POLICY NOTE
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Anti-Competitive Effects of Regulatory Restrictions: The Case of the Construction Sector

The licensing rules implemented by the Philippine Contractors Accreditation Board (PCAB) contain a nationality distinction in its classification of licenses that has deleterious effects on competition in the construction sector. Simulations of license applications in a typical year suggest that to engage in the same level of activity, foreign firms have to pay as much as 12 times more in application fees compared to local firms. This nationality distinction hinders potential economic growth by constraining effective competition in the sector.

The PCC is mandated to issue advisory opinions and guidelines on competition matters for the effective enforcement of the PCA and to advocate pro-competition policies of the government by reviewing economic and administrative regulations that may adversely affect relevant market competition.

In line with this, the PCC submitted to the Supreme Court its amicus brief on the Philippine Contractors Accreditation Board (PCAB)-Manila Water Company Inc. case in December 2016. The PCC's intervention as amicus curiae is allowed under Rule 138, Section 36 in relation to Rule 19, Section 1 of the Rules of Court. The resolution of the said case is expected to make a significant impact in the dynamics and level of competition in the construction industry.

The analysis presented in this Policy Note is based on the information gathered as of the preparation of the amicus brief in the PCAB-Manila Water Company, Inc. case.

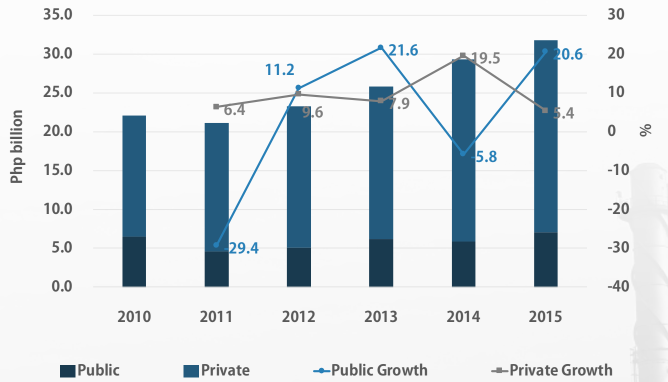
Overview of the Philippine construction industry

The construction industry in the Philippines plays an important role in economic development, providing services for households and in building infrastructure vital for the functioning of other industries including transportation, power, electricity, water, housing, and information and communications technology, among others.

Through its linkages with other industries, the construction sector generates significant economic activity, both as provider of production inputs and as consumer of services and products from other sectors.

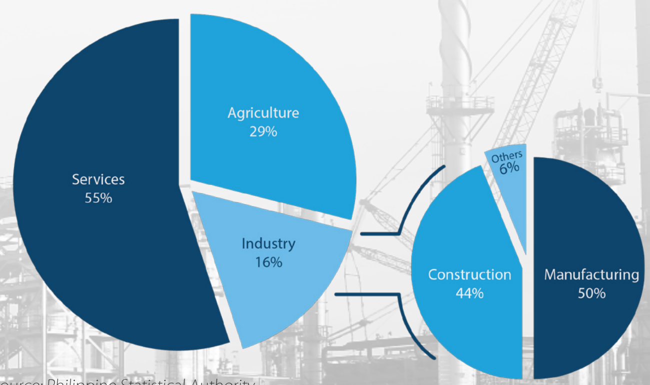
Between 2010 and 2015, the gross value of construction grew by 40 percent. Public construction grew by eight percent while private construction grew even more substantially by 58 percent (Figure 1). In 2015, the construction sector employed over 2.71 million Filipinos, constituting seven percent of total employment (Figure 2).

Figure 1. Gross Value of Construction Sector, Public and Private, 2010-2015



Source: World Bank Development Indicators

Figure 2: Employment in the Construction Sector (2015)



Source: Philippine Statistical Authority

Notwithstanding the decent performance of the construction sector, vital infrastructure concerns still need to be addressed including, among others, the following: (i) increase in energy demand; (ii) insufficient transport facilities; (iii) escalating traffic congestion; and (iv) increasing housing needs for low- and middle-income families.

It is clearly apparent that more investments and greater productivity are still required. To attain this, restrictive policies that hinder growth need to be reviewed and revised to take advantage of opportunities that come with a stronger economy.

Foremost among these restrictive policies is the nationality distinction in the classification of contractors applying for licenses as mandated by the implementing rules and regulations (IRR) of R.A. 4566 or the Contractors' License Law.

Nationality distinction in the classification of contractors' license

Presidential Decree No. 1746 created the Philippine Contractors Accreditation Board (PCAB) as an implementing arm of the Construction Industry Authority of the Philippines (CIAP) with the power to issue, suspend and revoke licenses of construction contractors under R.A. No. 4566 or the Contractors' License Law.

The PCAB introduced a nationality requirement in its implementing rules and regulations (IRR) that became the basis of its classification of contractors applying for licenses (Table 1).

Table 1: Classification of Contractors' License

	Regular license	Special License
Licensee	• Construction firm of Filipino sole proprietorship • Partnership/ corporation with at least sixty percent (60%) Filipino equity participation	• Foreign contractor • Joint venture (JV) or a consortium • For JVs or consortia, foreign contractors are expected to partner with domestic contractors and the constituent firms must both be individually licensed
Scope	• Construction contracting within the field and scope of license • Validity is maintained through annual renewal	• Construction contracting of a single specific undertaking/ project • Validity is maintained through annual renewal.

Regular licenses are preferred over special licenses because regular licenses permit the holders to engage continuously in construction activities for one year, while special licenses only allow the grantee to engage in one project or undertaking under such license.

Nationality-based distinctions are not mere labels and in fact carry with them substantial distinctions in terms of costs and benefits. It is a restriction that hinders competition in the construction industry, creating an uneven playing field between local and foreign

> **"Nationality-based distinction hinders competition in the construction industry, creating an uneven playing field between local and foreign contractors. Foreign firms possess capacity to construct vital projects and share technical expertise with local firms."**

contractors. Foreign firms possess capacity to construct vital projects and share technical expertise with local firms.

The said regulation effectively creates a barrier to entry of foreign firms which violates the constitutional state policy against unfair competition. Article XII, Section 19 of the 1987 Constitution mandates:

> *"The State shall regulate or prohibit monopolies when the public interest so requires. No combinations in restraint of trade or unfair competition shall be allowed."*

The Constitution thus provides the legal impetus for nullifying governmental acts that restrain competition. Such acts can range from laws passed by Congress, to rules and regulations issued by administrative agencies, and even contracts entered into by the Government with a private party.

Anti-competitive effects of the nationality-based classification for contractor's licenses

On businesses

In effect, PCAB's nationality requirement in the granting of licenses institutes a substantial barrier to entry of foreign contractors in the construction industry. The scheme fosters an uneven playing field between local and foreign contractors, thereby discouraging potential foreign firms from entering the market.

In particular, the said nationality-based distinctions create a substantial difference in the costs borne by local and foreign contractors in securing licenses.

As a foreign firm may undertake only one project specified under its special license, it will be costly for it to undertake several projects as compared with a local firm that has continuing authority to engage in multiple projects under a regular license.

To illustrate, given an estimated potential cost of a

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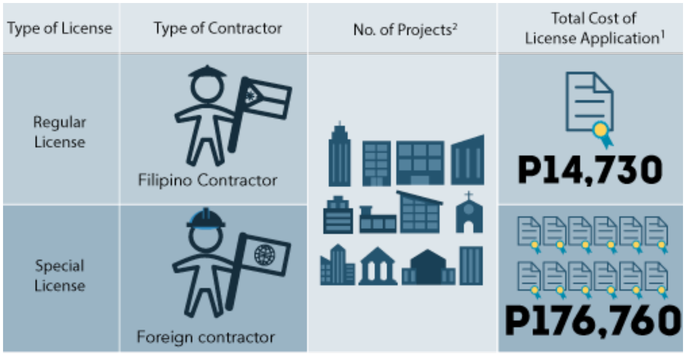
[1] *Excluding registration fees. Estimated using the average 30-day duration of an application process and daily minimum wage rate of P491 in NCR as of 29 November 2016.*

[2] *Average computed based on 2015 data on registered contractors (10,526 firms) and total number of construction projects (132,006 projects).*

license application of P14,730[1] and an average of 12 projects[2] undertaken by a contractor in a year, a foreign firm will have to spend P176,760, which is 12 times the estimated potential cost for the application process alone to engage in the same level of activity as with the local firm. In terms of potential benefits, given the same amount of resources spent, the local firm is in a better position to secure more benefits than the foreign firm (Figure 3).

Figure 3: Estimated Annual Cost of License Applications for Local and Foreign Contractors

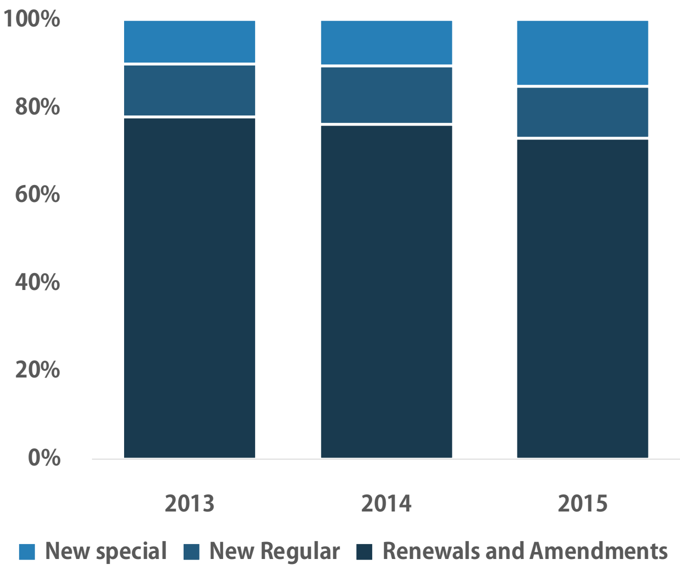


While a regular license may be issued to partnerships and corporate entities with up to 40 percent foreign equity, foreign firms are likely to be discouraged to enter the market through such option, as it is exposed to the risk of not having full control and management over their investments.

A survey of PCAB's data on licenses issued annually may indicate the restrictiveness of the nationality requirement on foreign firms.

From 2013 to 2015, foreign participation in the industry remained limited, with new special licenses accounting for just 10 to 15 percent of total licenses issued during the period. It must be noted that actual foreign participation may be significantly lower, as special licenses are also being issued to local firms in consortium or joint venture arrangements; in 2015, out of 1,600 special licenses issued, only 20 were issued to foreign firms and four (4) were issued to joint venture or consortiums with foreign participation.

Figure 4: Summary Statistics of PCAB Licenses Issued, 2013-2015



Source: CIAP Accomplishment Reports

"The Government must ensure a level playing field where no market participant, whether from the public or private sector, is given undue advantage that would allow it to gain market share over otherwise more effective and efficient competitor. "

Moreover, the data show that local entrants to the industry were also low, with new regular licenses issued accounting for a mere 12 percent of total licenses issued in 2015. More than 70 percent of the total licenses that PCAB issued annually from 2013 to 2015 were renewals and amendments to existing licenses, which illustrate a structurally unchanged Philippine construction industry (Figure 4).

In so far as the rate of entry indicates the level of competition within a given industry, the very low rate of entry of both new players and foreign firms in the construction industry is indicative of how competition in the industry remained limited throughout the years.

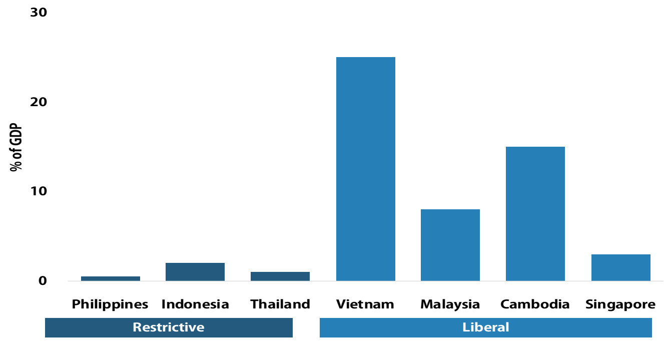
On the economy

Government restrictions on foreign participation in domestic industries reduce competitive pressure on local market participants, particularly in sectors where foreign entry is the primary source of potential competition. There are fewer incentives for incumbent firms to innovate and the limited threat of entry of a potential competitor reduces market dynamism. Essentially, such government restrictions hinder potential economic growth from competition.

In the case of the construction industry, the hindering effect of restrictions on economic growth may be illustrated in the levels of foreign direct investments (FDI) inflow. While the low level of FDI attracted by the Philippine construction industry, which is barely one percent of GDP, cannot be attributed to any single factor, entry barriers across ASEAN countries reflect similar patterns in FDI inflows.

Indonesia and Thailand, which impose foreign equity limitations of up to 67 percent and 49 percent, respectively, registered similarly low levels of construction FDI inflows of less than ten (10) percent of GDP in 2014. On the other hand, Vietnam, Malaysia, Cambodia, and Singapore, where entry barriers are relaxed, attracted higher levels of FDIs. From these comparative data, one may infer a negative relationship between FDI inflow and the restrictiveness of policy in the construction industry. In the ASEAN case, more restrictive policies appear to translate to lower levels of FDI inflows (Figure 5).

Figure 5: Restrictiveness and Construction FDI (as % of GDP, 2014)



Source: World Bank data

On consumers

It is a well-recognized principle that restricted competition in markets results in goods and services that are of inferior quality and higher cost, to the detriment of consumers – both households and businesses.

Comparison with other ASEAN countries indicates that the Philippines is already suffering from inflated construction costs (Table 2). The Philippines is also lagging behind many countries in terms of quality of infrastructure. According to the Global Competitiveness Report 2016-2017, the Philippines ranks 95th out of 138 countries in terms of infrastructure. In fact, the quality of overall infrastructure ranks even lower at a dismal 112th out of 138.

Consequently, consumers have to contend with persisting infrastructure-related concerns including limited power supply, insufficient transport facilities, worsening traffic, housing shortage, and water and sanitation issues.

Potential gains from lifting the restrictions

The participation of foreign firms in the construction industry is seen to generate growth due to the considerable scope for learning-by-doing, knowledge generation, expansion of product variety, and an upgrade on product quality.[3]

Private construction, particularly the residential condominiums, commercial, industrial, and institutional segments that account for more than half of private construction, will likely be attractive to foreign investors. PCC estimates that the lifting of the restrictions on foreign contractors will yield an additional P210 billion worth of private construction activities in these segments.[4]

Public construction is also seen to gain from the lifting of the restriction on foreign contractors through opportunities for knowledge transfer and application of new and advanced technologies.[5]

Conclusion

To achieve the objectives of a national competition policy, the Government should address public restraints as much as it enjoins private restraints.

The Government must ensure a level playing field where no market participant is given undue advantages that would allow it to gain market share over otherwise more effective and efficient competitors. This should apply to all players regardless of whether these players are controlled by the private sector or the State.

Economically sound policies should not give incumbents competitive advantages for tenuous reasons such as nationality alone. Claims of protecting the interest of the public through regulatory action should be evaluated in terms of the resulting incentive distortions that reduce competition and the countervailing efficiencies arising from the regulation. Discriminating in favor of certain market participants without valid economic basis or policy rationale tends to reward poor performance, reduce competitive pressure, and distort incentives to innovate.

Restrictive rules which do not take into consideration market competition are very likely to diminish both short-run and long-run efficiency improvements. Consumer welfare, which in this case refers to the welfare of both households and other businesses, is maximized when competition allows consumers to access and choose the most efficient producers, regardless of the service provider's nationality. Indeed, it is a settled principle in economics that if there are many players in the market, healthy competition will ensue. The competitors will try to outdo each other in terms of quality and price in order to survive and profit. Competition therefore results in better quality products and competitive prices, which redound to the benefit of the public.

Table 2: Estimated Construction Costs in ASEAN, 2016 (in US$ per square meter)

Area	Standard High Rise Apartments	Prestige High Rise Offices	Average Standard High Rise Offices	Prestige Shopping Centers	Ave. Standard Shopping Centers	Industrial Units	Business Hotel
Manila	900.0	1320.0	870.0	1115.0	815.0	470.0	1330.0
Bangkok	773.5	990.0	727.5	882.0	750.5	565.0	1593.0
Jakarta	707.0	1025.5	757.5	649.0	594.0	315.0	1681.5
Vietnam	665.5	942.5	750.0	-	740.0	330.0	1787.5
Kuala Lumpur	465.0	1190.0	757.5	885.0	690.0	422.5	2192.5

Source: Langdon & Seah Construction Cost Handbook (2016)

[3] Mattoo, A., Rathindran, R., & Subramanian, A. (2006). Measuring Services Trade Liberalization and Its Impact on Economic Growth: An Illustration. Journal of Economic Integration.
[4] Estimated using a model that predicts the amount of additional FDI that will come into the Philippines once the restrictions are lifted. The predicted figure is then contrasted against the status quo FDI levels.
[5] Mercurio, R. (24 February 2016), ECCP exec laments restrictions on international contractors, The Philippine Star online, available at http://www.philstar.com/business/2016/02/24/1556057/eccp-exec-laments-restrictions- international-contractors, last accessed 9 November 2016.