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Assessment of the Philippine Economic Reform Program, Evaluation of Past USAID Program Assistances, and Future Recommendations

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FINAL REPORT

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Acronyms

ADB	Asian Development Bank
APT	Asset Privatization Trust
BIR	Bureau of Internal Revenue
BOP	Balance of Payments
BSP	Budget Support Program
CARP	Comprehensive Agrarian Reform Program
CB	Central Bank of the Philippines
COA	Commission on Audit
COP	Committee on Privatization
CPI	Consumer Price Index
CY	Calendar Year
DA	Development Assistance (U.S.)
DBM	Department of Budget and Management
DBP	Development Bank of the Philippines
DSP	Development Support Program
DTI	Department of Trade and Industry
ERP	Economic Recovery Program (World Bank)
ESF	Economic Support Fund (U.S.)
FPA	Fertilizer and Pesticide Authority
FY	Fiscal Year
GFI	Government Financial Institution
GOP	Government of the Philippines
IBRD	International Bank for Reconstruction and Development, or the World Bank
IMF	International Monetary Fund
LGU	Local Government Unit
MAI	Multilateral Assistance Initiative
MoF	Ministry of Finance
NEDA	National Economic and Development Authority
NFP	Non-financial Public Corporations
NFA	National Food Authority
NGA	National Grains Authority
NPC	National Power Corporation
NRO	NEDA Regional Office
ODA	Official Development Assistance
OIC	Omnibus Investments Code
P/	Philippine peso
PAAD	Program Assistance Approval Document
PL-480	Public Law 480, Food Aid
PNB	Philippine National Bank
RDC	Regional Development Council
RPSP	Rural Productivity Support Program
USAID	United States Agency for International Development

Note: US $1.00 = 20.8 Philippine pesos (P/) as of August 1988
= 21.4 Philippine pesos (P/) as of December 1988

Executive Summary

This report has three main purposes: (1) to evaluate the role and success of USAID program assistances to the Philippines over the past four years; (2) to evaluate the progress of the Philippines since 1983 in a number of key structural reform areas, many of which were supported by donor assistance; and (3) to discuss the key areas still in need of national structural reform, and to make recommendations on the role to be assumed by USAID in the Multilateral Assistance Initiative.

Parts I and II

The report is divided into four parts. Part I is introductory, and provides a context for the policy and program review. Part II evaluates USAID's four program assistance grants made between 1984 and 1987, i.e. the Rural Productivity Support Program, the Development Support Program, the Budget Support Program, and the Budget Support Program II. It concludes that USAID provided timely and desperately needed balance of payments support during these critical years, and that the local currency budget contributions were also helpful in offsetting high domestic budget deficits and cutbacks in capital expenditures. Minor implementation problems were experienced in the management of local funds.

Part III

Part III contains in-depth analysis of each of the following seven areas of structural and sectoral reform:

1. Trade Policy and Investment Incentives
2. Tax Reform
3. Government Corporations and Financial Institutions
4. The Financial System
5. Agricultural System
6. Public Sector Investment Program and Decentralization
7. Transportation and the Transport Infrastructure

Due to the length and complexity of the issues covered in Part III, it is not possible to summarize them all here. However, it was generally observed that much of the policy reform efforts begun in the early and mid-1980s have been positive. The current challenge is to continue in the direction already established, and to regain momentum lost during the change in governments and that has not yet been wholly regained by the Aquino Administration.

Part IV

Part IV shapes the findings of Part III into an overall national economic reform agenda. It outlines a set of reforms that we consider to be of the highest priority to steer the country towards a path of increased efficiency and growth. Its recommendations are summarized below.

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1. Highest Priority Issues:

We consider the following list to contain the most urgent economic policy reforms to be undertaken in the Philippines.

a. Ongoing trade policy reform and liberalization.

b. Currency devaluation.

c. Improved tax collection efficiency, and reduction of the domestic budget deficit. This includes strengthening the legal system to better enforce the tax code, and undertaking cadastral work in the context of both property tax collection and land reform.

d. Deregulated inter-island transportation.

e. Improvements in the services and collection efficiency of the utilities, including water, power, irrigation, and telecommunications.

f. Increased maintenance of existing regional infrastructure.

In all cases, these reforms touch on either (a) the macroeconomic environment affecting all productive sectors, or (b) the physical supply-side constraints affecting all productive sectors. The first two reforms are particularly important to help increase trade and the international competitiveness of the Philippines. The third reform is important to reduce both interest rates and the crowding out of private borrowers (investors) during a time of growth. The last three are to reduce constraints to the production of industrial, non-traditional export, and agricultural products, and improve the efficiency of government corporations serving the productive sectors. These three reforms also have a strong bias towards economic dispersal away from Manila.

2. Important issues:

We consider the following list to include policy actions that are very important to the Philippine economy, but of secondary importance to the above list:

a. Privatization of government-owned corporations.

b. Promoting financial sector competition/efficiency.

c. Reduced government sanctioned "rent-generating" activities, affecting both public and private corporations, such as monopolies, quantitative restraints, export quotas, credit allocation controls, certain industrial regulations, and tax exemptions.

d. Revisions in the current investment incentive code.

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e. Agricultural sector policy reforms.

Privatization is an extremely important long-term goal, but one in which the prospects for short-term improvements and economic impact are less than for the higher priority items. It is important for reasons of both (a) economic efficiency, and (b) a clear signal to the private sector of the reduced role of the public-sector in patronage and "rent-generating" activities in the economy.

Items b, c, and d are important revisions in policies affecting the business climate -- policies that currently lead to important and negative misallocations of resources. The last item refers to agricultural policy reforms that are "internal" to the agricultural sector. The fact remains, however, that the most important steps to be taken affecting Philippine agriculture are all included on the highest priority list: e.g. currency devaluation, deregulated inter-island shipping, improvements in irrigation management, and increased maintenance of regional infrastructure, including irrigation.

The last chapter of Part IV discusses the role of USAID in the Philippine policy reform effort, and the role of USAID in the Multilateral Assistance Initiative. It begins by grouping the priority reform areas identified above, and regrouping them into overall thematic groupings. Four areas emerge:

1. Macroeconomic Reforms: the most important macroeconomic reforms are (a) currency devaluation and (b) improved tax collection efficiency to reduce the fiscal deficit. In balancing the budget, it is concluded that revenue expansion is a higher short-term priority than expenditure reduction.

2. Trade and Private Sector Promotion: this grouping includes a variety of efforts to promote trade and the growth of the private sector. These include (a) trade liberalization, (b) reduced "rent-generating" activities, (c) investment (industrial) incentive policies, and (d) development/reform of the financial sector.

3. Regional Development: this grouping includes a wide range of efforts to promote rural and regional development, and regional income generation. The most important reform areas are (a) deregulated inter-island shipping, (b) increased public expenditure in infrastructure maintenance, (c) accelerated public investment in regional infrastructure development projects, (d) agricultural policy reforms, (e) utility pricing rationalization, and (f) government decentralization.

4. Improvements in Government Functions: this grouping includes those reform areas that focus on institutional development and operational efficiency of both public and parastatal entities. The most important of these reform efforts are (a) management and accounting reform of government corporations and government financial institutions, (b) privatization, and (c) government accounting.

We recommend that USAID, given this broad agenda, focus on reform activities in groups 2 and 3, i.e. trade and private sector promotion, and regional development. Both areas are consistent with its current portfolio of projects, its areas of expertise, and its probable funding levels. Of course, USAID is already also active in several areas in group 4, but less comprehensively than in groups 2 and 3. Rather than expand its activities in areas covered by group 4 -- other than privatization -- we feel that USAID should focus its program activities in the areas of group 2 and 3.

In coordinating its effort with the other donors involved in the MAI, suggestions are also given relating to USAID's involvement in macroeconomic issues (group 1), and institution building (group 4). One area that all donors can assist to their mutual benefit is the ability of the GOP to implement projects in their development pipeline.

Although the MAI negotiations are still in their early stages, we note the following:

1. There should be a clear delineation of which USAID funds are conditional -- and thereby invite policy dialogue -- and which funds are unconditionally disbursed (e.g. ESF funds under bases agreements). It appears that past discussions between USAID and Philippines have suffered from radically different understandings of what was appropriate in aid discussions. It should be easier to emphasize policy conditionality on MAI "new money", especially with multilateral donor coordination, than it has been on BSP-III.

2. There should also be more forthright statements of aid conditions by other bilateral donors -- Japan in particular -- so that the United States is not alone in imposing policy conditions.

3. There should be continual recognition that successful conditions are those that the country shares as economic objectives, and not conditions that are imposed. This affects the likely success in meeting conditions, but also the permanence of reforms once they are installed.

Finally, Chapter 13 discusses areas in which additional work would benefit USAID and the MAI in shaping its policy initiatives. Five areas of further analytical work are suggested.

1. The overall balance of incentives -- including incentives, exchange rate, and trade policy -- on the industrial and agricultural sectors could be better understood. This study, which would be broader than the one on industrial incentives currently being completed by John Power, should address such issues as:

   - the "competitiveness" of the exchange rate vis-a-vis other countries;

- the degree of backward production linkages, compared with other countries, and as affected by the overall policy mix;

- the actual bias against domestic suppliers of intermediate goods used by export industries;

- exploration of means to compensate domestic suppliers-- consistent with GATT -- for their current disadvantage in competing with foreign suppliers of intermediate goods for export industries.

2. There is a need for a detailed study on the organization and performance of the inter-island shipping industry. The ADB has recently completed an engineering study of the inter-island network, but virtually no work has been done on the economics of the industry. Related work needs to be done on safety regulation of the industry. Both studies would be an essential step in deregulating the industry.

3. The fiscal deficits in the Philippines need to be better understood, especially in terms of their inflationary effect and their effect on crowding out private investment. Better understanding of the crowding out effect could lead to greater urgency in GOP efforts to reduce the deficit through revenue enhancement.

4. There is a need for monitoring studies on the pace and impact of trade liberalization. Although much has been made of the number of quantitative restrictions that have been lifted, and of the number of commodities still on Lists A, B, and C, little analysis has been done on the economic impact of trade liberalization to date. Economic impact studies should go beyond the impact on the current account, to looking at the impact on investment, industrial structure, and the capital account.

5. There is a strong link between the need for cadastral surveys for the purpose of increasing local property taxes, and the need for land valuation studies in the context of land reform. Landowner incentives on property valuation for taxation and for land reform (transfer) compensation are directly opposing, and there is scope for significant increases in tax register land valuation. USAID could help promote this link through an appropriate study.

As a final note, we reiterate our overall finding that the rate of meaningful policy reform has slowed significantly during the past 2-3 years, and there is a need to create new momentum. The MAI may be useful in encouraging this momentum. We feel that the general outlines of the reform package are clear and discrete enough that the desire for "additional study" should not be used as an excuse for further delay.

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PART I

Chapters 1-2

Assessment of the Philippine Economic Reform Program, Evaluation of Past USAID Program Assistances, and Future Recommendations

PART I -- Introduction and Overview of the Philippine Economy

Chapter 1. Introduction

A. Context

This report is being written at a pivotal time in the structural reform of the economy of the Philippines. Many significant reforms, such as trade liberalization, financial sector reform, and the breakup of major government monopolies, were begun during the last years of the Marcos Administration. There has been an unusually high degree of agreement between the Philippine government and the international donor community on the nature and direction these reforms should take.

None of the major reform efforts were brought to completion under the Marcos regime, nor could they have been completed, given the severe economic crises and the short time elapsed before the fall of Marcos. Most reforms, however, have been endorsed by the Aquino Administration, and some progress has been made since 1986. The level of agreement between various key parties within the Philippines and the donor community, while sometimes differing on issues of timing and sequencing, is still largely intact. However, all of the major reform efforts require additional steps and renewed political commitment.

This report is being written at a pivotal time because the economy of the Philipines is poised, for the first time in years, for a long and steady period of economic growth. The country has already recovered from the serious recession suffered in the mid-1980s. Major macroeconomic variables, such as interest rates, inflation, unemployment, and foreign exchange reserves, are healthier than they were 2-3 years ago. The economic conditions of today imply that (a) the reform measures are important, if not essential, for sustaining long-term growth, and (b) the economic and social costs of adjustment can be better absorbed now than in recent years.

Also, the donor community is contemplating a new, coordinated "Multilateral Assistance Initiative" (MAI), financed with new funding commitments to the Philippines. While the MAI has not yet taken shape, it would ease some of the economic adjustment costs of the contemplated reform measures.

There have certainly been some negative circumstances that have served to slow the pace of certain reform efforts. In one of the most important areas -- trade liberalization -- the Philippine government is seriously divided. In other areas such as decentralization and financial sector reform, the administration's political commitment appears weak, and

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policy statements are not always implemented. In still other areas, the political reality of the new legislature has altered the nature of the reform dialogue.

Taking all of this into account, this report is designed to contribute to the planning of the Multilateral Assistance Initiative. It attempts to document progress achieved to date, and to lay out an agenda for further effort.

B. Organization of this Report

In order to not become overly unwieldy, this report has been organized into four distinct parts. The first part is introductory. The three remaining parts are dedicated to three principal purposes of the report:

(1) to evaluate the role and success of USAID program assistances to the Philippines over the past four years;

(2) to evaluate the progress of the Philippines since 1983 in a number of key structural reform areas, many of which were supported by donor assistance;

(3) to discuss the key areas still in need of national structural reform, and to make recommendations on the role to be assumed by USAID in the Multilateral Assistance Initiative.

Clearly, this report has a lot of ground to cover, and serves several different audiences. In order to provide a context for the policy and program review, Chapter 2 gives a summary of economic events over the past ten years, and a profile of the basic crisis and reform period.

Part II evaluates the impact of USAID's four program assistance grants made between 1984 and 1987. These were:

1. Rural Productivity Support Program
2. Development Support Program
3. Budget Support Program I
4. Budget Support Program II

Chapter 3 discusses the economic impact of these grants, as well as the problems incurred in their implementation.

Part III contains a much more detailed presentation of the scope and progress made in the Philippine Economic Reform Program. The period covered is primarily 1981 to the present, but a slightly longer view is taken when necessary. A chapter is devoted to each of the following areas of structural and sectoral reform:

1. Trade Policy and Investment Incentives
2. Tax reform
3. Government Corporations and Financial Institutions

4. The Financial System
5. Agricultural Sector
6. Public Sector Investment Program and Decentralization
7. Transportation and the Transport Infrastructure

Each of these seven chapters discusses both the changes that have brought about to date under the Marcos and Aquino governments, and the steps that remain. The remaining steps may be ones that have been previously agreed to by the Philippine government (GOP), or they may be new.

Part IV presents the findings of Part III in the context of an overall national economic agenda. This section regroups the priority reforms identified above in terms of priorities for future program assistance. It makes recommendations on an overall reform agenda that could become a basis for future multilateral policy discussions.

The second chapter of Part IV looks into Central Bank projections of the medium-term (1988-1993) balance of payments and financing gap. Although there is no direct link between the apparent financing gap and the projected level of ODA assistance, this analysis does give an indication of the projected need for additional foreign exchange in the Philippines.

Finally, the last chapter of Part IV makes recommendations on the possible role to be assumed by USAID in the upcoming multilateral assistance initiative. This is done by looking at both the economic agenda items highlighted above, and at the historical strengths, vis-a-vis other donors, of USAID in the Philippines. It is found that USAID, within a broad MAI policy dialogue, should focus on issues relating to trade liberalization, private sector promotion, financial sector development, and regional development (including deregulation, targetted public investment, and agricultural reform).

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Chapter 2

Chapter 2. Overview of Philippine Economic Structural Weaknesses

In order to evaluate AID policy-based programs in the Philippines in the 1984-87 period, and to intelligently fashion reform programs for the future, one must have an understanding of the structural weaknesses of the Philippine economy and the economic crisis that the Philippines experienced in the early 1980s.

A. The 1970s

During the 1970s the Philippines was able to achieve accelerated economic growth and rapid growth in exports. But the improvement in macroeconomic performance was built on a very narrow and ultimately unsustainable base. The growth in output after the first oil shock was heavily dependent on the expansion of public investment expenditure, financed almost exclusively by foreign borrowing. An increase in construction activity alone accounted for almost 30 percent of the increase in output between 1974 and 1979. In addition, manufacturing was increasingly dependent on the expansion of investment. When the momentum of public investment faltered in the 1980s, both the construction and manufacturing industries were unable to shift to other markets, and output dropped dramatically in each.

The expansion of exports, and the shift in the composition of exports towards manufactured goods were also misleading. The Philippines encouraged the expansion of manufactured exports by allowing exporters duty-free access to imported inputs. At the same time the country retained its traditional policy of heavy protection of the domestic manufacturing sector, and increased that protection through a variety of non-tariff barriers during the 1970s. The result was a high degree of dualism in Philippine manufacturing. Manufactured exports were restricted to a small number of products, the most important of which were semi-conductors and garments.

Manufactured export industries were characterized by high dependence on imported inputs and relatively low domestic value added. As a result, the net foreign exchange generation of the manufactured export sector was relatively low, since imports of inputs expanded along with exports. The Philippines was not as successful as other East Asian countries in deepening its export sector. In addition, if imports of consignment inputs are netted out from the export figures, the Philippine export base actually narrowed during the martial law period.

While manufactured exports were promoted, the balance of incentives in the trade policy and exchange rate structure continued to discriminate against exports of traditional commodities. International prices declined for most Philippine commodity exports after 1974, further discouraging their export growth. But in addition, the Philippine

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government increasingly taxed the commodity export sector, not only through direct export taxes, but more insideously through the monopolization of key export crops (coconuts and sugar) and the siphoning off of economic rents.

B. The 1980s

The volume of Philippine commodity exports did not grow at all between 1972 and 1980, and fell by 40 percent in the following four years. The importance of the weakness of the traditional export sector is hard to overstate. Had the volume of Philippine commodity exports grown at the same rate as GDP, other things being equal, Philippine exports would have been 54 percent, or $2.9 billion, higher in 1984. The transformation of Philippine export structure was as much a result of the poor growth of traditional exports as it was the result of growing manufactured exports.

The failure of net export earnings to expand more rapidly meant a continuing weakness in the balance of payments, which was covered by an increasing resort to external borrowing. When access to external capital diminished, the narrowness of the manufactured export base and the heavy taxation of the commodity export sector made it impossible for the traded goods sector in the Philippines to respond.

Critical to understanding the crisis in the Philippine economy in the 1980s is an appreciation of the extent of deterioration in the economic environment and in economic institutions that took place under martial law. Part of this was what has been termed "crony capitalism" -- the use of state influence to reward and foster individuals close to the regime. Graft and corruption were present in previous administrations but increased greatly in scale due to the increased resources flowing through the public sector during martial law.

However, considerably more was involved. Much of the patronage under martial law came from the intervention in profitable markets and the creation of monopoly positions. The monopolistic organization of the sugar and coconut industries referred to above was a prime example, and served to weaken the performance of those sectors. Monopolization was extended to a variety of other industries -- grain importation and trading, meat imports. transport facilities, cigarette filters, fertilizer production, coconut-based chemicals, and labor export -- to name just a few. In each case, the restriction of competition was used to generate rents to favored individuals, and often to Marcos himself, with detrimental effects on the industries involved.

Finally, much of the growth of corporate empires of the cronies was achieved through acquisition of existing firms, often through thinly veiled extortion. As a result, businessmen not directly tied to the Marcos government became reluctant to expand or become too profitable for fear of inviting the attention of Marcos and his associates. They also became reluctant to enter new areas of operation, since one could not be sure of the rules of the game affecting firms in that industry. Domestic

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firms invited foreign joint venture partners as a way of protecting themselves against their own government; foreign firms used OPIC insurance or IFC funding as a way of dissuading moves against them; and entrepreneurs moved their capital beyond the reach of the government through capital flight. This discouragement of the non-associated private sector was one of the reasons behind the steadily falling rate of growth of output in the 1980s, despite the efforts of the government to stimulate the economy.

By 1980, net direct investment had turned negative, and the pace of capital flight increased sharply above levels of the 1970s. The major years for capital flight were 1981 and 1982, when it may have reached as much as five percent of GNP -- exceeding even the period after the Aquino assasination.

The second set of economic institutions weakened by the martial law period were the country's financial institutions. Although the Philippines has had a relatively small public sector, its involvement in the financial sector has traditionally been high, and it increased after 1972. Increased public sector investment, rising external borrowing, and the preference of external creditors for government guarantees caused an increasing flow of financial resources through the two state owned financial institutions, the Philippine National Bank and the Development Bank of the Philippines. Many of the loans of these two institutions were made on the basis of political considerations, to individuals or firms favored by the Marcos government. The projects were often overpriced, and profits were made in the act of investment and not in the profitable operation of the created facilities. When these firms failed in the 1980s, the Philippine government was saddled with high levels of guaranteed loans and corresponding assets of little value.

The financial system in general became more reckless and vulnerable to crisis during the late 1970s. The longstanding preference for short term lending meant that firms, and not banks, did the intermediation, funding long term assets with short term borrowing, and thus were vulnerable to increases in interest rates and liquidity crises. In addition, the development of alternative institutions to bank finance -- investment houses, finance companies, and the money and commercial paper market-resulted in less supervision of the financial sector and greater possibilities for abuse. Finally, Philippine firms were heavily leveraged, particularly the rapidly expanding corporate empires of the Marcos cronies, and highly vulnerable to a change in business or credit conditions. The result was a highly volatile mixture by the early 1980s.

The Philippine government began a series of structural reforms in the 1980s, with support from the World Bank and the IMF. Various financial sector reforms, including the freeing of interest rates and the reduction of functional differences among financial institutions, proceeded under a World Bank/IMF Apex loan. The Philippines also began major reforms of its trade policy and industrial incentives systems under two World Bank Structural Adjustment Loans. And in its last years in office, the Marcos government began a number of reforms of agricultural monopolies,

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government corporations, and government financial institutions. Some of these efforts, particularly the reform of industrial incentives and the rationalization of tariff rates, were successful. However these reform efforts were overtaken by events in the 1980s, particularly the balance of payments crisis and debt moratorium in 1983. Although discussion of structural reforms had gone on for several years, most structural reform measures had not been implemented when the Aquino government came to power in 1986.

The first two USAID programs that this report evaluates take place during the worst economic crisis in Philippine postwar history. The Philippines had borrowed heavily and on a short term basis during the 1980s to sustain the balance of payments. In addition, the country drew down its reserves by $2.5 billion (75 percent) between 1980 and September 1983, although this was not known at the time because the Central Bank was systematically overstating its foreign exchange reserves. When the Philippines declared a moratorium on its principal repayments in October, 1983, foreign exchange reserves were only $700 million, or about 3 weeks worth of imports.

The extreme foreign exchange stringency of the Philippine position greatly increased the severity of the adjustment process.

PART II

Chapter 3

PART II -- Evaluation of Past USAID Program Assistance in the Philippines

Chapter 3. Evaluation of USAID's Program Assistances, 1984-87

A. Introduction

Since 1984, USAID has given four program assistance grants to the Philippines, all of which have been completely disbursed. In addition, it has undertaken a variety of policy reform activities specific to the agricultural sector under the 1985-1987 PL-480 Title I food aid program. This chapter will give an overview of these programs, and will discuss issues related to their economic impact, implementation, and accountability.

The four program assistances were:

1.	Rural Productivity Support Program	\$ 47.5 million
2.	Development Support Program	\$ 45.0 "
3.	Budget Support Program	\$300.0 "
4.	Budget Support Program II	\$150.0 "

The first two were designed primarily as balance of payment support programs, and the latter two as budget support programs. Despite the different names, the distinction between these two types is not great, as both types increase the supply of foreign exchange available to the Central Bank, as well as free up local funds available for domestic budgetary expenditures.

The key conceptual difference between balance of payments support and budgetary support is that in the case of the former, the balance of payments situation is certified by USAID to require urgent outside assistance. In the case of the latter, USAID finds that the domestic fiscal situation is in need of assistance. In a balance of payments support program, USAID gives dollars to the GOP, against which the GOP puts up an equal amount of local currency to be expended according to certain agreed-upon rules. The local pesos should, in theory, be spent on 'additional' budgetary items, i.e. items not included in the original GOP budget. In contrast, budget support programs provide pesos that are meant to be spent on recurring cost items already included in the GOP budget, and no additionality is implied.

To take the distinction between the two types of programs a step further, it is noted that the pesos generated by balance of payments of support often go towards financing projects, whereas the pesos generated in budget support programs are always given in support of policy reform.

In addition to the four program assistances, USAID entered into policy dialogues with the GOP during 1985-1987 in the context of PL-480 Title I

Agreements. Each of these agreements provided for policy reforms in the agricultural sector that were designed to stimulate productivity growth and future self-suffiency in the agricultural sector. The policy reform measures attached to PL-480 were consistent with the larger structural reform measures being adopted by the IMF, World Bank, and USAID (under BSP-II). Unfortunately, to date, compliance with specific PL-480 policy reform measures has not been great.

The following chart summarizes the four programs assistances and the three PL-480 Title I Agreements.

<u>Table 3.1 USAID Program Assistances and PL-480, 1984-1988</u>

<u>1. Rural Productivity Support Program</u>

Startup date:	Dec. 22, 1984.
Completion date:	Sept. 30, 1986.
Funds disbursed:	$47.5 million, dispersed Dec. 24, 1984. P/940.6 million (equivalent local currency) disbursed approximately 80% in 1985, and 20% in 1986.
Use of funds:	The primary objective was balance of payments support, given with "free" foreign exchange. The equivalent pesos were used to help finance, with some degree of budgetary additionality, counterpart funding for ongoing IBRD, ADB, and AID projects in the areas of rural development.

<u>2. Development Support Program</u>

Startup date:	Sepember 30, 1985.
Completion date:	June 30, 1987.
Funds disbursed:	$45 million, dispersed in December 1985. P/853.8 million in local currency dispursed between October 1, 1986 and June 30, 1987.
Use of funds:	The primary objective was balance of payments support. The equivalent pesos were used to make counterpart contributions to ongoing IBRD, ADB, and USAID rural development projects.

<u>3. Budget Support Program</u>

Startup date:	June 25, 1986.
Completion date:	December 31, 1986.
Funds disbursed:	$200 million in June, 1986, and $100 million in September, 1986. The local currency equivalent of P/6.15 billion was expended by the end of the year.
Use of funds:	USAID transferred pesos used for budget support, with no policy conditionality. Funds used to

	help finance recurring costs in the areas of education, health, and agriculture. The US dollars, while not technically transferred by USAID, were changed by the U.S. Treasury at the Central Bank and were available as free foreign exchange.

4. Budget Support Program II

Startup date:	May 28, 1987.
Completion date:	December 31, 1987.
Funds disbursed:	$150 million in two tranches ($75 million in June and $75 million in November, 1987). Local currency generated was P/3.1 billion. All expenditures were made by Dec. 1987.
Use of funds:	Dollars were used to meet IMF debt service payments. Pesos were used for budget support in the areas of health and education. Policy conditions were attached in the areas of macroeconomic policy (exchange rates, fiscal policy, and monetary policy), and government involvement in the economy (privatization, trade liberalization, and simplified investment regulations).

5. PL-480, Title I

1985 Program:	$40 million (138,000 mt rice).
Policy concerns:	1. Deregulation of price of rice. 2. Establish rice stabilization program. 3. Divestiture of NFA non-foodgrain activities. 4. Liberalize the wheat sector. 5. Liberalize the fertilizer sector.
1986 Program:	$35 million (263,000 mt of wheat).
Policy concerns:	1. Continued deregulation of wheat. 2. Divestiture of NFA non-foodgrain activities. 3. Establish price program for rice and corn.
1987 Program:	$43.5 million (234,800 mt of wheat).
Policy concerns:	1. Divestiture of selected corporations under the Department of Agriculture, particularly the Philippine Cotton Corp., the Philippine Dairy Corp., and NFA subsidiaries.

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Table 3.1 USAID Program Assistances and PL-480, 1984-88 (con't)

1988 Program:	$30 million (72,000 mt of rice) -- loan.
Policy concerns:	1. Measures to improve the production, storage, and distribution of commodi-ties, especially in the area of fertilizer marketing and information. 2. Divestiture of NFA subsidiaries in Kadiwa, Tabangao, Digos, and the Northern Philippines Grains Complex. 3. Access to fertilizer at world prices.

B. Rural Productivity Support Program

1. Background

The Rural Productivity Support Program (RPSP) was designed to provide balance of payments support at a time when the Philippine Government was in its most serious crisis since World War II. Precipitated by the assassination of former Senator Aquino in 1983 led to massive capital flight and the declaration of a commercial bank debt moratorium, as the country's foreign exchange reserves dissipated.

As shown in Graph 3.1, at the time of the RPSP, Central Bank reserves had fallen to the level of one month's imports of goods and services. This was the lowest level to which reserves fell during the entire 1985-88 period. In October, 1984, the government announced a flexible peso exchange rate. The estimated financing gap for 1984-85, including balance of payments deficits, arrears, and the effect of debt reschedulings, was estimated to be $3.1 billion. It was in this context that the RPSP pledged $47.5 million.

Also during this economic crisis period, GOP budgetary outlays had been significantly reduced due to tight fiscal and monetary policies. This cutback delayed the completion of many donor-assisted investment projects, and slowed the disbusement of IBRD, ADB, and USAID development assistance funds. The economic and social benefits to be derived from the projects were being delayed, and costs, due to inflation, were rising.

The peso equivalent amount to the RPSP dollar funding was earmarked to help fund counterpart contributions to IBRD, ADB, and USAID projects. The funds were to be "in addition to" other GOP resources available as counterpart funding for these projects. The principle of additionality was established to (a) ensure that the GOP was not relieved of its responsibility to finance its share of project costs, at the same time as (b) the pace of project implementation would not suffer unduly due to national and international economic setbacks that were not foreseen at the time of the original project agreements.

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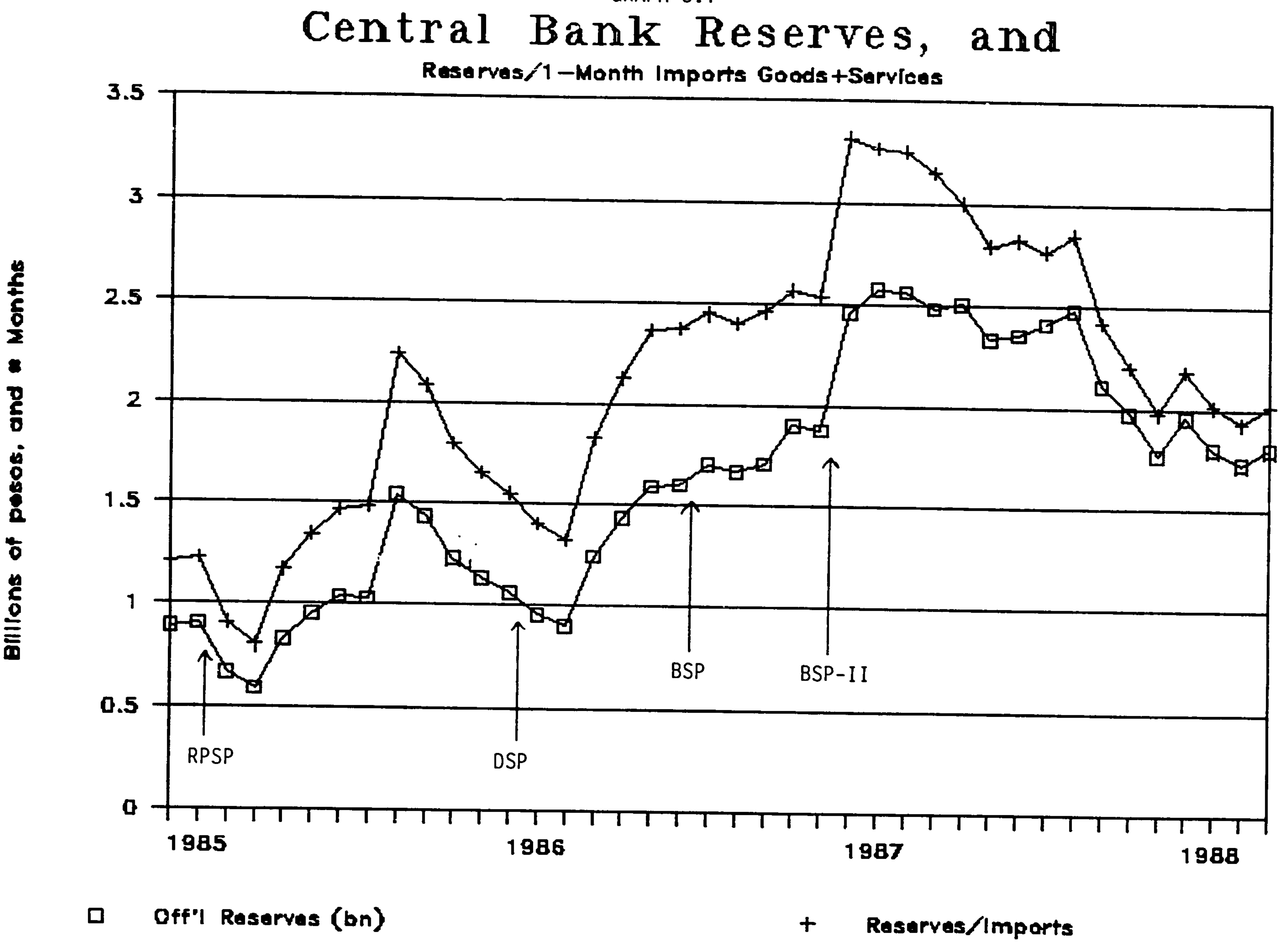
GRAPH 3.1


Central Bank Reserves, and
Reserves/1-Month Imports Goods+Services
Billions of pesos, and # Months
3.5
3
2.5
2
1.5
1
0.5
0
1985
1986
1987
1988
RPSP
DSP
BSP
BSP-II
Off'l Reserves (bn)
Reserves/Imports

The RPSP Program Assistance Approval Document (November, 1984) noted that the real value of GOP capital budget outlays had fallen by over 50% since 1983, and that the 1985 budgeted level of capital expenditure outlays was a third below the budget request made by the various GOP implementing agencies. The RPSP was intended to provide support to the general ability of the GOP to implement projects, and not provide support directly to specific projects.

2. Program Evaluation

a. Disbursements

The RPSP dollars were made available to the GOP immediately upon grant approval in December, 1984, and the peso equivalent amount was deposited in a special Central Bank account in January, 1985. It was agreed that additionality would be measured "against the amount of GOP counterpart pesos, and grant and loan proceeds for this group of selected projects provided in the national budget as approved by the Philippine Legislature."[1] This meant that the P/941 million in ESP-generated funds would be added to the budgeted amount of P/1,119 million in counterpart funds, for a total of P/2,060 in peso financing of RPSP projects in 1985.

RPSP-approved projects were selected on the basis of three criteria: (1) projects with a strong relationship with the development objective of improving productivity in rural areas and stimulating productive rural employment; (2) projects already under implementation whose benefits will be realized quickly once additional resources are provided; and (3) projects with a high probability that they can expend promptly the RPSP funding made available to them. The resulting list of approved projects included 16 Asian Development Bank projects, 22 World Bank projects, and 10 USAID projects.

In 1985, RPSP local currency outlays were broken down as follows:

Asian Development Bank	-- 11 projects	24%
World Bank	-- 15 projects	69%
USAID	-- 9 projects	7%

Due to problems of slow disbursement of RPSP funds, only P/1,589 million, or 77% of total RPSP pesos funds were disbursed in 1985. By grant amendment, two steps were taken in 1986. First, the required level of GOP funding of RPSP projects was reduced by 22.1%, from P/1,119 to P/871 million. This was done due to continued budgetary constraints and reductions in capital outlays detrimental to the progress of the RPSP projects. Second, the unexpended RPSP balance, a newly-calculated residual of P/222 million, was carried over into 1986.

[1]RPSP Program Assistance Approval Document, November, 1984, pg. 20.

The disbursement of RPSP funds was completed by September of 1986. In 1986, no monies were used for ADB projects, as by this time the ADB had approved its own credit line of $100 million to finance the full counterpart needs of their projects. The 1986 outlays of RPSP funds were approximately 93% on thirteen World Bank projects, and 7% on seven USAID projects.

b. Resource Impact

As shown in Graph 3.1, the contribution of $47.5 million in foreign exchange came at a time of extreme depletion of international reserves in the Philippines. Although the dollar amount involved was insufficient to have any dramatic impact on exchange rates, reserve levels, or capital flight, the GOP was desparate at that time for foreign exchange. Given that RPSP monies were made available at the same time that the IMF negotiated a new Stand-by Agreement (October, 1984), they were a significant vote of confidence in the GOP reform efforts in the area of fiscal and exchange rate policies.

The resource impact of the peso counterpart funds was also positive. In 1985, even with problems concerning the slow rate of peso disbursements on RPSP projects, additionality on the order of 42% was achieved.[2] This additionality was achieved at a time when total budget outlays were falling, tax revenues were well below targets, and cost-overruns on non-discretionary expenditure items were common. However, given that the GOP fiscal position was steadily weakening during the course of the RPSP program, and that capital outlays on RPSP projects fell in 1986 to approximately one quarter the level of outlays in 1985, the degree of additionality achieved over the course of the whole program was less than 42%. USAID was fully aware of this, and determined that (a) a lower degree additionality was acceptable in light of the urgent need for continued resource mobilization in rural areas, and (b) that as a program objective, additionality was secondary to balance of payments support, which had already been successfully achieved.

c. Implementation Issues

The RPSP program is the only one of the four program assistances evaluated here that has been audited by the Regional Inspector General of USAID. The Audit Report, dated July 12, 1988, was somewhat critical of USAID's management of the RPSP counterpart funds.[3] These criticism were

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[2]P/1,589 million in combined ESF-generated and GOP counterpart funds were expended on RPSP projects in 1985, as against an approved GOP budget outlay of P/1,119 million.

[3]The Audit Report concluded that "funds made available through the RPSP were not provided as promptly as ilntended, the funds were not managed as well as possible, and the projects which were to receive the benefit from the program had not fully benefited as originally intended" (pg. 3). The report further

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vigorously contested by the USAID Mission in comments attached to the Audit Report.

Without responding in a detailed fashion to each of the audit findings, which the Mission has already done, this evaluation concludes that:

1. The objective of balance of payments support to the GOP was promptly achieved following the date of signing the RPSP Grant Agreement; and

2. The objective of local currency support to counterpart funding of rural development projects was satisfactorily accomplished, albeit with delays in disbursement and a lower degree of budgetary additionality than was originally foreseen. However, both the disbursement delays and lower additionality can be attributed more to the performance of the GOP and to the political and economic uncertainty during the program period than to the performance of USAID.

The issue of accurate and timely financial reporting of USAID-generated peso funds has plagued not only the RPSP, but later program assistances. The issue turns on whether or not GOP reporting, while flawed, gave USAID a "reasonable assurance" of program activities. USAID has answered this question in the affirmative, while the auditor found that reporting inconsistencies called the test of "reasonableness" into question, and that closer monitoring by USAID of GOP budgeting and expenditure activities was required. USAID was not unaware of persistent problems in the accuracy and timeliness of GOP reporting under RPSP, and the Grant Amendment #1 revised the reporting requirements after prolonged discussions with the GOP. Although the final accounting of RPSP disbursements was not complete until March 31, 1987, USAID was satisfied with the content of the reports.

One of the reasons the GOP was slow in RPSP reporting was that reporting requirements cut across traditional GOP bureaucratic reporting lines. This finding should be taken into account when USAID balances the benefits of accurate reporting with the cost of donor-imposed "red tape" in the design of future program assistances.

C. Development Support Program

1. Background

The Development Support Program (DSP) was a continuation of the RPSP in almost every regard: its primary objective was balance of payments

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determined that "the data provided by the GOP concerning how the funds were used was not sufficient nor fully reliable", and that "USAID should not have relied heavily on these [financial reports] for control and compliance purposes" (pg. 3).

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support, and the equivalent pesos were programmed for counterpart contributions to IBRD and USAID rural development projects. Under DSP, $45 million was disbursed in December, 1985, and P/854 million was disbursed between October, 1986, and June, 1987. The disbursement of peso funds was delayed pending the final disbursement of RPSP peso funds, which was not complete until the third quarter of 1986.

Graph 3.1 provides the context for the continued need for balance of payments support to the Philippines. In the last quarter of 1985, both the Philippine official reserves and the ratio of reserves to imports had fallen for several months, almost to the lowest level reached during the crisis of late 1984, early 1985.

The situation concerning counterpart funding of donor-assisted rural development projects, as described above, had deteriorated: GOP outlays on RPSP-approved projects had fallen to P/256 million in the first three quarters of 1986, as opposed to P/1,589 in CY 1985. Not only had budgeted capital outlays fallen steadily from 1984-1986, but expenditures on operations and maintenance of existing capital stock was less (in real terms) than in 1985, which in turn was already 34% below 1979 levels. Finally, revenues collected remained will below targets.

To a large degree, however, the change in government in early 1986 brought much of government operations to a halt, pending the appointment of new officials, the review of government operations, and an assessment of the government's financial situation following a period of extraordinary campaign-related expenditures. By late 1986, the government had been placed on a more stable basis, and implementation and funding of donor projects began to accelerate.

2. Program Evaluation

a. Disbursements

The $45 million DSP disbursement was made in December 1985, but the peso counterpart funds were not touched until October, 1986. Final pesos disbursements were made by June 30, 1987. The list of DSP-approved projects was originally the same as for RPSP. However, after the ADB provided $100 million to finance the full counterpart needs of their projects, the list was shortened to include only IBRD and USAID projects.

Delays in peso fund disbursements can be attributed to:

1. Continuing budgetary crisis in the GOP.

2. Unexpended carry-over of RPSP funds.

3. The removal of ADB projects from the RPSP/DSP list of approved projects.

4. The joint GOP-USAID decision to not consider any disbursements during the politically volatile first quarter of 1986.

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In order to accelerate the disbursement of DSP local funds, the additionality requirement was removed in January, 1987 (in Grant Amendment #1). This change was done solely to assist the new Aquino Government, and was done to conform the peso component of DSP to the budget support objective of the Budget Support Program (see below). Nevertheless, DSP peso funds remained earmarked for IBRD and USAID rural development projects, as opposed for general budget categories. To confirm GOP outlays on approved projects, the DSP reporting requirement was strengthened in Grant Amendment #1 along a project-by-project basis. Finally, the deadline for DS disbursements was extended into 1987, initially to March 31, and then later to June 30.

DSP peso disbursements were broken down as follows:

- IBRD projects	17 projects	P/825 million	97%
- USAID projects	9 projects	P/ 28 million	3%

Since the original additionality requirement was released, total disbursements are equal to the peso equivalent of $45 million.

b. Resource Impact

As noted, at the time of the $45 million DSP disbursement in December 1985, the reserve situation of the GOP was extremely weak. Six months later, it had improved by over 50%, and by the beginning of 1987, by over 100% (see Graph 3.1). This strong rebound was assisted by the balance of payments support of DSP, and, during 1986, of BSP and BSP-II. The strengthening of the foreign exchange situation during the first year of the Aquino Government was an important boost to the reestablishment of economic stability.

The impact of the local component is more straightforward, and more direct. Given that the additionality requirement was lifted due to the dire GOP budget situation, it is safe to assume that much of the P/854 million in DSP disbursements would not have been made without the DSP program grant. Even though government monies are fungible, the project-by-project accounting of DSP monies shows that most of the funds went to assist IBRD rural projects.[4]

c. Implementation Issues

The implementation of DSP learned from the experience of RPSP, and drew, in 1987, on the framework developed for BSP. In particular, the reporting requirements of DSP were refined based on the experience of RPSP, and the additionality requirement was lifted to conform with BSP

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[4]The IBRD projects receiving the greatest amount of DSP support were Highways IV, Education VII (especially the component implemented by the Department of Public Works and Highways), Regional Cities, and Samar Integrated Development.

(which had been approved in mid-1986). Also, the issue of delayed local money disbursements experienced under RPSP was foreseen in the DSP Grant Agreement, and more flexible arrangements were worked out as a result. These arrangements required less consultation time between GOP and USAID during the financially difficult months of late 1986 and early 1987.

D. Budget Support Program

1. Background

The Budget Support Program (BSP) was designed during the early months of the Aquino administration, when it was clear that the government faced an immediate serious budget crisis due to: (a) an ongoing severe recession that had seriously reduced revenue inflows; (b) a depleted treasury, due to exceptionally high expenditures during the end of 1985 and early 1986; and (c) huge losses in publically-controlled corporations and financial institutions, which required support from the national government. In addition to helping meet the immediate budget crisis, BSP was also intended to contribute to the GOP financial and political stability by ensuring it the resources to continue financing basic services in the priority budget areas of health, education, and agriculture.

The new Aquino Government proved to be enormously popular in the Philippines, and the desire to support its efforts was also very strong in the U.S. In addition, the specific economic policies being articulated by the Aquino Government in the first half of 1986 were consistent with the market-oriented strategies endorsed by both USAID and other foreign donors. The GOP had already embarked on a series of structural reform efforts in coordination with the IMF, World Bank, and USAID (see both section D and the next chapter), which sought to redress some of the distortions that had contributed to the recession.

Budget support was important to preserving stability. In fact, the foreign exchange crisis had receded somewhat from the previous year, through a severe reduction in imports rather than an increase in exports. Gross international reserves had recovered by May, 1986, to $1.6 billion, up from $.9 billion as recently as February, 1986. Debt rescheduling, moreover, had relieved immediate pressure on the peso, which had held its value, relative to the dollar, throughout 1985 and into 1986.

By early 1986 the seriousness of the budget crisis was very apparent. The IMF target for the 1986 budget deficit (P/6.9 billion) had been exceeded by 33% during the first four months alone. Also, revenue inflows continued to be low, due to the recession, declining oil prices, tax reform measures that were not yet completely implemented, and serious collection leakages.

The final justification for BSP support was the desire of the Aquino Government to provide some fiscal stimulus to the economy, particularly in the rural areas, in spite of the immediate fiscal crisis. The government program projected, as of June, 1986, a deficit of P/26.2

billion without BSP, and P/22.0 billion with BSP (at the original funding level of $200 million). BSP would reduce the deficit from over 4% of GNP to a more manageable 3.4%.

2. Program Evaluation

a. Disbursements

BSP disbursements were targeted by USAID and the GOP to support recurrent costs in three priority sectors: education, health, and agriculture. The intent was to help guarantee that the budgeted levels of 1986 expenditures in these areas could be sustained, and to reduce the risk of any unforeseen budgetary cutbacks. Neither policy conditionality nor budgetary additionality were requirements. The GOP and USAID agreed on the minimum level of total disbursements (of combined GOP and BSP resources) in the three priority areas. The GOP was required to report quarterly on the budget expenditures made after March 1, 1986, in the budget categories eligible for BSP support.

There were no substantive or policy conditions precedent to the disbursement of the BSP funds. As a result, $200 million in local currency (P/4.1 billion) were quickly disbursed to the GOP into a special BSP account. (The dollars were technically changed by the U.S. Treasury into pesos, and USAID delivered only pesos to the GOP. This eliminated the need for USAID to have a separate accounting of the dollars.) The pesos were then periodically transferred to GOP General Funds on the basis of an implementation plan and estimated schedule of payments through the next budgetary quarter. On this basis, the BSP funds were rapidly disbursed during the remaining months of 1986.

In September, 1986, USAID increased the BSP funding level by $100 million, to $300 million total. The objective and budgetary mechanisms of the project remained the same. Between June and September, the budget crisis had worsened, as revenues had slipped and expenditures had increased from the projected levels. The second BSP outlay netted P/2.046 billion in local currency.

By the end of 1986, all BSP funds had been expended. Total GOP disbursements in the BSP-eligible categories were as follows:

Reported Disbursements Qualifying for BSP Funds, 1986

Ministry of Education, Culture, Sports	P/6.54 billion
Ministry of Agriculture and Food	0.34 "
Ministry Health	1.29 "
State Universities and Colleges	1.58 "
-- Total	P/9.75 billion
-- Level of BSP Peso Funding	6.15 "
-- Total qualifying expenditures as a percent of BSP funding	158.5%

b. Resource Impact

The BSP infusion of funds came at the critical early stages of the Aquino Administration. The last quarter of 1986 produced the first positive economic growth in almost three years. By the end of year, the total budget deficit had risen to P/28.1 billion (inclusive of BSP) -- 4.7% of GNP -- or 28% greater than the level projected in June, 1986. There were many reasons for this, but the most important was that government expenditure over the 4% deficit target was necessary to stimulate the economy.

Graph 3.2 compares the projected deficits (ex ante) with the actual deficits (ex post) for the years 1985-1987. This graph also shows the point at which BSP funds gave budget support. It is clearly seen that the actual deficit was soaring at this point, although it was significantly reduced again by the next year.

In several interviews conducted as part of this evaluation, it was repeatedly stressed that the BSP funding played a significant positive role in allowing the GOP to meet priority expenditures, and in helped keep the budget crisis to a manageable level. Without the BSP funding, the deficit could have risen to as much as three times the size of the previous year, with corresponding inflationary effects, increases in domestic indebtedness, and additional crowding out of the private sector in short-term financial markets.

c. Implementation Issues

The unaudited reports submitted by the GOP served the needs of USAID during 1986 and allowing the prompt release of funds. However, the requirement for a final audited report of the use of funds has not yet been satisfied. In a letter from USAID to the GOP dated April 29, 1988, USAID rejected the GOP submission, and extended the final report deadline from September, 1987, to later in 1988.

The difficulty experienced on the GOP side appears to be: (a) the changing operating procedures of the Commission on Audit; (b) the large number of eligible agencies involved in expending BSP resources; and (c) the low priority the GOP places on accounting for funds already expended in face of the need to accelerate disbursements on current projects.

E. Budget Support Program II (BSP-II)

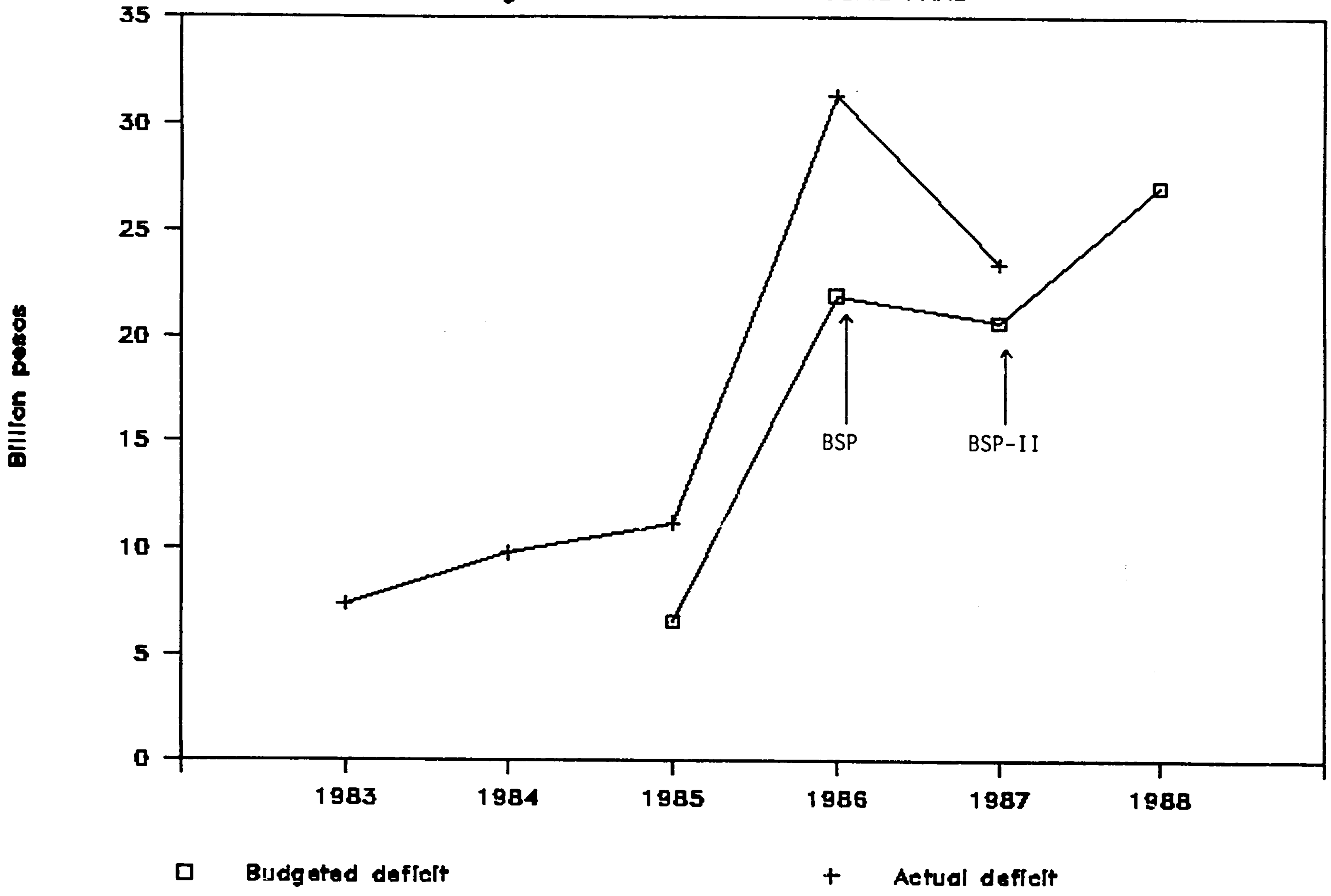
1. Background

BSP-II was a continuation of BSP, and was designed to give additional budget support assistance to the Aquino Administration at a time of ongoing fiscal difficulties. It was also intended to be an endorsement of ongoing key economic policy reforms which were deemed to be crucial to

GRAPH 3.2

Actual and Budgeted Gov't Deficits

Budgeted deficits at time of USAID PAAD



achieving sustained recovery and growth. While the dollars given under BSP-II ($150 million, in two tranches) would help increase the availability of foreign exchange, the primary focus of the program was to support CY 1987 budgeted levels of funding for basic services in the areas of education and health.

In 1986, the economy of the Philippines registered its first quarter of positive growth after nearly three years of contraction. Inflation was under control, consumer demand was rising, and the foreign exchange crisis had eased. In the first half of 1987, political stability and investor confidence were increasing, as indicated (for example) by dramatic increases in the Philippine stock market.

The key sectoral areas of economic reform endorsed by the Aquino administration in 1986 and 1987 included:

a. trade liberalization;
b. agricultural markets deregulation;
c. increased public sector accountability, primarily in government corporations and financial institutions;
d. privatization, and reduction of the size of the public- sector-controlled portion of the economy;
e. tax reform;
f. reform and rehabilitation of government financial institutions;
g. government decentralization.

Although most of these reform measures had originated under the previous administration, important steps remained to be taken before significant flaws and biases in the economy were removed. (The next section discusses in greater detail the progress made to date in these reform areas.) It was decided that the BSP-II grant, in addition to providing budget support and foreign exchange, would be tied to policy reform progress in some of these areas.

In negotiations between USAID and the GOP, six policy objectives were identified and included in a policy implementation matrix for BSP-II. The second tranche disbursement was made conditional on satisfactory progress in these six areas of policy conditionality.

The six areas of policy conditionality were divided into two larger groupings, as follows:

A. Macroeconomic Framework Supportive of Private Sector Led Growth

   1. Exchange rate system supportive of export promotion and international competitiveness: (a) maintenance of a floating market-oriented exchange rate; (b) maintenance of a sufficient level of international reserves.

   2. Fiscal responsibility consistent with sustainable growth: (a) constraining the national government deficit; (b) limiting public sector borrowing; (c) adequate provision for operations

and maintenance of existing capital stock; and (d) improved monitoring of the public investment program.

3. Monetary responsibility: monetary program consistent with growth and price and external stability.

B. Reduced Government Involvement/Deregulation

1. Privatization of acquired assets and selected public corporations: (a) obtainment of clear titles for assets transferred to the APT; (b) promulagation of a list of corporations to be privatized; (c) issuance of privatization guidelines; and (d) preparation of privatization work plans.

2. Trade liberalization: (a) implementation, as scheduled of liberalization of 155 items in 1987; and (b) adherence to the 50% maximum tariff.

3. Simplification of investment rules: (a) creation of a simplified investment approval procedures; and (b) review of the debt-equity conversion program.

The minutes of the policy conditionality negotiations show that it was agreed that the second tranche disbursement would be based on satisfactory "overall performance against the stated policy objectives rather than performance on each indicator". Furthermore, external economic factors, including the timely disbursement of ODA (in comparison with official 1987 projections), would be taken into consideration when determining progress.

At the time that BSP-II was prepared, the GOP was projecting a budget deficit of P/20.7 billion, or 3.1% of GNP, even after including the BSP-II support (see Graph 3.2). Total projected 1987 budget expenditures were about 13% higher than actual expenditures in 1986, but still below the real level of 1981 expenditures. Revenues were lagging behind projections for a number of reasons, and the realization of 1987 projections were dependent on achieving higher collection efficiencies and more effective implementation of the tax reform measures already under way.

2. <u>Program Evaluation</u>

a. <u>Disbursements</u>

The first tranche of $75 million was transferred in June, 1987, and was used to meet IMF debt service payments between July 24 and September 15, 1987. These payments were made out of a separate dollar account created for BSP-II, necessitated by special USAID accounting requirements. The second tranche of $75 million was made in November, and was used to meet IMF debt service payments between November 18 and December 23, 1987.

The BSP-II pesos disbursements were used for budgetary support in the areas of education and health. As for BSP-II dollars, peso transfers into the General Fund were also made from a special account. The GOP certified that the budgetary disbursements made in the agreed-upon budget categories exceeded the minimum amount to be disbursed during the course of the year, including both GOP and USAID funds.

As the following chart shows, this requirement was easily satisfied. All of the BSP-II funds were transferred from the special peso account into General Funds by the end of 1987.

Reported Disbursements Qualifying for BSP-II Funds, 1987

Department of Education, Culture, Sports	P/5.22 billion
Department of Health	1.33 "
-- Total	P/6.54 billion
-- Level of BSP-II Peso Funding	3.09 "
-- Total qualifying expenditures as a percent of BSP-II funding	211.5%

The conditions precedent for the the first tranche were that the GOP supply to USAID a satisfactory implementation and accounting plan for use of dollars disbursed from the BSP-II dollar special account, including a schedule of proposed debt service payments. The conditions precedent for the initial transfer of pesos from the special peso account into the General Fund were similar: (a) an implementation and accounting plan, (b) a statement of eligible budget categories and programs, and (c) a schedule of estimated disbursements in the eligible budget categories. These conditions were met fairly easily in the month of June.

The conditions precedent for the second dollar tranche were that satisfactory progress be made on (a) the policy implementation matrix, as of September 30, and (b) the accounting of the dollar debt service payments as specified in the implementation plan. The policy review took place as scheduled in October with a positive outcome (see below). The more procedural requirements for both the dollar and peso disbursements were also met with little delay.

b. Policy Conditionality

In assessing progress of the GOP towards meeting the performance targets outlined in the BSP-II policy implementation matrix, emphasis was given to determining the "collective progress toward the agreed upon specific policy objectives and actions or targets rather than performance on each indicator per se." Some extraordinary economic fluctuations (e.g. in foreign exchange) occurred during the period under review due to the coup attempt in August and the resulting political uncertainties and rapid capital flight.

The minutes of the policy review indicate that one recurring theme was the slowness of ODA assistance flows, tied up with the slowness of GOP implementation of ODA-funded projects. These delays affected, among other things, the level of gross international reserves and the rate of public investment expenditures. On the other hand, disbursments for operations and maintenance of existing capital stock were 75% above the level for the same period in 1986, and were well above the 50% target.

In the area of privatization, the explicit targets were not met, but it was concluded that the APT was making satisfactory progress without a formal implementation plan for much of its activity. Progress in trade liberalization, involving Congressional legislation, was deemed satisfactory on the basis of available information. In the areas of simplifying investment rules and promoting debt-equity swaps, appropriate progress was made in terms of promulgating administrative regulations--e.g. a new code of regulations governing foreign investment was issued in July, 1987. However, the implementation of fully functioning operations was not yet achieved.

In summary, there were no areas of significant dispute between the GOP and USAID, although there were some areas in which USAID had clearly hoped for greater progress. Also, some of the policy targets had been fully implemented earlier in the year, due to the delay between drafting the policy matrix and the signing of the BSP-II grant agreement. The second tranche was approved in October with virtually no delay.

The BSP-II exercise kept USAID involved in the GOP policy reform process, and allowed USAID to have an explicit mechanism for supporting policy directions already adopted by the Aquino administration. The program was a success in that the targetted reforms were continued roughly on schedule, that policy dialogue was frank and engaging, and that policy objectives of both the GOP and USAID remained in harmony. The economic and political decisions that would have been required of USAID had the targets not been largely achieved were successfully avoided.

One legacy of the BSP-II policy dialogue, however, is a substantial resentment on the part of the GOP towards policy conditionality imposed on ESF grant funds. This problem, which has become acute in the current BSP-III negotiations, appears to be unrelated to the policy <u>content</u> of the conditions, but is linked to simple <u>imposition</u> of any conditions at all. This is true in spite of the BSP-II experience, in which the negotiations were successful and all of the policy objectives themselves were mutually endorsed.

c. <u>Resource Impact</u>

The BSP-II program assistance was designed at a time when the budget deficit for CY 1987 was projected to be 20.7 billion pesos, down from an actual deficit of over 30 billion pesos in CY 1986. This projected deficit was 3.1% of GNP, and 17.1% of total expenditures. Without the BSP-II support, the deficit would have risen, ceteris paribus, to 3.6% of GNP. In actuality, the total 1987 budget deficit was 17.7 billion pesos, or 3 billion pesos below the projected level, while expenditures were

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slightly above the targeted level. The difference is accounted for by a higher than expected rate of revenue collections, and lower than expected levels of public investment.

The BSP-II support definitely assisted the GOP in meeting its fiscal targets, and in minimizing its domestic borrowing. (Given the large degree of public sector borrowing, with a commensurate degree of crowding out of private sector borrowers, this, alone, has a material benefit to the economy.) As shown in Graph 3.2, above, the BSP-II injection came at a time when projected deficits were increasing, again, almost to the level of actual deficits experienced in 1986 at the time of BSP-I.

In spite of strong revenue collections for the year, both current and capital outlays were significantly below projected levels, and transfers to public corporations were much higher than projected levels. This fact alone suggests two important findings pertaining to the BP-II program:

(a) the continuing fiscal drain of public corporations remains an ongoing concern and will remain significant through the medium term; and

(b) budget support for essential current expenditures such as health and education has a clear positive impact, given downward budget pressures on current expenditures due to unexpectedly high payments for debt service and public corporation transfers.

d. Implementation Issues

The main implementation issue concerning BSP-II is the apparent difficulty of the GOP in providing timely and satisfactory audit certificates pertaining to the use of BSP-II funds. The issue arose with BSP, and as of July, 1988 -- 18 months after the completion of the program -- the auditing requirements for BSP had not been fully satisfied.

A similar delay is expected for BSP-II. The current filing date deadline for the BSP-II audited report is September 30, 1988. It is too soon to know with what difficulty USAID's accounting requirements will be fulfilled by the GOP, and/or if GOP difficulties with the reporting requirements may indicate that future program assistances should be modified in some regard.

F. PL-480 Title I Agreements

This section will quickly summarize the four PL-480 Title I Agreements entered into between 1985 and 1988 as one continuous effort. Table 3.1 at the beginning of this chapter breaks down the PL-480 program into each of the four yearly components.

Each year's policy reform measures, called "self-help measures", were designed to build on the results and progress achieved during the previous year. Each set of self-help measures provided for policy reforms that were designed to stimulate productivity growth and future self-suffiency in the agricultural sector.

Since 1985, the PL-480 agreements have stressed five policy areas within the agricultural sector. These areas are consistent with the larger structural reform measures being adopted by the IMF, World Bank, and USAID (under BSP-II). They are:

1. Deregulation of price of rice.

2. Establishment of stabilization programs for rice and corn.

3. Divestiture of NFA non-foodgrain activities.

4. Liberalization of the wheat importation and flour distribution sectors.

5. Liberalization of the fertilizer importation and distribution sectors.

Unfortunately, to date, overall compliance with these specific policy reform measures has not been great, even though some progress has been made in most areas. The most dramatic improvements have been in ending the NFA monopoly in wheat.

The reasons for the lack of compliance in other areas have less to do with any GOP disagreements with the fundamental objectives than with disagreements over the nature and pace of proper implementation of them. As examples, the Department of Agriculture agrees in principle to both the divestiture of several NFA operations, and the removal of trade protection given to PHILPHOS, the Philippine phosphate fertilizer producer, but has been either unable or unwilling to effect actual change.

Also, once the annual grain procurement targets are announced in the U.S., it has been virtually impossible for USAID to enforce any degree of conditionality whatsoever over its PL-480 contributions, even if the policy conditions were clearly not met. This is primarily due to the lobbying power of US grain exporters.

PART III

Chapters 4-10

PART III -- Progress in the Philippine Economic Reform Program

Chapter 4 Trade Policy, Industrial Policy, and the Exchange Rate

A. Introduction

Among areas of policy discussion and reform, none is more crucial for affecting the structure of the economy, employment generation, and the rate of growth than trade and exchange rate policy, and the accompanying decisions on industrial incentives. There is very strong circumstantial evidence, as well as some theoretical support, that the most rapid growth in output and incomes comes from an emphasis on external markets and increasing exports, rather than a protective policy designed to reserve the domestic market to domestic producers. Much of the disappointing performance of the Philippine economy, described below, can be ascribed to trade and industrial policies that consistently concentrated on home production for the domestic market.

In the last eight years the Philippine government, under both Mr. Marcos and Mrs. Aquino, carried out a series of policy reforms affecting tariffs and quantitative restraints, industrial incentives policy, as well as taxation and marketing reforms in traditional export industries. Although much has been accomplished, there are still some important, unfinished areas. This chapter outlines what has been accomplished and makes priority recommendations for what remains.

Trade and industrial policy reform in the Philippines would move country towards greater trade liberalization and export orientation. It would be achieved through the reduction of tariffs protecting domestic industry, the elimination of quantitative restraints on imports, and the reduction of explicit taxes or implicit discrimination against the traditional export sector.

Policy shifts of this type are usually presented as a shift in the balance of incentives favoring production for the home market versus production for the international market. However another, equally important principle is at stake in the Philippines, and in many other LDCs: i.e. the influence of government policies on the nature and type of the most profitable domestic business activities. In the Philippines for much of the postwar period, and in the martial law period, arranging for protection from imports, access to low interest rate loans, and the grant of exclusive privilege was the most profitable use of entrepreneurial energy, rather than cost reduction, quality improvement, and the attainment of international competitiveness. The locus of profitability was Malacanang Palace and not the world market. The standard tc be adopted for evaluating recommendations for trade policy reforms should include not only the shifts in current production incentives, but also their effect in channeling entrepreneurial and managerial energies into efficient and competitive operations.

In arguing -- as we do here -- that the Philippines maintain the momentum of trade policy reform, it is important to re-establish the rationale for doing so. The objectives would be, not only, a more sustainable rate of economic growth, but equally important, more widely disbursed benefits of growth, away from the control of government over rent-generating controls and privileges.

B. Background -- Trade Policy and Economic Performance in the Philippines

The trade and industrial policy that would characterize most of the postwar period for the Philippines was established shortly after independence. An early balance of payments crisis led to quantitative controls on imports, based on the degree of essentiality, with particularly stringent regulation of consumer goods imports. Domestic manufacturing developed to replace imports, and this import-substituting industrial policy has persisted since the 1950s. Industrial nationalism increased, as did interest in government industrial incentives programs.

Despite the rhetoric of having an outward oriented trade policy, this policy stance was never really altered by the Marcos government. Martial law trade policy was characterized by three themes:

1. Continued protection of the domestic industrial sector, with tariffs increasingly supplemented by quantitative restrictions during the 1970s.

2. The encouragement of non-traditional exports, by providing exporters with imported inputs at world market prices, supplemented by modest incentives, and low Philippine real wages.

3. Increasingly heavy taxation of the traditional export industry, through export taxes, and later through monopolization of sugar and coconuts, the two principal export crops.

The protective system and heavy foreign borrowing maintained an overvalued exchange rate, particularly after 1978, when the peso appreciated in real terms against the currencies of its trading partners, and against its East Asian competitors.

The legacy of the policy of protecting the industrial sector may be seen in the postwar record of Philippine manufacturing. In contrast to other successful LDCs, the Philippine manufacturing sector has lagged behind the growth of the rest of the economy rather than leading it. The manufacturing sector has failed as a generator of employment -- its share of total employment peaked at 12 percent in 1956, and its productivity performance has been poor. The best estimates of total factor productivity for Philippine manufacturing indicate that it fell by 13 percent over the decade of the 1970s.[1] And the manufacturing sector proved quite fragile in the 1980s. Total manufacturing output declined by 14 percent between 1983 and 1985, with particularly large drops in the sectors that had been most heavily protected.

The effects of Philippine trade policy showed up more directly in the worsening fortunes of the traditional export industries. To begin with, the external environment was not favorable for Philippine traditional exports. The country experienced a pronounced and prolonged deterioration in its terms of trade, starting in the mid-1960s, and extending until the present day. Despite the worsening international price environment, the Philippine government increased the rate of effective taxation of the sector. Monopolies in sugar and coconut drained off significant income from both crops: Intal and Power have estimated differences between border and producer prices averaging 22 percent for sugar and 37 percent for coconuts in the early 1980s.[2]

Declining terms of trade and increasing taxation took its toll. A quantity index of Philippine traditional exports, formed using 1978 weights is constant between 1972 and 1980. From 1980 to 1985 the same index fell by 43 percent. The effect of this drop in traditional exports in the period of the run up to the Philippine foreign debt crisis cannot be overstated; had traditional exports stayed constant during the first half of the 1980s, exports would have been $880 million (19 percent) higher in 1985.

Non-traditional exports grew rapidly in the ten years after the declaration of martial law, and by 1983 the structure of Philippine exports had been transformed from one dominated by commodities to one where manufactured goods formed the majority of exports. But this rapid growth of new exports was not sufficient to overcome the other biases in the trade system. In contrast to other countries in the region, where merchandise exports grew relative to GDP, in the Philippines they just held their own (see Table 4.1). In fact, simple export figures overstate actual Philippine export performance. The growth of manufactured exports and the stagnation of traditional exports shifted the structure of Philippine exports towards goods with low domestic content. When consignment inputs are netted out of Philippine exports, the share of exports in GDP drops significantly over the decade (see the second to last line in Table 4.1).

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[1]Hooley, Richard, Productivity Growth in Philippine Manufacturing: Retrospect and Future Prospects Monograph Series #9 (Manila: Philippine Institute for Development Studies, 1985)

[2]Intal, Ponciano Jr. and Power, John. "Political Economy of Agricultural Pricing Policies: The Philippines" Final Report to the World Bank (Washington; the World Bank, September, 1987).

Table 4.1
Export Shares in GDP

	1970	1974	1976	1978	1980	1982	1984
Percentage Shares Merchandise Exports to GDP							
Philippines	15.1	18.6	14.2	14.2	16.4	12.6	16.7
Indonesia	12.7	28.8	22.9	22.6	33.0	24.8	26.1
Korea	10.1	24.1	27.0	25.4	28.1	28.8	30.8
Malaysia	41.3	43.8	47.5	46.7	54.0	44.6	48.3
Thailand	10.5	18.1	17.9	17.5	19.3	18.6	20.2
Philippines Memo Items:							
Exports net of Consigned Imports	15.1	17.7	12.6	12.4	14.0	10.3	12.5
Service Exports*	2.6	3.5	3.0	4.6	4.7	5.9	6.3

Note: * Net of interest receipts and U.S. base rental.

Sources: Philippines: Central Bank and National Census and Statistical Office. Also, Asian Development Bank, Key Indicators of Developing Member Countries, 1986.

C. Reform Efforts

Trade policy reform efforts started in the early 1980s with two World Bank Structural Adjustment Loans. These reforms are divided here into four areas:

1. Tariff reductions,
2. Reform of industrial incentives,
3. Removal of quantitative restraints ("import liberalization"), and
4. Policy reforms affecting traditional export commodities.

The Marcos government was largely responsible for reforms in the first two areas, while reforms under the latter two have been the product of the Aquino government.

1. Tariff Reduction

The first Structural Adjustment Loan set out a timetable for the lowering of tariff rates as well as a narrowing of tariff differentials. Tariff rates were to be confined to a range of 10 to 50 percent in a series of steps running from 1981 to 1985. The Marcos government successfully carried out the tariff reform program; by 1985 the average rate had fallen from 43 percent to 29 percent, and the effective rate of protection of manufacturing had been reduced from 44 percent to 36 percent. The reform also successfully established a 10 to 50 percent range, which limited the dispersion between rates.[3] The resulting tariff averages were comparable to those of other East Asian countries, and low by general LDC standards (Table 4.2).

The Aquino government came to power with the tariff reform program largely complete. The 1986 tax reform measures included provisions to raise a few remaining (largely agricultural inputs) tariffs from 0 to 10 percent, so that all tariffs fell in the 10 to 50 percent range. Tariff policy under the Aquino government has been confined to revisions in tariffs on commodity import lines where quantitative restrictions were removed under the import liberalization program. As discussed below, these have been confined to 10 to 50 percent. There have also been pressures from Congress to raise tariffs on some items above 50 percent; so far these measures have been vetoed by Mrs Aquino.

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[3]There were a few commodity lines with zero tariffs in 1985. These were raised to 10 percent by the Aquino government, under prodding from the IMF. The Philippines also had a system of domestic excise taxes that imposed higher rates on imported products, adding further protection to domestic industries. This was eliminated under the tariff reform program.

Table 4.2
Comparative Trade Protection
East Asian Countries

	Average Nominal Tariff	Percent of Import items Restricted
Philippines		
1980	43	37
1986	29	17
Indonesia		
1980	28	na
1987	23	16
Korea		
1980	25	31
1985	22	12
Malaysia		
1980	12	<5
1985	14	<5
Thailand		
1980	31	<5
1985	34	<5

Source: World Bank, The Philippines: Issues in the Industrial Sector, Volume II (Washington; 1987), Table 2.5, p 54.

The Structural Adjustment program had contained a second phase of tariff reduction (apparently as a goal and not a requirement) in which the Philippines would restrict all tariffs to a range of 20 to 30 percent. This second phase is now rarely mentioned, and at this time appears unlikely to take place.

2. Industrial Incentives

The other notable success of the Marcos Government reforms was the revamping of the system of industrial incentives. The previous system, established by the Industrial Incentives Act of 1967 and the Export Incentives Act of 1970, had been criticized for: (a) favoring investment in new capacity over the profitable operation of existing plants; (b) limiting competition in industries where sufficient domestic "measured capacity" existed by controlling imports of capital goods; and (c) cheapening capital and encouraging capital intensive techniques, through incentives for investment, accelerated depreciation, duty free import of capital equipment, and provision of credit at below market interest rates. The administration of the incentive by the Bureau of Industry was also criticized for favoring large-scale, capital intensive industries that served only the domestic market. Major reform legislation in 1983 (BP 391) shifted the emphasis of industrial incentives to increasing exports, replaced the incentives that focused on new investment, and lowered the cost of capital by offering tax credits tied to profit performance and domestic value-added.

BP 391 represents a high water mark in the reform of industrial incentives. There was a desire on the part of the new government to formulate its own industrial incentives policy. This led to the rewriting of the investment incentives program and the Omnibus Investment Code of July 1987. The new industrial incentives system is ambiguous. It appears to have been motivated by the desire to formulate a "Philippine" industrial policy, and to match the investment incentives given by neighboring countries, rather than a well thought out strategy of encouraging particular industries. In some aspects it is a step back, for example in its re-introduction of the concept of measured capacity, a feature of the pre-1983 system that would shut off incentives and block entry once sufficient capacity in an industry had been established. The Philippine accession to GATT required that certain subsidy elements in the previous code be changed, and this led to the substitution of tax deductions for tax credits under the program.

The Philippine industrial incentive system is the subject of another US Agency for International Development sponsored study and is not analyzed extensively here.[4] However there are some reasons for believing that the industrial incentives system is relatively unimportant in the Philippines. Tax deductions, which characterize the program, are only of value if the company is earning money and paying taxes -- which may not be the case in the initial years of the company's operation when the incentives are in effect. Under US tax regulations, foreign taxes paid out may be credited against US tax liability on foreign source income; only in the case of excess tax credits for US tax purposes would a US company gain from tax deductibility in the Philippines (or elsewhere.) Finally, repeated surveys of the investment decisions of firms place incentives low on the list of relevent factors.

3. Progressive Manufacturing Programs

One other industrial measure is likely to be far more important than BP 391. This is the Progressive Manufacturing Program (PMP), which was introduced during the late 1970s by the Marcos Government, and then revived by the Ministry of Trade and Industry in the Aquino government. Originally covering automobiles, and later extended to cars, trucks, motorcycles, diesel engines, and consumer electronics, the Progressive

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[4]Power, John, "Industrial Incentives in the Philippines" (Manila; USAID, in process).

Manufacturing Program was designed to force participating firms to increase their domestic value-added. In return, the participants received protection from imports and from domestic competition, as well as investment and capital incentives.

The original Progressive Manufacturing Program could be criticized on many grounds. Taking the automobile program as the most important example, there were too many participants for the small size of the Philippine market, leading to the creation of inefficiently small plants. Domestic value added was never very large. Producers imported completely knocked down (CKD) kits, which they then assembled into automobiles for sale in the domestic market. In some instances, the foreign exchange cost of the kits was greater than that of fully assembled imported automobiles, so that value-added in the industry, evaluated at border prices, was negative.[5] Finally, the industries covered by the programs were hit particularly hard by the recession in the early 1980s. Output in the transport equipment sector fell by over 80 percent between 1983 and 1985, and many of the installations closed down.

Even though many of the firms ceased production during the economic crisis, their assets remained. The Aquino Government quietly re-introduced the Progressive Manufacturing Programs for cars, trucks, motorcycles, and diesel engines, and not much thought was given to the performance or advisability of the programs. The Progressive Manufacturing Program for automobiles was modified to allow exports of domestically manufactured parts to be considered as value-added under the program, effectively subsidizing the export of automotive parts by the amount of economic rents available in serving the domestic auto sales market. While this is an export incentive measure for the parts industry, it is also an indirect and potentially very costly export promotion strategy.

The Progressive Manufacturing Program will soon come up for internal review in the Philippine government. The size and potential rent generation of the industries included in the PMP make it extremely important that a critical evaluation of the programs takes place.

4. Import Liberalization

The most important, and the most controversial area of trade reform has been import liberalization -- the lifting of bans and licensing restrictions on imports. Import liberalization was part of the first World Bank Structural Reform effort, but was far less successful under the Marcos Administration than was tariff reform. Items would be removed from the restricted list, only to be reintroduced after a few weeks or months. The early 1980s saw a reduction in the number of banned import categories, but a more than compensating increase in the number of product categories subject to restriction (Table 4.3). As a part of the

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[5]See World Bank, The Philippines; Issues in the Industrial Sector (1987) Vol II, p 310.

IMF program signed in December 1984, the Marcos government agreed to liberalize 1232 product categories, but no progress had been made by the time of the presidential election in February 1986.

Table 4.3
Import Liberalization in the Philippines

	Restricted		Banned	
	Commodities added/ (removed)	Total Restricted Items	Commodities added/ (removed)	Total Banned Items
1978	46	526	0	1301
1979	17	543	0	1301
1980	6	549	0	1301
1981	20	569	-263	1038
1982	312	881	-610	428
1983	585	1466	-48	380
1984	45	1511	0	380
1985	-26	1485	-46	334
1986	-820	665	-148	186
1987	-167	498	-9	177
1988	-108	390	-21	156

Source: Ali, Ifzal "Manufactured Exports from the Philippines", unpublished manuscript, (Manila; Asian Development Bank, August 1988), Table 12.

The Aquino Government picked up the program for the liberalization of 1232 restrained items that the Marcos Government had accepted but had not acted upon. These were successfully liberalized, after some delay, by April 1988. Among the important commodities have been liberalized are the imports of wheat and soy flour, synthetic resins, iron and steel products, synthetic fibers, and textile yarns and threads. At this point, another 637 commodity items remain regulated, some of which are legitimate restrictions on dangerous or illegal goods, while others represent very important protection devices.

Liberalization has had its difficulties. Domestic opposition to the program was strong from the beginning, and little thought was given to the appropriate sequencing of the items to be liberalized. Most of the items liberalized during the early stages, including many on the list of 1232 items, were finished goods, leaving intermediate goods still subject to restriction. Thus finished goods bore the full brunt of the reduction in protection without much relief from declining input costs. In addition, delays in introductions on previously quota-controlled items meant periods of temporary low protection. This led to accelerated imports in the intervening period, and unnecessary complaints over the liberalization program.

But the most vociferous outcries came from an unexpected corner: the liberalization of imports of fresh fruits prompted the strongest reaction and led to a quiet acquiesence by NEDA to allow health inspectors to regulate the flow of imported fruits. In so doing it was able to preserve the import liberalization program de jure, while heading off what could have been a larger challenge to the liberalization of other items.

It is difficult to develop a precise quantitative measure of the importance of items liberalized, and of the restricted items that remain. A measure that looks at the share of imports subject to restriction is not a very good measure, since a stringent restriction produces a very low import level, and therefore a very low contribution to the measure of its importance.[6] Nevertheless, the share of imports subject to restriction has fallen in the last four years from approximately 36 percent in 1984 to 10 percent.[7]

A better measure would match the import commodity categories with total domestic demand for that product, but that type of data is not yet available in the Philippines. An alternate and informative measure is the share of total imports accounted for by imports of items that have been liberalized. By 1987, 17 percent of total Philippine imports were in liberalized categories, compared to less than 1 percent for the early 1980s.

The remaining 637 items subject to restriction are described in Table 4.4. These are arranged in three lists. The first, or A list (104 items), are to be liberalized in stages, ending in June 30, 1989. The second, or B list (455 items) are those whose eventual liberalization or continued restriction is yet to be decided. The 114 items in list C are to remain restricted.

Many of the most important items are in list B. Some pertain to industries which are the subject of ongoing or previously existing Progressive Manufacturing Programs, such as cars, trucks, motorcycles, jeeps, diesel engines, and related accessories. Numerous consumer durables (e.g. television sets, refrigerators, freezers and air-conditioners) are also included. Some industries potentially affected are "distressed" or "overcrowded" and the subject of ongoing "modernization" and "rationalization" programs, such as the cement and cement-making

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[6]A banned item has zero imports, and zero weight in the measure.

[7]IMF, "Philippines - Staff Report for the 1988 Article IV Consultation" (SM/88/113, May 25, 1988) p 24.

Table 4.4
Philippine Trade Liberalization Program

Liberalized Items - May 1986 to April 1988

Total	1232
of which:	
Raw materials, intermediates	307
Intermediate goods, construction materials and capital goods	215
Consumer goods, other products	710
Remaining Quantitative Restrictions	637
List A (104 items)	
To be liberalized by June 30, 1988	
non-metric measuring devices	31
games and amusements	4
live animals for breeding	6
Subtotal	41
To be liberalized by Dec 31, 1988	
radio, telecommunication equipment	8
glassware, dinnerware, silverware	8
spare parts, machinery for pulp and paper industry	7
consumer durables	2
cinematographic films	9
other items, not elsewhere classified	9
Subtotal	43
To be liberalized by June 30, 1989	
new trucks and engines	20
Subtotal	20
List B (455 items)	
animals and meat products	31
coffee	9
fish and fish preparations	36
sugar	3
fertilizers	19

potatoes, onions, garlic	4
cement and cement products	5
antibiotics	23
vessels and appurtenances	14
radiation apparatus	21
spare parts, machinery, and equipment for iron and steel, cement, and textile industries	34
consumer durables, electrical goods	33
raw materials, parts, components for consumer electronic products	73
trucks and buses	10
motorcycles	2
cars, jeeps	10
used tires	2
cigarette paper	1
newsprint	1
spare parts for cars and trucks	73
coconut industry machinery	4
coal and derivatives	5
diesel, gasoline engines	26
refined petroleum products	15
Subtotal	455

Decisions on whether or not to remove the quantitative restrictions will be made on one third of the items each, by December 31, 1988, June 30, 1989, and December 31, 1989, respectively.

List C: for continued regulation

used tires	6
dangerous drugs	..a/
chemicals for making explosives	10
other chemicals	3
color reproduction machines	3
used vessels	5
ammunition and firearms	28
animals and animal effects	40
pesticides	7
rice and corn	12
Subtotal	114

Note: a/ no specific figure is available since items in this category are normally declared under generic names.

Source: IMF "Philippines - Staff Report for the 1988 Article IV Consultation" (May 25, 1988) pp 43-44, data from Philippine authorities.

machinery industries, textiles, and newsprint. Still others refer to industries where existing participants enjoy a degree of monopoly power, and possibly some political influence, e.g. shipping vessels, antibiotics, used tires, and petroleum products.

Import liberalization has been accompanied by adjustments in tariffs on the commodities on which quantitative restrictions have been removed. In most cases, this led to an increase in the tariffs on that particular product line, but a decrease in the overall level of protection. The implicit protection contained in the quantitative restriction, as measured by the ratio of the domestic price of the imported good to its price at the border, was in some instances huge, and frequently over 100 percent. To date, all tariff replacements have fallen in the 10 to 50 percent range.[8]

The trade liberalization program is critical in reorienting the Philippine economy towards external markets. Quantitative restraints had expanded to form a major part of import protection in the Philippines. From 1977 to 1983 the number of 7 digit product lines covered by quantitative restrictions had risen from 32 percent to 58 percent.[9] The implicit price premia in the restrictions was often very high.

In addition, in the monopolistic situation that characterizes many Philippine industries, quantitative restraints operate fundamentally differently from tariffs. Tariffs allow an essentially unlimited quantity of imports to enter at the tariff inclusive price. Any scope for raising the domestic price by restricting quantity supplied is lost to domestic producers. However the import restrictions set a ceiling on quantity, allowing the price to adjust in response to domestic actions. Thus quantitative restraints preserve domestic monopoly power, and the inefficiencies and lack of progressiveness that monopolies can entail.

Finally, quantitative restrictions generate rents to anyone who has the right to import and can buy at the world market price and resell at the higher domestic price. These import rights must be allocated, and their generation and distribution re-enforces the orientation towards lobbying domestic political institutions as a source of profitability, rather than a reliance on superior and less costly production.

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[8]Some data is available for one set of tariff adjustments, that of RA 6647, which adjusted tariffs on 147 products. The average level of resulting tariffs was 29.5 percent, which is roughly equal to the average level of tariffs overall. The largest number of tariffs (43 percent) fell in the 30-35 percent tariff range.

[9]de Dios, Loreli "Non-Tariff Measures Affecting Philippine Imports" Philippine Tariff Commission - Philippine Institute for Development Studies Joint Research Project Staff Paper Series No. 86-10 (1986) p 132.

For all of these reasons, each item liberalized, even when replaced by a tariff at the high end of the allowable range, is a step towards liberalization.

One side issue deserves a short discussion. The Minister of Trade and Industry has criticized the procedure for implementing liberalization because of the lag that has occurred in replacing quantitative restrictions with tariffs. He has stated that MTI will not go forward with future liberalizations until the accompanying tariff is already in place. A lag between the lifting of a quantitative restriction and its replacement with a tariff encourages accelerated importation to take advantage of the temporary lapse of protection. This import surge can frighten policymakers into a re-introduction of restrictions, as it did in the case of apples this summer.

In fact, it is highly desirable that the new tariff be in place before the item is liberalized, and should be encouraged. A tariff on an item subject to restriction does not change the amount of protection involved, but it does tax away some of the rents inherent in the difference between domestic and world prices, transferring them to the Treasury. As such it can reduce or eliminate one source of vested interest in the quantitative restrictions, that of the recipients of the quota rents.

5. Tax and Marketing Reforms in Traditional Exports

During martial law, trade policy increasingly discriminated against traditional exports through export taxes and through the monopolization of marketing arrangements in the sugar and coconut industries. The elimination of export taxes and the dismantling of the marketing arrangements were conditions of the December 1984 IMF program, but in spite of cosmetic changes, the system remained until the end of the Marcos government.

The Aquino government moved quickly in these areas. The purchasing monopolies in the sugar and coconut industries were removed and the ban on copra exports was lifted. The measures taken in the coconut industry played an important part in the rise in rural incomes in 1986 and early 1987, and strongly aided the economic recovery. The sugar industry is still subject to sales and price regulation, in part because the US sugar quota must be allocated to producers, but also because domestic sugar prices are controlled below the export (US) price level. As a part of the tax reform program in 1986, the new government removed all export taxes, except those retained for conservation purposes on log exports.

D. <u>Trade Policy -- Current Status</u>

Although the Philippines has not completed all of the goals that have been established for tariff reduction and import liberalization, the extent to which the balance of incentives has changed should not be underestimated. There is a widespread belief that the successful East

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Asian industrializers were characterized by a free trade regime with no import barriers. This may be generally true of Hong Kong and Singapore after 1965, but is definitely not true of Korea, Taiwan, or Japan, where import barriers and licensing requirements remained even during the period of rapid growth. As Table 2 indicates, Philippine tariffs and the (numerical) extent of licensing requirements on imports are moderate within East Asia, a region whose average is well below that of developing countries as a whole.[10] What distinguishes the Philippines, with its current structure of tariffs and quantitative restraints, from other successful East Asian industrializing countries, is its exchange rate policy, an issue that is discussed below.

Trade policy will become a more sensitive and difficult issue in the Philippines in the next few years, as the momentum behind liberalization begins to wane. Various factors are responsible for the slowing of momentum. The first is the amount of progress that has already been made. The second is the re-establishment of Congress, and the pressures on Members to assert themselves in areas of economic policy. But a stronger source is the rapid growth of imports and the widening of the trade deficit as the Philippine economy recovers. There is nothing unusual or abnormal about the rapid growth of imports. The closing of the current account deficit in 1985 and 1986 had been almost entirely the result of a compression of imports, particularly capital goods, as the recession deepened. But it has led to intense scrutiny of trade liberalizing measures, as well as widespread, but unfounded charges that the recovery has been "import led."

The Philippine Congress has already passed bills calling for tariff rates on selected products in excess of the 50 percent ceiling. So far these have been vetoed by President Aquino. However there is now a willingness at the Administration's subcommittee level to grant a maximum 100% tariff for "highly meritorious" cases. Some conditions applying to such cases are: that the domestic resource cost for the applicant-firm or industry should be less than the shadow exchange rate and that the protection given should be limited to five years.

The critical issues for trade policy in the Philippines now are maintaining the progress that has been achieved in tariff reduction and removal of quantitative restraints, and carrying forward the remaining program of import liberalization on the A and B lists. These are likely to face continued challenge in the next few years.

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[10]Comparative studies of degree of import protection across a wide range of less developed countries are not very common. See World Bank, World Development Report 1987 pp 82-89, and for a study limited to East Asia, see Charles Findlay and Ross Garnaut, The Political Economy of Manufacturing Protection: Experience of ASEAN and Australia (Sidney; Allen and Unwin, 1986) esp. Chapter 1.

E. Exchange Rate Policy

The real exchange rate is a powerful tool for reallocating resources across sectors, and for encouraging or discouraging exports and efficient import substitution.[11] Successful East Asian exporters have been aware of this link, and have aggressively used the real exchange rate to encourage export growth. Korea is the primary example, having maintained its real exchange rate over time at a level that encouraged traded goods production.

The Philippines has had a long history of exchange rate stability, punctuated by brief periods of sharp depreciations of the peso, brought on by balance of payments crises. Thus changes in the peso exchange rate occurred not by design, but when such changes were unavoidable.

The exchange rate has been viewed as more of a nominal magnitude in the Philippines, strongly influencing the rate of inflation, particularly through its link to domestic food prices, and not as a tool of industrial and trade strategy. This is particularly true of the devaluations starting in 1983 which were accompanied by massive increases in the money supply, leading to high inflation but little change in relative prices.

Several indicative measures of Philippine real exchange rates are shown in Table 4.5. Although there are differences among the measures, they tell much the same story. After improving in the early 1970s, the real exchange rate depreciated gradually in the late 1970s, and then quite sharply in the early 1980s, before the exchange rate depreciations of 1983 and 1984. In the past two years the depreciation of the US dollar has benefitted the Philippines in non-US markets, as column 2 indicates. But the improvement has been much less when the Philippines is compared to other East Asian exporters, whose currencies are also defined in dollars (column 3). What is striking from Table 5 is the fact that the depreciations of the last five years led to only a temporary increase in competitiveness as measured by ratios of domestic prices (columns 1 and 5). By these measures, the Philippines has had no success in shifting the balance of price incentives towards production of traded goods from their very low levels of the early 1980s.

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[11]There are various ways of measuring real exchange rates, as Table 4.4 points out. What is at issue is domestic costs and prices relative to world market prices, so both exchange rates and price levels (ie past inflation) are important. This may be expressed as prices of Philippine goods in importing markets, or against competing exporters, or it may be measured as externally determined (traded goods) prices relative to domestic (non-traded) goods prices. An exchange rate depreciation that is not offset by domestic inflation will lead to an improvement in competitiveness by any of these measures.

Table 4.5

Relative Price Indexes in the Philippines

	(1) PTraded/ PNonTraded	(2) REER Export markets	(3) REER Asian compet.	(4) Terms of Trade	(5) PExports/ PGDP	(6) Manu- facturing Real Wage
1967	85	73	79	127	94	
1968	88	73	80	123	95	108
1969	92	74	82	121	90	107
1970	97	109	111	119	118	103
1971	100	107	106	111	109	105
1972	100	100	100	100	100	100
1973	110	108	108	113	125	87
1974	115	96	100	115	159	77
1975	112	104	107	88	125	86
1976	107	102	104	78	102	81
1977	105	101	101	71	95	86
1978	102	108	104	78	98	85
1979	101	101	97	82	105	85
1980	97	99	92	69	96	91
1981	93	96	93	60	90	na
1982	91	91	93	59	74	na
1983	93	109	109	61	91	na
1984	103	109	109	60	101	na
1985	98	96	93	56	83	na
1986	92	117	100	60	88	na
1987	90	123	102	65	91	na

Notes to Series:

(1) Traded goods prices are a weighted average of gross value added deflators for agriculture and forestry, mining, and tradable manufactures. Non-traded prices are a weighted average of deflators for construction, electricity and gas, and services. Weights are 1972 value addeds.

(2) Dollar wholesale prices in major Philippine markets divided by dollar prices in the Philippines. Markets are U.S., Japan, Germany, Netherlands, and Korea. Increase is real depreciation.

(3) Weighted average of consumer price indexes in dollars in Korea, Indonesia, Malaysia, Thailand, and Singapore, divided by Philippine CPI in dollars. Weighted by 1980 exports. Increase is real depreciation.

Table 4.5 (cont)

(4) Export unit value divided by import unit value.

(5) gross value added deflators from national accounts.

(6) Basic manufacturing wage divided by GDP deflator. Wage series discontinued in 1981.

The steadiness of the Philippine real exchange rate is surprising, since several factors should be pushing the real exchange rate down. The first is the large shift in net transfers in the balance of payments after the Philippine debt crisis, as Philippine access to voluntary external lending was cut off. The second is the reduction in tariff rates and the import liberalization that have taken place, eliminating policies that work to sustain overvalued exchange rates. And the final is the recovery of the economy that has led to a strong increase in imports since 1986. Any and all of these should be pushing the exchange rate down.

The explanation for the steadiness of the real exchange rate is the high level of Philippine interest rates. Since mid-1985 Philippine peso securities have been very profitable, measured either in terms of domestic prices, or as an uncovered alternative to US dollar deposits. In the summer of 1988, 1-year Philippine Treasury securities yielded about 16 percent versus just under 8 percent in the United States. Such yield differences should reflect an expected future exchange rate depreciation, or a risk premium of a sharp discrete change, but the Central Bank has been able so far, through intervention and domestic open market operations, to engineer a very gradual depreciation of the peso.

Besides identifying exchange rate depreciation with domestic inflation, the Philippines has developed several powerful constituencies opposed to a more competitive rate. The first of these is urban wage earners and consumers, who would see their real income eroded by higher prices for imports, or domestically produced tradable goods -- particularly foodstuffs.

Second, much of the manufacturing sector is opposed to exchange rate depreciation due to the historic reliance of the protective trade regime on quantitative restraints. With quantitative limits on imports, prices for these goods are determined in domestic markets, just like non-traded goods. Firms that are dependent on imported inputs would see costs rise with a devaluation, squeezing them from the cost side. However as tariffs continue to replace quantitative restraints, the position of these industries will reverse, since both output and input prices rise with a devaluation, and the net effect will be an increase in domestic value-added.

The third constituency opposed to devaluation are those who have foreign debts, which would have to be serviced with more expensive foreign currency. Those whose incomes are determined in foreign currency lose less than those whose incomes are set in domestic currency. The financial position of the national government isn't entirely clear, but it is likely to be a small net gainer from exchange depreciation, as earnings from import taxes and foreign grants are more than likely to offset its foreign debt servicing obligations.[12] Government corporations, particularly utilities such as NPC, would see their profits fall, or losses increase with a devaluation.

Despite its own disinclination towards devaluation for inflationary concerns, the Central Bank is also an important net loser on debt servicing. The net foreign liabilities of the Central Bank are $760 million, and in addition, the Central Bank has $787 million of outstanding swap and forward exchange contracts that it now regularly renews but must ultimately make good on.

The constituencies for devaluation and a more competitive exchange rate are now quite limited. The strongest voice is NEDA, although its recent arguments with the Central Bank over interest rates and the level of reserves have raised the exchange rate issue only indirectly. Both the agricultural sector and the non-traditional, labor-intensive manufacturing sector would stand to gain strongly from a real devaluation, but neither has mobilized as an effective voice in favor of a more competitive (lower) exchange rate. Other proponents are the external agencies, including the World Bank and USAID in particular.

F. Other Trade Policies

One additional issue concerning the structure of the manufactured industry is also important. Non-traditional manufactured exports grew on a very thin value-added basis in the 1970s, in large part because the protection accorded to domestic manufacturing made domestic procurement impossible for these exporting industries. This has meant that large increases in gross exports were needed for relatively small increases in net foreign exchange generation. Growth in some of these industries is

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[12] Projections for 1988 for foreign-based revenues and debt service are (billion pesos):

Import duties	27.7	Foreign interest	11.9
ESF	2.7	Foreign amort.	7.9
Foreign grants	1.9		
Total	32.3	Total	19.8

In addition, some portion of the national government's investment program, estimated at P. 17.2 billion for 1988, comprises payments for imported capital.

limited by import quotas in the major markets (garments), while others are limited by the cyclical nature of world demand (semi-conductors.)

The policy that this calls for is one of encouraging backward integration in existing export industries, and the development of other industries that require domestic intermediate and primary inputs. The approach that the Philippines has taken to this problem, the Progressive Manufacturing Program, is an extremely costly and inefficient way of compensating for the higher costs of protected domestic manufacturing. Although this problem will diminish as a result of the tariff reductions and import liberalization, and would be eliminated by a substantial depreciation of the exchange rate, domestic manufacturing inputs are likely to remain relatively expensive.

G. Recommendations

1. Completion of the import liberalization program is a particularly strong priority. The Philippine government should be strongly encouraged to go ahead with the liberalization of items on the "A" and "B" lists. Also:

   a. Tariffs that replace import licenses should be imposed before the licensing requirement is eliminated.

   b. Particular emphasis should be placed on the liberalization of intermediate goods, particularly those that produce inputs to export industries (eg agricultural inputs, textiles, fibers.)

   c. Tariffs replacing import restrictions should fall in the 10 to 50 percent current tariff range. It is not so important that these be set at or under current average nominal tariff levels, since the removal of import restrictions generally substantially reduces the protection of the industry. Implicit protection under licensing requirements is often much higher than 50 percent.

2. A gradual, but significant, real depreciation of the peso should be encouraged to stimulate exports and efficient import substitution, and to compensate for the remaining protection-created bias towards domestic sales.

3. Measures to encourage indirect exports should be emphasized. These include access to inputs at world market prices, and access to finance at exporter rates through domestic letters of credit. To the extent consistent with GATT rules, direct exporters purchasing domestically should be compensated for the higher cost of procurement in the domestic market. Also, backward linkages of non-traditional exports should be encouraged to increase the value-added component of exports.

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4. The Philippines should develop a set of guidelines governing industrial programs outside the system of incentives in the Omnibus Investment Code of 1987. Such programs should compensate for identified market failures or distortions, and should be limited to industries in which the Philippines has a competitive (domestic resource cost) advantage at international prices.

   In particular, the costs and benefits of the current Progressive Manufacturing Programs should be analyzed. The pace of domestic value-added replacement, and the rents generated by industry protection and transferred to the participants, should be consistent with Philippine comparative advantage in the industries concerned, and with the additional costs borne by the program participants.

5. Additional reductions of tariffs, and reductions in their disparity, should be encouraged. However, this should be done <u>after</u> the completion of the import liberalization program.

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Chapter 5

Chapter 5. Tax and Fiscal Issues

A. Introduction

One of the characteristics of successful East Asian industrializing countries is the shift, at the beginning of their periods of rapid industrialization, towards government budget surplus. This shift added publicly-generated resources to the pool of private savings available to domestic borrowers, thereby increasing the amount of investment that could be financed domestically. The current fiscal situation in the Philippines is almost exactly the opposite; a budget deficit of between 2 and 5 percent of GNP has forced the Philippine government to borrow extensively in the domestic capital market in the last 4 years, raising domestic interest rates and crowding out private borrowers.

A fiscal system that reserves domestic savings to the private sector, and perhaps adds to them through a budget surplus, is now crucial for the Philippines, because it has very limited access to external funds as a result of its debt rescheduling. Reforms in tax collection and revenue generation effort will also be critical because a variety of pressures in the next few years will work in the direction of raising the budget deficit.

Achieving a budget surplus will be extremely difficult. First, there are a large number of demands on public expenditure for critical social needs, for raising public sector salaries, and for raising public investment. Second, several of the reform issues discussed in this study, and elsewhere, require the elimination or reduction of significant sources of government revenue, which, if taken alone, would widen the budget deficit. The main reason that the government has succeeded in reducing its budget deficit in the past two years is that investment expenditure that has been well under target.

B. The Philippine Tax System

The Philippines has had one of the lowest tax efforts (tax revenues as a share of GNP), as well as one of the lowest rates of effective taxation of the existing tax base, of any less developed country.[1] Historically the Philippine Congress limited efforts to raise taxes, reflecting their

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[1]See Manasan, Rosario "Public Finance" in Philippine Institute for Development Studies, Survey of Philippine Development Research Vol II (Manila, PIDS, 1982) pp 261-62. Tait, Alan, et. al. "International Comparisons of Taxation for Selected Developing Countries: 1972-76" IMF Staff Papers 26 (1979):123-56, rank the Philippines 41st out of sample of 47 countries in the rate of collection on tax bases.

own interests, and a desire to keep a rein on the Philippine president. However tax <u>rates</u> in the Philippines are not low. What is responsible for the low revenue share in the Philippines is a low collection efficiency on existing taxes.

On the personal income tax side, collections have been hampered by non-reporting and tax evasion. An IMF study in 1985 conservatively estimated that the personal income tax in the Philippines should have netted at least P/10 billion in 1984; in fact collections in that year were P/4.5 billion.[2]

Corporate income taxes in the 1970 were sapped by numerous tax exemptions under a variety of programs, and by presidential decrees granting exemptions to individual firms. A World Bank mission in 1979 calculated that nearly 45 percent of taxable corporations were exempt from paying taxes, and that deductions claimed by corporations amounted to about 70 percent of their gross income.[3] Real property valuations are out of date and have not been adjusted for inflation. The lack of cadastral surveying has allowed many properties to escape the tax rolls. In addition, collection on assessed rates is low; a study by the National Tax Research Center estimated that only 50 percent of real property taxes based on actual assessments were collected between 1976 and 1985.

A further problem with the Philippine tax system is its high dependence on indirect taxes -- taxes on international trade and on domestic transactions. As Table 5.1 indicates, indirect taxes have accounted for about 70 percent of total tax collections. The counterpart to this dependence on indirect taxation is the low share of income taxes, both corporate and personal, in the total. This dependence on indirect taxes has reduced the equity of the tax system; the regressive burden of indirect taxes has dominated the slight progressivity of income tax collections.[4] It has also made the tax system less responsive to income growth, which is the next tax issue.

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[2]IMF Fiscal Affairs Division, "Tax and Customs System of the Philippines" (Washington, 25 June 1985) pp 26-31, and Table 13.

[3]World Bank, <u>The Philippines: Domestic and External Resources for Development</u> Report No. 2674-PH (Washington, World Bank, 12 November 1979).

[4]See Manasan, op. cit., pp 264-66.

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Table 5.1
Philippine Fiscal Summary 1982-1987
(million pesos and percent)

	1982	1983	1984	1985	1986	1987
Total Revenue	38,205	45,632	56,861	68,961	79,245	103,214
Tax Revenue	33,795	39,525	50,005	61,190	65,491	85,923
Non-tax revenue	4,410	6,107	6,856	7,771	13,754	17,291
Total Expenditures	52,610	53,063	66,689	80,102	110,497	119,907
Surplus/(deficit)	-14,405	-7,431	-9,828	-11,141	-31,252	-16,693
Percent of GNP						
Total Revenue	11.4	12.0	10.8	11.6	13.0	15.0
Tax Revenue	10.1	10.4	9.5	10.3	10.7	12.5
Non-tax revenue	1.3	1.6	1.3	1.3	2.3	2.5
Total Expenditure	15.7	14.0	12.7	13.5	18.1	17.4
Surplus/(deficit)	-4.3	-2.0	-1.9	-1.9	-5.1	-2.4
Percent of Taxes						
Income and profit	24.5	22.4	24.6	30.4	29.2	25.4
International Trade	36.2	41.6	35.0	30.1	27.2	30.6
Domestic goods/serv	36.3	33.1	37.5	37.5	40.7	41.8
Other taxes	3.0	2.9	2.8	3.3	2.8	2.3
Memo Items:						
Consolidated govt deficit (% of GNP)	n.a.	-8.2	-8.3	-6.1	-5.8	-3.1[p]

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One of the most disturbing features of the fiscal system under martial law was the very low responsiveness of tax collections to inflation and economic growth. An IMF mission estimated an average elasticity of only 0.5 in the Philippines from 1978 to 1985, meaning that a ten percent increase in the value of output and income would lead to only a 5 percent increase in tax collections. Despite repeated introductions of major new tax measures in the Marcos government and frequent increases in tax rates, the Philippines succeeded only in standing still, and there was an dramatic slide in tax effort in the early 1980s. As a result, the Philippine government borrowed heavily, in international markets until 1983, and in domestic markets thereafter.

The reasons for the low responsiveness of tax collections were numerous. One was the low share of income taxes, taxes which usually have high elasticity. In addition, many of the indirect taxes were specific (fixed peso amount per unit), and therefore did not increase when prices rose. A variety of tax exemptions lowered the responsiveness of corporate taxes. Finally, the martial law government created a variety of special tax funds, some public, some essentially private, that competed with the central tax administration. These special tax funds covered petroleum and energy, housing, as well as the essentially private levy imposed on coconut producers.

The last set of issues posed by the tax system were the unequal distribution of the tax burden, and the performance of the tax system in encouraging growth and the efficient allocation of resources. The predominance of indirect taxes gave an overall regressivity to the tax system. This was significantly increased by the introduction of a schedular income tax system (different schedules for different sources of income) in 1981, that significantly <u>reduced</u> tax collections at the upper income levels. A variety of tax exemptions and tax incentives skewed the allocation of resources, and particularly affected public corporations. Numerous tariff categories, bans, and licensing requirements encouraged smuggling or the misdeclaration of imports. Finally the Philippines increased its effective taxation of the traditional export sector significantly in the late 1970s and 1980s through increases in export taxes, and through monopolization of the sugar and coconut industries.

C. The 1986 Tax Reform

In June 1986, shortly after Mrs. Aquino came to power, the Philippine government carried out a comprehensive reform of the tax system. The aims of the reform program were several, to:

1. simplify and make more equitable the Philippine tax system, and reduce the rate of taxation of the poorest citizens.

2. address distortions in resource allocation in the previous tax code.

3. increase the responsiveness of tax collections to economic growth.

4. raise revenue.

5. improve tax administration.

The tax reform program included a large number of measures of which the most important are discussed here. Within income and corporate taxes, the reform shifted personal income taxation back towards a global (single schedule) basis, reduced the maximum marginal rate to 35 percent, and raised personal exemptions so that incomes below the poverty line were not subject to taxation. The Philippine government also adopted a uniform corporate income tax with a maximum rate of 35 percent, coupled with a ceiling on corporate income deductions.

Excise taxes were converted to *ad valorem* bases, and there were significant increases in taxes on cigarettes and beer to raise revenue. Taxes on fuels and oil were also raised. The variety of general sales tax rates were reduced to just three rates (10, 20, and 30 percent). The general sales tax on manufacturers' sales and imports, and the 1.5 percent turnover tax on middlemen, were replaced at the beginning of 1988 by a value-added tax with a uniform 10 percent rate.[5]

In the area of international trade taxes, the reform eliminated all export duties except those on logs, imposed a 10 percent minimum tariff on imports, and converted the Philippine home consumption value (HCV) measurement to a cost-insurance-freight (CIF) basis, bringing the Philippines in line with international practice.

An executive order issued in December 1986 eliminated exemptions from import and sales taxes for most firms, including public enterprises, except firms registered under BOI incentives, the Export Processing Zone Authority, and firms whose exemptions were subject to international contract.

The tax administration measures that were adopted were income and property tax amnesties, strengthened BIR authority to reach compromises with tax delinquents, and monetary incentives to BIR officials to raise tax collections. In addition, after much internal struggle, the Philippine government employed the services of a foreign firm, the Societe Generale de Surveillance (SGS), to do preshipment checks at several foreign ports of goods destined for import into the Philippines. Finally, the special tax funds that had been created in the previous administration were consolidated under general revenue, and the coconut levy was removed.

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[5]In addition, the value added tax also replaced a variety of minor taxes on business, the miller's tax, the contractor's tax, the broker's tax, and all fixed taxes on business.

D. Results of the Reform Efforts

The tax changes that began in June 1986 have addressed many of the equity and allocational issues of the previous tax code. The taxation of the poorest families has been reduced, and the shift toward a global method of taxation will raise the tax liability at higher incomes. No subsequent study has been done on the incidence of the tax system, but such a study would probably indicate a proportional to mildly regressive incidence of overall statutory liability, and a significant improvement over the tax structure of the early 1980s. The elimination of many of the exemptions that characterized the Philippine tax system, and the elimination of export duties were important steps in reducing the allocational distortions of the tax system.

The second result of the tax reforms was to make the Philippine tax system more responsive to economic growth, as well as to inflation. This was accomplished through the elimination of many exemptions, the conversion of specific taxes to an ad valorem basis, the reduction in the number and dispersion of sales and tariff rates, and the globalization of individual income taxes. Tax collections as a percent of GNP rose significantly in 1987. Highly preliminary estimates done by the IMF put the elasticity of the tax system in the range of 1.3 to 2.0 (compared to 0.5 for the 1978-85 period).[6] The true elasticity is probably closer to 1.0, but still a significant improvement over the earlier value.

Tax reform has had a limited impact on improving tax administration and raising collection efficiency, and much more remains to be done in this area. The most important effect of the tax initiatives has been to greatly simplify the tax system, by reducing the number of tax and duty rates, and by removing many of the exemptions that characterized the Philippine corporate tax system. Incentives for misclassification of goods have been greatly reduced by the narrowing of tariff and sales tax rates, and import liberalization has also lowered the incentives to smuggle.

There have been some setbacks in tax revenue measures, with problems in particular in non-tax sources and administrative reforms. Implementation delays in 1986 prevented the full revenue impact from the tax reform being realized in that year. The value added tax (VAT) was initiated in January 1988, with substantial domestic opposition. Firms with sales below a minimum monthly level were exempted from paying VAT duties, removing the administration problems of trying to collect from the numerous sari-sari stores. Exemptions to the VAT were also given to export sales, some agricultural products, petroleum products, and published media. The Bureau of Internal Revenue estimates assumed a 50 percent leakage -- due but uncollected taxes -- from the VAT in its first year. Revisions in budget projections since January 1988 have seen a

[6] IMF "Philippines - Recent Economic Developments" Supplement 1 (SM/88/121) June 6, 1988, Annex I, p 7.

slight (P/15.1 billion to P/14.7 billion) reductions in estimates for VAT collections, despite faster than projected economic growth. But the estimated total is still expected to be well over the P/12.1 billion collected for the sales tax category in 1987.

The effects of the tax collection incentive program for Bureau of Internal Revenue employees appear to be minimal, and the incentives have been removed from the budget prepared in August. Although the work of SGS has raised import tariff collections, the effect has not been great. In addition, relative to what trade statistics and the applicable duties would suggest, there is currently an unexplained shortfall of P/1.4 billion in customs duty collections.

The Philippine government also overestimated potential revenue additions through the recovery of ill-gotten wealth and the disposal of sequestered assets through the Philippine Commission on Good Government (PCGG), and the sale of non-performing assets from the Asset Privatization Trust (APT). The actual collections from PCGG and the APT, shown below, are well below the government's initial expectations.

Table 5.2
Revenue Contributions from PCGG and APT
(million pesos)

	1986	1987	1988a/
PCGG	0	214	3000
APT	0	1039	4528

Note: a/ Original government estimate.

Sales of the Asset Privatization Trust in 1988 may actually exceed the P/4.5 billion level indicated in the table, but collections from PCGG will fall well short, probably no more than P/500 million for the year.

E. Remaining Issues

There are some important issues that remain in the Philippine tax system. The first is the continued high dependence on indirect taxes for Philippine revenue. Taxes on domestic sales and international trade taxes still account for just over 70 percent of total government tax revenue. International trade taxes have diminished somewhat in importance as a result of tariff reductions and the removal of export duties. Import liberalization has added to import tax collections by replacing licenses with tariff collections, but the effect has been small -- an additional P/540 million in 1987 and P/640 million in 1988, or about 2 percent of total trade taxes. The diminished importance of trade taxes has been compensated by increased domestic excise taxes

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(cigarettes, beer, petroleum products) and the introduction of the value added tax.

The high dependence on indirect taxes reduces the equity of the tax system, since indirect taxes are generally regressive in their incidence. In addition, the key role that indirect taxes play in Philippine revenue weakens other initiatives designed to increase the efficiency of the economy, such as further reductions in tariffs or an elimination of the Gross Receipts Tax in the financial sector, due to their importance as revenue sources.

Aside from simplification of the tax system and reduction of incentives for misdeclaration and smuggling, improvements in tax administration have been marginal. The BIR incentives for increased collections, as well as the SGS preshipment checks, have been minor changes that have not really affected the system of administration and tax collection, and have so far produced minimal results. Tax administration and collection efficiency now looms as the major issue confronting the Philippine tax system, and is a crucial area for future attention.

F. Recommendations on Strengthening Tax Administration

The low rate of collection on existing taxes should caution one against suggesting new tax measures as a solution to revenue generation problem in the Philippines. At the same time, it also suggests that the most promising avenue for increasing revenue generation is improving collection efficiency and tax administration.

The Bureau of Internal Revenue (BIR) faces a variety of problems in enforcing the tax laws in the Philippines. It's useful to break tax administration down into two areas. The first, the technical enforcement capacity, is the ability to obtain and retrieve information, identify non-filers and returns that should be audited, and collect evidence on which a correct review or successful prosecution may be based. The second is the institutional enforcement capacity, the commitment to successfully pursue and prosecute offenders of the tax administration, the government, and the judicial authorities.

Philippine tax administration has shortcomings in both areas, with institutional capacity providing the more serious problems.

On the technical side, there is a strong need for better handling, identification, and control of filed returns. Currently Philippine taxpayers are required to provide two copies of their return to reduce the risk of loss. Returns are accepted at district offices and immediately forwarded to the regional office. At each stage in the process, returns are subject to loss, "hijacking," or tampering. Inadequate identification and control over documents often make it difficult to locate current or past returns.

The recommendations for these problems are straightforward, and require equipment and some technical assistance. The BIR needs to development a stronger system of document recording and control, such as a Document Locator Numbering (DLN) system. Returns should be assigned control numbers at the point of receipt, and the amount of processing and recording should be increased at that level. Increased computerization would allow the entry of major return items into a master computer file, reducing the risk of loss or theft of returns once in the system. A stronger system of identification and control would eliminate the requirement to present two copies of returns, in turn reducing the storage and handling requirements of BIR.

The Bureau of Internal Revenue has significant staffing problems, and a backlog of audit, review, and refund cases extending back several years. The BIR has a three-tiered structure, with a national headquarters office, 17 regional offices, and 95 district offices, with various sub-offices under them. However, much of the authority is centralized in the headquarters office, and all cases exceeding various peso ceilings must be sent to the head office, including all cases involving fraud. In addition, all returns claiming refunds must be sent to the Refund Audit Division at BIR headquarters. Much of the activity of the headquarters staff involves tax casework, rather than broader questions of tax policy and information. This centralization has also fostered the impression that BIR headquarters is the place to "adjust" a return under scrutiny.

A further technical obstacle to tax enforcement are Philippine requirements on bank secrecy. The Philippine Bank Secrecy Act (RA 1405 of 1955) bars BIR from access to bank records, a crucial source of information in major tax fraud cases, since nearly all large financial transactions go through the banking system.

But many of the problems in Philippine tax enforcement are institutional problems, in the form of inadequate commitment to vigorous enforcement of the tax laws. In carrying out investigations, BIR employees are often subject to threats and intimidation, as well as taxpayer suits for harassment. In the latter case, the bureau does not defend its employees, and the defendants are forced to pay their own legal costs. Political connections have historically been useful in closing off tax cases, and in some instances have led to BIR disciplinary actions against the investigating official.

In the event a taxpayer appeals a ruling of the BIR, the legal proceedings are subject to long delays. In 1985 it took an average of 5 years for a tax case to come before the Court of Tax Appeals, which handles local government tax and customs cases, as well as those of BIR. The penalties in such cases are weak, and prison sentences are almost never imposed.

The result of the difficulties in tax enforcement, and the lack of successful and well publicized cases against tax offenders has been to strengthen the widespread impression that the rich and the powerful successfully evade taxes in the Philippines. Those who are caught are considered merely the unlucky and unconnected. This general attitude has undermined the entire collection effort, weakening the self-enforcement on which much of tax collection depends. Many of the restrictions facing BIR employees -- susceptibility to taxpayer suits, lack of legal protection, lack of access to bank records -- come from general public distrust of the institution. Any attempts to strengthen the authority of BIR without strengthening its capabilities and public image, are likely to fail.

G. A Separate Issue: Local Government Finance

Local government finance is a neglected area in Philippine economic policy analysis; most discussions are one or two paragraph descriptions.[7] This is a product of the high degree of centralization of government authority in the Philippines, and the minor fiscal and expenditure roles of the local governments.

However, local government finance is important for at least two reasons. First, local governments are responsible for the collection of all real property taxes in the Philippines. The associated issues, land titling, tax mapping, and land valuation, are important not only for local government taxation, but also for issues of land transfer and compensation under land reform. Second, the fiscal position of local governments is an important influence on the success of decentralization efforts in the Philippines.

A summary of the fiscal operations of local governments is shown in Table 5.3 below. Property taxes are the largest single source of revenue for these units. In addition to their own property assessments, local governments collect as agents for the national government a one percent tax on property to support the National Education Fund. The local governments retain some of this revenue for their own educational use and remit the rest to the national government; as a part of the 1986 tax changes, the remitted proportion was raised from 20 percent to 80 percent of the total.

Additional local source revenue comes from business taxes, and from non-tax revenue, primarily licenses and fees. A major share of the funds of the local governments come as transfers from the national government. These take two forms, a statutory allotment, and special allotments for the maintenance of roads and bridges and other construction projects. Local governments do not have authority to borrow, so their accounts are in balance or show a small surplus each year. As is indicated in Table 3, capital expenditure is a very small portion of the outlays of the local governments.

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[7]An exception, although an old one, is The World Bank, <u>The Philippines: Priorities and Prospects for Development</u> (Washington; World Bank, 1976) pp 425-434, 444-447.

Table 5.3
Consolidated Income and Expenditure
of Local Governments, 1982-1987
(million pesos)

	1982	1983	1984	1985	1986	1987p
Total Revenue	6215	6827	7468	8649	8930	9609
Tax Revenue	1964	2191	2391	2696	3078	3357
Property taxes	1125	1238	1359	1492	1812	1984
Business taxes	839	953	1032	1204	1266	1373
Non-tax Revenue	1694	1752	1995	2218	2182	2304
Aids and allotments from national govt	2557	2884	3082	3735	3670	3948
statutory allot.		2519	2676	3205	3229	3485
special aid		365	406	530	441	463
Expenditures	5828	6513	7396	8348	8626	9326
Current	5131	5684	6505	7480	8018	8740
Capital	697	829	891	868	608	586
Surplus (deficit)	387	314	72	301	304	283
Percent of GNP						
Total Revenue	1.9	1.8	1.4	1.5	1.5	1.4
Tax Revenue	0.6	0.6	0.5	0.5	0.5	0.5
Property taxes	0.3	0.3	0.3	0.3	0.3	0.3
Business taxes	0.3	0.3	0.2	0.2	0.2	0.2
Non-tax Revenue	0.5	0.5	0.4	0.4	0.4	0.3
Aids and allotments from national govt	0.8	0.8	0.6	0.6	0.6	0.6
Expenditures	1.7	1.7	1.4	1.4	1.4	1.4
Current	1.5	1.5	1.2	1.3	1.3	1.3
Capital	0.2	0.2	0.2	0.1	0.1	0.1
Surplus (deficit)	0.1	0.1	0.0	0.1	0.0	0.0

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Various problems limit the collection of property taxes, the major source of revenue for the local governments. The first is undervalued and outdated assessments of property values. This problem was partially addressed in the 1986 tax changes adjusting property values for inflation from 1978 to 1984, but widespread undervaluation of properties on the tax rolls remains. Besides the undervaluation of existing properties on the tax rolls, many taxable properties escape taxation because of outdated or inadequate tax maps, and the absence of a system of cadastral surveying. AID and the World Bank have had a reform project in this area, involving a major tax mapping effort, but the Philippine government has not shown much interest until recently.

The suggested reforms in this area are easily described but difficult to implement. The Philippines needs to develop and strengthen basic tools of real property taxation. The first, and most important is up to date surveying and land valuation. In valuing land, the emphasis should be on potential use, rather than actual use as is presently done; not only would this bring in more revenue, it would also encourage more productive use of land.

The fact that local politics in the Philippines is dominated by wealthy families will make any significant rise in the effective taxation of local property extremely difficult. However, the country has in the next few years a unique opportunity to revise local property taxation under the shadow of its land reform activities. <u>Landowner incentives on property valuation for taxation and for land reform (transfer) compensation are directly opposing</u>, and there is scope for significant increases in tax register land valuation.

The problems of titling and land assignment are the same in land reform as they are in determining tax assessments. Thus assistance to local tax collection, surveying, and value assessment efforts are a way in which USAID could indirectly support land reform, as well as fiscal and decentralization initiatives, without directly funding land transfer.

H. Recommendations

1. The most essential step to be taken in the Philippine fiscal situation is to reduce its budget deficit in order to help lower domestic interest rates and to minimize the crowding out of private borrowers and investors. In order to accomplish this, the following is recommended:

   a) Vast improvements in tax collection efficiency and administration, rather than the imposition of new taxes. The "technical enforcement capability" of the BIR must be strengthened.

   b) Strengthening of the use of the legal system to pursue and prosecute tax offenders.

c) Increased support of government and judicial employees who pursue and prosecute offenders.

2. Updating of real property registers and valuations, which are out of date and have not been adjusted for inflation. The lack of cadastral surveying has allowed many properties to escape the tax roles.

   This recommendation is particularly timely, given that the country has a unique opportunity to revise local property taxation under the shadow of its land reform activities. Landowner incentives on property valuation for taxation and for land reform (transfer) compensation are directly opposing, and there is scope for significant increases in tax register land valuation.

3. Continue ongoing efforts to increase the elasticity of the tax system relative to increases in national income and inflation. Revenue gains achieved through increased revenue efficiency must not be given up through a declining effective tax rate.

4. Continue efforts to reduce the regressivity of the tax system, which is heavily based in indirect taxes. This should be done not only for reasons of equity, but because resource misallocation has resulted from the current regime of tariffs, import controls, tax exemptions, and tax incentives.

5. Tax exemptions that favor public corporations should all be removed, in favor of more transparent accounting and, if necessary, subsidy transfers.

Chapter 6

Chapter 6. Government Corporate Sector Reforms and Privatization

A. Background

The martial law period saw a tremendous growth in state activity and public investment, much of it carried on through government owned corporations and government financial institutions. From approximately 30 government corporations before martial law, the number expanded to 285 corporations and subsidiaries by 1985. These entities were formed

> ... for any or all purposes, ranging from banks, nuclear plant, real estate, racehorses and gamecocks, gambling casinos and lottery houses, poultry farms and tomato paste, to a dizzying array of Centers concerned with culture, music, science, health, artists, and all known fields of human endeavor including the meaning of life.[1]

In addition to the corporations that the government established, a large number of private companies were acquired by the Philippine government in the 1980s, either as the result of a government bailout, or because the firm had defaulted on a government guaranteed loan.

The two major government owned financial institutions, the Philippine National Bank and the Development Bank of the Philippines, became the borrowing conduit for many public and private projects under martial law. In addition, they were used by the Marcos administration to channel funds to favored borrowers, in so-called "behest" loans. The 1980s saw a massive deterioration in the quality of the portfolios of these two institutions. By 1985 over half the assets of PNB and almost 90 percent of the assets of DBP were non-performing. Government support for these two institutions alone swelled to P. 16 billion in 1986, 15 percent of the budget and 2.6 percent of GNP.

Mrs. Aquino campaigned on a promise to reduce the state role in the economy and sell off or dismantle many of the corporations founded or acquired during Marcos administration. The reduction in the investment programs of the state corporations had greatly reduced their draw on the national budget by the time Mrs Aquino came to power, but the hemorrhage of the state financial institutions, and dealing with their rapidly growing inventory of non-performing assets and acquired corporations, demanded immediate attention. In one of her first acts in office, Mrs Aquino established a Presidential Commission on Government Reorganization (PCGR) to develop procedures for the rehabilitation of the financial institutions, and to inventory and make recommendations concerning the disposition of public corporations.

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[1]Briones, Leonor, "Philippine Public Enterprises in the 1980s: Problems and Issues" PIDS Development Research News 3:4 (Manila; Philippine Institute for Development Studies, 1985) p 2.

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B. <u>Reform Efforts</u>

1. Financial Institution Reform

The problems of dealing with the Development Bank of the Philippines and the Philippine National Bank were essentially those of rehabilitating insolvent financial institutions. These involve separating off non-performing assets, shrinking the size of the institution, and then allowing them to operate independently.

The Philippine government developed a rationalization program for both institutions with the support of a $150 million World Bank Economic Recovery Loan. Under the program, both institutions transferred their non-performing assets to the national government, which also assumed the corresponding liabilities. An Asset Privatization Trust (APT) was established, with a five year time span to arrange for final clearance of assets for sale, and to dispose of them through auction sales on a cash basis. The book value of the assets transferred came to P/85 million for DBP ($4.2 million) and P/72 billion ($3.6 billion) for PNB.[2] Both institutions made substantial cuts in staff to reduce costs, and PNB closed most of its overseas branches.

The reform measures that the Philippines adopted with respect to PNB and DBP were designed to place both institutions on an equal footing with private commercial banks. The obligations of the two institutions would no longer carry government guarantees, nor would they have access to special credit or tax privileges. Public sector deposits would no longer be available on the scale or low cost as before, and, as for private commercial banks, both would be subject to external audit. In addition, the government agreed that social projects with below-market rates of return would be funded through explicit budgetary support, rather than at government behest through its financial institutions.

The transfer of assets of PNB and DBP to the national government, and the government assumption of liabilities of the two institutions, greatly reduced the share of the government in the domestic financial market.[3] Under the restructuring program, the government pledged to operate PNB as an ordinary commercial bank, eventually offering shares for sale to the private sector as its profitability improved. The emphasis on DBP was to shift from large scale, industrial sector loans to the provision of credit for agriculture, housing, and small and medium-sized firms.

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[2]Non-performing assets of book value less than P. 10 million were retained by the two financial institutions.

[3] As a result of the restructuring the share of the Philippine National Bank in commercial bank assets was reduced from 28 percent in 1985 to 13 percent in 1987.

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The rehabilitation programs for both institutions have proceeded well. The Development Bank of the Philippines achieved the major targets of its three year rehabilitation program in 1987, showing a profit of P/765 million, well above the original forecast of P/420 million. The Philippine National Bank also returned to profitability last year. The crucial test for the future is whether the Philippine government can run these institutions on commercial terms, and in particular whether it can avoid using them to finance high priority but low profitability investments. The Philippine National Bank still views itself as the financial institution for the national government, as indicated by the dispute over proposals to hold government working balances in selected large private banks.

2. Government Corporate Reforms and Privatization

Along with the rehabilitation of government financial institutions, the new Aquino government faced the problem of the disposition of the non-performing assets of those institutions, as well as the reorganization of the public corporate sector. For the government corporate sector, the PCGR settled on a list of 296 corporations and subsidiaries, and adopted the following breakdown for disposition:

Privatization	130
Abolition	56
Conversion into line agencies	40
Consolidation into other govt corps.	25
Retention as public corporations	37
Special cases (eg Red Cross)	8
Total	296

It is important to mention that the recommendations on disposition represented only one of several reform efforts involving the government corporate sector. Along with the reorganization proposals, the PCGR recommended policies to rationalize the operations of public corporations and increase the transparency of government support for those institutions. The ground rules governing future operation of retained government corporations are examined below, following the analysis of the privatization effort.

The initial privatization program presented huge technical, legal, and administrative challenges. In addition to the 130 government corporations slated for privatization, there were approximately 390 non-performing accounts of the government financial institutions. Furthermore, the Presidential Commission on Good Government sequestered

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the assets of some 260 Philippine corporations, and depending on the resolution of their investigations, some of these were to be transferred to the APT for sale.

Several external agencies were involved in the rehabilitation, reform, and privatization efforts. The World Bank took the lead in the rehabilitation of government financial institutions, and supported the effort through a $310 million economic recovery loan. The Bank also assisted the reform efforts of public corporations through an additional $150 million Public Corporate Sector Rationalization loan and assistance program. USAID was also involved at an early stage, funding a study by the First Boston Corporation on recommended strategies for privatization. Later USAID, through its Privatization Project, designed a program of assistance to the APT.

The strategy that was adopted was to sell off acquired assets and corporations as quickly as possible, without investing in government rehabilitation efforts. In the original proposals, the Asset Privatization Trust was to be responsible for the sale of government corporations slated for privatization, as well as of non-performing assets and assets transferred from PCGG. However, in practice more decentralized responsibilities for privatization developed, with the sale of government-owned corporations left to the parent corporation or government agency to which the corporation was attached.

3. Privatization of Acquired Assets

While the efforts of the Asset Privatization Trust in disposing of assets transferred to it have fallen somewhat short of target, they have gone reasonably well. Realizations from APT sales are shown below (billion pesos):

1987		1988 (Jan-July)		
Projected	Actual	Projected	Actual	Total
3.82	3.47	2.22	2.32	5.78

In its sales, the APT has been able to realize about 20 percent of book value for the assets, which is in line with initial expectations.

The APT has been hampered in its sales by the fact that many of the accounts are financial claims on unforeclosed assets, or "financial form" assets, and the fact that Philippine law gives substantial rights to initial owners, even after foreclosure, to block sales of assets. The APT has considered schemes to persuade debtors to agree to uncontested foreclosure and waiver of redemption rights in return for a government agreement of full settlement and some preference in bidding.

4. Privatization of Government Owned Corporations

The sale of government owned and controlled corporations has been far less successful than the disposition of non-performing assets. The original list of 130 firms slated for privatization has been revised several times. There has been confusion about which corporations have received final approval for sale, and persistent delays and equivocation in offering major assets such as Philippine Airlines and the Manila Hotel despite the high degree of investor interest. As of the end of July, only 9 government owned or controlled corporations had been sold, and an additional 5 partially sold, for a total of P/2.03 billion. In the cases PNOC, the Associated Bank, and MERALCO, the government has pulled back from approved disposal plans or agreements in principle already reached with prospective buyers. Despite repeated statements by Mrs Aquino of her commitment to privatization, little progress has been made in the government corporate sector.

C. Assessment of the Privatization Effort

1. Factors Delaying Privatization

The obstacles to progress in the Philippine privatization effort have been several. To some extent they are legal and technical, involving the difficulties of identifying and preparing assets for sale, and foreclosing on the claims of the original owners. Somewhat unexpectedly, insufficient investor interest or funds have not been obstacles affecting the pace of privatization. However, the primary obstacles have been ideological and political, as the initial coalition that brought Mrs Aquino to power splintered, and as the historical pattern of patronage politics reasserted itself in the country.

The split between the center-right and the center-left within the Aquino Government developed quickly on the privatization issue, with the populist and nationalist elements in the Cabinet -- epitomized by Mrs Aquino's first executive secretary, Joker Arroyo -- opposing and delaying the privatization effort. They have argued, in part, that the strategy of selling quickly without rehabilitation efforts would lead to sale prices well below the intrinsic value of the enterprises. In addition, they have argued that the eligibility of debt equity conversions for purchase of state-owned assets represents an additional and substantial discount. This argument of "giving away the store" is a powerful one in Philippine politics, and the fear of selling too low has led to an unwillingness to let anyone gain from successful risk taking, as the recent suspension of the purchase agreement for MERALCO illustrates.

But the arguments have gone beyond price. In a society with wealth as concentrated as it is in the Philippines, and where disbursed public stock ownership is almost non-existent, none of the potential buyers have been attractive to the populist and nationalist sentiment in the government. The existing Philippine elite, the Filipino-Chinese community, and foreign investors, including Asian Chinese, have been the principal bidders for government assets. In addition, many worry that Marcos' cronies might buy their way back into their companies for a fraction of the liabilities they accumulated as original owners. The plans for the privatization of both the PNOC subsidiaries and MERALCO included plans for public stock offerings, but using privatization as a way of developing the domestic stock market and disbursing ownership has not been pushed strongly or convincingly enough.

Perhaps the strongest resistance to privatization has been bureaucratic. The designation of parent companies and ministries of attachment as the disposition entities for most of the state-owned corporations has put those appointed as executives and administrators into the position of having to disband much of what they preside over. Many appointees have worked hard to delay or exempt their corporations from privatization. One of the principal rationales for privatization is that the management of state-owned companies is inherently bureaucratic and politicized, and because of that, the retention of the corporations and the patronage opportunities that they create is more important to their current management than the revenue that could be gained through their sale.

2. Prospects for the Privatization Effort

Despite the importance of the privatization effort in increasing the efficiency of the Philippine public sector and the corporations themselves, the future prospects for privatization are not good. The first reason is that the initial period in which bold initiatives could be undertaken is now past, and time works against the privatization effort. This is because the passage of time further entrenches and strengthens the existing bureaucratic management, as well as the fabric of patronage politics.

The second reason is that the privatization effort has lost most of its champions within the Philippine government. The principal architect, Jaime Ongpin, has died; David Sycip resigned from the APT after his heart attack; and Edgardo del Fonso and Vincente Paterno have resigned from government, one to the private sector and the other to the Senate. Only Solita Monsod remains as a forceful advocate of privatization, but her influence is diffused across many issues. Forceful advocacy and leadership from the top is crucial in privatization efforts, because privatization is more a matter of dealing with and completing individual cases than it is a matter of policy.

Finally, successful privatization is an extremely difficult area for conditions imposed by outside donors and lenders. This is fundamentally because of the sensitivity of issues involving sovereignty in the Philippines, and the longstanding suspicion of foreign investment. Outside agencies supporting privatization, particularly US agencies or agencies in which the United States plays a major role, will inevitably be suspected of mixed motives in fostering privatization efforts.

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Even though decisions "in principle" may be made on the disposition of lists of state entities, requiring that so many firms be made ready for sale by a certain date, no one can require the government to accept any particular offer, or indeed, any offer at all. Therefore, it is the internal willingness to carry through with privatization that will always be controlling.

This in no way suggests that USAID and other external agencies should abandon their support for privatization. They should encourage the government in its efforts, and provide assistance, both technical and financial, in the privatization efforts. Discussions with the government should continually stress the Philippine interest in privatization as a way of increasing both the efficiency of the corporate sector and the efficiency of the government. But in all likelihood, the Philippine privatization effort is likely to be slow and incomplete.

D. Further Reforms of Government Corporate Operations

The operations and efficiency of corporations that are retained by the Philippine government is an issue of equal, and perhaps even greater importance than privatization. The first reason is the sheer size of the entities involved. Even in the original and most ambitious scheme for privatization, the largest government corporations were slated to remain in the public sector. Only 37 corporations were to be retained, but these accounted for over half of the total assets of the non-financial government corporate sector. And, as the public investment program of the Philippine government expands to reach its target of five percent of GNP, much of the investment will take place through these major corporations.

Furthermore, the privatization of government corporations will take a long time. In the interim, the government will necessarily be managing these corporations, and the way in which this is done will affect not only the current operations and income of these firms, but also their prospects for sale in the future.

1. Reform Measures

The reforms of government corporation operations have been the particular interest of the International Monetary Fund, but also an interest of the World Bank. Under the terms of the 1986 stabilization program with the Fund, the Philippines agreed: (a) to eliminate tax and tariff exemptions for government corporations; (b) to clear up arrears among government corporations and arrears between the corporations and the national government; (c) to require interest payments on lending from the government and dividend payments on government equity; and (d) to limit the ability of the corporations to draw on government subsidies, net lending, and equity infusions to cover deficits.

To date only partial progress has been made on these measures. The government has successfully introduced interest payments on borrowings

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from the central government (with rates tied to the Treasury bill rate) as well as dividend payments of a minimum of five percent. The largest arrears involve companies engaged in the energy sector, and little progress has been made in clearing these up. Tax and tariff exemptions were removed from public corporations in the tax reform measures adopted in 1986.[4] This year however, tax exemptions for the National Power Company were reintroduced, and the NPC was exempted from the requirement to make peso counterpart deposits at the Central Bank against its external liabilities. Although this has been the only exception to date, it is troubling because NPC is by far the largest public entity and public corporate taxpayer.

These reform measures affect the incentive environment in which government corporations operate. They also contribute in an important albeit indirect way to strengthening the actual operations of the firms. (More direct means to strengthen the management and operations of public corporations are discussed in the next section.) These reform measures help establish transparent and arm's-length relationships among government firms, and between firms and the central government. By explicitly accounting for all hidden subsidies, exemptions, and cross subsidization of loss-making activities, each entity is forced to become more transparently accountable.

At first, changes in the accounting of public corporate transfers resulted in changing how and where their costs and losses show up in the consolidated government accounts. Improved cost accounting increases the efficiency of operation of the public corporate sector, since the prices that state entities face reflect true opportunity costs for the government as a whole. Second, these changes are important for generating political pressure, if not economic pressure, on state-owned enterprises to operate more efficiently. It is important that loss making operations show losses, rather than being absorbed through tax exemptions, arrears, or cross subsidization. It is arguable that the end of the profitable wheat and soy monopolies of the National Food Authority, which revealed the large losses in rice stabilization, played an important role in the forced resignation of the NFA's chairman.

Establishing transparent and arm's-length relationships for state-owned companies is important for their eventual privatization. With the variety of means available for sheltering loss-making operations, it is difficult to determine the true sales value of an enterprise.[5] Furthermore, when sales take place, they are often conditional on the maintenance of government supports. An example of this exists already in the six acquired banks of the public sector, which are supported by

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[4]There were some exceptions in instances required by Philippine international commitments.

[5]As a somewhat flawed example, one of the most difficult problems in preparing a privatization plan for the subsidiaries of PNOC was determining their true profitability.

account activity and low interest rate deposits of their government parent. Although shares in these banks have been sold to private firms, the government still maintains a majority interest in each, and, because of the supports, it is the preference of the minority shareholders that this remain so. In sum, efforts to establish more transparent and arm's-length relationship among state-owned firms are policies that assist privatization.

2. Strengthening the Operation of State-Owned Firms

In addition to policies that shape the price and regulatory environment facing government owned firms, it is important to strengthen the internal operations of state-owned enterprises and their responsiveness to price signals. These efforts have already begun in the Philippines, with USAID's project on strengthening the cash management of government agencies, and with the effort of the World Bank to strengthen financial management and planning activities.

In the Philippines at least two fundamental difficulties remain, and both are strong arguments for privatization of many public sector activities. However both must be dealt with when privatization cannot or does not take place.

The first issue is patronage. This applies not only to the management and directors of state-owned corporations, but to their employment levels generally. To deal successfully with this problem requires establishing as much operating independence as possible, whether the firms are publicly or privately owned. To the extent possible, the management of state-owned enterprises must be judged on their ability to generate dividends for the central government and to lower prices for their services. Any losses generated must generate pressures for changes, including change in staffing.

The second issue is collection. Publicly owned firms in the Philippines, particularly flow-service utilities such as electricity, water, and irrigation, have historically had great difficulty in billing and collecting.[6] Rates for paying customers have been adjusted to take this into account, resulting in high utility rates, and in effect, a high cost of honesty. For example, since MERALCO is allowed to pass 70% of its

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[6] A short case study is that of the Manila Water and Sewerage System (MWSS). The ratio of MWSS water paid for water produced is a mere 38%. Half of the losses are considered to be physical losses, and half are non-payment losses. Unpaid accounts almost doubled from 1985 to 1986, with the unpaid bills of commercial/industrial users showing a 285% increase.

The Local Waterworks and Utilities Administration (LWUA) also has trouble collecting, only they collect from water districts. LWUA has a collection ratio of 52%.

losses (including arrearages) on to consumers, it has a reduced incentive to reduce those losses.

The low collection efficiency of these firms can be partly corrected at the level of the enterprise. But in large part it reflects an attitude toward state provided services as being government favors, and a legal system that provides extensive protection to customers and makes suspension of services difficult.

An important issue is whether the problem of collection efficiency can be solved short of privatization. It may be possible to strengthen the enforcement and suspension measures against non-payers, perhaps as a general campaign against graft that also includes higher penalties for tax evasion. It may also be solvable through partial privatization or franchising of the delivery stage of state services production. One example of this would be privatizing electricity distribution while maintaining state ownership of generation.

Whether or not the management problems of state-owned enterprises can be solved without a change in ownership, the importance of improving their operational efficiency will increase with time. At the present, the investment expenditures of these enterprises are far below target. As public investment expands to meet the infrastructural needs of the Philippine economy, the efficiency of state-owned enterprises will become critical. The reform of public sector operations should be seen as a broad effort involving all three levels of activity discussed above, i.e. privatization, changes in public corporate pricing and incentives, and strengthening the internal operations of the firms themselves.

E. Recommendations

1. USAID should continue to stress the importance of the Philippine privatization effort as a means of increasing the efficiency of the Philippine economy, reducing the losses of corporations now in government hands, and freeing scarce public sector time and staff attention to crucial public policy issues. USAID should try to promote its technical and operational assistance to the Philippine privatization efforts.

2. Privatization should be seen as one part of a wide range of issues involving the efficiency of operation of the public sector. USAID should stress the importance of transparent, and, to the extent possible, arm's-length relationships among state-owned companies, and between state-owned companies and the central government. The US should also continue to support measures to increase the operational efficiency of government line agencies and public corporations.

3. Measures to increase the collection efficiency of public corporations are crucial, both for the revenue performance of the public sector, and for the efficiency and competitiveness of pricing

of Philippine publicly provided services. These involve legal and policy changes as well as operational changes. The United States should assist in programs to strengthen collection efforts. Since USAID has long been involved in rural sector issues, it could play an especially important role in collections for irrigation and rural electricity.

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Chapter 7

Chapter 7 Financial Sector Issues

A. Introduction

Aside from the restructuring of the government financial institutions (the Philippine National Bank and the Development Bank of the Philippines), financial sector issues have not played a prominent role in the internal policy discussions within the Philippines, nor in the external conditions that have been placed on Philippine performance. This is somewhat surprising given the emphasis in the early 1980s on financial sector reforms, and the important role that the financial sector played in the economic crises of the early 1980s. This lack of emphasis appears to be changing, as the World Bank is now taking a more intensive look at financial sector issues, and as debates over financial policy, particularly between NEDA and the Central Bank, have arisen in the past year. In addition, if the Philippines is to create sustained recovery and investment with limited recourse to foreign funds, domestic financial sector performance will have to improve significantly.

B. Background and Characteristics

1. Role of the Commercial Banks

The Philippine financial system has a mixture of characteristics common to a number of LDCs, and some unique to the Philippines. As in most LDCs, the commercial banking sector is the primary source of industrial finance. Equity and securities markets are only minimally developed, and account for very small shares of the total finance available to enterprises. Corporate bond issues have been insignificant, and government securities have been largely sold to captive purchasers-- commercial banks and government social security institutions -- at below market interest rates. One result of the stunted development of securities markets in the Philippines was the high dependence of industrial firms on debt financing, leading to particularly high debt/equity ratios after the economic crisis of 1983-86.

As in many LDCs, Philippine financial policy has been concerned with channelling credit to favored borrowers at low interest rates, and has been less concerned with deposit mobilization. The reasons for this policy stance have been partly developmental -- encouraging investment and activity in priority areas -- but also partly political, since access to credit at favorable rates has been one of the most important benefits of political office, as well as a source of patronage. The Philippines maintained interest rate ceilings on deposits and loans until 1983.

As a result of the excess demand for credit that arose, Philippine banks lent primarily to the largest blue chip firms, or to those firms with bank affiliations. With few exceptions, loans were short term and were successively rolled over, since short-term loans were safer and allowed the levying of additional charges that raised effective yields. Competing for borrowers was not an issue for banks, and credit analysis remained weak. Low returns available to domestic savers gave little incentive to hold savings deposits. As a result, financial institutions were dependent on Central Bank funds and external borrowing for much of their resources.[1]

Philippine financial markets were also characterized by a variety of schemes to channel credit to priority sectors. Selective credit allocation programs, for agriculture, industrial investment, exports, small and medium industry, were supported with preferential rediscount windows at the Central Bank, and the Central Bank was an important, and regular source of funds for many financial institutions. In several instances specialized financial institutions were created to be the facilitating agents of particular credit programs. Rural banks and private development banks are two examples of this type of institution.

2. Organization of the Financial Sector

The Philippine commercial banking sector stands out among other LDCs as having a large number of relatively small institutions. The country now has 24 private commercial banks (of which 6 have been acquired by the government as a result of the financial crises of the 1980s), four branches of foreign banks, and two government owned commercial banks, the Philippine National Bank (PNB) and the Land Bank of the Philippines. PNB once accounted for 30 percent of the assets of commercial banks, and is still the largest commercial bank, but as a result of its restructuring and asset transfer now accounts for only 12 percent of commercial bank assets. The concentration of the four largest banks as a percentage of total commercial bank assets is only 37 percent, a figure that is quite low by LDC and even developed country standards.[2]

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[1]The effects of interest rate ceilings were to some extent mitigated by the development of an active money market in the Philippines. The money market started in the late 1960s when a few investment houses began selling short-dated government obligations. While primarily a market for interbank trading, the money market also offered alternatives -- "deposit substitutes"-- to depositors, offering higher rates than bank deposits. It was also a source of funds to firms who were excluded from commercial bank financing. This market grew rapidly until the late 1970s, when the Central Bank imposed reserve requirements and rate ceilings on quasi-bank institutions. Credit in this market was also overwhelmingly short term, reinforcing the dependence of Philippine firms on credit rollovers.

[2]The large number of commercial banks relative to the size of the banking market in the Philippines was the result of Central Bank policy that encouraged the formation of new banks in the two decades after independence. During this period many families formed banks as complements to their other industrial

While equity and other long term financial markets have not advanced, short term markets in the Philippines have proved innovative, if somewhat reckless in character. The country has experienced a number of runs on financial institutions, including a serious crisis in 1981 associated with the sudden departure of Dewey Dee, and the financial crises of 1984 and 1985. The reliance of most firms on debt financing, and the dependence of borrowers on successive rollovers of short term loans, make the system vulnerable to liquidity crises. But most financial institution failures have been associated with poor loan placements, most often to directors, officers, shareholders, or related interests of the institution, or what are known as DOSRI loans.

3. Government Involvement

The last characteristic of the Philippine financial sector has been the high degree of government involvement. The Philippine government has played a prominent role through ownership of financial institutions, including the Philippine National Bank, the largest commercial bank, and the Development Bank of the Philippines, a specialized development bank.[3] The government also acquired a number of small, financially troubled commercial banks in the 1980s. By the early 1980s roughly 40 percent of the assets of the entire financial system were held by government owned institutions.

But the government role in the financial sector went beyond the ownership of financial institutions. The selective credit allocation schemes, the variety of Central Bank rediscount windows, and the dependence of financial institutions on Central Bank credit, provided influence over the direction of private sector credit. The expansion of external borrowing in the 1970s also increased the government role, since much of this was channelled through the Development Bank of the Philippines, and through the Central Bank's Consolidated Foreign Borrowing Program. Finally, under martial law, the influence of the government in the financial sector expanded through the growth of patronage relationships. Several privately owned banks became closely associated with the Marcos government, and grew rapidly during the martial law period. In turn, the

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activities. The result was a banking structure linked to industrial groupings, similar in character to the Japanese interwar _zaibatsu_.

[3]In addition to these two major institutions, the Philippine government also owned the Land Bank of the Philippines set up to finance agrarian reform, and the Philippine Amanah Bank, a Muslim financial institution.

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Marcos government exercised some influence over the bank's loan portfolios.[4]

C. Early Reforms and the Financial Sector Crisis

1. Financial Sector Reforms, 1981-1983

Financial sector reform efforts began in 1980, and were in many respects successful, although they were overshadowed by the financial crises later in the decade. The reform efforts were undertaken as a part of the World Bank's Industrial Sector Finance Loan in 1981, and the 1980 IMF program. The centerpiece of the efforts was a financial liberalization program, requiring the lifting of interest rate ceilings on deposits and loans, and the dismantling of most of the selective credit allocation schemes. Central Bank policy was to shift away from controlling credit allocation towards becoming lender of last resort. Reserve requirements were to be reduced, and Central Bank discounting tied to market interest rates.

The liberalization program was in most respects successful. The last controls on interest rates, those on short term loans, were lifted in 1983. After a proliferation of preferential rediscount windows in the early 1980s, their number was drastically reduced. By the end of 1985 there was a single preferential rediscount window for export loans and certain rural bank loans to the agricultural sector, with an interest rate tied to the interbank Manila Reference Rate. Reserve requirements were initially reduced from 20 to 18 percent, but the need to control the growth of the money supply in 1983 and 1984 led to a reversal of this policy, and reserve requirements were raised in increments to 24 percent.

In order to strengthen financial institutions, many of the requirements limiting lending to certain types of activity were removed, particularly for thrift institutions and private development banks. The Central Bank also created the category of expanded commercial bank, or "unibank", with a minimum capital requirement of P/500 million, and with the ability to engage in underwriting and purchase equity of non-allied businesses.

The reform efforts of the early 1980s had some success in improving the performance of the financial sector. Between 1980 and 1983 financial mobilization increased, as did the share of bank loans of medium and long term maturity. However, this initial progress was interrupted by the balance of payments crisis in 1983 and the financial crises that followed.

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[4]Patrick and Moreno (1985) estimate that there were 8 banks closely associated with the Marcos Administration. Even banks not associated with the government made behest loans, since there were a variety of ways to threaten or punish a bank that refused to cooperate.

2. The 1983-86 Financial Crisis

Although Philippine financial markets have always been crisis prone, the 1983-86 period is by far the worst that the country has ever experienced. Even for financial institutions that survived, this was a wrenching and traumatic experience, and one that still casts a pall over current financial operations.

In addition to the swings in confidence that affected some institutions, difficulties for financial institutions came from three sources:

1. sharp rises in interest rates,

2. disintermediation,

3. the domestic recession that forced many borrowers into insolvency.

When the Central Bank began selling its own bills in 1984 to rein in the money supply, interest rates jumped. Deposit rates rose sharply as banks were forced to compete with these "Jobo" bill yields -- which went up to as high as 44 percent -- and as depositors preterminated existing deposits. Even though most loans were short term, banks were caught in an intermediation squeeze as the yields on their existing portfolios failed to keep up. Banks also felt the effects of high reserve requirements and agricultural lending restrictions, which trapped a large proportion of their resources in low-yielding assets.

The direct sale of government securities to the non-banking sector drained the resources of financial institutions. Between 1983 and 1985 the real resources of the commercial banking system fell by a third. Finally, the loan portfolios of financial institutions deteriorated sharply with the severe domestic recession, and with the shift of bank asset portfolios towards government securities.

The effects of the crisis were felt across the financial system. Finance companies and other money market institutions were hit particularly hard, and a variety of abuses were discovered in the wake of the failures. The money market that had grown so rapidly during the 1970s essentially disappeared as depositors lost most of their placements. One major savings bank, Banco Filipino, experienced a run and required P/3 billion in support from the Central Bank before it was finally closed. Philippine Veterans Bank was closed, and four other commercial banks were absorbed by larger institutions. A second interest rate shock occurred in 1986, when the Central Bank again sold its own securities to reduce the money supply in the wake of the election campaign and revolution.

The effects of the crisis period on the behavior of financial institutions could be clearly seen in 1986 and 1987 in the high liquidity of financial institutions, and the unwillingness to lend for all but the safest investments and shortest maturities. Although difficult to measure, financial crisis period still affects the willingness of commercial banks and other financial institutions to compete and take risks.

D. Status of the Financial Sector

1. Financial Liberalization

The structural reform measures adopted by the Marcos and Aquino governments addressed two of the critical financial sector problems described above. The first was a liberalization of the financial sector, abolishing interest rate controls and dismantling selective and priority credit allocation schemes. Interest rate ceilings on loan and deposit rates have been removed, and banks are free to compete on price for deposits and loan accounts. Questions remain about the extent to which financial institutions have actually competed on price terms, as tacit co-ordination of interest rates has appeared to characterize the industry. But the ability of interest rates to respond to inflation and domestic credit stringency was demonstrated starting in 1984, when banks and other financial institutions were forced to compete with the Central Bank in attracting depositors' funds. Interest rates on both deposits and new loans increased rapidly.

The selective and priority credit allocation schemes that proliferated during the martial law period have also largely been eliminated. The variety of Central Bank rediscount windows have been reduced to just a single facility, with the rate tied to market interest rates. Central Bank non-emergency loans to commercial banks have been reduced by 88 percent since 1983. The Central Bank continues to rediscount export loans and some food production loans coursed through the rural banks. A variety of agricultural loan funds have been combined in the Consolidated Agricultural Loan Facility (CALF), but these total only about a half a billion pesos, and the facility is primarily a guarantee fund rather than a subsidized credit fund.

The remaining credit allocational policy is the agri/agra requirement facing commercial banks. Under this policy, banks are required to direct 15 percent of their lending to agriculture and 10 percent to agrarian reform loans. In practice the first requirement has not been binding, since an inclusive definition of agricultural industries was adopted. The agrarian reform requirement still persists, but, as is discussed below, is in reality a scheme for channelling low interest rate funds to the government rather than a program of credit support to agrarian reform.

2. Government Involvement

The second achievement of the financial sector reforms and reorganization is that the government involvement in the financial sector has been substantially reduced. This was principally accomplished by the reorganizations of the Philippine National Bank and the Development Bank of the Philippines, which greatly reduced the size of each institution.

Also, government influence over the direction of loan funds has also diminished greatly following the elimination of the subsidized credit schemes described above, and following the collapse of external borrowing.

At this point the strongest influence of the government on the direction of loans is as a borrower. Since 1984 the public sector has been forced to finance its deficit almost entirely through domestic borrowing, in competition with private borrowers. The period since 1984 has seen a decisive shift in domestic credit toward the public sector and away from the private sector, as the government has borrowed both from banks and directly from the public.

A remaining area of government influence in the commercial banking sector is the six banks that were acquired from the private sector by the Marcos Government, and that still remain in government hands.[5] These banks are small, and together account for only 8 percent of total commercial bank assets. Shares of several of them have been sold to the private sector, although the government retains a controlling interest in each. Complete privatization of these banks is made difficult by their dependence on government deposits and government accounts for their current viability, and because of that fact the current minority shareholders are likely to oppose complete privatization. These six acquired banks remain a visible reminder of the past role of the government in the financial sector, and their sale should be pursued.

However, a more critical issue for the financial sector is the future role of PNB and DBP. The Philippine government has pledged to operate both on commercial principles. Neither would have access to government funds to cover losses, nor would they be subject to special privileges. The government has committed itself to fund any non-market (e.g. subsidized) loans by PNB or DB through specific budgetary transfers. The ability of the Philippine government to hold to this principle is critical to the financial sector, and the current (summer 1988) controversy over holding government deposits in commercial banks other than PNB is an early test of this principle.

E. Remaining Financial Sector Problems

Many of the structural and policy problems in the financial sector have already been addressed. Several structural issues remain, but the most important problems currently facing the financial sector are largely issues regarding performance. More extensive competition among financial institutions and more effective regulation and supervision are required. While policy leverage in these areas may be less, there are a few

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[5]The acquired banks are Associated Bank (acquired by DBP), Commercial Bank of Manila (GSIS), International Corporate Bank (NDC), Pilipinas Bank (PNB), and Union Bank (SSS and Land Bank.) The sixth bank is Republic Planters Bank, acquired in 1978.

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important changes that might enhance the effectiveness of the Philippine financial system.

1. Financial Intermediation and the Availability of Credit

Financial intermediation remains low in the Philippines, both historically and by regional standards. As Graphs 7.1 and 7.2 point out, broad money holdings relative to GDP have fallen in the years since 1983. However these measures may be somewhat deceptive in the case of the Philippines, because of the extensive sale of government securities to the non-bank public. These securities are safe, short term, and relatively liquid, and are thus close substitutes to time and savings deposits. When private, non-banking sector holdings of government securities are added to broad money, the extent of public financial asset holding has expanded significantly relative to output.

While the responsiveness of Philippine savings to interest rates may still be uncertain, holding of savings in financial form appears to be responsive to real interest earnings on financial assets.[6] The ability of the public sector to finance its deficit domestically indicates the responsiveness of wealth holding decisions to interest rates. This suggests that financial intermediation can develop strongly in the Philippines in response to positive real returns and a stable financial environment.

The extent to which the public sector has monopolized domestic credit in the Philippines is even greater than is suggested by Graph 7.2, since there has been a marked shift in bank lending toward the public sector. While this was not such a problem in 1985-1987, when investment demand in the Philippines was so depressed, the crowding out issue is likely to be more important as the Philippine recovery proceeds and investment demand increases. The debt crisis and rescheduling has made access to foreign funds far more restricted than during the previous administration, and therefore it is critically important for sustainable growth that the Philippine public sector deficit be reduced, freeing up domestic savings for the promotion of private sector investment.

The development of longer term lending remains a major issue. The stunted development of equity and bond markets, coupled with the lack of longer term loan finance, has saddled domestic firms with high financial risk. As Table 7.1 indicates, there has been modest improvement in the share of longer term loans in bank portfolios since 1984. Some of this is due to falling total bank loan portfolios, but, also due to increased longer term lending, particularly in 1986. The growth of longer term

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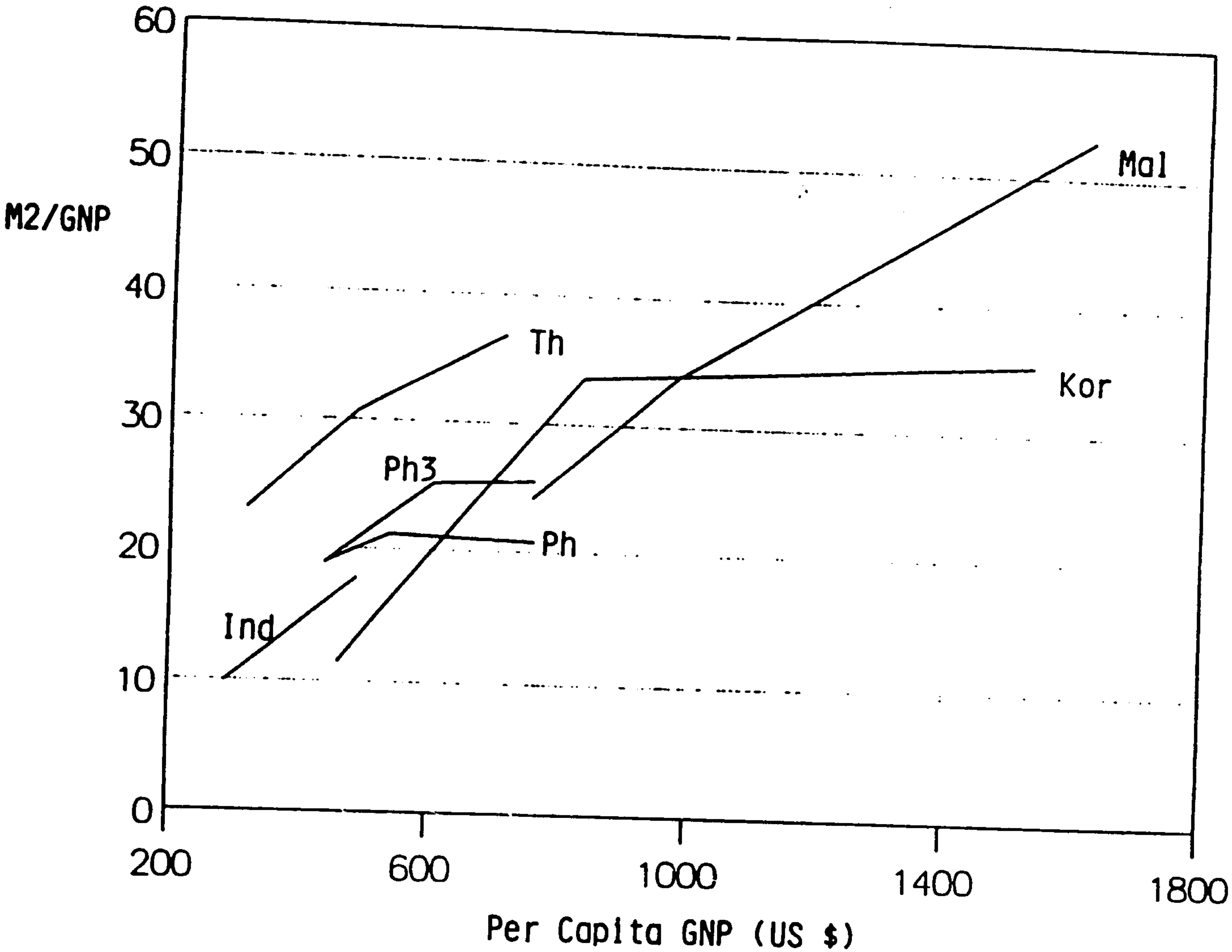
[6]Low inflation in the 1950s produced positive real deposit rates and a growth of bank intermediation. Deposit substitute holdings expanded rapidly in the 1970s, in response to the higher earnings on those assets, and financial intermediation increased modestly in the early 1980s in response to financial sector deregulation.

GRAPH 7.1
Philippine Financial Ratios

GRAPH 7.2

Financial Deepening in East Asian Countries (1960, 1970, 1980)



Ind - Indonesia (1970, 1980)
Kor - Korea
Mal - Malaysia
Ph - Philippines
Ph3 - Philippines (M3)
Th - Thailand

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Source: IMF, International Financial Statistics.

Table 7.1
Maturity Composition of Bank Loan Portfolios
(million Pesos)

Year	Demand	Short term	Medium term	Long term	Total
1981	10667 (12.3)	52823 (61.1)	14976 (17.3)	8038 (9.3)	86505
1982	9308 (9.5)	58478 (59.4)	17778 (18.1)	12676 (12.9)	98240
1983	10434 (9.4)	66792 (60.0)	16858 (15.1)	17304 (15.5)	111,388
1984	10624 (8.8)	7284 (59.9)	21035 (17.4)	16880 (13.9)	121,023
1985	8061 (9.2)	50038 (57.1)	14668 (16.7)	14807 (16.9)	87573
Sept 1986	8932 (9.9)	48557 (53.9)	16928 (18.8)	15743 (17.5)	90160

Numbers in parentheses are percentages.
Source: Latest published Central Bank Annual Report (1986).

lending has come from the pressure of prime borrowers for longer term funds, but almost all term loans carry adjustable interest rates, which is symptomatic of the caution of financial institutions.

2. Real Interest Rates and Bank Spreads

The period since 1985 has seen very high, as well as variable, real interest rates: ex post real interest rates for 90 day secured loans in 1987 were still almost 13 percent. Part of the high real interest rates on loans in the Philippines has come from financial sector reforms that have given depositors higher real return on their assets.

But to an important extent high real loan rates are the result of large spreads between deposit and loan rates. Data on bank spreads are shown in Table 7.2. The current spread between deposit and loan rates is on the order of five percentage points.

The Manila Reference Rate on money market transactions gives an estimate of the marginal cost of funds, and is available over a longer period. As the table indicates, spreads on this measure have been about four and one half percent recently. Table 7.2 also indicates that bank spreads have remained high in the past two years, despite the fact that banks are highly liquid.

Table 7.2
Commercial Banks
Average Spreads, 90 day Secured Loans

	Secured Loan Rate	Spread MRR	Spread Deposit Rate
1982 q1	16.79	NA	
q2	17.28	0.97	
q3	17.43	2.18	
q4	17.06	2.13	
1983 q1	17.51	2.80	
q2	17.77	3.18	
q3	18.27	3.14	
q4	20.57	4.30	
1984 q1	23.44	6.01	
q2	31.63	12.62	
q3	31.91	7.27	
q4	40.32	4.32	
1985 q1	35.16	8.56	10.65
q2	33.83	9.07	11.83
q3	25.90	6.06	9.16
q4	18.85	4.99	6.45
1986 q1	20.26	4.92	7.24
q2	18.86	4.33	6.01
q3	16.43	5.28	6.17
q4	14.04	4.41	5.16
1987 q1	12.28	4.90	5.58
q2	11.85	2.97	3.32
q3	12.93	4.04	5.10
q4	15.49	4.74	5.74

Source: Central Bank Philippine Financial Statistics various issues and Buhat, Vivien, "Movements in the Manila Reference Rates and Lending Rates of Commercial Banks (1982-1986)" CB Review (Manila) February 1987, pp. 26-29.

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The bank spread is made up of two components, the intermediation cost of the bank, and the spread over the bank's effective cost of providing loan funds (see Table 7.3). Intermediation costs in the Philippines arise from two sources; the first is the restriction that part of bank funds be placed in assets that earn less than the cost of funds to the bank. The second is taxation on bank interest earnings. Both have combined to add significantly to bank spreads.

Table 7.3
<u>Formula for Breakeven Bank Spread</u>

The breakeven spread occurs when interest earnings, net of the gross receipts tax, just match the cost of deposits. Earnings come from market lending, earnings on required reserves, and earnings on agrarian reform loans or securities.

$$(1-t)[D - rD - a(1-r)D]i_L + (1-t)(rD)i_r + (1-t)(1-r)(aD)i_a = Di_d$$

or, solving for the spread:

$$i_L - i_d = \frac{i_d - (1-t)ri_r - (1-t)(1-r)ai_a}{(1-t)(1 - r - a(1-r))} - i_d$$

where:

	Current Values
i_L = breakeven loan interest rate	
D = deposit holdings	
r = reserve requirement	.21
a = agrarian reform requirement (% of loanable funds)	.10
t = gross receipts tax	.05
i_d = deposit interest rate	.12 (time deposits)
i_r = yield on reserves	.04
i_a = yield on agrarian reform loans and agrarian reform eligible securities	.09

The first component of intermediation costs is bank reserve requirements. These currently stand at 21 percent for most deposits (time deposits of more than two years maturity have a reserve requirement of 5 percent.) Banks are required to hold 25 percent of their required reserves as deposits at the Central Bank, and the remainder may be held in cash or in certain reserve eligible government securities. The Central Bank currently pays 4 percent interest on reserves, well below current deposit rates. Although the reserve requirement has come down by three percentage points since the financial crisis, it is still three percentage points above its pre-crisis level.

The second component of intermediation costs is the requirement that banks direct 25 percent of their loanable funds to the agricultural sector, split 15 percent to agriculture, and 10 percent to agrarian reform. In practice the 15 percent "agri" requirement has not been binding, since banks have been able to easily meet the requirement through loans to food processing industries, among others. The 10 percent "agra" requirement has had a greater effect, and has been met primarily through the purchase of eligible government securities carrying an interest rate of 9 percent. Thus the requirement in large part has served as a way of channeling low interest rate funds to the national government. The final intermediation cost arises from the Gross Receipts Tax, which is levied at 5 percent on all interest earnings from loans of under two years' maturity.[7]

The effect of each of these provisions is to raise the spread over deposit rates at which the bank breaks even. At current values for reserve requirements and deposit rates, the breakeven spread is 3.6 percentage points on time deposits of under two years maturity, which is a substantial portion of the total spread of secured loan over deposit rates.[8] What is particularly troublesome about these intermediation cost measures is that their effect increases when inflation, and thus deposit rates, increases. This is because the yields on reserves and agrarian reform eligible securities are fixed, and because the gross receipts tax is applied to nominal interest earnings, a part of which are really repayment of principal in an inflationary setting. The combination of these three measures has been estimated to have added almost 12 percentage points to breakeven spreads during 1985.[9]

The agrarian reform lending requirement and the gross receipts tax should be rescinded, and the level of reserve requirements reduced in the

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[7]The GRT rate is 3 percent on loans of two to four years' maturity, and 1 percent on loans of over four years maturity.

[8]The formula for calculating breakeven spread is shown in Table 7.3.

[9]Valenzuela, R. "The Availability and Cost of Credit: Situationer for the Industrial Sector", May 12, 1988, Table 6.

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Philippines. Each as they now stand constitute a tax on the intermediation function. Their effect is to increase real loan interest rates and discourage investment, particularly longer term investment, in the country.

Neither the agricultural lending nor the agrarian lending requirement serves its function of increasing the flow of financial resources to the rural sector, and neither was able to prevent the sharp drop in credit to the rural sector that took place in the 1980s. Reserve requirements in the Philippines are far in excess of those in neighboring countries, and do not add to the safety of the financial system, particularly in an inflationary environment. The original financial liberalization plan called for a reduction of reserve requirements to 16 percent, and a reduction to at least this level is warranted. (An alternative, and in fact a useful complement to reduction in reserve requirements is a rise in the interest yield on reserve holdings at the Central Bank.) Finally, the gross receipts tax is an inefficient substitute for a tax on bank incomes, since most of it is likely to be passed on to the borrower.

The arguments against measures to reduce the intermediation tax are all fiscal. The gross receipts tax brought in P/1.2 billion in 1986 and P/846 million in 1987, or 1.8 and 0.9 percent of total tax revenue, respectively. The agrarian reform measures channel funds to the national government at rates below the cost of ordinary Treasury bills when commercial banks purchase agrarian eligible securities. Refinancing the stock of existing agra securities at current Treasury bill rates would add about P/300 million to the annual domestic interest burden of the Philippine government.

The high level of reserve requirements in the Philippines is also a form of taxation, since it raises the seignorage that the government enjoys through base money creation. Thus there would be an increased fiscal burden in the reduction of required reserve holdings. Reductions in reserve requirements also increase the money multiplier, and thus complicate monetary targets. The Philippines could avoid this problem by reducing reserve requirements and simultaneously phasing out reserve eligible securities, refinancing them with non-eligible market rate securities. Currently, there are P/4.3 billion of reserve eligible securities, enough to allow a reduction of reserve requirements for commercial banks to 18 percent without creating excess reserves. Refinancing the reserve eligible securities at market rates would add about P/470 million to interest service costs.

3. Supervision of Financial Institutions

The problems of supervision of financial insitutions have not been ones of inadequate authority or regulatory power. Rather, the problems have been ones of inadequate implementation of existing authority, or inability to enforce sufficient sanctions against offenders. The almost negligent supervision of finance companies and the commercial paper market by the Securities and Exchange Commission is the best recent example of the first problem. The inability to enforce sanctions, and thus to deter abuses, is a more general problem of the Philippine legal system, and affects the banking system in particular because of the close association of regulators and regulated.[10] The continuing legal challenges to the decision to close Banco Filipino, is an example of the difficulty in enforcing closure of financial institutions.

The current approach of the Central Bank has been to encourage the consolidation of financial institution, through the absorption of smaller, weaker institutions. Since many of the smaller banks in the Philippines have been family-owned and managed, this approach is likely to strengthen the overall quality of financial institution management. Consolidation of this kind is unlikely to lead to a significant reduction in competition among banks, since the market is relatively unconcentrated, and only a few of the (larger) banks are aggressive competitors. But the benefits of consolidation should not be overstated; consolidation largely deals with the effects of a weak financial system, and only tangentially with its source.

Two things are required of an effective supervisory system. The first is timely monitoring and the identification of potential problems as early as possible. The development of financial yardsticks, and the publication of a watch list, or independent credit ratings, would encourage financial institutions to address problems at an early stage. The second requisite is the ability to bring sanctions against offenders, through receivership, and in cases of fraud, through prison terms.

One area where current policy is inadequate is the protection of depositors. Deposit insurance exists in the Philippines, but the capitalization of the PDIC is low, and coverage is limited to P/40,000 (about $2000) per depositor. A strengthening of the PDIC, and a substantial rise in the coverage ceiling would encourage financial mobilization, longer term deposits, and also deposit stability. However deposit insurance without adequate supervision is a waste of resources. The PDIC should be given adequate supervisory powers, perhaps in conjunction with the Central Bank, and the ability to vary premiums on the basis of assessed risk of various institutions.

4. Encouraging Bank Competition

The reduction of bank spreads, and the provision of credit to non-traditional borrowers -- medium and smaller firms, and rural sector borrowers -- will require more extensive and effective competition among commercial banks. Currently there is strong competition only for the loan accounts of large domestic and multinational firms. Banks offer little incentive for deposits, depositor service is generally poor, and

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[10] The long association of Jose Fernandez, the Central Bank Governor, with the Far Eastern Bank and Trust Company, has made enforcement more difficult, and encouraged legal challenges to Central Bank actions.

there is little competition for new accounts with firms below the top 500.

The lack of competition is largely a product of the environment in which banks have operated. In the 1960s and 1970s Philippine banking was very comfortable. No new banking licenses have been granted since 1965. Interest rate controls on deposits, and excess demand for credit produced economic rents for commercial banks. The largest industrial firms were willing to borrow short term, so there was little need on the part of banks to develop sophisticated credit analysis. Although financial liberalization came in the 1980s, the financial crises of that period reinforced the caution and conservatism of commercial banks.

Central Bank policies designed to strengthen the financial system have also worked to diminish competition. The absence of any new bank licenses has eliminated the threat of entry. In addition, it has become virtually impossible to obtain a license for a new branch, which has limited the competition among existing banks for deposit accounts.

The primary elements of a policy to encourage competition are financial liberalization and financial stability. Banking competition, particularly on margins, is likely to be stronger when total resources of the banking system are growing. Banks will undertake more intermediation risk in a stable financial environment. The maintenance of economic growth, and stable and low inflation, will be a powerful spur to banking competition.

The restrictions on entry and bank branching should be relaxed, if not eliminated. Short of granting new institution licenses, the Philippine government could encourage the sale of the acquired banks to new, and perhaps foreign, entrants, once their balance sheets have been cleaned up and they are able to exist independently of government support. The Central Bank could also encourage new, perhaps foreign, investment in existing, smaller institutions. The restriction on new bank branches should be lifted -- at the least outside Metro Manila where the Philippines is not overbanked. In some areas, existing but non-operating bank branches have prevented the establishment of new branchs. In these areas branch licenses could be re-bid, perhaps with some payment to the current licensee. The Central Bank might also experiment with temporary branch licenses, where maintenance of the license would be conditional on deposit mobilization.

The Philippine government could encourage competition by spreading its sizable deposits more widely and bargaining for higher returns on its cash balances. The recent practice of maintaining large balances with little or no interest return has generated substantial rents. It has also encouraged slow processing of payments claims, by PNB in particular. There is no reason that government deposits should be restricted to a government-owned bank, and little to recommend the payments of large rents to a government-owned body.

F. Rural Financial Markets

1. Introduction and Background

Money is a fungible commodity and any study of the rural financial system cannot be made in isolation from the financial system as a whole. However, the rural financial system does have certain characteristics which make it necessary to examine it separately from the broader financial system.

Rural areas are served by commercial banks, specialized government financial institutions, and over 1000 rural banks. But banking services, however measured, are heavily concentrated in Metro Manila. Outside the National Capital Region the density of banking services is much lower, and 42 percent of the municipalities in the Philippines have no banks.[11] Although 84 percent of the banking system's resources originated in Manila, Philippine commercial banks use their rural offices as deposit generators, for relending in Manila, as Table 7.4 points out.

Table 7.4
Philippine Banks
Loan to Deposit Ratio

Type of Bank	Metro Manila	Rural*
Commercial Banks	85.6%	47.5%
Private Development Banks	95.7%	46.3%
Savings Banks	89.2%	9.1%
Stock Savings & Loans Assoc.	68.3%	78.8%
Rural Banks	77.3%	184.0%

* Defined as outside Metro Manila.
Source: Central Bank, "Study on Strategies for the Expansion of Banking Services in Rural Areas" (Manila; 1987)

Rural banks receive much of their funds from the Central Bank and lend almost all of their resources in their area of incorporation, thus the high loan to deposit ratio outside Metro Manila. The stock savings and loan association show no definite regional bias indicating that resources garnered in an area tend to be spent in the area.

Despite their bias in favor of Metro Manila, the commercial banks accounted for over 50% of the loans placed outside the capital. Next in

[11] The proportion of municipalities without banks ranges from a high of 76% in the Eastern Visayas Region to 36% in the Ilocos Region.

importance are the rural banks, providing a further 27.4% of loans outstanding. Effective commercial bank lending in rural areas may in fact be much greater, since many large agro-industrial and agricultural corporations borrow funds through their Manila Head Offices for use elsewhere in the country. However for small and medium borrowers in rural areas the most important formal sector source of funds are the rural banks.

2. Rural Banks

Rural banks were first chartered in 1952 to channel credit to the agricultural sector. Although they account for only 2.6% of the assets of the financial system, they provided over 10% of the total institutional credit to agriculture. Most are small, one office operations. Their clientele are the small farmers, and their average loan size in 1985 was about P/7,500. Well over 80% of their loans are in agriculture, although they account for only a third of formal credit in the agriculture sector. Most of their loans are short term production loans.

Today a majority of the 1000-odd rural banks are facing trouble, and the survival of many of them is in doubt. During the financial crisis of 1984-86 over 100 rural banks became insolvent, and rural bank arrearages as a proportion of Central Bank rediscounts reached 83 percent in 1985.[12] As of December 31, 1986, only 875 of the 1021 licensed rural banks were operating.

The Central Bank has been involved in rehabilitation efforts for the country's rural banking system. According to its Rural Bank Rehabilitation Review Committee, of the 1000 odd rural banks:

- 28% have a risk asset ratio below 10%
- 72% have past due ratios over 25%
- 47% have legal reserve deficiencies
- 48% have capital deficiencies
- 80% have arrearages with the Central Bank (CB)
- 36% incurred losses from operation
- 13% have negative net worth
- 74% are no longer qualified to rediscount with CB.

Despite these problems the official commitment to rural banks is strong, as they remain the most effective formal sector conduit of resources to the agriculture sector. They are currently participating in 27 out of 38 credit programs (21 locally funded and 6 foreign funded).

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[12] Philippine Government, Ad Hoc Study Group on the Rural Financial System (1986) p 23.

3. Noninstitutional Rural Credit

Despite the contribution of rural banks, the informal sector continues to provide the bulk of the funds available to rural borrowers. This is particularly true for small farmers. Noninstitutional lenders charge a risk premium, yet their repayment records are significantly better than those of the formal sector.

The sources of informal credit include family, friends and traditional money lenders, but also input suppliers and buyers. Input suppliers have become more important as more input intensive and high yielding varieties are planted. In many cases these sources are on-lending funds borrowed under other headings from the formal sector. Under normal circumstances, these funds would not be available to small borrowers not having a credit history or much collateral. There is, however, some degree of competition among input suppliers.

4. Subsidized Lending for Agriculture

The Philippines has attempted to channel low cost funds to agricultural activities, as have many LDCs. This was done initially through the creation of the rural banking system that was heavily dependent on Central Bank support. Later on it became dependent on the agri/agra lending requirement for commercial banks, the Masangana 99 program of credit subsidy, and other subsidized rediscount windows at the Commercial Bank. As in other countries, the results have been unexpected and disturbing.

Despite the efforts to channel credit to agricultural activities, the Philippines has not succeeded in moving resources in this direction. More recent economic analysis of the allocation of credit between subsidized and unsubsidized markets indicates that a subsidization scheme might well lead to a lower volume of credit allocated to the favored sector.[13]

The Philippine government has recently closed its subsidized rediscount window for agriculture, and a single rediscount facility, tied to the market rate, was established. The Comprehensive Agricultural Loan Fund (CALF), which merged 17 separate commodity loan funds, was created as a <u>guarantee</u> fund to encourage more lending to the agricultural sector by absorbing some of the risk. The Central Bank has begun to recognize the importance of rural savings mobilization and the informal credit sector, and has emphasized both in its rehabilitation program for the rural banking system.[14]

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[13]See Lamberte, Mario, and Joseph Lim, "Rural Financial Markets: A Review of the Literature" PIDS Staff Paper no. 87-02 (Manila; Philippine Institute for Development Studies, 1987).

[14]See Llanto, Gilberto, "Rural Credit Policy: Do We Need to Target?" <u>CB Review</u> (July 1987):25-31,36.

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Both the agricultural lending requirement and the agrarian reform loan requirements remain in force, as was discussed above. There appears to be a growing sentiment to drop the agrarian reform lending requirement in favor of a single requirement.[15] Yet even this is too restrictive, as Gustav Ranis has argued in several briefings prepared for USAID Manila-- rural credit extending beyond agricultural activities is an important rural need.

G. Recommendations

1. Corporate Sector

a. Government policies that increase the cost of bank intermediation should be removed, and alternate sources of government finance should be identified. In particular:

   1) The gross receipts tax should be removed. (Budgetary cost: approximately P/ 1 billion).

   2) The agrarian reform lending requirement should be lifted. Lending quotas for the agricultural sector should be replaced by other measures that encourage rural finance. If an agricultural lending requirement is retained, it should be a single requirement, defined as broadly as possible. The agrarian reform eligible government securities should be replaced by ordinary Treasury borrowings. (Budgetary cost: approximately P/ 0.3 billion.)

   3) Reserve requirements on bank deposits should be reduced in stages, with a preliminary goal of 18 percent. Government reserve eligible securities should be replaced by ordinary Treasury borrowings. (Budgetary cost: approximately P/ 0.5 billion.)

b. Supervision of financial institutions should be strengthened, in particular with stronger penalties for offenders, including criminal penalties in cases of fraud or misappropriation.

c. The capitalization of the Philippine Deposit Insurance Corporation (PDIC) should be increased, and the maximum insured deposit raised to P/ 100,000 per depositor.

d. Restrictions discouraging bank branching should be lifted, in particular for areas outside Metro Manila. Foreign investment or acquisition should be encouraged in cases where it can improve the

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[15]See Caneda, Leo, "Recent Developments on the Agricultural Credit Quota Policy" CB Review 40:3 (March 1988):14-19.

management and competitiveness of smaller banks, or banks acquired by the national government.

e. The regulatory and technical assistance tasks performed by the Central Bank should be separated.

f. The national government should undertake a more aggressive and diversified program of cash management to encourage competition among financial institutions for government accounts.

2. Recommendations for Action on Rural Credit

a. Remove restrictions on branching of banks in rural areas -- while Metro Manila is overbanked, rural Philippines is not. In some regions over 50% of the municipalities have no banking offices.

b. As a corollary to the above, restrictions on expansion and formation of rural banks should be relaxed, although at the same time they should be monitored better. The present restrictions are based on the fear that concentration of ownership (i.e.holdings of 25% or more by individual families) will adversely affect borrowers. If restrictions on entry and expansion of banking in rural areas are dropped then competition would take care of the borrowers' interest.

c. As the recent rural banking study notes, a significant proportion of the rural banks are in financial trouble. Those beyond help should be helped to close down, and the others rehabilitated.

d. USAID should follow up its present Rural Banking Project with another. A 1988 study confirms that for major crops, availability of rural bank credit is a key determinant of productivity increases.[16]

[16] Supply Response in Philippine Agriculture, Economic Working Paper # 2, Louis Berger International, National Road Improvement Project.

Chapter 8

Chapter 8. The Agriculture Sector

A. Introduction

The agriculture sector is the most important single sector in the Philippines, adding about 29% of GDP in 1987, and accounting for over 50% of the total national employment in 1986. When one includes semi-processed and processed agricultural products, approximately $1 billion of agricultural goods were exported -- comprising nearly 25% of total exports. However, the 25% contribution is deceptively low when one takes into account domestic value added. The domestic value content of agriculture-based exports is very high compared to most manufactured exports. If one considers the low domestic value-added component of other exports, the contribution of agriculture to net export earnings is overwhelmingly important.

The sector was the least affected by the 1983 recession. Growth in the agriculture sector between 1970 and 1986 was about 3.9% overall, and 5.0% in the crop sector. (Crop sector growth is higher due to a 7% decline in the forestry sector over the period.) Overall sector growth was slowed by the 1980s recession, dropped to under 3% during 1981-86. National GDP growth fell from over 5% in 1970-86 to about 1% during 1981-86.

This report is not intended to be a comprehensive review of the agriculture sector in the Philippines. USAID's long involvement with the agriculture sector has generated a wide variety of reports and surveys, which provide fairly detailed knowledge of the sector. This chapter will focus on policy issues where the agriculture sector activities are influenced by other sectors. As a methodological approach to identifying cross sector influences, the study begins by isolating the key sources of agricultural growth, and then proceeds to discuss the constraints that impede the fullest development of those sources of growth.

B. Potential Sources of Growth in Philippine Agriculture

Historical evidence indicates that the potential growth in Philippine agriculture will come from crop diversification and the growth of aquaculture, livestock, and poultry. The data in Table 8.1 shows that while the three traditional crops -- rice, corn and coconuts -- occupy 83% of cropped area, they produce less than 60% of output. The other 20-odd significant crops occupy about 16% of the area and produce almost 41% of the value of production. The highest impact ratio, defined as the percent contribution to production divided by the percent of area cropped, is for mangos, at 8.12. (An impact ratio of one indicates that the contribution to value equals share of area cropped.) Other high impact crops are pineapples (7.60), vegetables (6.67), coffee (4.05) and sugarcane (3.16).

Table 8.1

Structure of Crop Production Showing Possible Benefit from Diversification /1

Crop	Area Cultivated 1976	Area Cultivated 1986	Value of Prod. (millions) 1976	Value of Prod. (millions) 1986	Value/Hectare 1976	Value/Hectare 1986	Share 1986 Area	Share 1986 Value	Impact Ratio/2
Foodcrops									
Palay (Rough Rice)	3,674	3,402	3,720	6,066	1,013	1,783	27.8%	39.7%	1.43
Corn (shelled)	3,193	3,545	1,437	2,134	450	602	29.0%	14.0%	0.48
Banana	298	330	544	798	1,829	2,416	2.7%	5.2%	1.94
Mango	36	49	394	492	11,018	10,103	0.4%	3.2%	8.10
Pineapple	35	60	347	562	9,871	9,454	0.5%	3.7%	7.58
Other Fruits & Nuts(3)	65	68	369	166	5,692	2,431	0.6%	1.1%	1.95
Citrus	22	26	162	102	7,254	3,854	0.2%	0.7%	3.09
Rootcrops	401	423	552	607	1,377	1,435	3.5%	4.0%	1.15
Other Vegetables(4)	74	67	534	554	7,248	8,296	0.5%	3.6%	6.65
Beans & Peas	63	50	93	78	1,488	1,574	0.4%	0.5%	1.26
Coffee	77	148	392	745	5,102	5,040	1.2%	4.9%	4.04
Cacao	4	15	28	36	6,883	2,375	0.1%	0.2%	1.90
Peanuts (Unshelled)	61	50	79	83	1,297	1,657	0.4%	0.5%	1.33
Other Foodcrops	84	82	275	245	3,267	2,999	0.7%	1.6%	2.41
Commercial Crops									
Coconut	2,521	3,262	965	820	383	251	26.6%	5.4%	0.20
Sugarcane	573	356	1,535	1,397	2,681	3,925	2.9%	9.2%	3.15
Abaca	244	162	150	80	616	496	1.3%	0.5%	0.40
Native Tobacco	52	22	60	23	1,160	1,047	0.2%	0.2%	0.84
Virginia Tobacco	34	34	62	85	1,813	2,461	0.3%	0.6%	1.97
Ramie	0	3	0	44	2,397	13,030	0.0%	0.3%	10.45
Rubber	55	75	74	91	1,340	1,208	0.6%	0.6%	0.97
Maguey	3	3	1	2	462	575	0.0%	0.0%	0.46
Other Commercial Crops	2	9	2	53	1,438	5,949	0.1%	0.3%	4.77
Total	11,569	12,240	11,778	15,263	1,018	1,247			
-Food Crops	8,086	8,313	8,927	12,667	1,104	1,524	67.9%	83.0%	1.22
-Commercial Crops	3,484	3,927	2,851	2,595	818	661	32.1%	17.0%	0.53
Comparison of Value									
-Rice, Corn, & Coconut	9,388	10,208	6,122	9,020	652	884	83.4%	59.1%	0.71
-Other Crops	2,181	2,032	5,656	6,243	366	363	16.6%	40.9%	2.46

Notes:
1. All values deflated to 1972 prices based on producer price index by crop.
2. Impact Ratio is derived by dividing percent value by percent area.
3. Other fruits and nuts includes atis, avocado, caimoto, cashew, chico, guayabano, jackfruit, lanzones, papaya, pili and watermelon.
4. Includes cabbage, eggplant, garlic, pechay, radish, tomatoes and ginger.
5. Other Commercial Crops includes castor beans, kapok & seeded cotton.

Despite the phenomenal rate increase of per hectare productivity in palay production, most of the growth in crop production can be traced to diversification to non-traditional higher valued crops. The results of a recent World Bank Agriculture Sector Strategy Review (Report No. 6819-PH), which estimated the sub-sectoral contributions to agricultural growth between 1970 and 1986, are reproduced in Table 8.2. Table 8.3 shows the ranking of crops by production value per hectare, and Table 8.4 estimates average crop net yields per hectare.

Table 8.2 shows clearly that traditional items such as forestry and sugar made a net negative contribution to sectoral growth. The most important source of growth, accounting for almost 38% of the growth, was diversification to other crops, primarily pineapples, mangos, coffee and vegetables. The next most important contributors were rice, fisheries, and poultry. The growth in rice came primarily as a result of the intensification of cultivation -- net area planted actually decreased but the irrigated area expanded.

The growth in fisheries is expected to continue, as demand for fish in international markets continues to grow. The main source of growth in fisheries is expected in aquaculture. However, since growth in fisheries depends so much on the international market, it is highly susceptible to the value of the peso. More on this will be discussed later.

The very high growth in poultry has brought it to a par with the livestock industry, which, while starting from a higher base has expanded relatively slowly over the past decade and a half. The demand for meat and poultry is primarily in the domestic market. A recent study has presented estimates of the income/expenditure elasticities of demand for various key product groups.[1] These elasticities are very high for meat, meat products, and dairy products. Therefore, growth in per capita incomes will lead to an accelerated increase in the growth in demand for poultry and livestock products. For the growth of the local dairy industry a devaluation of the peso would be particularly useful as they cannot compete at present with the dairy industries from Australia or New Zealand, or dumping by the EEC.

The data in Table 8.2 shows that coconuts had a high growth rate over the past decade and a half. A great deal of this past growth can be explained by bringing in more areas under coconut production. This is particularly true in Mindanao, where much of the tropical forests have been replaced by coconut groves. Now, this crop faces fierce international competition from palm oil and sunflower oil. The EEC is subsidizing exports of sunflower oil in the world market, while many countries are bringing into production large palm oil projects. Coconut

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[1] Economic Working Paper #3, Sources of Growth in Demand for Transportation Services, Qaiser M. Khan, Louis Berger International, National Road Improvement Project, Manila, June, 1988.

Table 8.2

Contributions of Agriculture to Growth by Key Crop and Subsector

	Gross Value Added P billion at 1972 Prices		Percent Share in Gross Value Added		Growth Rate	Contribution to Growth
	1970	1986	1970	1986	1970-86	1970-86
Rice	2.8	5.0	18.9%	18.3%	3.7%	17.5%
Corn	0.9	1.8	6.1%	6.8%	4.4%	7.6%
Coconuts	0.8	1.8	5.3%	6.7%	5.5%	8.4%
Sugar	1.0	0.8	6.6%	2.8%	-1.4%	-1.7%
Bananas	0.3	0.9	1.7%	3.4%	8.5%	5.5%
Other Crops	2.2	6.8	14.5%	25.1%	7.5%	37.8%
Total Crops	7.9	17.8	53.1%	63.1%	5.0%	75.1%
Livestock	1.8	2.3	11.8%	8.4%	1.5%	4.2%
Poultry	0.6	2.5	4.1%	9.4%	9.3%	15.6%
Fisheries	2.6	4.6	17.5%	16.7%	3.6%	15.8%
Forestry	2.0	0.6	13.4%	2.4%	-6.7%	-10.7%
All Agriculture	14.8	27.1	100.0%	100.0%	3.9%	100.0%

Source: Table 2, World Bank Report 6819-PH.

Table 8.3

Value Ranking of Different Crops in the Philippines

(Values in 1972 Prices)

Crop	Value/Hectare		Ranking		Increase in Rank
	1976	1986	1976	1986	
Mango	11018	10103	1	1	0
Pineapple	9871	9454	2	2	0
Other Vegetables(3)	7248	8296	4	3	1
Coffee	5102	5040	7	4	3
Sugarcane	2681	3925	9	5	4
Citrus	7254	3854	3	6	-3
Other Foodcrops	3287	2999	8	7	1
Virginia Tobacco	1813	2461	11	8	3
Other Fruits & Nuts(4)	5692	2431	6	9	-3
Banana	1829	2416	10	10	0
Cacao	6883	2375	5	11	-6
Palay (Rough Rice)	1013	1783	17	12	5
Peanuts (Unshelled)	1297	1657	15	13	2
Beans & Peas	1488	1574	12	14	-2
Rootcrops	1377	1435	13	15	-2
Rubber	1340	1208	14	16	-2
Native Tobacco	1160	1047	16	17	-1
Corn (shelled)	450	602	20	18	2
Maguey	462	575	19	19	0
Abaca	616	496	18	20	-2
Coconut	383	251	21	21	0

Notes:

1. Estimated from Data in NEDA yearbook.
2. All values deflated to 1972 prices based on producer price index by crop as presented in NEDA Yearbook.
3. Includes cabbage, eggplant, garlic, pechay, radish, tomatoes and ginger.
4. Other fruits and nuts includes atis, avocado, caimoto, cashew, chico, guayabano, jackfruit, lanzones, papaya, pili and watermelon.

Table 8.4

Estimates of Annualized Crop Returns per Hectare

(Philippine Pesos at 1988 Prices)

Crops	Returns per Hectare: Gross Value Added	Net Value Added	Net Profit
Seasonal Crops			
Rice (Irrigated)	10562	10146	6332
Rice (Rainfed)	3843	3623	1525
Corn	3842	3685	1756
Sweet Potato	6876	6650	3985
Eggplant	33006	32693	29106
Tomato	26857	26572	23263
Mungbean	7149	6933	3939
Annual/Biennial Crops			
Cassava	5968	5887	4914
Pineapple	29568	29311	26399
Sugarcane	9078	8791	8564
Perennial Crops			
Abaca	7265	6740	-2423
Banana	22310	21944	18009
Cacao	24969	24449	21929
Citrus	14487	14645	13244
Coconut	4509	4430	3028
Coffee	28210	28074	27214
Rubber	4077	3886	582

Source: Louis Berger International, "Farm Budgets for the Philippines, National Road Improvement Project, Economic Working Paper # 4, Manila, September, 1988.

production is unlikely to be a source of significant growth in the future.

C. The Principal Constraints to Growth in Philippine Agriculture

The key sources of potential growth in Philippine agriculture are going to be in non-traditional areas. The areas are identified below, together with their primary growth constraints:

Source of Growth	Primary Constraints
Fruits and Vegetables	Intra-island and inter-island transport costs. Overvalued peso making imports cheaper.
Fisheries (primarily aquaculture)	Overvalued peso and inter-island shipping costs.
Meat and Poultry	Intra and inter-island transport costs.
Dairy Products	Overvalued peso, EEC surplus dumping.

The removal of these constraints would certainly accelerate the growth and diversification of the agriculture. Sugar is not included in this list (even though Table 8.1 shows that it has one of the highest "impact ratios"), because the current structure of the world sugar market severely limits the possibility of expansion. Table 2 shows that sugar had a negative growth rate between 1970 and 1986, largely because principle export markets were more or less closed down. Even though the Philippines has a high quota in the U.S., future growth in sugar is unlikely.

A recent paper entitled "Supply Response in Philippine Agriculture"[2] shows a significant supply response to real price increases in rice and corn, and a lesser response to price increases in fruit and vegetables. This can be explained by the higher risk entailed in fruit and vegetable production: not only is the production perishable and cannot be stored, it is not a staple food. Growth, therefore, in the higher value added fruit and vegetable sectors requires reliable access to markets. It would also be assisted by the price effects of a devaluation in both domestic and export markets.

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[2]"Supply Response in Philippine Agriculture", Louis Berger International, Economic Working Paper #2, National Road Improvement Project, Manila, May, 1988.

1. Overvalued Exchange Rates

Competitiveness of the agriculture sector (and other export- oriented production) is being hampered by an overvalued peso. There is a need to realign significantly. Our estimates, based on purchasing power comparisons with neighboring (and competing) countries such as Thailand, suggest the that exchange rate is from 15% to 20% overvalued.

This overvaluation means that Filipino producers of shrimp, fish, vegetables, and fruit, face stiff competition from neighboring countries with similar resource endowments. Recently they have managed to compete in the shrimp market due to sharp appreciation in the value of the Japanese yen, as well the Korean won and the Taiwan dollar. Taiwan is a competitor while Japan is the major buyer. Even so, Filipino exporters found their costs to be significantly higher than other regional producers. The relatively rapid appreciation of the yen is unlikely to continue (and has already stabilized). Already, some of the larger Filipino producers of shrimp are exploring the possibility of expanding into other lower cost Asian countries.

Producers of fruits and vegetables would also benefit significantly from a devaluation, and would benefit in both export and domestic markets. Currently, Filipino fruit costs as much as imported apples or oranges in Manila supermarkets. Very high domestic transport costs partly explain this, but the fact that imports enter cheaply due to the high value of the Peso is also important.

The dairy industry is also affected by the high peso but not to the same extent as aquaculture, fruits, and vegetables. The effect is mostly indirect. Imports enter cheaply, even in the absence of dumping by owners of butter mountains like the EEC, and this keeps the price level relatively low. It is difficult to envisage that in the near future, even with a more competitive exchange rate, that the Philippines could become self-sufficient in dairy products. But it is desirable to develop a competitive dairy industry to the extent possible, as long as that is done without protection.

Devaluation would not only help exporters and domestic producers of perishable crops, it would also significantly improve the income distribution in rural areas. For example, the benefits from devaluation would accrue directly to coconut farmers, 50% of whom live below the rural poverty line. Rice and corn farmers, who are the largest group among those living below the poverty line, would also be helped.

2. Intra-Island Transport

Generally, the problems of intra-island transportation can be equated with the problems with roads and road transport. This topic is discussed at greater length in the Chapter 10. However, in terms of agriculture, the impact of poor intra-island transport is felt by the producers in terms of lower producer prices.

Traders' margins include transport, storage costs, and the cost of losses in transit through perishability and/or pilferage. In remote and inaccessible areas, the trader also earns a premium based on the lack of competition from other buyers. In practice, the buyer's control is more effective for perishable products and less effective in the case of non-perishable products. As the level of competition among buyers increases, more and more of the buyer's margin is transferred back to the producers, until it reaches the point below which buyers will not enter the market.

Producer prices will increase when the following happens:

- improved access to remote areas induces more competition between buyers, and

- transport charges and travel times fall.

Travel time is particularly important for perishable products such as fish. The longer the travel time, the more ice is required, and the higher the transportation cost.

3. Inter-Island Transport

Nearly all inter-island transport in the Philippines is by sea, and this is certainly the case for agricultural products. Chapter 10 goes into some length on the organizational and cost issues in inter-island shipping. It concludes that the problems of inter-island shipping loom large in impeding domestic resource utilization and resource-based exports. These problems also constrain the agricultural sector. No attempt is made here, however, to quantify the impact of cost inefficiency of the shipping industry on the production and marketing costs of the agricultural sector.

D. Other Important Issues

The other important issues that need to be covered are (1) rice marketing, (2) fertilizer and pesticide marketing, (3) rural credit, and (4) irrigation. These have all been previously studied by USAID and they will be given less prominence here.

1. Rice Marketing

The National Food Marketing Authority lost 2 billion pesos last year. As long as the NFA had monopoly ocntrol over the wheat market, the losses on the rice side were hidden by the guaranteed profits from handling wheat. The large current losses, however, are due more to the impossibility of its task, rather than to mismanagement.

The NFA's dual mandate requires it to support floor prices for farmers as well as provide ceiling prices for consumers. The World Bank Agricultural Sector Strategy Review noted that since the NFA's ability to purchase from farmers is limited to 5% - 15% of the rice crop, its impact on the market price of rice is negligible. The only way to defend a floor price is to be a buyer of last resort, and to be able to purchase everything that is offered for sale at that price. Budgetary implications of such a policy rule it out. It has therefore been better able to achieve the second of its two conflicting goals.

Given the NFA's impossible task, one policy question is to revamp the government's rice pricing policy. One approach would be to adopt a flexible import tariff. Under such a system a tariff -- adjusted yearly or seasonally -- would be set in order to maintain a producer floor price. The tariff would be based on the difference between the world market price and the recommended floor price. The price would be set by the National Food Council. Prices to consumers would not rise above that level because rice imports would become profitable in that case. The role of the NFA would then be reduced to an importer of rice stocks to keep consumer prices from rising in case of shortfalls.

In the medium term the Philippines is likely to be self-sufficient in rice. If a trade-oriented pricing policy is adopted, as just described, the need for keeping the NFA operating is questionable. The food import role can easily be filled by the private sector.

2. Fertilizer and Pesticide Marketing

The inefficiencies and debts of domestic fertilizer manufacturers have been imposed, in part, on the farmers. The government agreed to impose a 10 peso per 50 kg surcharge as part of an agreement to pay off the debts of PHILPHOS and Planter's Products. It seems inappropriate to place this burden on the backs of the poorest segments of the population--particularly since the debts incurred by Planter's were not even guaranteed by the government. The government has imposed a 20% duty on phosphate fertilizers in order to further protect PHILPHOS.

It is recommended that farmers pay no more than the world market price for fertilizer. This is effectively the case for urea and potash, and there seems to be no sound economic rationale for discrimination against farmers who use phosphates. Also, the Fertilizer and Pesticide Authority should guarantee the freedom of the private sector in the areas of fertilizer and pesticide marketing and distribution.

3. Rural Credit[3]

The formal financial sector tends to use rural markets for securing deposits, which are lent out to urban borrowers. The rural banks tend to somewhat reverse this process by borrowing funds from a Central Bank fund. The effectiveness of the Central Bank window is lessened, however,

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[3]Although this issue is discussed at greater length in the previous chapter, a few key points are summarized here.

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by the fact that many loans are given to the larger agricultural and agro-industrial corporations in Metro Manila.

Despite the contribution of the rural banks, the informal sector continues to provide the bulk of the funds available to rural borrowers. This is particularly true for small farmers. Although these lenders charge a risk premium, their repayment records are significantly better than that of the formal sector. Other sources of credit include input suppliers and buyers, who often extract repayment in kind. Input suppliers have progressively become more and more important as more input-intensive high yielding varieties are planted. There appears to be some degree of competition among input suppliers ensuring better interest rates for borrowers. In many cases these sources are on-lending funds borrowed from the formal sector. These funds would not be available under normal circumstances to small borrowers lacking a credit history or much collateral.

Attempts to limit rural bank lending to agriculture production do not make much sense. Even if the objective is to favor agriculture production over other types of rural activity, that objective will not be met since rural traders provide a significant proportion of the production credit to farmers. As Ranis notes, in his annual thoughts on the Philippines, "Rural credit must be seen as a whole".

4. Irrigation

The irrigation sector is in major need of rehabilitation, and irrigation maintenance must be improved. A recent simulation carrried out by the World Bank found the rates of return on irrigation operations and maintenance improvements to be over 20% (see below). It is important to note that these estimates were done in 1987, when rice prices were lower than now. Rice prices have risen sharply above the World Bank's projected prices. If re-estimated now, these rates of return would be higher, but the relative positions would remain unchanged.

Type of Project	Rate of Return
Rehabilitation	12.7%
O & M Improvement	18% to 25%
New Investment, Run of the River Systems	
-Large	7.0%
-Medium	7.3%
-Small	13.3%
Communal Systems	15% to 16%
Storage Systems	2.7%

The above figures demonstrate clearly that the best investments are in improving the Operations and Maintenance of existing systems. If irrigation command areas are to be expanded, it should be done through communal systems or small-scale run of the river systems. Recently, the government has expanded its budget for O&M and rehabilitation, but the penchant for large scale systems continue -- including investments in Storage Systems which have the lowest rates of return. In this context it should be noted that the important factor in making investment decisions in capital scarce countries is not only the absolute values of the rates of return, but also their relative values. The recent upsurge in rice prices may make the larger-scale schemes look feasible, but the important fact remains that the other types of investment are relatively better investments.

The other area of donor interest in irrigation is the cost-recovery issue. Recently, facing internal budget crunches, the National Irrigation Administration (NIA) has improved collection of irrigation service fees (ISF). This improved fee collection seems to be at the expense of maintenance. Technical staff were assigned to fee collection. However, the best time for fee collection is the immediate post-harvest period, when maintenance requirements are highest. The NIA allowed its workers a percentage of the fees collected as incentive. This meant that the incentive structure was biased against maintenance. In the long run this may reduce fee collections, as the farmers' willingness to pay depends on the quality of service received, i.e. on better O & M.

E. Recommendations for Policy Reforms

1. Key Policy Issues

a. Devaluation of the Philippine peso would be one of the most important contributions to improving the performance of the agriculture sector.

b. Encourage the development of private ports, which would provide competitive services to ports operated by the PPA. The PPA should not be given any operating subsidy and should have to compete with private ports. This policy would be a key to reducing port charges.

c. Deregulate inter-island shipping industry. The claims that this would reduce service to the smaller islands is not valid. It would probably reduce service by the higher cost lines to those islands, but the niche would be filled by others in a deregulated environment. USAID could further the debate by funding a study to examine the de-regulation of inter-island shipping.

d. Press for the development of smaller scale irrigation systems and the rehabilitation and maintenance of existing systems.

2. Secondary Policy Issues

a. Abolish the National Food Authority. USAID could fund the process of abolition by financing redundancy payments and/or retraining.

b. Deregulate intra-island transport.

c. Irrigation user charges should not be collected by the technical staff of the National Irrigation Authority.

d. Remove restrictions on the branching and expansions of commercial banks in rural areas. As a corollary to this, restrictions on expansion and formation of rural banks should be relaxed, though at the same time they should be monitored better (see Chapter 7). Also, USAID should follow up its present Rural Banking Project with another.

e. Tariff and surcharge protection of phosphate fertilizers should be removed, as farmers should not be responsible for non-government guaranteed debt of PHILPHOS. Also, the Fertilizer and Pesticide Authority should guarantee the private sector freedom in the area of fertilizer and pesticide marketing and distribution.

Chapter 9

Chapter 9. The Public Investment Program and Decentralization

A. Background

In the government's efforts to meet the requirements of a growing economy, and to veer away from dependence on imported energy, the rate of public sector investment in the Philippines rose gradually throughout the 1970s. By the early 1980s, however, with the second oil price shock and the ensuing world recession, the government stepped up the pace of its public investment program, both as a counter-cyclical measure and as a means of further reducing its dependence on imported oil. Import substitution through major industrial projects was also launched. The share of public sector investment in GNP increased from only 1.5% in 1970 to 6.0% in 1979, reaching a peak of 8.7% in 1981 (Table 9.1). This growth was financed increasingly through foreign borrowings, which by 1983 accounted for about 45% of the public investment program.

Upon hindsight, many projects proved to be ill-conceived, highly capital-intensive, and with long gestation periods. Since the government had also guaranteed the foreign borrowings of many private ventures which turned unviable and collapsed, it was left with a heavy external debt burden. The sudden drying up of foreign commercial bank credit forced the government into a severe austerity program where public investment had to suffer major cutbacks. Political expediency constrained the government from laying off workers. Between 1983 and 1985, total public investment in real terms dropped by almost 60%, and its share in GNP declining to 3.6% (Table 9.1). The decline was equally felt (in percentage terms) by both the national government and government corporations. In sectoral terms, industry experienced the heaviest drop (83%), followed by transport and communications (80%) and water supply (65%).

The public investment program would perhaps have suffered even greater cutbacks were it not for the accommodations from both bilateral and multilateral sources in extending program assistance through balance of payments and budgetary support. In 1984, for example, the USAID mission began providing program assistance that allowed the financing of the government counterpart contributions to selected foreign-assisted projects, the implementation of which was gravely delayed because of the lack of counterpart funds (see Chapter 3).

Maintenance and operating expenditures began to decline even faster then public investment, leading not only to the deterioration of infrastructure, but also to failure in the delivery of basic services. Unlike public investment, however, expenditures on maintenance, operations, and services recovered in 1986-87 from the lows of 1984-85 (see Table 9.2).

Table 9.1
PUBLIC SECTOR INVESTMENT, BY SECTOR
(P billion, at constant 1984 prices)

Sector	1981	1982	1983	1984	1985	1986	1987	% change 1983-85	% change 1985-87
Agriculture/irrigation	4.2	4.3	3.9	2.4	1.6	3.2	1.9	-59.0%	20.8%
Transport/communication	17.2	12.9	10.1	4.8	2.0	2.4	3.3	-80.2%	67.4%
Industry	2.8	3.7	1.8	0.3	0.3	0.2	0.3	-83.3%	-13.9%
Energy	14.2	11.8	14.8	8.3	6.8	4.9	3.9	-54.1%	-43.3%
Water supply/floods	3.9	3.3	4.0	2.0	1.4	2.0	1.4	-65.0%	2.9%
Education/health/housing	2.7	2.6	3.3	2.2	1.4	0.6	1.6	-57.6%	15.4%
Others	4.7	2.9	5.1	3.9	4.2	2.0	2.2	-17.6%	-46.7%
Total	49.7	41.5	43.0	23.9	17.7	15.4	14.7	-58.8%	-17.0%
National government	24.0	17.6	16.0	9.8	6.5	9.8	8.1	-59.4%	24.3%
Corporations	24.5	22.7	25.8	12.7	10.6	5.0	6.1	-58.9%	-42.6%
Local government	1.3	1.2	1.1	1.5	0.6	0.5	0.5	-45.5%	-18.1%
Share in GNP (%)	8.7%	7.0%	7.7%	4.6%	3.6%	3.0%	2.5%		

Source: NEDA, as cited by the World Bank (1987), p. 5, and the IMF (6/6/1988), p. 74.
NEDA, Updated Philippine Development Plan, 1988-92 (July draft).

Table 9.2

PUBLIC MAINTENANCE & OPERATING EXPENDITURES, 1982-1987

(In million pesos, 1984 prices)

	1982	1983	1984	1985	1986	1987	% change 1982-85	% change 1985-87
Economic services	5508	4582	3299	2774	2859	4985	-49.6%	79.7%
Agriculture	1176	880	496	598	647	1007	-49.1%	68.3%
Natural resources	328	278	180	149	426	489	-54.6%	229.1%
Trade/industry	879	657	276	288	174	205	-67.2%	-28.9%
Tourism	82	73	46	35	41	76	-57.5%	117.3%
Power & energy	117	141	71	53	124	1186	-55.0%	2151.1%
Water	23	21	18	16	*	*	-31.0%	*
Transport/communication	266[illegible]	2334	1990	1455	1413	1702	-45.5%	15.7%
Other economic services	236	199	222	181	34	321	-23.2%	77.5%
Social services	5648	4711	3472	3261	3359	4873	-42.3%	49.4%
Education/training	1938	1678	1409	1435	1676	1708	-26.0%	19.0%
Health	2283	2117	1339	1228	1359	1512	-46.2%	23.1%
Social security, labor	528	353	371	273	320	917	-48.3%	236.3%
Housing	597	157	130	129	**	**	-78.3%	**
Other social services	302	405	223	196	4	736	-35.1%	126.5%
Defense/gen. services	10873	8572	5633	5178	6423	7390	-52.4%	42.7%
Total	22029	17864	12404	11213	12641	17248	-49.1%	53.8%

* Included with transport & communication.

** Included with social security & labor.

Source: NEDA, as cited by the World Bank (1987), p. 6, and the IMF (6/6/1988), p. 70. Recomputed to reflect 1984 base prices.

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The IMF stand-by agreement entered into by the new Aquino government involved the commitment to the following measures with respect to the public investment program:

a. Reorient the public investment program to more rural- oriented and less capital- and import-intensive projects;

b. Restore public investment to 5% of GNP, with increases in maintenance and operating expenditures; and

c. Install improved procedures for the appraisal, contracting, and monitoring of investment projects.

The next three sections examine the extent to which the Philippine government has kept to these policy reforms. Following that, the issue of government decentralization is explored. A final section offers recommendations on policy issues related to public investment.

B. The Sectoral and Regional Distribution of Public Investment

The public investment program of the new government for 1987-92 initially showed a substantial reduction in the relative share of energy and power development, towards a more even distribution across sectors. However, with the decision to mothball the Bataan nuclear power plant, power development became once more the major focus of the public investment program, accounting for 29% of the public sector's capital expenditures in 1986-87 (Table 9.3). The energy sector also experienced fewer delays in project implementation than other sectors, notably in transport and communications, which saw their share drop to only 19% of public investment expenditures. Agriculture was the other important net gainers in 1986-87.

The NEDA's Updated Development Plan for 1988-92 (July 1988 draft) nevertheless continues to de-emphasize investment in the energy sector, projecting only a 20% share over the four years. The government looks forward to increased participation of private capital in source development, electrification, and downstream facilities to help meet the sector's total investment requirements. If this private sector "partnership" is achieved, then the pattern of public investment across sectors will appear to differ significantly from that of the first half of the decade.

The Updated Plan thus proposes a more balanced set of public investment activities across sectors, with agriculture, water supply, and social infrastructure (school buildings, health facilities, housing) getting about 12% each, while transport and communications comprise 31% of the capital budget. The double- digit share of social infrastructure arises from the government's new commitment to provide free secondary education. How well the government can achieve its public investment objectives will depend, of course, on the speed of project implementation. Dispersed rural projects, such as rural roads and water supply systems, tend to

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Table 9.3
PUBLIC INVESTMENT, BY SECTOR, 1981-87 AND 1988-92
(Percentage distribution)

Sector	(a) Including "Others" 1981-85	1986-87	1987-92 (old)	1988-92 (new)	(b) Excluding "Others" 1981-85	1986-87	1987-92 (old)	1988-92 (new)
Agriculture/irrigation	9.3	17.1	10.2	12.2	10.6	19.9	11.8	13.9
Transport/communication	26.7	19.3	28.5	31.1	30.3	22.4	33.0	35.3
Industry	5.1	1.6	1.0	1.0	5.7	1.8	1.2	1.1
Energy and power	31.8	29.0	24.7	20.1	36.1	33.7	28.6	22.7
Water supply/flood control	8.3	11.6	12.4	12.5	9.4	13.5	14.4	14.2
Education/health/housing	6.9	7.4	9.6	11.3	7.9	8.7	11.1	12.8
Others (incl. lump-sum)	11.8	14.0	13.6	11.8				
TOTAL	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Sources: NEDA, as cited by the World Bank (1987) for 1981-85 and 1987-92;
NEDA, Updated Philippine Development Plan (July 1988 draft) for 1988-92.

have greater administrative problems than capital-intensive energy projects.

In terms of regional orientation, the Updated Plan has included a greater number of projects emanating from the Regional Development Investment Program (RDIP) than before. A frequent criticism of earlier national planning efforts was that the larger projects identified at the national level received priority over regionally promoted ones. (The issue of decentralization is discussed below.)

The DPWH has drawn up a fund allocation process across project categories and across regions that attempts to be transparent and to explicitly take account of regional disparities.[1] However, some aspects of the procedure are subject to question. The regional apportionment of funds, for example, is made in proportion to the "cost of the needs" established in each region. This implicitly assumes that benefit-cost ratios are the same across project categories and across regions. As this is impossible to achieve, the distribution of resources across regions involves a substantial amount of value and political judgement.

In spite of these efforts to give the updated infrastructure program a strong regional and rural orientation, the 1988-92 program still shows a strong bias in favor of the richer regions, especially Metro Manila. There is a strong positive correlation between the regional per capita allocations and the Gross Regional Domestic Product (GRDP) per capita (Table 9.4). While negative relationships are observed in roads, airports, irrigation, and telecommunications, the correlations are weak; it is only with health facilities that expenditures strongly favor the poorer regions. Infrastructure expenditures per capita for Metro Manila are 72% higher than those for the next-ranking region (Cagayan Valley), and are three times the least favored regions (Regions VI and IX). Water supply and urban transport investments in particular account for a large portion (47%) of capital spending in Metro Manila.

C. Restoring the Level of Public Investment

The government has been having difficulties meeting its target level of public investment spending over the past two years. In 1987, out of an

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[1]The process can be summarized in four steps:

(a) The needs per project category are determined based on sector surveys.
(b) The total infrastructure investment ceiling is obtained from fiscal authorities.
(c) The total national infrastructure funds are apportioned among project categories in proportion to cost of needs.
(d) For each project category, the total national funds are allocated among the regions based on socio-economic factors (e.g., area, population, production, existing infrastructure, poverty incidence, etc.).

Table 9.4
PUBLIC INVESTMENT PER CAPITA, BY REGION, BY PROJECT TYPE, 1988-92
(In pesos per capita, 1988 population)

Project Type	NCR	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII	Correl. Coeff.*
1 Roads	739	924	1406	375	804	909	651	813	1231	739	828	617	1153	- 0.3526
2 Ports	345	42	144	5	152	121	55	131	89	72	118	105	18	0.7817
3 Urban Transport	660	0	0	0	0	0	0	0	0	0	0	0	0	0.9069
4 Railways	92	7	0	39	85	93	1	0	0	0	2	1	2	0.4928
5 Airports	4	1	8	0	6	8	13	70	11	20	14	25	12	- 0.0300
6 Water Supply	1623	97	111	202	91	134	90	149	102	132	122	93	132	0.9045
7 Irrigation	0	145	406	807	135	102	99	125	78	42	145	433	612	- 0.1691
8 Flood Control	348	153	92	171	34	175	37	31	28	22	150	59	57	0.6380
9 Schools	448	211	237	206	232	246	249	227	281	270	253	249	273	0.8021
10 Health Facilities	42	172	206	158	173	185	182	154	199	172	163	204	178	- 0.8927
11 Urban Infrastructure	393	15	0	9	20	9	31	0	7	4	54	63	19	0.9316
12 Telecommunications	100	211	180	317	164	174	185	252	103	164	341	269	211	- 0.1970
13 Postal Facilities	35	10	13	8	8	8	8	11	10	12	11	9	11	0.8460
Total	4828	1989	2802	2297	1905	2164	1601	1961	2140	1650	2202	2128	2678	0.7921
Total less (3)	4168	1989	2802	2297	1905	2164	1601	1961	2140	1650	2202	2128	2678	0.7354
Total less (3) & (6)	2545	1891	2691	2095	1814	2030	1511	1812	2038	1518	2080	2034	2546	0.2950
GRDP per capita, 1987	3959	1008	938	1408	1842	776	1344	1574	729	1117	1441	1736	1360	

* Correlation coefficient with 1987 GRDP per capita.

Source: NEDA, Updated Philippine Development Plan, 1988-92 (July 1988 draft).

approved infrastructure program of P/26.2 billion, only P/15.4 billion was released, of which only P/13.8 billion was actually disbursed. This level of disbursement was only 2.2% of GNP, way below the target of 4.0%. For the public investment program as a whole, only P/17.6 billion (or 2.5% of GNP) was disbursed, only 45% of the target. Prospects for 1988 do not look much brighter.

These low levels of public investment expenditures are at a time when government salaries have been adjusted significantly upward. The IMF has criticized the level of salary increases.[2] Part of the increase in personnel expenditures was also due to the retrenchment program for early retirement.

The shortfalls in infrastructure spending in 1987 have been attributed by NEDA to several factors:

a. Interruptions in project implementation due to:

- the election ban on public works;
- adverse peace and order conditions in some areas;
- government reorganization/change in officials;
- low implementing capabilities of some agencies;
- delays in preparing project documents and contracts, and in reactivating inactive projects.

b. Inadequacy of some feasibility studies such that financial assistance could not proceed quickly; and

c. Initial difficulties with "bottom-up" project development at the RDC level.

While the focus of much attention has been on implementation problems (see below), the last two factors deserve an equally close look. Many projects in the pipeline do need a thorough review, and for which substantial realignments in output and input prices have occurred. Also, as more responsibilities for project development are placed in the hands of the regional offices, technical capabilities to conduct feasibility studies are lagging.

D. Improving Project Appraisal, Contracting, and Monitoring

There is a celebrated backlog in the Philippine project "pipeline", which represents some $1.5 billion of approved but seriously delayed projects. Project implementation procedure are clearly inadequate. Without attempting any original analysis of the problem, a few key issues are highlighted here.

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[2] IMF, 1988, No. SM/88/113, May 25, 1988, Pg. 19.

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a. NEDA has recently completed a reorganization, which has clearly affected its ability to facilitate the project pipeline. It is too early to say, however, if the reorganization will help turn around the situation.

b. The Asian Development Bank has recently extended technical assistance to NEDA for a study on the formulation and monitoring of the public investment program. One output will be the design and installation of a computer system. The scope of work, however, focuses on the NEDA, even though it is recognized that project reports submitted by the proponent agencies are often inadequate for decision-making.

c. To help remedy the lack of expertise in the line agencies, the Project Development Institute was set up recently within the Development Academy of the Philippines to train the line agency personnel in project development work.

d. Implementation bottlenecks are being addressed by the cabinet-level Project Facilitation Committee (PFC). The PFC was set up in 1987 specifically to address the problem of delays in project implementation. It is too early to evaluate its impact.

Finally, in a minor gesture towards regional autonomy in project implementation, in late 1987 the government increased the fund ceilings for project authority at the local and regional levels. Local government units may now approve projects up to P/200,000, district engineers up to P/500,000, and regional directors up to P/3 million.

E. Decentralization

The above sections suggest project planning, programming, and implementation would all benefit by a greater degree of decentralized responsibility within the Philippine government. This implies decentralization of decision-making authority to the regional, provincial, and/or municipal levels. This section assesses the policy and institutional issues involved in accelerating decentralization.

In fact, decentralization has been a major priority of this government. Several major elements are coming together and the more detailed work seems underway. There are a lot of hurdles to be overcome and the process may yet take some time.

1. Decentralization Progress to Date

a. General Administration

The decentralization process has so far been stalled, due generally to the unwillingness of national legislators to surrender powers and priveleges to the local governments. They have also been aided by the desire of the staff of the national departments to maintain their links with Manila. Most of this has been done under the guise of the need for quality control.

Most National Departments charged with line responsibilities maintain staff at the Provincial level. The major exceptions is the Department of Public Works and Highways (DPWH), although some DPWH districts tend to follow the geographical boundaries of provinces and/or chartered cities. Provincial and City governments maintain their own engineering departments but they do not have either the equipment or the human resources of the corresponding DPWH district offices.

NEDA has regional offices but no provincial offices, where it relies on the Provincial Planning and Development Offices (PPDO). This is difficult at times due to the sharp variation in quality of the PPDOs.

Previous attempts at donor funded projects with Local Government Units (LGUs) have generally not succeeded primarily to due to the lack of qualified staff in these units. National government staff assigned to many of the local units were unwilling to work under the supervison of the local leadership. The local leadership were unable to effectively exert control over the staff because their tenure and promotion decisions were in the hands of the national departments.

b. Local Finance

The principal tax base of local government units is the property tax. This is collected by the municipalities and and a small percentage of that is transfered to the provinces. The provincial governments use their share of the revenue to help out municipalities with a low revenue base.

Under the previous government some revenue sharing was mandated. The sum mandated amounted to about 20% of total national revenues. However, the formula developed for allocation tied up the bulk of these funds for specific purposes and left little manoeuvering room to the local leadership. Furthermore, a revenue drawback system allowed automatic reduction of the allocated revenue shares in cases where there was a national government project benefiting the province. For example if, a nationally funded irrigation project benefitted a province, the allocation of revenue designated for irrigation was corespondingly reduced. While there is some element of inter-provincial fairness to this, it came at the expense of local autonomy and decision-making power.

Financial independence is a key to decentralization. As long as LGUs must function under the financial control of national departments, the goal of decentralization will continue to be subverted.

3. The Political and Constitutional Process

The cabinet is scheduled to consider a decentralization bill proposed by the Department of Local Government (DLG) in the fall of 1988. Another bill proposed by the Governors Conference has been submitted to the

Senate. Although quite similar, the two bills differ in the role played by the governors. Under the governors' bill everything would be handled through the provincial governments, including funds destined for municipal governments. The DLG would allocate funds and other resources directly to all local government units and not give any special role to the governors. Both bills propose seconding national government staff to the local government units, and they both propose revenue sharing and block grants.

The political alliances being formed for and against decentralization seem to be based primarily on the patronage system and not on philosophical grounds. The Senate, which is elected at large, is generally supportive of decentralization while the Congress is less so. Under the Governor's bill the Governors would replace the Congressmen (Congresswomen) as local arbiters of power and patronage. The DLG would transfer a good part of this patronage power from Congressmen to both Governors and Mayors. The mayors benefit under both bills, but they benefit more under the DLG bill.

4. Functional Responsibilities after the Decentralization Act

The decentralization bill proposed by the DLG would transfer much of the functional responsibilities to the LGUs. They would become responsible for the front-line delivery of services. The discussion is divided into (1) infrastructure development, (2) local staffing, and (3) financial resources.

a. Infrastructure Development

The LGUs would control all infrastructure projects regardless of size as long they fall totally within the jurisdiction of the province (or municipality). Inter-provincial and intra-regional projects, consisting primarily of roads and large-scale irrigation projects, would be left to the National Departments. Otherwise the national departments would only have responsibility for assuring quality standards. These guidelines should apply to foreign-funded projects as well as domestically-funded projects.

At present only projects worth less than P/200,000 are under the purview of the provinces though in four provinces an experimental limit has been set at P/500,000. The limits are too small to be meaningful: for example, even one kilometer of barangay road costs more than P/200,000 unless designed to very low standards. (An approximate cost for one kilometer of barangay road on flat terrain is about P/300,000.)[3] Even the P/500,000 limit being tested in four provinces can be seen as being very low.

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[3]Louis Berger International, <u>A Screening Model for Barangay Roads</u>, National Road Improvement Project, Economic Working Paper # 7), September, 1988.

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The proposal in the Decentralization Act is much more comprehensive and should not be watered down. To assure that the implementation of infrastructure development takes place smoothly, the DPWH should consider seconding its more experienced staff to the LGUs at least during the initial phases. These staff could also fulfill a training function.

b. LGU Staffing

The Decentralization Act recommends that all staff serving in the LGUs be under the jurisdiction of the Chief Executive of their respective LGUs. This would apply to LGU own recruited staff and staff seconded from the National Government Departments. This is an excellent proposal. If the LGUs are to properly fulfill their functions, they must have control over their staff. There are of course problems with this in terms of the potential for favoritism in promotions and transfers, but these problems also exist in the national departments.

Civil servants recruited by LGUs could be recruited from a basic list of candidates qualifying in a competitive examination. Separate lists could be prepared for general administration candidates, economic management candidates, and engineering and technical candidates. LGUs would be free to recruit from among the people qualifying.

Once the proposed competitive selection system is in place, the same minimum standards that are used for national government could be used for local governments. At that point the staff positions currently budgeted to the national departments could be transferred to the LGUs (along with the necessary budgetary suppor). The National Government staff made redundant by this transfer would get first preference in the choices for the comparable LGU positions. As protection against the actions of potentially capricious local Chief Executives, civil service protection similar to that offered to national government employees could be extended to the local government employees.

c. Financial Resources

Both versions of the Decentralization Act provide for a broader tax base for the LGUs -- the higher tax base is needed to provide some additional revenues for LGU operations. Furthermore, if the local community is paying, they will be more inclined to insist that their funds are not wasted and bring pressure on the local administration to combat waste and corruption.

Clearly, however, the total revenues generated by local taxes will not be sufficient to provide resources for effective decentralization. There is going to be the need for formal revenue sharing with the national government.

The proportion of national revenues to be shared has to go up beyond the present level if the LGUs are to successfully carry out delivery of front-line services. The formula proposed by the Governor's bill relies on a fixed number of pesos per capita. This would be a mistake.

Instead, the actual per capita amount should be fixed annually by taking the amount of revenue to be allocated divided by the population base. This allocative formula has the advantage of being indexed to national revenue, and would take inflationary and recessionary periods into account.

Block grants, whether from donor agencies or from the national government, are normally intended for development projects. To help ensure efficient local utilization, block grants should be linked to some performance criteria on the part of the LGUs.

F. Recommendations

The statistics show that the Aquino government's track record in the accomplishment of its stated public investment and decentralization goals have been poor. While some of the paralysis can be attributed to the newness of the government, it must also be attributed to excess centralization, excess caution, lack of efficient management, and lack of technical skills. Steps that can be taken to facilitate these objectives include:

a. Private sector participation in the public investment program. While this is an avowed goal of the government, especially for power generation and telecommunications, the implementing guidelines for private sector involvement have been slow to come by. This issue ties in with the incentives program for foreign investors in these capital- and technology-intensive sectors. In particular, ceiling requirements on foreign equity participation in these sectors should be reviewed.

   Private sector maintenance contracting could also be experimented with, especially for irrigation, power distribution, and even road infrastructure. Fees could be determined by competitive bidding.

b. Decentralization in project development. Pre-investment activities are considered to be too centralized by the line agencies. Regional planning bodies should have greater control over allocating its approved overall resource levels into the various sectors.

c. Increased local autonomy. Responsibilities for project preparation, monitoring, and supervision are being given to the Regional Development Councils and, through them, to the Provincial and Municipal Development Councils. However, real devolution of power to the regional and local levels must include giving local governments greater fiscal authority and direct access to sources of funds.

d. All foreign and locally funded infrastructure and other projects within a province or municipality should be carried out by the respective LGU. Only inter-provincial or inter-regional projects should be carried out by the National Departments.

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e. <u>Many of the present national project planning and implementation staff positions should be transferred to the LGUs along with the budgetary resources to pay for them</u>. Once the positions are transfered to LGUs they should not be recreated again at the national level.

f. <u>Local Chief Executives should have complete jurisdiction over staff working for them</u>. To protect the staff from the possibly capricious actions of Chief Executives, some version of civil service type protection should be extended to local government employees.

Chapter 10

Chapter 10. Transport and the Transport Infrastructure

A. Introduction

The transport industry and the transport infrastructure are the lifeline of a country, especially one as discontinuous as the Philipines. The problems of this sector spills over into all other sectors of the economy. This chapter analyze key constraints in the Philipine transport sector. For convenience, it has been divided into sections on: (1) intra-island transport; (2) inter-island transport; (3) international transport; and (4) recommendations.

B. Intra-Island Transport

Outside of Luzon, where there is a functioning railway, most intra-island transport is by road. Some larger rivers are used for short distance navigation. On Mindanao, where the road network is yet to be fully developed, sea transport is used -- particularly between Zamboanga and the cities of Cotabato, General Santos and Davao. Sea-transport is used for intra-island movements between Pagadien, Malabang and Cotabato, because the road connecting these points is in a bad state and the security condition is tenuous.

From the consumer's perspective, the quality of the road transport services is determined by the extent of the road network and the cost of using it, where the term 'cost' is expanded to its broader economic meaning that includes physical discomfort in travel. 'Cost' depends on three principal factors -- the size of the road network, the quality and effectiveness of road maintenance, and the market structure affecting the tariff level of transport services.

1. Road Investment

Investments on the road network peaked in 1983, and declined during the ensuing recession to a fraction of previous levels. The current public investment plan shows, however, a marked increase in expenditure on road projects. A significant number of feasibility studies have been done showing the return on investment on many of these projects to be well over 15%. The primary bottleneck is likely to be the implementation rate, as discussed in the previous chapter.

2. Maintenance

Costly investments on the road infrastructure disappear without adequate maintenance. The present government has recognized that need in principle and increased allocations to maintenance. Operations an maintenance expenditures on roads declined to P/1.2 in 1985. The new government's commitment to maintenance is reflected in the sharp increase in O & M allocations in 1986, to P/2.2 billion.

While the allocation of funds is important, the actual mode in which the funds are used is just as important. To deal with problems faced in the present system, private sector maintenance initiatives are being tried out in Batangas and Bohol. (Although the Bureau of Maintenance initially objected to the experiments, they seem to have changed their viewpoint.) The private contractors would be given sections of road to maintain and they would do so at a pre-set price. The local maintenance engineers would be responsible for assuring quality control. The staff in the bureau of maintenance would probably need to be reduced, but it is expected that the private maintenance industry would probably be able to absorb all of them.

Another advantage of private sector maintenance is that the large holdings of light and heavy equipment maintained by DPWH for maintenance would be more or less unnecessary. The state of much of this equipment is poor due to the lack of proper maintenance and maintenance funds. The equipment could be sold off to the private sector either to large construction and maintenance firms or to equipment rental firms. Private firms are likely to maintain equipment better than the government.

3. Pricing Structure of the Road Transport Industry

Transport charges depend on both road quality (which affects vehicle operating costs), and on the market structure of the transport industry. Transport costs can be viewed as vehicle operating costs plus a premium, which is determined by the competition (or lack thereof) within the industry. The more competitive the industry, the lower the premium and hence the lower the charges paid by the consumers.[1] Thus, even if the roads are improved, transport charges may not fall. Regulated industries and routes generally restrict pricing flexibility and market entry, and therefore reduce competition.

Not only is an improvement in road maintenance and an expansion of the road network important for economic integration of the country; it should also be accompanied by a deregulation of the transport industry, where required, to promote service level and price competition.

C. Inter-Island Shipping

The inter-island shipping industry can be considered the lifeline of the Philippines. The problems of inter-island shipping loom importantly in the national spectrum.

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[1]For example, the transport charge on a bad mountainious road in Cotabato is about P 4.60/ton-km, while on a good National Highway it is about P 0.40/ton-km. This difference reflects much more than the difference in vehicle operating costs per kilometer, which are likely to be a maximum of six times higher, not 12 times higher.

It has been observed that it is cheaper to ship freight from Bangkok to Manila than from Mindanao to Manila. The costs are higher for a variety of reasons:

- port charges, including pilotage, stevedoring and arrastre services.
- rate setting formulas used by MARINA.
- structure of competition within the shipping industry.

Before proceeding to each of these points, it is noted that about half of the inter-island freight and most passengers travelling by sea are carried by scheduled services, even though trampers (charters) can offer lower costs. The discussion here focuses on scheduled services, since most shippers who have to meet regular delivery schedules cannot use trampers. Furthermore, small and medium-sized shippers cannot afford to charter their own vessels.

1. Port Charges

Any analysis of inter-island shipping tends to focus on port charges as the principal source of high costs. This argument is illustrated by the following example taken from a report entitled Productivity and Philippines Transportation presented to the Fifth National Productivity Congress, Manila, October, 1986.

> "The short run (70 nautical miles) between Cebu and Dumaguete earns the capital intensive and highly taxed shipping industry a net two-way revenue of P/87.80 per revenue ton. On the other hand, PPA (Philippine Port Authority). appointed port handlers using PPA approved rates net P/125.10 per revenue ton of the same cargo. In short port-handling costs are 142.5% of freight costs."

The above percentage drops for longer haul routes but nevertheless they remain high as the following data taken from the same report illustrates:

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Table 10.1
Indicative Philippine Seafreight Costs

Route	Charges (Pesos) Port	Seafreight	Percent
Manila-Davao-Manila			
-Beer	130.20	580.80	22.5%
-Softdrinks	130.20	416.63	31.3%
Cebu-Davao-Cebu			
-Beer	125.00	319.77	39.1%
-Softdrinks	125.00	226.81	55.1%
Cebu-Dumaguete-Cebu			
-Beer	125.10	129.00	97.0%
-Softdrinks	125.10	87.80	142.5%

The above charges are to be paid regardless of whether the services of the PPA appointed freight handler are engaged or not. Even where the shipping companies provide freight handling equipment and do the actual unloading, they are only given a 35% discount.

The reasons for these high charges lie primarily with the quasi-monopolistic stevedoring and arrastre contracts awarded by the PPA. The PPA collects 10% of the handling fees. The authority also levies the same charges at private ports (these charges are set equal to what the costs would be in the public port). The following example taken from the productivity conference report, illustrates the differences between Public and Private Ports:

	Public Port	Private Port
Total Gross for Handler	106.26	26.63
Less:		
-PPA Share	10.63	10.63
-4% Contractor's Tax	3.68	-
Net Revenue	91.95	16.00

The handlers at the private ports seem to be able to survive on much lower margins. The quasi-monopolistic structure of port handling charges in the public ports is the primary source of the difference. Another study indicates that the workers actually doing the work do not seem to benefit from this. It seems that the bulk of the handling charges are

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kept by management and not by the workers.[2] The following example is drawn from a certain port where the charge was 1.20 per bag.

	As per PPA Guidelines	As Actually Practiced
Approved Tariff	1.20	1.20
PPA's Share	0.12	0.12
Arrastre Management Share	0.32	0.93
Laborer's Pay	0.76	0.15

The figures are tentative but they help to illustrate that the high charges in PPA ports are primarily monopoly profits accruing to management. Benefits to labor are low.

Compulsory pilotage charges also add costs to inter-island shipping. An inter-island ship with a 20 member crew calling at four ports a week pays P/8000 for pilotage, or roughly half its vessel crewing costs. Since crewing costs average about 30%-33% of total costs, this sort of additional and generally non-essential charge adds almost 15% to the cost of operation. Most ship captains operating on scheduled inter-island routes have been calling at the same ports for years and have little need of the pilot's assistance. Pilotage also adds to delays as the ship's captain is typically required to wait for three hours for a pilot or before being allowed to dock on his own. Even in the latter case, the pilotage charge has to be paid.

2. Rate Setting Formulas used by MARINA

The Maritime Industry Authority (MARINA) sets charges based on formulas which are based primarily on distance travelled and do not take into account the economies or diseconomies of particular routes. Load factors are not taken into account. This cross-subsidization increases costs on certain key routes. For, example more goods are shipped from Mindanao to Manila than vice versa. The load factors from Mindanao to Manila are higher than in the opposite direction. Under a free market setting the charges from Mindanao would be lower. Producers in Mindanao would have a greater incentive to produce for supplying the markets on Luzon.

The rate setting formulas also do not provide much of an incentive to scheduled ship-owners to reduce their own operating costs. A deregegulation of the industry would probably reduce costs (see below).

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[2]Prepared by the Davao Provincial Chamber of Commerce and Industry, and cited in the above-mentioned report.

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3. Structure of Competition within the Shipping Industry

Scheduled liners carry about half the total domestic freight. Larger shippers can take advantage of the more competitive prices offered by charter operators, but smaller shippers cannot.

The scheduled services are dominated by five large companies grouped into Conference of Inter-island Shipowners (CISO), which functions as a cartel. The members of the cartel have been fairly efficient in modernising by containerizing and introducing Ro-Ro ferries. The cost savings which would result from such modernisation have not been transferred to the consumers due to anachronistic rate setting mechanisms.

The powers of CISO are mitigated to some extent by MARINA, through its rate setting and route licensing activities. On the other hand, the existence of route licensing requirements makes entry into the industry by newcomers difficult, and helps perpetuate the monopoly.

CISO claims not to be a cartel but it does control schedules. However, a recent study on the inter-island shipping industry by the Center for Research and Communication shows that 27.1% of total revenues of the inter-island industry was in the form of operating surplus. There is therefore room for a competitive reduction of charges on routes with high load factors.

There has recently been pressure put on MARINA by short-haul ferry operators wanting to join CISO. This may not be good idea as the short-haul ferry operators that carry vehicular traffic provide an alternative to some shippers, and therefore generate competitive pressures on the shipping industry.

4. Development of Local Ports

Municipal ports serve communities and act as feeders to the national network. Sometimes they are also used to bypass the high charges at PPA ports. For example, eggs shipped from neighboring islands to Cebu are landed at small municipal ports such as San Remigio and then taken by road.

While municipal ports perform very useful functions they are not always well maintained. Although DPWH has taken up the task of maintaining selected municipal ports, it is unwilling to take on municipal port maintenance on a regular basis. The decentralization process underway should provide more resources to local government units. It is expected that given the additional resources and the strict understanding that the DPWH will not provide a bail-out, municipalities will get on with the task of maintaining its ports.

D. International Transport

Although international transport policy is not wholly within the jurisdiction of the Philippine government, there are areas where the government could take action to reduce costs for Philippine consumers.

Scheduled international shipping is available only from Cebu or Manila. This makes access to markets difficult for exporters (or importers) from other islands, particularly Mindanao (even though the larger traders can afford to charter vessels). Any regulations that limit the development of other ports for scheduled services should be eliminated. There are generally customs officials present in all the major national ports.

The Philippines is the most expensive point for airfares in Asia, with the exception of Japan. These high fares increases the cost of businesses based in the Philippines. Gray market prices on the other hand are fairly atractive but difficult for legitimate businesses to access. Rate setting treaties and the high peso are primarily responsible. There is room for movement in all of these areas.

E. Recommendations

Key policy recommendations are:

1. Encourage the development of private ports, which would provide competitive services to ports operated by the PPA. The PPA should not be given any operating subsidy and should have to compete with private ports. This policy would be a key to reducing port charges.

2. Deregulate inter-island shipping industry. The claims that this would reduce service to the smaller islands is not a valid one. It would probably reduce service by the higher cost lines to those islands but the niche would be filled by others in a deregulated environment. USAID could further the process by funding a study to examine the deregulation of inter-island shipping.

3. Privatize road maintenance through contracts to private companies. Companies would be given responsibility for particular road segments, and paid a fee determined by competitive bidding.

4. The maintenance of municipal ports should be the reponsibility of the municipality or the province. If necessary they should be provided block grant resources including the funds currently used by DPWH to maintain certain municipal ports. Under the decentralization bill the local government units will be assigned staff seconded from the National Government Departments.

PART IV

<u>Chapters 11-13</u>

PART IV -- Recommended Economic Reform Priorities, and the Role of USAID

Chapter 11. National Economic Reform Priorities for 1989 and Beyond

A. Overview of Economic Reform Priorities

This section outlines a set of reforms that we consider to be of the highest priority to steer the country towards a path of increased efficiency and growth. It regroups the recommendations made in Part III, in which various sectors were examined in detail, into a broad economic reform agenda for the Philippines.

1. Highest Priority Issues:

We consider the following list to contain the most urgent economic policy reforms to be undertaken in the Philippines:

a. Ongoing trade policy reform and liberalization.

b. Currency devaluation.

c. Improved tax collection efficiency, and reduction of the domestic budget deficit. This includes strengthening the legal system to better enforce the tax code, and undertaking cadastral work in the context of both property tax collection and land reform.

d. Deregulated inter-island transportation.

e. Improvements in the services and collection efficiency of the utilities, including water, power, irrigation, and telecommunications.

f. Increased maintenance of existing regional infrastructure.

In all cases, these reforms touch on either (a) the macroeconomic environment affecting all productive sectors, or (b) the physical supply-side constraints affecting all productive sectors. The first two reforms are particularly important to help increase trade and the international competitiveness of the Philippines. The third reform is important to reduce both interest rates and the crowding out of private borrowers (investors) during a time of growth. The last three are to reduce constraints to the production of industrial, non-traditional export, and agricultural products, and improve the efficiency of government corporations serving the productive sectors. These three reforms also have a strong bias towards economic dispersal away from Manila.

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2. Important issues:

We consider the following list to include policy actions that are very important to the Philippine economy, but of secondary importance to the above list:

a. Privatization of government-owned corporations.

b. Promoting financial sector competition/efficiency.

c. Reduced government sanctioned "rent-generating" activities, affecting both public and private corporations, such as monopolies, quantitative restraints, export quotas, credit allocation controls, certain industrial regulations, and tax exemptions.

d. Revisions in the current investment incentive code.

e. Agricultural sector policy reforms.

Privatization is an extremely important long-term goal, but one in which the prospects for short-term improvements and economic impact are less than for the higher priority items. It is important for reasons of both (a) economic efficiency, and (b) a clear signal to the private sector of the reduced role of the public-sector in patronage and "rent-generating" activities in the economy.

Items b, c, and d are important revisions in policies affecting the business climate -- policies that currently lead to important and negative misallocations of resources. The last item refers to agricultural policy reforms that are "internal" to the agricultural sector. The fact remains, however, that the most important steps to be taken affecting Philippine agriculture are all included on the highest priority list: e.g. currency devaluation, deregulated inter-island shipping, improvements in irrigation management, and increased maintenance of regional infrastructure, including irrigation.

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B. Further Details on the High Priority Recommendations

This section elaborates on the above recommendations, and is based directly on the recommendations included at the end of each chapter in Part III.

1. Ongoing Trade Liberalization

a. Completion of the import liberalization program is a particularly strong priority. The Philippine government should be strongly encouraged to go ahead with the liberalization of items on the "A" and "B" lists. Also:

   1) Import licenses should be replaced with tariffs, and these tariffs should fall in the 10 to 50 percent range. These tariffs should be imposed before the licensing requirement is eliminated.

      However, it is important but not an absolute requirement that the new tariffs be set at or under current average nominal tariff levels, since the removal of import restrictions generally substantially reduces the protection of the industry. Implicit protection under licensing requirements is often much higher than 50 percent.

   2) Particular emphasis should be placed on the liberalization of intermediate goods.

b. Measures to encourage indirect exports should be emphasized. These include access to inputs at world market prices, and access to finance at exporter rates through domestic letters of credit. To the extent consistent with GATT rules, direct exporters purchasing domestically should be compensated for the higher cost of procurement in the domestic market.

c. Additional reductions of tariffs, and reductions in their disparity, should be encouraged. However, this should be done after the completion of the import liberalization program.

d. Backward linkages of non-traditional exports should be encouraged to increase the value-added component of exports.

2. Currency Devaluation

A gradual, but significant, real depreciation of the peso should be encouraged to stimulate exports and efficient import substitution, and to compensate for the remaining protection-created bias towards domestic sales. A devaluation would have a positive impact in both industrial and agricultural sectors, as well as on the regional and rural development objectives of the government.

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3. Increasing Tax Efficiency

a. The most essential step in the Philippine fiscal situation is to reduce its budget deficit in order to help lower domestic interest rates and to minimize the crowding out of private borrowers and investors. In order to accomplish this, the following is recommended:

   1. Improvements in tax collection efficiency and administration, rather than the imposition of new taxes. The "technical enforcement capability" of the BIR must be strengthened

   2. Strengthening of the use of the legal system to pursue and prosecute tax offenders.

   3. Increased support of government and judicial employees who pursue and prosecute offenders.

b. Updating of real property registers and valuations, which are out of date and have not been adjusted for inflation. The lack of cadastral surveying has allowed many properties to escape the tax roles.

   This recommendation is particularly timely, given that the country has a unique opportunity to revise local property taxation under the shadow of its land reform activities. Landowner incentives on property valuation for taxation and for land reform (transfer) compensation are directly opposing, and there is scope for significant increases in tax register land valuation.

c. Continue ongoing efforts to increase the elasticity of the tax system relative to increases in national income and inflation. Revenue gains achieved through increased revenue efficiency must not be given up through a declining effective tax rate.

d. Continue efforts to reduce the regressivity of the tax system, which is heavily based in indirect taxes. This should be done not only for reasons of equity, but because resource misallocation has resulted from the current regime of tariffs, import controls, tax exemptions, and tax incentives.

e. Tax exemptions that favor public corporations should all be removed, in favor of more transparent accounting and, if necessary, subsidy transfers.

4. Deregulated Inter-island Shipping

a. Encourage the development of private ports which would provide competitive services to ports operated by the PPA. The PPA should not be given any operating subsidy and should have to compete with private ports. This policy would be a key to reducing port charges.

b. Deregulate inter-island shipping industry. The claims that this would reduce service to the smaller islands is not valid. It would probably reduce service by the higher cost lines to those islands, but the niche would be filled by others in a deregulated environment. USAID could further the debate by funding a study to examine the de-regulation of inter-island shipping.

c. The maintenance of municipal ports should be the reponsibility of the municipality or the province. If necessary they should be provided block grant resources including the funds currently used by DPWH to maintain certain municipal ports. Under the decentralization bill, the local government units will be assigned staff seconded from the National Government Departments.

5. Improved Efficiency of Utilities and Infrastructure

a. Measures to increase the collection efficiency of public corporations are crucial, both for the revenue performance of the public sector, and for the efficiency and competitiveness of pricing of Philippine publicly provided services. These involve legal and policy changes as well as operational changes, and the United States should assist in programs to strengthen collection efforts. Since USAID has long been involved in rural sector issues, it could play an especially important role in collections for irrigation and rural electricity.

b. Private sector maintenance contracting could also be experimented with, especially for irrigation, power distribution, and even road infrastructure. Private road maintenance contracts could be let under which private companies would be given responsibility for particular road segments and paid a fee determined by competitive bidding.

c. Irrigation user charges should not be collected by the technical staff of the National Irrigation Authority.

6. Increased Public Sector Investment and Decentralization

The Aquino government's track record in the accomplishment of its stated public investment and decentralization goals has been poor. This can be attributed to the newness of the government, excess centralization, excess caution, lack of efficient management, and lack of technical skills. Steps that can be taken to facilitate these objectives include:

a. Private sector participation in the public investment program. While this is an avowed goal of the government, especially for power generation and telecommunications, the implementing guidelines for private sector involvement have been slow to come by.

This issue ties in with the incentives program for foreign investors in these capital- and technology-intensive sectors. In particular, ceiling requirements on foreign equity participation in these sectors should be reviewed, consistent with national interests.

b. Decentralization in project development. Pre-investment activities are considered to be too centralized by the line agencies. Regional planning bodies should have greater control over allocating its approved overall resource levels into the various sectors.

c. Increased local autonomy. Responsibilities for project preparation, monitoring, and supervision are being given to the Regional Development Councils and, through them, to the Provincial and Municipal Development Councils. However, real devolution of power to the regional and local levels must include giving local governments greater fiscal authority and direct access to sources of funds.

d. All foreign and locally funded infrastructure and other projects within a province or municipality should be carried out by the respective LGU. Only inter-provincial or inter-regional projects should be carried out by the National Departments.

e. Many of the present national project planning and implementation staff positions should be transfered to the LGUs along with the budgetary resources to pay for them. Once the positions are transfered to LGUs they should not be recreated again at the national level.

f. Local Chief Executives should have complete jurisdiction over staff working for them. To protect the staff from the possibly capricious actions of Chief Executives, some version of civil service type protection should be extended to local government employees.

C. Further Details on the Lower Priority Recommendations

1. Privatizing Government Corporations

a. USAID should continue to stress the importance of the Philippine privatization effort as a means of increasing the efficiency of the Philippine economy, reducing the losses of corporations now in government hands, and freeing scarce public sector staff attention to crucial public policy issues. USAID should try to promote its technical and operational assistance to the privatization effort.

b. Privatization should be seen as one part of a large range of issues involving the efficiency of operation of the public sector. USAID should stress the importance of transparent, and, to the extent

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possible, arm's-length relationships among state-owned companies, and between state-owned companies and the central government. The US should also continue to support measures to increase the operational efficiency of government line agencies and public corporations.

2. <u>Promoting Financial Sector Competition and Efficiency</u>

a. Government policies that increase the cost of bank intermediation should be removed, and alternate sources of government finance should be identified. In particular:

   1. The gross receipts tax should be removed. (Budgetary cost: approximately P/ 1 billion.)

   2. The agrarian reform lending requirement should be lifted. Lending quotas for the agricultural sector should be replaced by other measures that encourage rural finance. If an agricultural lending requirement is retained, it should be a single requirement, defined as broadly as possible. The agrarian reform eligible government securities should be replaced by ordinary Treasury borrowings. (Budgetary cost: approximately P/ 0.3 billion.)

   3. Reserve requirements on bank deposits should be reduced in stages, with a preliminary goal of 18 percent. Government reserve eligible securities should be replaced by ordinary Treasury borrowings. (Budgetary cost: approximately P/ 0.5 billion.)

b. Supervision of financial institutions should be strengthened, in particular with stronger penalties for offenders, including criminal penalties in cases of fraud or misappropriation.

c. The capitalization of the Philippine Deposit Insurance Corporation (PDIC) should be increased, and the maximum insured deposit raised to P/100,000 per depositor.

d. Restrictions discouraging bank branching should be lifted, in particular for areas outside Metro Manila. Foreign investment or acquisition should be encouraged in cases where it can improve the management and competitiveness of smaller banks, or banks acquired by the national government.

e. The regulatory and technical assistance tasks performed by the Central Bank should be separated.

f. The national government should undertake a more aggressive and diversified program of cash management to encourage competition among financial institutions for government accounts.

3. <u>Reduced Government Sanctioned "Rent-Generating" Activities</u>

Perhaps the single most insidious characteristic of "crony capitalism" was the conspicuous role of the government in creating and sanctioning rent-generating activities that gave high returns with low risk to indivuals favored by government officials. The impact of this on the economy has been pervasive and highly negative. The role of "rents" in the economy was a pervasive theme throughout Part III.

Examples of such activities include: (a) artificial monopolies, (b) quantitative restrictions, (c) quotas on selected export products, such as garments and coconuts, (d) schemes to allocate credit, including the allocation of interest-free government deposits, (e) discretionary tax exemptions, and (f) excessive regulation of certain industries.

It is not true, of course, that all, or even most, cases of the above examples were misguided -- i.e. not all (for example) quantitative restrictions, regulations, or tax exemptions were without a sound public policy basis. However, there are cases in all of these types of policies where economic rents were created by the application of policies, and where these rents were directed to favored individuals.

These activities led to large-scale resource misallocation in the Philippines, undercut the integrity of markets, and reduced the willingness of investors to assume risk. More subtly, government rent allocation weakens the productive capacity of the economy by turning the attention of entrepreneurs and managers away from innovation and towards the granting of special government privileges. Finally, it weakens the ability of the government carry out its proper policies.

The key to reducing government sanctioned or allocated rent-generating activities is twofold. First, where possible, the GOP should reduce or eliminate its role in allocating benefits, designating participants, and directly providing finance. Second, where the government does directly intervene, it should try to limit the rents involved (e.g. by providing funds at market rates), or should capture the rents itself. Tariffs, as opposed to quantitative restraints on imports are an obvious example. Wherever possible, markets and competitive bidding should be used to allocate benefits.

The reduction of the government's role in these types of activities is an important and wide-ranging priority. In addition, more effective and balanced enforcement of laws and tax regulations is required to improve the functioning of markets and of the government itself.

4. <u>Industrial Incentives</u>

a. The Philippines should develop a set of guidelines governing industrial programs outside the system of incentives in the Omnibus Investment Code of 1987. Tighter links are required between each incentive scheme and the rationale for the incentive scheme. Such programs should compensate for identified market failures or

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distortions, and should be limited to industries in which the Philippines has a competitive (domestic resource cost) advantage at international prices.

b. All incentives should be monitored to ensure that the total cost of incentives to pioneer/export exemptions does not undercut the tax base.

c. In particular, the costs and benefits of the current Progressive Manufacturing Programs should be analyzed. The pace of domestic value-added replacement, and the rents generated by industry protection and transferred to the participants, should be consistent with Philippine comparative advantage in the industries concerned, and the additional costs borne by the program participants.

5. The Agricultural Sector and Rural Credit

As mentioned above, the devaluation of the Philippine peso would be one of the most important contributions to improving the performance of the agriculture sector. Similarly, deregulation of inter-island shipping, improvements in irrigation and road infrastructure maintenance, will all help promote agricultural development.

Other measures are:

a. The development of smaller scale irrigation systems and the rehabilitation and maintenance of existing systems. Also, irrigation user charges should not be collected by the technical staff of the National Irrigation Authority.

b. Abolition of the National Food Authority. USAID could fund the process of abolition by financing redundancy payments and/or retraining.

c. Removal of restrictions on the branching and expansions of commercial banks in rural areas.

d. As a corollary to (c), restrictions on expansion and formation of rural banks should be relaxed, though at the same time they should be monitored better. The present restrictions are based on the fear that concentration of ownership will adversely affect borrowers. If restrictions on entry and expansion of banking in rural areas are dropped, then competition would take care of the borrowers' interest. Also, those rural banks that are insolvent should be helped to close down.

e. Tariff and surcharge protection of phosphate fertilizers should be removed, as farmers should not be responsible for non-government guaranteed debt of PHILPHOS. Also, the Fertilizer and Pesticide Authority should guarantee the private sector freedom in the area of fertilizer and pesticide marketing and distribution.

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Chapter 12

Chapter 12 The Balance of Payments and External Gap Projections

A. On the External Financing Gap

At the center of Philippine discussions with the donor community, the multilaterals, and its commercial creditors are the projections of the external financing gap over the medium term, and the share of each external group in that financing. The external balance of a country is tremendously difficult to project with accuracy, since external prices, world trade demand, and domestic trade response are all uncertain. Furthermore, the assumptions underlying the Philippine external gap projections have changed repeatedly, as the country continues to refine its medium term development plan. Finally, these projections have been made even more difficult by the fact that external assistance commitments to the Philippines are in flux, with discussions underway regarding the Multilateral Assistance Initiative and related financial commitments, e.g. the Japanese aid commitment to the country, the recently concluded extension of the Military Bases Agreement, and the upcoming renegotiation of the Bases Agreement.

The task of preparing an independent set of external gap projections for the Philippines is beyond the scope of this report. Instead we use official Philippine projections, which form the basis for the discussions with the country's external creditors and the IMF. This section discusses the nature and value of external gap projections, considerations specific to the Philippines that affect the external gap, and the reasonableness of the assumptions underlying the Philippine projections.

Since the balance of payments is an accounting concept, and, properly defined, must balance _ex post_, external gap projections are primarily planning exercises, designed to identify additional financing requirements that are necessary to realize the assumed values of other components in the balance. At base, one projects the external gap in two steps. The first step identifies the current account deficit, which records the country's net borrowing from the rest of the world, or its _net_ increase in external liabilities. Next one looks at the stock of external assets and liabilities to identify the _gross_ changes that are scheduled and targeted, and those that remain currently unidentified, i.e. the gap. The gross financing requirements consist of financing for the current account deficit, scheduled repayments of principal on external debt, and any targeted increase in external assets (reserves). From these requirements one subtracts scheduled (pipeline) inflows, indicative financing commitments, and rescheduled principal payments, to arrive at a "gap" -- required additional financing under the exercise.

Subjects of dispute in discussing the external gap -- the areas of "give" in the projections -- are the size of the projected current account deficit, targeted reserve accumulations, indicative financing, and (future) reschedulings. Even if there were complete agreement on the

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size of the external gap, there would still be dispute over where the finance would come from (bilateral sources, multilaterals, commercial creditors), and on what terms. Most of the analysis underlying external gap projections focusses on the current account balance. However, the reserve accumulation target is an important and large element in the near term financing gap. This target has been the subject of dispute between the National Economic and Development Authority (NEDA) and the Central Bank, as well as between Philippine negotiators and the commercial banks.

The Philippine government has recently revised (November, 1988) its estimates of the external financing gap, particularly the estimates of components of the current account. These estimates are shown in Table 12.1, and form the basis for our discussion of the financing requirement.

B. Current Account Projection

The most common way to form a current account projection is to separately project exports and imports, estimating volumes and price changes in both instances. Import volumes are determined by the growth of the domestic economy, while export volumes are determined by growth in major markets, perhaps with some assumptions about changes in market share. Prices for both export and import commodities depend on world price trends, about which some assumptions must be made. For the Philippines, the key parameters in this kind of approach are:

1. the growth rate of the Philippine economy;

2. the investment rate (for capital goods imports);

3. industrialized country growth, particularly the United States;

4. world markets for semiconductors and electrical equipment;

5. garment quotas and the US sugar quota;

6. commodity prices - sugar, coconut, copper (exports), and oil (imports);

7. interest rates.

The Philippine Central Bank used this approach of forecasting imports and exports to produce the balance of payments and external gap projections shown in Table 12.1. Compared to previous estimates, these figures show substantial increases in both exports and imports in 1988, in line with the actual figures for the first seven months of the year. Using the 1988 figures as the new base, growth rates for imports over the next five years are almost identical to those under the earlier projections, while the expected growth of exports has been increased slightly.

Adjustments have also been made to services and transfers, the two other components of the current account balance. The November 1988 revisions

Table 12.1
Philippines: Balance of Payments, 1987-95 Projections
(in million US $)

	1987	1988	1989	1990	1991	1992	1993	1995
Trade Balance	-1017	-1200	-1425	-1515	-1488	-1387	-1085	30
Exports	5720	6830	7695	8675	9779	11164	12770	16850
Imports	6737	8030	9120	10190	11267	12551	13855	16820
Services (net)	-76	-322	-251	-537	-729	-1015	-1271	-1553
Receipts	3497	3544	4046	4144	4365	4459	4686	5278
Payments	3573	3866	4297	4681	5094	5474	5957	6831
interest	2226	2405	2635	2826	2990	3105	3285	3370
Transfers (net)	554	779	802	901	978	1000	1069	1325
Current Account	-539	-743	-874	-1151	-1239	-1402	-1287	-198
(% of GNP)	-1.6	-2	-2.1	-2.6	-2.5	-2.6	-2.2	-0.3
Capital Account	-653	-842	83	-148	-330	118	-300	-145
MLT Loans (net)	-1214	-1854	-778	-874	-1019	-593	-1152	-1222
Inflows	981	687	1684	1512	1565	1620	1676	1796
identified		687	952	1055	805	611	220	73
under negot.			732	457	257	251	166	0
to be arranged					503	758	1290	1723
Outflows	2195	2541	2462	2386	2584	2213	2828	3018
Direct Invest (net)	205	617	537	376	326	330	402	534
debt conversion	166	456	410	205	105	50	52	0
Short term cap (net)	52	80	-21	-30	-57	-79	-55	-67
Other*	304	315	345	380	420	460	505	610
Net Intl Res (- incr)	-265	134	-1972	-662	-775	-660	-786	-1271
Gross Reserves (- in	22	250	-1942	-466	-462	-512	-546	-580
Central Bank	500	459	-1862	-383	-377	-424	-456	-481
Liabilities (+ incr)	-287	-325	-110	-279	-398	-236	-330	-529
Use of IMF credit	-138	-67	105	-46	1	-148	-66	-174
Rescheduling	1456	1208	880	968	906	714	543	0
Paris Club	599	376	0	0	0	0	0	0
Commercial Banks	857	832	880	968	906	714	543	0
Financing Gap	0	243	1883	993	1439	1230	1830	1614
Possible future Paris Club rescheduling	0	243	590	547	514	0	0	0
Residual Financing	0	0	1293	446	925	1230	1830	1614

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Table 12.1 (cont.)

Philippines: Balance of Payments, 1987-95 Projections

(in million US $)

	1987	1988	1989	1990	1991	1992	1993	1995
Memorandum Items:								
Gross Official Reserv	1959	500	3362	3745	4122	4546	5002	5983
(months of imports)	2.3	1.5	3	3	3	3	3	3
Total External Debt	28649	28259	30349	31390	32717	33920	35075	36233
(percent of GNP)	83.4	74.4	72.1	69.8	67.2	62.9	59.7	51.8
Debt Service Ratio								
before rescheduling	51.1	49.3	45	43.3	41.5	35	35.4	29.7
after rescheduling	35.3	35.3	32.5	31.5	31.4	30.4	32.3	29.7
Interest as % of GNP	6.5	6.3	6.3	6.3	6.1	5.8	5.6	4.8
GNP in US $	34351	37983	42093	44971	48686	53927	58752	69948

Source: Central Bank, Preliminary, November 14, 1987.

Note: * Other = Monetization of gold and valuation adjustments.

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result in a higher current account deficit in 1988 and 1989 than before, but a lower deficit over the medium term.

1. Imports and Import Prospects

Our discussion of the current account projections begins on the import side. As is the case with many LDC's that have followed import substituting policies, there is relatively little flexibility in the Philippine economy on the import side. Consumer goods, the more elastic elements of commodity imports, have been greatly reduced as a proportion of imports: imports are now comprised mostly of capital goods, raw materials and intermediates, and mineral fuels. Table 12.2 traces the importance of these import components in terms of GNP over the past few years.

Between 1983 and 1986 the Philippines brought about a huge change in its current account position, from a deficit of 8 percent of GNP to a surplus of almost 3 percent of GNP. During this same period, however, the value of Philippine exports fell by three percent, so that the entire improvement in the trade balance was achieved by a fall in imports. Table 12.2 makes clear how this was done. The stabilization period saw huge falls in imports of capital goods and mineral fuels, and a substantial drop in imports of raw materials (up to 1985). The fall in oil prices in 1986 brought about some of the reduction in fuel imports. However, most of the import reduction was due to the drop in domestic industrial activity (the sharpest drops were in the industries most dependent on imports) and the dramatic drop in fixed investment.

This type of import compression almost assures that import demand will spring back sharply as the economy recovers, and this is just what has happened in the Philippines. Raw material and intermediate imports increased rapidly as the economy recovered, and as inventories were rebuilt in 1987 and 1988. Capital goods imports rose rapidly as investment recovered, particularly in 1988, when their value increased by 40 percent (first 3 quarters over comparable 1987 period.) Imports of fuel increased, both as a result of domestic growth, and due to the recovery of oil prices from their low levels in 1986.

Thus despite the rapid growth in exports during the Philippine recovery, imports have also increased sharply and the current account deficit has widened to about two percent of GNP. This was to be expected, and is a sign of the health of the economy. It is not, as has been argued in some quarters in the Philippines, an indication that the recovery has been "import-led", nor that liberalization has led to a swamping of the economy with imported goods. It is, however, symptomatic of the external resources constraint that the Philippines faces if the economy is to continue to grow.

If the Philippines approaches its official growth targets of 6.4 percent real growth per year over the medium term planning period, the prospect is for continued growth of imports at a pace slightly higher than the

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Table 12.2
Philippine Imports by End Use Category
(percent of GNP)

Import Categories:	1981	1982	1983	1984	1985	1986	1987
Capital Goods	5.0	4.5	5.0	3.6	2.5	2.8	3.5
Non-oil Raw Materials	5.0	5.3	5.7	4.6	4.0	5.5	7.0
Mineral Fuels	6.4	5.4	6.2	5.2	4.5	2.9	3.6
Consumer goods	4.3	4.4	5.0	5.8	4.9	5.4	5.5
TOTAL	20.7	19.5	21.9	19.3	15.9	16.6	19.6
Memo Items (percent of GNP)							
Exports	14.9	12.8	14.7	17.1	14.4	15.9	16.7
Fixed Investment	26.1	25.7	25.1	20.1	15.1	13.0	14.0
Industrial Output	36.8	36.5	36.4	35.4	33.6	32.6	32.6

Source: National Economic and Development Authority, Philippine Statistical Yearbook 1987.

dollar value of GNP. This will occur as the investment rate rises from its current level of about 16.2 percent of GNP to the roughly 20 percent of GNP that has emerged as a target in discussions with the World Bank. Part of this increase will come about as government investment rises from its current level of about 3 and one-half percent of GNP to a targeted 5 percent of GNP. In a sense, this rise will be self-financed since it will allow the Philippines to draw on committed donor funds that have not been drawn down due to implementation difficulties.

A major source of uncertainty in the import projections is the international price of crude oil. The Philippine currently imports about 75 million barrels of crude oil, fuels and lubricants per year, at a cost of $1.1 billion (about 14 percent of imports and 3.5 percent of GNP.) The most recent IMF Economic Outlook projects a rise in oil prices of about 3.5 percent per year until 1992, the same as their estimate of the increase in price of manufactured exports from the developed countries. A one dollar per barrel increase in the world price of oil translates into a $70-75 million increase in Philippine imports.

Finally, one should recognize the links between the growth of Philippine imports and exports. This arises in all economies, since export growth raises real incomes and expenditure, and thus the level of imports. For the Philippines other, more direct, links exist. Much of the manufacturing export sector is dependent on imports of raw materials and intermediate goods; this is particularly true of the electronics and garments industries. In 1987, imports of intermediate inputs for the textile and electronics industries came to $1.38 billion, or 62 percent of exports of the garments and electronics industries. More successful growth of Philippine non-traditional export industries will also be accompanied by more rapid growth in intermediate imports. This is not in itself a bad thing, since the country gains from the domestic value added and employment. But it does cast doubt on sketching out favorable and unfavorable scenarios where exports and imports move in opposite directions.

2. Exports and Export Prospects

The past two years have seen a very heartening increase in Philippine exports, a rise of 18 percent in 1987, and 25 percent in the first half of 1988. The 1988 result has so far been well above predictions made early in the year. Much of this increase has been due to policy changes and the improved economic climate in the Philippines. In addition, the Philippines has benefitted from improved international prices for sugar, coconuts and copper, which combined to raise average export prices for the Philippines by 14 percent from mid-1987 to mid-1988. In addition, Philippine exports were spurred by industrial country economic growth in 1988 that was substantially higher, particularly in the United States, than anticipated. The Philippines also benefitted from the drought in the United States, which led to an increase in the sugar import quota.

Current Philippine forecasts call for continued growth in exports at an average rate of almost 14 percent per year between 1988 and 1995 in value terms (Table 12.1.) This would result in a significant increase in the share of exports in GNP, from the current level of 18 percent to 21.7 percent in 1993 and 24 percent in 1995. Almost all of this export growth is projected to come from increases in manufactured and other non-traditional exports. As Table 12.3 indicates, official Philippine forecasts done in August, 1988, project a fall in the volume of non-traditional exports, with particularly sharp drops for sugar and coconuts.[1] Over the forecast period (1987 to 1993) the value of traditional exports would increase by only 37 percent, due entirely to price changes. In contrast, exports of manufactured goods are expected to double in volume over the period.

The forecasts for traditional exports, although pessimistic, are not unreasonable. The Philippines is now entirely dependent on the US market for its sugar exports, and that market shows every sign of disappearing over the next few years. While there may be some prospect for improvements in the coconut forecast, the Philippines faces the difficulty of aging trees and falling yields, coupled with increasing competition from other vegetable oils. The highly optimistic forecasts for non-traditional exports, while they cannot be ruled out a priori, call for a growth comparable to that of the Asian NICs after the 1974 oil shock. Export growth at this rate is by no means automatic.

This year experienced favorable commodity price shifts and higher than anticipated industrial country growth. On both counts, the outlook is likely to be less favorable in 1989 and beyond. The improvement in commodity prices is likely to reverse modestly in the coming year, particularly for coconut oil. In addition, economic growth in the industrialized countries is expected to fall from 3.9 percent in 1988 to 2.8 percent in 1989, and average about 3 percent until 1992.[2] For the United States, the consensus forecast calls for a reduction in growth in the coming year, although few see a recession as likely before 1990. A recession in the United States sometime during the Philippine medium term plan period (1988-93) is exceedingly likely, however.

Furthermore, the medium term prospect is that there will be a substantial reduction in the US current account deficit, and a shift in the locus of industrial country economic and import growth away from the United States. Both of these factors present challenges for Philippine policy. The Philippines is not likely to be hit as hard as other East Asian trading partners of the United States, and may benefit from the appreciation of their currencies against the US dollar. What is clear, however, is that the Philippines will not be able to passively rely on growth in its external markets to pull its exports along at targeted

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[1]Details of the August 1988 projections were available to us, but unfortunately not for the November revisions. The broad outlines of the underlying splits are unlikely to have changed markedly during the interim.

[2]IMF World Economic Outlook, October 1988.

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Table 12.3

Philippines: Components of Export Forecasts

(1987-1993)

	Volume Change (percent)	Price Change (percent)	(% per year)
Traditional Exports	-11.7	57.2	7.8
Coconut Products	-31.8	75.7	9.9
Sugar & Sugar Products	-88.0	75.7	9.9
Forest Products	28.4	37.0	5.4
Minerals	7.3	42.2	6.0
Fruits, Vegetables	5.4	30.9	4.6
Non-Traditional Exports	89.3	26.6	4.0
Manufactured	103.6	22.2	3.4
Electrical Equip	45.1	29.0	4.3
Garments	65.1	29.0	4.3
Copper	17.5	31.2	4.6
Unmanufactured	0.0	78.3	10.1

Source: Central Bank, Exports by Major Commodity Group, 1987-1993 (Model I - Revised Desired Scenario) Workscreen, July 13, 1988.

rates. Aggressive movements in quota bargaining, particularly for garment quotas, export promotion, and exchange rate adjustment will be necessary to achieve sufficient export growth.

3. Services and Transfers

The Philippines is unusual among heavily indebted LDC's in having had, until recently, a surplus on its non-merchandise trade balance. This has been the result of substantial earnings of overseas laborers and of some Philippine service industries, such as construction. (The classification of US ESF funds as service receipts has also contributed, although it has not been the most important factor.) The balance of payments projections call for a continuing deterioration of the service balance through 1995. This is primarily the result of increasing payments for non-interest services as the economy grows, coupled with diminished prospects for overseas construction and services, particularly in the Middle East.

In the other direction, the extension of the Military Bases Agreement is projected to result in payments of approximately $480 million per year over the next two years. Although we do not have the detailed breakdown of components in the revised balance of payments projections, these do not appear to be included in service receipt estimates (which is the place where they are recorded in Philippine external accounts).

The November revision of the balance of payments projections shows an increase in interest payments of about nine percent over the August projections. This is due entirely to an increase in interest rates, since total external debt outstanding in the revised projections is below that of the August projections. This is a reasonable assumption, since interest rates are likely to continue to increase in the United States well into the next year. Approximately 60 percent of Philippine external debt is tied to market interest rates in London or the United States, and a one percent increase in interest rates would lead to an increase of about $170 million in Philippine interest payments.

C. The Capital Account, Reserves, and the Financing Gap

We have only limited information available concerning likely adjustments within the capital account, particularly on indicative capital inflows. This limits our analysis to only a few remarks concerning the capital account components and the targeted reserve increment. The size of the problem is immediately evident from Table 12.1. Principal repayment obligations (before rescheduling) are large, varying between two and three times the size of the projected current account deficits. Direct investment inflows are expected to increase substantially, but will still play a minor role in meeting the Philippines required financing. The "Other" category in Table 12.1, which is the gain from monetization of gold and valuation adjustments, is on the same order as direct investment. Short term capital flows are impossible to predict, so that line in Table 12.1 should merely be considered indicative.

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Much of the gross financing requirement has been covered by identified inflows, indicative commitments, and agreed upon rescheduling. The remaining financing gap is roughly equivalent to the projection of the current account. The Philippines has already announced its intention to make a third approach to its official (Paris Club) creditors for a further rescheduling, and the anticipated rescheduled obligations and interest are also shown in Table 12.1. The major disagreement in the Philippine discussions with its external creditors, particularly the commercial banks, is likely to be the anticipated reserve accumulation targets, particularly in 1989.

The NEDA target, incorporated in the balance of payments projections by the Central Bank, calls for a $1.9 billion increase in official reserves in 1989, and further modest increases to maintain official reserves at levels equivalent to three months of imports. This reserve level is a reasonable target for the Philippines, but its accumulation in the following year is in fact a demand for substantial, near-term additional resources from the country's external creditors. One can view the reserve target in a variety of ways, but the most reasonable is that it makes financial resources available in advance to the Philippines, and provides a cushion against unfavorable outcomes in the future. The impact would be very large in 1989, and in fact accounts for more than the total projected gap. The targeted reserve level is desirable from the standpoint of the Philippines, but it is a target that the country is unlikely to achieve. After heated discussions with the commercial banks, this target is likely to be spread out over several years.

Further definition of the identified, likely, and possible capital and grant inflows to the Philippines over the medium term planning period is highly desirable. The scheduled renegotiation of the Military Bases Agreement holds the possibility of a substantial increase in resources going to the Philippines, a modest increase in resources, or a sharp drop in flows if the bases are dismantled. Aid flows from the Japanese, and the net additional financial flows under the Multilateral Assistance Initiative, are both uncertain. This uncertainty will make Philippine planning more difficult. More importantly, the uncertainty surrounding bilateral aid flows will greatly complicate Philippine discussions with its commercial bank creditors, since they have a strong interest in not committing themselves now, in anticipation of substantial funds from official sources. The reserve accumulation target may be an attempt to circumvent this difficulty, by assuring an early injection of funds, but, as indicated above, the Philippines is unlikely to be successful. The most likely prospect is for more acrimonious relations with the commercial banks, in large part due to the underlying uncertainty and the free rider problem attendant on new money commitments.

Chapter 13

Chapter 13. Recommendations for the Role of USAID in the Multilateral Assistance Initiative (MAI)

This chapter makes recommendations concerning the role USAID should take in the next few years of the multilateral reform effort in the Philippines. Part of this reform effort may crystalize in the form of a coordinated Multilateral Assistance Initiative (MAI), which, as of this date, is in its early discussion phase amongst donors and with the GOP. However, regardless of the ultimate focus and funding level of the MAI, the reform effort will continue in all of the ongoing activities of each of the donor agencies. This section will recommend areas of activity that USAID should pursue both as part of, and in addition to, the MAI.

This chapter has three sections. The first section groups the priority economic reform areas as summarized in Chapter 11 into priority areas that are consistent with the programmatic strengths of USAID. The second section provides additional notes on the potential role of USAID within the larger MAI. The third section gives ideas for immediate follow-on activities.

A. Priority Programmatic Areas of Involvement for USAID

Chapter 11 laid out a detailed agenda for economic reform in the Philippines, based on the macroeconomic and sectoral analyses included in Part III of this report. Some of the reform priorities were macro-economic in nature, such as currency devaluation and reduction of the fiscal deficit. Other reform priorities were microeconomic in nature, such as deregulation of inter-island shipping, improvements in public utilities, and increased maintenance of regional infrastructure. Chapter 11 was organized by the degree of importance of each of the reform areas.

This section takes an alternative approach. The same priority reform areas are regrouped into overall thematic groupings. Four areas emerge:

1. Macroeconomic Reforms: the most important macroeconomic reforms are (a) currency devaluation and (b) improved tax collection efficiency to reduce the fiscal deficit. In balancing the budget, it is concluded that revenue expansion is a higher short-term priority than expenditure reduction.

2. Trade and Private Sector Promotion: this grouping includes a variety of efforts to promote trade and the growth of the private sector. These include (a) trade liberalization, (b) reduced "rent-generating" activities, (c) investment (industrial) incentive policies, and (d) development/reform of the financial sector.

3. Regional Development: this grouping includes a wide range of efforts to promote rural and regional development, and regional income generation. The most important reform areas are (a)

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deregulated inter-island shipping, (b) increased public expenditure in infrastructure maintenance, (c) accelerated public investment in regional infrastructure development projects, (d) agricultural policy reforms, (e) utility pricing rationalization, and (f) government decentralization.

4. Improvements in Government Functions: this grouping includes those reform areas that focus on institutional development and operational efficiency of both public and parastatal entities. The most important of these reform efforts are (a) management and accounting reform of government corporations and government financial institutions, (b) privatization, and (c) government accounting.

There is, of course, some overlap between these thematic groupings. Although government decentralization and improved management of public utilities are classified here as areas that would help promote regional development (group 3), they are also areas requiring improvements in government functions (group 4). For the purposes of thematic justification, however, their impact on the regional development objective is the most important.

We recommend that USAID, given this broad agenda, focus on reform activities in groups 2 and 3, i.e. trade and private sector promotion, and regional development. Both areas are consistent with its current portfolio of projects, its areas of expertise, and its probable funding levels. Of course, USAID is already also active in several areas in group 4, but less comprehensively than in groups 2 and 3. Rather than expand its activities in areas covered by group 4 -- other than privatization -- we feel that USAID should focus its program activities in the areas of group 2 and 3.

We also note the following:

1. The macroeconomic reform efforts included in group 1 are fundamentally and traditionally the focus of IMF agreements, upon which large amounts of standby financing is often hinged. USAID is not in a position in the Philippines to take on, either programmatically or financially, these basic macroeconomic reforms.

2. Trade liberalization is the key policy action required in group 2. The completion of the Philippine import liberalization program begun under Marcos, under which some 559 items on GOP Lists A and B remain to be liberalized, is a high priority upon which virtually all donors agree. Although the leverage available to USAID to encourage the GOP to continue its liberalization drive is relatively small, the liberalization objective should be forcefully linked to all other USAID trade promotion and private sector related activities. Also, the donors should consistently endorse the liberalization objective in a coordinated manner.

3. A wide variety of trade and private sector development activities are available to USAID that would supplement the more basic trade

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liberalization program. USAID has much experience in many of these areas, including export promotion, industrial policy, and financial sector development. This area of focus for USAID should be sustained, both independently and as part of the MAI.

4. Although privatization has been categorized in group 4 above, USAID's current privatization program should remain a high priority due to its linkage to policy objectives contained in both groups 2 and 4. USAID has greater expertise in the area of privatization than most other donors, and its links to US markets, brokers, and legal and financial expertise should be promoted.

5. Of the four groupings, group 3 -- regional development -- is most in line with USAID's traditional orientation towards agriculture, rural development, and infrastructure development. Increased effort in this areas is warranted both economically, as discussed Chapters 8, 9, and 10, and politically, given the ongoing unrest in rural Philippines. USAID activities in this area can and should be both project- and policy-oriented.

6. The institutional development activities implicit in group 4, including the management of government corporations and improved public sector accounting practices, are recommended as only a secondary area for USAID activity. Rather than USAID taking the lead, activities in this area should be promoted under the larger rubric of the MAI, involving a coordinated donor effort.

   This recommendation is made for two reasons. First, USAID is not always idealogically in agreement with parastatal reform, and the World Bank or ADB is more prepared to work in this area than USAID. Parastatal reform remains a worthwhile priority, even if privatization remains the a longer-term objective. Second, USAID does not have the resources to focus a large effort in the overall area covered thematically in group 4.

7. One caveat to point 6 is in the area of project management and implementation. All donors are equally concerned in the Philippines with the slow rate of project implementation. Targetted USAID activities to help accelerate this process in key GOP offices would benefit USAID, other donors, and the MAI.

B. The Role of USAID in the Multilateral Assistance Initiative

The MAI negotiations are still in their early stages, during which neither the final funding levels nor the programmatic focus have been agreed upon. As consultants, we were not party to any actual MAI minutes or materials. However, in shaping the donor commitments to the MAI, we would like to note the following:

1. There should be a clear delineation of which USAID funds are conditional -- and thereby invite policy dialogue -- and which funds

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are unconditionally disbursed (e.g. ESF funds under bases agreements). It appears that past discussions between USAID and Philippines have suffered from radically different understandings of what was appropriate in aid discussions. It should be easier to emphasize policy conditionality on MAI "new money", especially with multilateral donor coordination, than it has been on BSP-III.

2. There should also be more forthright statements of aid conditions by other bilateral donors -- Japan in particular -- so that the United States is not alone in imposing policy conditions.

3. There should be continual recognition that successful conditions are those that the country shares as economic objectives, and not conditions that are imposed. This affects the likely success in meeting conditions, but also the permanence of reforms once they are installed.

C. Follow-on Steps

Many of the areas of policy initiative endorsed here have been well-studied by USAID and other donors, and wide agreement on implementation strategy has been reached. This is generally true in the areas of trade liberalization, privatization, and reform of government corporations.

There are other areas, however, where additional study may assist USAID and the MAI in shaping its policy reform package. Five areas of further analytical work are suggested below.

1. The overall balance of incentives -- including incentives, exchange rate, and trade policy -- on the industrial and agricultural sectors could be better understood. This study, which would be broader than the one on industrial incentives currently being completed by John Power, should address such issues as:

   - the "competitiveness" of the exchange rate vis-a-vis other countries;

   - the degree of backward production linkages, compared with other countries, and as affected by the overall policy mix;

   - the actual bias against domestic suppliers of intermediate goods used by export industries;

   - exploration of means to compensate domestic suppliers-- consistent with GATT -- for their current disadvantage in competing with foreign suppliers of intermediate goods for export industries.

2. There is a need for a detailed study on the organization and performance of the inter-island shipping industry. The ADB has recently completed an engineering study of the inter-island network,

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but virtually no work has been done on the economics of the industry. Related work needs to be done on safety regulation of the industry. Both studies would be an essential step in deregulating the industry.

3. The fiscal deficits in the Philippines need to be better understood, especially in terms of their inflationary effect and their effect on crowding out private investment. Better understanding of the crowding out effect could lead to greater urgency in GOP efforts to reduce the deficit through revenue enhancement.

4. There is a need for monitoring studies on the pace and impact of trade liberalization. Although much has been made of the number of quantitative restrictions that have been lifted, and of the number of commodities still on Lists A, B, and C, little analysis has been done on the economic impact of trade liberalization to date. Economic impact studies should go beyond the impact on the current account, to looking at the impact on investment, industrial structure, and the capital account.

5. There is a strong link between the need for cadastral surveys for the purpose of increasing local property taxes, and the need for land valuation studies in the context of land reform. Landowner incentives on property valuation for taxation and for land reform (transfer) compensation are directly opposing, and there is scope for significant increases in tax register land valuation. USAID could help promote this link through an appropriate study.

As a final note, we reiterate our overall finding that the rate of meaningful policy reform has slowed significantly during the past 2-3 years, and there is a need to create new momentum. The MAI may be useful in encouraging this momentum. We feel that the general outlines of the reform package are clear and discrete enough that the desire for "additional study" should not be used as an excuse for further delay.

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