currency can be accessed on more flexible terms on the local foreign exchange market. Overall, the cancellations seem to have been caused by financial problems of the companies as well as implementation and operational disputes between the project sponsors and the government.

115. **Overall, PSOD support has been complementary to ADB's overall PSD support agenda.** Despite being small in amount and number, the CAPE indicated that PSOD operations in LGU and housing finance proved complementary with the overall PSD-related work of ADB and were in line with the government and ADB strategies.

C. Directions under the New Country Partnership Strategy

116. **The overall objective of ADB's private sector support is to facilitate increased private sector investment.** The Philippine private sector was investing at the level of 20% of GDP in the mid-1990s; therefore, the overall objective of ADB support under the new CPS, 2011–2016 could be to facilitate increased private investment back to this level through supporting reforms and projects aimed at lowering the cost of doing business. This can be done through supporting both public and private sector projects.

117. **Support through public sector operations can be in terms of project financing and programmatic development policy lending.** ADB can support an improved private sector-enabling environment through investment operations aimed at physical capital and infrastructure enhancement (i.e., energy, transport, irrigation, and water supply and sanitation) and capacity development, especially in PPP-related areas. Necessary regulatory and institutional reforms at the central and local government levels should be supported through programmatic development policy operations. Specifically, investment climate-related reforms could be supported over the medium term through a development policy support cluster program, which could serve as ADB's umbrella operation for strengthening the investment climate in the Philippines. This program can focus on such reform areas as competition policy, regulatory efficiency, taxation system to make it more business friendly, employment, and the labor market, and pay special attention to improving the enabling environment for PPPs. Further support to justice sector reform might be needed, specifically to improve the mechanisms and procedures of courts so that arbitration awards are implemented quickly without reopening cases. Also, implementation of efficient, effective alternative dispute resolution mechanisms nationwide needs to be supported to improve the pace and to reduce the cost of resolving business-related disputes.

118. **Support can be provided to facilitate long-term financing for infrastructure projects via currency swaps…** Local banks will be interested in providing medium-term investing for PPP projects if there is a credible source of supplementary long-term financing (i.e., for more than 12 years of tenor). In this respect, ADB local currency capabilities could become the critical catalyst of long-term financing for PPP projects (ADB 2005d). One option could be a currency swap facility between ADB and the government where ADB would provide foreign exchange, receive pesos for long tenors, and use these pesos to fund infrastructure and development projects directly or through financial intermediaries.

119. **… and establishing a dedicated infrastructure financing facility.** To address a key gap in the private sector infrastructure financing market, namely the lack of access to long-term finance and specialized infrastructure finance services, setting up a dedicated infrastructure financing facility should be considered. In considering options for such a facility, ADB experience in India and Indonesia in supporting the development of similar infrastructure finance facilities can be useful (Appendix and ADB 2009b). Such a facility in the Philippines could be, for example, established as a commercially oriented, specialized nonbank financial institution focused specifically on the infrastructure financing space, bringing focused expertise to developing and structuring PPPs or wholly private sector projects. It could provide a range of fund-based products (e.g., debt, subordinated debt, equity, bridge finance and refinancing, and securitization), nonfund products such as guarantees,[74] and fee-based services (e.g., underwriting, loan syndication, and project development advice).

120. **Moreover, comprehensive capacity building is required to improve the government's capacity and systems in PPPs.** ADB should consider providing coordinated, integrated support to the government to strengthen PPP legal and regulatory frameworks, enhance the capacity of the recently restructured PPP Center attached to NEDA, institutionalize PPP best practices in selected line departments and LGUs, and help consider options for establishing long-term financing and risk management mechanisms. For example, support might be useful in reviewing the PPP-related legal and regulatory framework to address issues related to right-of-way acquisition and granting of franchises for public utility PPP projects; developing approaches for viability gap financing for socially beneficial but commercially less viable projects; and streamlining the government's PPP institutional setup to ensure efficiency and effectiveness for the PPP system as whole. The PPP Center should be supported in terms of improving PPP toolkits and model PPP agreements, developing sector-specific guidelines to cover risk-sharing arrangements and appropriate contractual mechanisms, and improving the content and design of the PPP Center's website.

121. **In parallel, it is important to support improvement of the government's capacity to develop well-structured, bankable PPP projects.** The government has allocated P300 million to the Project Development and Monitoring Facility, which functions as a revolving fund. Several line agencies have received significant budget allocations for 2011 to prepare PPP projects and finance the cost of the right-of-way and land acquisition.[75] However, these funds cannot meet the increasing demand of line agencies, LGUs, and government-owned and -controlled corporations to prepare PPP projects that could attract the private sector through competitive

[74] For example, in Indonesia, selected guarantees for PPP projects are offered by the Indonesia Infrastructure Guarantee Fund, which is a state-owned company established in December 2009 with World Bank support. The fund works as an instrument to protect investors in infrastructure projects against potential risks that emerge from changes in government policies and the regulatory framework that may have an impact on the investment. More details can be obtained from http://www.iigf.co.id.

[75] For example, for PPP projects in 2011, the Department of Public Works and Highways has been allocated P5.0 billion; Department of Transportation and Communications, P5.0 billion; and Department of Agriculture, P2.5 billion.

bidding. To improve sufficiency and sustainability of financing for preparation of PPP projects, it might be worthwhile to consider augmenting Project Development and Monitoring Facility resources and helping the government improve the facility's governance systems to ensure its transparent, efficient, and effective functioning. The facility could cover such aspects of PPP project development as (i) project feasibility studies, assessments of PPP options, and business case development, including environmental and social considerations; (ii) financial analyses, modeling, and project structuring; (iii) preparation of bidding documents and draft contracts; and (iv) support throughout the bidding process and contract negotiations.

122. **A PSD policy dialogue and coordination mechanism might be introduced to maximize impact of ADB's support.** It is important to ensure adequate mainstreaming of the PSD agenda, including PPPs, into the design of projects in the Philippines. In addition to the ADB response, the fast-evolving PSD agendas of the government and the overall business environment need to be timely and appropriate. This calls for establishing a country-level coordination mechanism, which would ensure coordination within ADB and with external stakeholders (i.e., development partners, the private sector, academe, and the government), and facilitate PSD-related policy dialogue. Since PSD is at the focus of ADB's private and public sector operations and benefits from ADB's location in the Philippines, such a coordination mechanism could be operationalized at the Philippines Country Office, with close coordination with PSOD and the Public Management, Financial Sector, and Trade Division of SERD. SERD and PSOD could further elaborate on how to make this mechanism work. Establishing a PSD coordination mechanism would necessitate enhancement of PSD staff capacity at the Philippines Country Office, which is required in any case for the implementation of the challenging PSD agenda of the next CPS.

123. **PSOD would respond to market dynamics with specific attention to selected focus directions**. PSOD would continue to be responsive to the demands of the private sector[76] and priorities of the government. At the same time, PSOD could give specific attention to infrastructure projects that would (i) address power shortages; (ii) develop renewable energy; (iii) provide clean water and/or wastewater and/or sanitation services; and (iv) facilitate the movement of goods and services through toll road construction, mass transport, and interisland transport. In the financial sector, PSOD could partner with the private sector in projects that would channel funds to SMEs and microfinance, housing and housing finance, infrastructure, and trade finance.

124. **Joint public and private sector operations must support PPPs.** Given the government's focus on PPPs, SERD and PSOD should work together on (i) strengthening the institutional framework of PPPs; (ii) providing advice to the government on innovative approaches and solutions in PPP project development, financing, and implementation; and (iii) mainstreaming PPPs in country programming and project processing. This stronger cooperation will build on and be complemented by the expertise of PSOD's PPP advisory unit and SERD's advisor on PPPs.

[76]To receive ADB's financial assistance, private sector projects and companies need to meet such investment criteria as long-term financial viability, significant and positive development impact, contribution to the target strata of society, sufficient project scale, good corporate governance, and compliance with ADB safeguard policies. The attrition rate of prospective private sector operations is high, as not all prospects meet these criteria. PSOD should work in close collaboration with SERD to identify potential investments and to create synergies with ADB assistance to the public sector in the Philippines.

APPENDIX

ADB EXPERIENCE WITH INFRASTRUCTURE FUNDS: INDIA AND INDONESIA

1. The Asian Development Bank (ADB) has helped establish infrastructure financing facilities in both India and Indonesia. The two existing investment financial institutions in India are Infrastructure Leasing and Financial Services (ILFS) and the Infrastructure Development Finance Company (IDFC). In Indonesia, it is the recently established PT Indonesia Infrastructure Finance (PTIIF). These three examples represent benchmarks that operate in two developing member countries with significant government presence in infrastructure. In the case of India, successful operations have already been achieved through nonbank financial institutions.

A. India

2. IDFC and ILFS involved the Government of India as one of the initial promoters, but both of these entities have always operated on the basis of management principles associated with the private sector.

3. IDFC, a specialist infrastructure finance company, provides finance for infrastructure projects including through ownership of infrastructure assets. It operates a full range of business lines, from project and corporate finance to asset management (e.g., mutual funds). The company is engaged in providing finance and advisory services for infrastructure projects, asset management, and investment banking.

4. IDFC was set up in 1997, jointly by the Government of India, Industrial Development Bank of India, Reserve Bank of India, various Indian banks and financial institutions, plus foreign and multilateral institutions including ADB. It began with a strong capital base totaling Rs16 billion ($339 million at current rates), which remained mostly unused in the first few years of operations as IDFC needed time to build up its business. Following the initial public offering in 2005, IDFC was listed on India's stock exchanges, and the holding of the government was decreased. Currently, the government's equity holding is about 22%. Fee-based income currently comprises about 7% of total income. Cumulative loans to infrastructure rose from $106.0 million in 1998 to a current level of about $4.3 billion.

5. ILFS is one of India's leading infrastructure development and finance companies. It was set up in 1987 by the Central Bank of India, Housing Development Finance Corporation, and Unit Trust of India. Over the last 20 years, ILFS has welcomed several new shareholders, including the Abu Dhabi Investment Authority, Life Insurance Corporation of India, Orix Corporation (Japan), and State Bank of India. Nevertheless, it has not gone public (although several of its subsidiary and associated companies have been listed). ILFS follows a strategy of actively leveraging its connection with the government to get involved in the project development process at an early stage, often investing its own funds to support project development activities.

6. ILFS is widely recognized as the pioneer of public–private partnerships (PPPs) in India. Over the years, building on experience gained in the infrastructure space, ILFS has widened its business scope from development of infrastructure projects to encompass a full range of financial, project development, and management services.

7. Both ILFS and IDFC have adopted roles that extend beyond providing debt funding for infrastructure projects. Both companies have leveraged their expertise and credibility relating to infrastructure projects to generate fee-based income from asset management and advisory services. Both are trusted by the private sector for their commercial orientation. At the same time, they enjoy privileged relationships with the government. This positioning allows both companies to bring together various stakeholders required for the successful implementation of a PPP project.

8. A key lesson from both the IDFC and ILFS experiences is that it is important for such entities to take equity stakes in infrastructure players and projects on a selective basis. Both ILFS and IDFC have made equity investments in a variety of companies. This helps build credibility for projects and ensure their financial closure. Moreover, it allows the company to take higher levels of risk in projects that it understands by virtue of its involvement in project development processes and thus generates higher returns than is possible from pure lending activities.

9. A clear requirement for success in infrastructure financing is the ability to form and nurture relationships with a wide range of stakeholders. IDFC and ILFS have adopted a collaborative approach, entering into relationships and alliances even with competitors. ILFS has been far more aggressive in committing resources to project development than IDFC. The need for such positioning is underlined by the fact that IDFC has recently emulated ILFS by setting up IDFC projects.

10. When IDFC was created in 1998, India's infrastructure sectors were facing problems with a lack of bankable projects. A question at that time was whether IDFC should be created only after the success of reform and project preparation initiatives. Yet IDFC was created at an early stage, and it has proven successful. Learning from this experience, Indonesia has indicated that it also wishes to operate on a number of parallel tracks, such as to have reforms and project preparation initiatives simultaneously.

B. Indonesia

11. PTIIF was established in January 2010. The founding shareholders are the Government of Indonesia's Ministry of Finance through a fully government-owned holding company, PT Sarana Multi Infrastruktur, and a number of development financial institutions including ADB. PTIIF is expected to increase the availability of equity and long-term debt available for private infrastructure investment in Indonesia. It is privately owned and managed with initial founding equity shareholders being PT Sarana Multi Infrastruktur ($60 million), ADB ($40 million through the Private Sector Operations Department), International Finance Corporation ($40 million), and $20 million from Deutsche Investitions-und Entwicklungsgesellschaft.

12. The paid-up capital will be subscribed gradually over a period of up to 5 years and in tranches depending on the achievement of certain predefined milestones. This minimizes the investment risk and utilizes the equity funding more efficiently. The intention is to invite a select number of private sector Indonesian and international institutions to join the founding shareholders as additional equity partners. In no event will PT Sarana Multi Infrastruktur nor any other agency or subdivision of the government contribute more than 50% of PTIIF's share capital. ADB and the World Bank are also each providing loans of up to $100 million to the government for relending to PT Sarana Multi Infrastruktur, which in turn relends these funds in their entirety to PTIIF as subordinated debt.

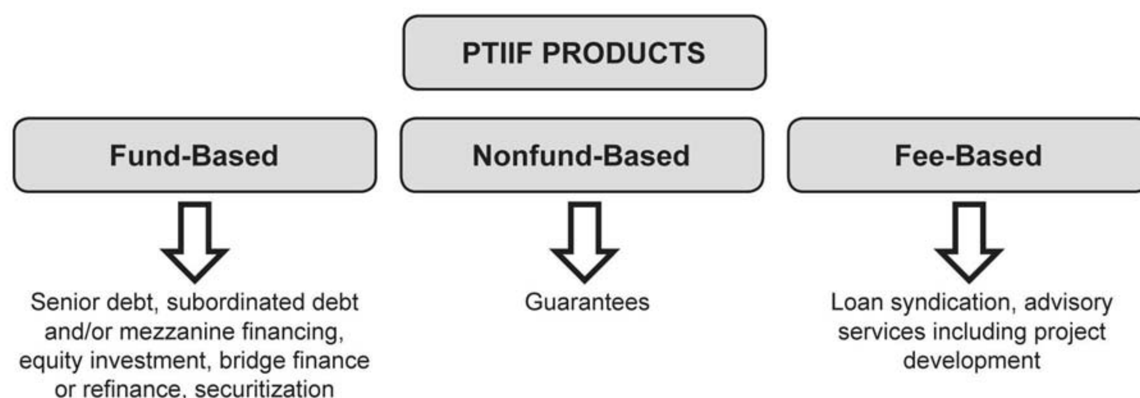
13. The concept of establishing a specialized infrastructure financing agency in Indonesia was first proposed in 2005. Since then, ADB, Deutsche Investitions-und Entwicklungsgesellschaft, International Finance Corporation, and World Bank have worked closely with the government to design and create a new, commercially focused agency to revitalize private investment in Indonesian infrastructure. The Australian Agency for International Development provided important financial support toward the development of the PTIIF business plan. PTIIF was conceptualized as a nonbank financial institution incorporated as a limited liability company, with a target fund base of about $1.0 billion in 5 years from the commencement of operations and is estimated to grow to about $4.4 billion by year 10.

14. PTIIF aims to finance commercially viable infrastructure projects in Indonesia by offering long-term debt denominated in local or foreign currency and by providing the intellectual capital needed to catalyze PPPs in such projects. It will provide funding through debt instruments, equity participation, or infrastructure financing guarantees for credit enhancement. Exposure to infrastructure projects that are solely developed by the public sector and state-owned enterprises are limited to a maximum of 20% of its overall lending portfolio.

15. To help finance infrastructure projects structured as PPPs, PTIIF seeks financial participation by pension funds, insurance companies, institutions, and new investor classes that can provide long-term sources of finance. In addition, it aims to seek, establish, and develop relationships with regional and local governments and to take on the development of projects promoted by these governments to generate fee-based income in the initial years of its operations. It is envisioned that PTIIF will be able to capitalize on its early involvement in advising the government and other parties in relation to developing infrastructure projects to generate funding opportunities. In the initial period of its operations, PTIIF is focusing on a selected target set of projects rather than dissipating its resources across a wide range of potential business opportunities.

16. In line with its market positioning, PTIIF offers three main categories of products: (i) fund-based products, (ii) nonfund-based products, and (iii) fee-based products (Figure A1). PTIIF endeavors to develop capabilities in structuring projects that will attract private sector investment. It is structured in such a way to prevent conflicts of interest from arising in terms of both its fund-based and advisory services. It seeks to assist both the government in its policy advisory role and the private sector in enhancing the commercial viability of projects through bankable contractual arrangements that reflect appropriate risk sharing. PTIIF is also looking to build capacity to operate as a domestic think tank on infrastructure, as it is expected to emerge as a national repository of experience and skills related to PPP projects in infrastructure. A basic objective of PTIIF is to bridge systemic gaps while not duplicating roles already fulfilled by other entities. In the finance sector, for example, PTIIF profiles itself as an entity creating a new set of financing opportunities rather than as competing with existing financial institutions.

Figure A1: PT Indonesian Infrastructure Finance Product Mix



PTIIF = PT Indonesia Infrastructure Finance.

C. Key Lessons and Possible Implications for the Philippines

17. **Setting up a new institution versus using an existing institution.** In all three cases, new, stand-alone nonbank financial institutions were established for the specific purpose of mobilizing infrastructure finance, structuring and investing in infrastructure projects, and providing related infrastructure products and services. While certainly a more complex approach than simply adding on a dedicated infrastructure finance unit to an existing financial institution, there are clear advantages to starting with a clean slate from an organizational standpoint. The three presented cases argue strongly for establishing a specialized nonbank financial institution that can focus specifically on the infrastructure financing space, bringing focused expertise to developing and structuring PPP or wholly private sector projects.

18. **Public–private financing model.** The mix of public and private financing, along with the sustained partial sponsorship of the government, provides a solid foundation for establishing a good credit rating to mobilize domestic capital from institutional investors and banks. Government participation provides credibility and a clear link to public sector infrastructure policy strategies and priorities. From a donor perspective, the mix of public and private sector financing provides an opportunity to utilize both sovereign and nonsovereign funding resources, and opens a window for loan and equity financing, such as the case for the ADB with PTIIF in Indonesia.

19. **Credibility and professionalism of a commercial entity.** All three cases presented here are intended to operate as commercial entities, with market-based rates and fees. They respond to market demand and adhere to international best practices on corporate governance, operating policies and risk management, and providing much-needed infrastructure financing expertise. They bring technical expertise and offer high-quality leadership and human resources. This gives them credibility with the financial markets and infrastructure project developers and sponsors.

20. **Mobilizing domestic private capital.** While not making a case for foreign versus domestic capital, the relative excess liquidity in the Philippine finance sector would argue for taking advantage of this domestic capital. The three cases presented make it clear that launching measures to attract private, domestic investment is useful. An important element of

this effort is the development of domestic capacity to finance infrastructure PPPs by complementing existing domestic financial institutions. All three were established as commercially oriented financial institutions to mobilize domestic currency financing of appropriate tenor, terms, and price for creditworthy infrastructure projects by (i) using their relatively good credit rating with a view to borrow from domestic institutional investors and banks looking for long-term placements with risk margins higher than sovereign and large corporate offerings, and (ii) providing financial products that meet the needs of infrastructure PPP or wholly private projects. However, none of these measures preclude mobilizing foreign investment.

21. **A center of excellence offering a range of products and services.** The core strength of the three cases presented is the breadth of resources offered. A key driver for success is the fact that these institutions play roles that extend well beyond passive funding of the debt component of infrastructure projects. While retaining debt funding at the core of operations, these institutions also seek to expand the market by contributing to policy and regulatory reforms, advising governments on structuring PPP projects, managing the bid process for selection of private sector bidders for PPP projects, enabling the entry of new classes of investors by arranging and managing third-party funds, and taking equity stakes in select projects. In the process, specialized technical knowledge and skills along with credibility, rather than mere size of the balance sheet, emerge as key elements that allow such entities to maintain competitive advantage and grow profitably.

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Philippines: Private Sector Development
Challenges and Ways to Go

In the last decade, employment gains from economic growth in the Philippines have been limited, largely due to the underperformance of the private sector. Success of the services sector in general, and that of the business process outsourcing industry in particular, shows that reforms fostering private sector development can be effective. This working paper's objective is to inform preparation of the Asian Development Bank's country partnership strategy for the Philippines, 2011–2016. It suggests two specific measures to foster private sector development for inclusive growth: improving government processes and creating an adequate business environment. Special attention is paid to infrastructure improvement by advancing a framework for public–private partnerships. The paper also suggests an approach to foster innovation and knowledge development by the private sector to contribute to productivity-based growth. It ends with suggestions on directions, modalities, and approaches that can be used by the country partnership strategy to support private sector development.

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