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ACRONYMS

ADB	Asian Development Bank
A.I.D.	U. S. Agency for International Development
APT	Asset Privatization Trust
ASAP	Agribusiness System Assistance Program
BAP	Bankers Association of the Philippines
BIR	Bureau of Internal Revenue
BOC	Bureau of Customs
BOI	Board of Investment
BPB	Budget Planning Bureau
BSP	Budget Support Program
BTr	Bureau of Treasury (DOF)
CB	Central Bank of the Philippines
CISO	Conference of Interisland Shippers and Operators
COA	Commission on Audit
CODA	Committee on Development Assistance
COP	Committee on Privatization
CP	Condition Precedent
CPI	Consumer Price Index
DBM	Department of Budget and Management
DFA	Department of Foreign Affairs
DFI	Direct Foreign Investment
DOF	Department of Finance
DOJ	Department of Justice
DOTC	Department of Transportation and Communication
DPWH	Department of Public Works
DTI	Department of Trade and Industry
EFF	Extended Fund Facility
EO	Executive Order of the GOP
EPR	Effective Rate of Protection
ERL	Economic Recovery Loan
ESF	Economic Support Fund
FPPO	Fiscal and Policy Planning Office (DOF)
FSAL	Financial Sector Adjustment Loan
GNP	Gross National Product
GOCC	Government-Owned or -Controlled Corporation
GOP	Government of the Philippines
GSIS	Government Services Insurance System
IAD	Integrated Area Development Projects
IFG	International Finance Group (DOF)
IMF	International Monetary Fund
IPP	Investment Priority Plan (BOI)
IRR	Internal Rate of Return
IS	Infrastructure Staff (NEDA)
LDAP	Local Development Assistance Program
LDA	Local Development Authority

ACRONYMS
(continued)

LDC	Local Development Council
LGU	local government unit
MAI	Multilateral Assistance Initiative
MARINA	Maritime Industry Authority
MOOE	Maintenance and Other Operating Expenses
NDC	National Development Corporation
NEDA	National Economic and Development Authority
NGO	Nongovernmental organization
NPC	National Power Company
NPPS	National Planning and Policy Staff (NEDA)
ODA	Official Development Assistance
OEA	Office of Energy Affairs (OP)
OP	Office of the President
OPSF	Oil Price Stabilization Fund
PAAD	Program Assistance Approval Document
PAP	Philippine Assistance Program
PEPS	Private Enterprise Policy Support Program
PFC	Project Facilitation Committee
PIDS	Philippine Institute of Development Studies
PIS	Public Investment Staff of the GOP
PMS	Project Monitoring Staff (NEDA); also Presidential Managing Staff
PNOC	Philippine National Oil Company
QR	Quantitative Restriction (on imports)
RDC	Regional Development Council
REER	Real Effective Exchange Rate
RPMES	Regional Project Monitoring and Evaluation System
SAL	Structural Adjustment Loan
SDP	Support for Development Program
SDS	Social Development Staff (NEDA)
SGS	Société Générale de Surveillance
TIUS	Trade and Industries Utilities Staff (NEDA)
TOR	Terms of Reference
TRIM	Tariff and Related Matters (NEDA)
USAID	A.I.D. Mission
USG	U. S. Government
VAT	Value-added tax

PREFACE

This report was prepared for USAID/Manila under the Macroeconomics and International Trade IQC, A.I.D. Contract No. PDC-0095-I-00-9096-00, a joint venture of Nathan Associates Inc. and Louis Berger International. The project research team, consisting of Dr. John Newton and Mr. Edgar Gordon as team leaders, Dr. Rosario Manasan as Macroeconomist, Mr. Haris Jafri as Macroeconomist/Training Specialist, and Mr. Alex Brillantes as Public Administration Specialist, performed the basic research for the project during February and March of 1991, submitting the final report in May 1991.

The project team would like to thank Acting Philippines Mission Director Mr. Richard Johnson (in the absence of Mr. Malcolm Butler) and his staff for their support during the course of this project. Dr. Paul Deuster, Mr. John Chang, Mr. Gil Dy-Liacco, Mr. Jun Trinidad, and the remaining staff of the Office of Program Economics were particularly helpful.

Special thanks are due the many Philippine Government officials who took the time to meet with the project team and present their observations on the design and functioning of the Support for Development Program, including especially Mr. Ponciano Intal, Deputy Secretary General of NEDA, and Mr. Romeo Bernardo, Undersecretary of the Department of Finance. The names of these officials and those of the USAID/Manila officers who aided the team are listed in Appendix C.

Chapter 1

INTRODUCTION AND EXECUTIVE SUMMARY

This report is intended to evaluate the Philippines Support for Development Program (SDP), initiated in 1989, and to make recommendations for follow-on programs of the same general type. The report is divided into four chapters, in addition to this introduction and executive summary. Chapter 2 describes the design and implementation of the SDP program, and Chapter 3 addresses its impact on the Philippine economy. Chapter 4 discusses the elements of a future SDP program, beginning with a summary of lessons learned from SDP I. Finally, Chapter 5 presents some recommendations for an SDP II program. The scope of work appears in Appendix A; a bibliography and a list of persons interviewed are contained in Appendixes B and C, respectively.

This final version of the report reflects comments from both USAID/Manila and the Government of the Philippines on the first and second drafts of the report and on the oral presentation given in Manila April 3, 1991.

Report Objectives

Specifically, the objectives of this report are as follows.

- Review and evaluate the design and implementation of SDP I and compare its results with its objectives.
- Determine the economic impact and benefits of the program.
- Building on the lessons learned and a review of issues that could be addressed by program assistance, recommend policy objectives and indicators that could be incorporated into an SDP II program.

Background

The SDP is the latest in a series of A.I.D. Economic Support Fund (ESF) program grants to the Government of the Philippines, designed as policy-based economic assistance with the immediate objective of balance of payments and budget support. It succeeds earlier aid of this type designed to promote the recovery of the economy during the 1986-1988 period, which was also linked to policy objectives as a condition for disbursement.

Because the grant source of the Support for Development Program is the ESF, the Government of the Philippines has come to regard the aid as a form of payment for U.S. base rights, whereas A.I.D. regards the program as a tool to promote development objectives and therefore subject to policy conditionality criteria.

Description of the SDP

The objective of the SDP program is to support economic policy and administrative reforms to promote sustainable broad-based, employment-oriented, private sector-led development. The original goals of the program can be grouped into three categories:

1. Increasing national revenues;

2. Making public spending more effective, including accelerating the use of available external aid; and

3. Increasing the scope and competitiveness of the private sector.

The first category was concerned with higher revenue yields for the value-added tax (VAT) and customs duties; the second group focused on maintenance spending, completion of feasibility studies and projects, and decentralization of operations; and the third concentrated on trade reform, privatization, and deregulation of interisland shipping.

SDP was disbursed in three tranches: the first on approval of the agreement and the second and third after the various conditions were fulfilled. The Government of the Philippines disbursed the equivalent in pesos after receipt of the dollars into special accounts that were then programmed for agreed-on or already authorized expenditures.

Summary of Results

This executive summary outlines the results of the full report, following the order of the succeeding chapters.

Review of SDP Design and Implementation

The policy goals, agreed on by the Government of the Philippines and USAID/Manila, were chosen from the mainstream agenda, created by the dialogue between the government and international donors, which had been going on since 1986. These goals were very similar to those embodied in Government of the Philippines agreements with the International Monetary Fund (IMF) and the World Bank and in official declarations, with performance indicators as implementing measures. The emphasis of SDP conditionality was on implementation of an agreed policy reform agenda. Macroeconomic policies in general appeared to be functioning well at the time and had, in fact, just been endorsed by the IMF in a multi-year program.

Except for the target for VAT registrants, a pragmatic approach and frequent communication at the technical level resolved implementation problems. Conditions were met and program disbursements were carried out more or less as planned. SDP I was a success in the sense that almost all its goals were met.

Assessment of Program Impact

The transfer of resources and the policy reforms had a considerable impact on the Philippine economy. The disbursement of $209 million, of which $169 million took place in CY 1989, had the effect of reducing the current account deficit of the balance of payments 10 percent in 1989, and reducing the registered national budget deficit by 16 percent. Using the Philippine Institute of Development Studies National Economic and Development Authority macroeconomic model, the evaluation team calculated the effects on growth, inflation, and certain other variables of each of the policy targets that could be quantified. The combined effect can be summed up as a 0.25 percent increase in the GDP growth trend. Associated with this increase are positive effects on revenue, employment, and the current account.

Economic Problems and Program Assistance

The policy conditions that might be included in an SDP II design should first of all be based on a review of the current economy, its problems, and its future prospects. We start from the premise that the major problem of the economy is the failure to sustain a broad-based increase of exports of goods and services that can meet the foreign exchange requirements of growth. For example, the period 1987-1990, in which GNP growth averaged 5

percent and net capital inflow 3.5 percent of GNP, ended with an unsustainable rise of imports and minimal foreign exchange reserves.

A GNP growth target of 5 to 6 percent is certainly not ambitious for an economy with the potential and the needs found in the Philippines. The problem with meeting such a target lies in long-standing public economic policies, of which there have been two distinct phases since 1950. The earliest, lasting through the early 1970s, favored import substitution, whereas the second promoted the export of light manufactures. Unlike other East Asian countries that had a similar history but whose export orientation eventually dominated the economy, the two sets of policies have continued to coexist in the Philippines. The technique allowing this dual policy was to confine export-oriented industry to enclaves where it could obtain inputs at world prices, while allowing the import substitution sector to operate inefficiently in the domestic market, behind a high level of protection. The resulting high-cost production prevented the domestic (import-substitution) sector from efficiently supplying inputs, thereby limiting domestic value added in the export sector.

This problem might have been partly offset by a policy of undervaluing the exchange rate, but instead was exacerbated by a tendency to value exchange rate stability for its alleged effect of dampening inflationary expectations. The practice of changing the peso/dollar rate as little as possible usually led to overvaluation because local inflation was almost always greater than that of regional competitors, thanks to the public sector deficit. This policy also favored import substitution industry, whose input prices were rising less rapidly than selling prices, compared to exporters who faced contrary trends.

The period since 1986-1990 illustrates the exchange rate policy cycle. The advantage of a more competitive exchange rate resulting from the 1984-1985 float was dissipated by depreciating the peso relative to the dollar too slowly during 1987-89. Although the decline of the dollar against the yen and European currencies until 1988 had some beneficial effect, it did not improve the Philippine position against regional competitors. Though a measure of competitiveness was restored by the combination of peso devaluation and dollar decline, the advantage may only be temporary. Even if the budget deficit is reduced as promised in the IMF agreement, Philippine inflation is unlikely to be less than 15 percent this year—10 points more than that of regional competitors. The link to the dollar has already caused a large appreciation of the peso in the past 6 weeks. While the present exchange rate "looks" competitive, it would take only a small revival of activity to put the exchange market under pressure again.

The misallocation of resources occurs not only as a result of exchange rate overvaluation and trade protection but also of continuing government intervention. New import substitution industry is promoted by tax breaks; the regulation of petroleum products undervalues heavy fuels compared with the

world market and therefore favors capital intensive forms of production; the public corporate sector remains very large 4 years after large-scale privatization has been decided; and the cartelization of interisland shipping depresses industrial and agricultural production outside of Metro Manila.

Recommendations for Future Program Assistance

The design of SDP II should be based on the experience of SDP I, as applied to a range of issues that can be addressed with program assistance.

As a model for a prospective SDP II program SDP I had several drawbacks: the multiplicity of objectives, the related proliferation of goals and indicators, and their perhaps too narrow formulation. A new program should have a more precisely focused overall goal whose achievement can be subdivided into a small number of objectives. While predetermined indicators would remain important, an element of flexibility could be built in, so that the judgment of the degree of success could be based more broadly on the objectives and the program as a whole.

The group of policies from which conditions would be chosen for SDP II should meet the following criteria.

- They should be concerned with resolving, to some degree, the issues cited above.
- They should implement the Government of the Philippines' announced policy goals.
- They should form a more tightly focused program than SDP I that can be easily justified and flexibly carried out.

The theme of this program should be, as the National Economic and Development Authority (NEDA) has proposed, a "strategy for export development." All the problems so far discussed influence the success or failure of this goal, which is obviously a high priority of the current administration.

The evaluation team suggests that four or five of the following policies be selected, with appropriate performance indicators, as the conditions attached to SDP II. By relating them to a single theme, the program as a whole becomes the major goal and individual targets become less important. The objectives, in priority order, are as follows.

1. Restructure the foreign exchange market so that the exchange rate adjusts continually to supply and demand.
2. Reduce or eliminate "negative effective protection" on exports.

3. Increase tax revenue.

4. Complete the privatization program.

5. Deregulate the prices of petroleum products.

6. Liberalize entry into interisland shipping.

7. Emphasize export-oriented rather than import-substitution industry when promoting new investment.

A specific exchange rate target is inappropriate for an international agreement because this rate is too sensitive for any government to entirely cede control over and because it is impractical to project, over the long term, what its correct level should be. The IMF typically approaches the subject of keeping the exchange rate as realistic as possible obliquely through a "net reserve target," which allows governments the required flexibility. Another method of achieving the same objective would be to unify the foreign exchange market, which is now segmented into an interbank and a commercial bank market which, in turn, is broken up into bank-by-bank transactions.

Currently, excess demand for foreign exchange appears in the parallel market in the form of a discount from the official rate, where it is countered eventually by higher short-term interest rates. In a unified market, the same pressure would have a smaller effect but, by incremental steps, a new equilibrium would be attained. Instead of periods of overvaluation, followed by abrupt depreciation, there would be a continuous adjustment that would be more favorable to exports and customs revenues. Extensive technical design of such a system has already been carried out by the IMF and discussed with the Central Bank.

Many Philippine exports suffer from "negative effective protection." True effective protection, as distinct from the nominal protection of quotas and tariffs on the selling price of a domestic product, is measured in terms of the costs of local value added relative to world costs of the same inputs. Negative effective protection occurs when an export sold at world prices includes inputs purchased at higher than world prices. This situation is the equivalent of establishing an exchange rate for exports that is less favorable than is the nominal exchange rate. The goal of public policy in this instance should be to select a group of products suffering from negative effective protection, determine the level in the production process at which protectionism for inputs has caused the cost distortion, and reduce such protectionism. Much of the background analytical work for carrying out such a policy has already been done.

With respect to budget revenue, the Philippines remains, despite the improved performance of the past few years, an economy in which the gap

between tax collection and potential tax liabilities is relatively high. The levies that offer the most promise are the VAT and excise taxes on petroleum products, once the liabilities of the Oil Price Stabilization Fund (OPSF) are paid off. The advantage of the VAT is that its yield should be more than proportionate to GNP in nominal terms for some time, as the collection apparatus improves. The advantage of a petroleum product excise is that it could make permanent the current gap between domestic prices and the world price of crude petroleum imports.

Concerning privatization, the current program is ambitious and could have a very beneficial effect on national productivity, but the easier steps have now been carried out. The objective of an enhanced program would be to accelerate the process by preparing major units for sale, with performance indicators based on a timetable for sales among a representative sample of the larger companies.

The proposed deregulation of petroleum prices could occur once OPSF's financial condition permits liquidation. Until mid-1990 the system tended to subsidize all petroleum product prices relative to the world crude price temporarily and to distort relative prices permanently. This distortion has been corrected, as domestic prices were raised sharply in the second half of 1990 and have been maintained at a high level despite the subsequent reduction in international prices. The OPSF pricing formula contains a significant discretionary element, however, which could lead to a recurrence of price distortion in the future. Consequently, policy analysts have suggested two alternatives to current policy: first, retail prices could be freed and the Government of the Philippines could use the national oil company to prevent the private companies from making excess profits; second, the OPSF could maintain a very limited ability to run a deficit, with the guideline of aligning relative prices to the world market.

Deregulation of interisland shipping requires both freedom of entry to the industry and freedom of operators to set cargo rates. Freedom of entry without freedom of pricing would be ineffective, whereas free pricing without free entry would transform the interisland shipping market from that of a regulated to that of an unregulated cartel. Freedom of entry to interisland shipping is unfinished business from SDP I, but a current USAID/Manila project should soon make available extensive information on pricing and routes, allowing concrete recommendations for SDP II.

The incentives available to investors should normally be the same whether for export or for production for the domestic market, but present protection makes the latter more profitable. One way of correcting this bias in favor of production for the local market is to reduce the number of protected sectors as much as possible, favoring only export-oriented production when protection is deemed necessary at all.

With respect to the programming of a local currency equivalent of ESF dollar transfers, the experience of SDP I suggests that the benefits of such a process are outweighed by the costs. The availability of local currency funding does help slant Government of the Philippines budgetary impacts in a direction favorable to policy reform objectives, and it may help win the support of Government of the Philippines officials for certain types of policy reform. Balancing these benefits, however, are the significant administrative costs resulting from the complexity of local currency conditionality and monitoring. In addition, the injection of local currency into the Government of the Philippines budget runs the risk of creating inflationary pressures, unless properly coordinated with fiscal and monetary programming. Consequently, the evaluation team recommends that SDP II not include a local currency programming component.

The Government of the Philippines can design a program, including many of these options, requiring very little legislation, and subject to implementation entirely by the executive branch. In certain cases legislation may be required, and "consultation" would be in order for others. From the technical point of view, most of these policies could be implemented fairly quickly, while others would require preliminary studies. The encouraging point for program design is that several options exist for fashioning a workable, productive SDP II policy package.

The economic impact of the program will depend on what package of policy objectives are chosen in the final agreement. For purely illustrative purposes, assumed quantitative effects of five of the proposed policy areas have been worked out: (1) exchange market reform, (2) reducing negative protection on exports, (3) increasing VAT revenues, (4) completing the privatization program, and (5) deregulating interisland shipping. The initial impact is to reduce GNP in 1991 and 1992 but increase it thereafter. The current account deficit would be reduced as would inflation after a lag.

Supporting Future Technical Assistance and Training

Philippine authorities have expressed a desire to improve the analytical skills of the staff of their policy-related public agencies. In Chapter 4, a training and technical assistance (TA) system is outlined that would link the implementation of an SDP type program. It would consist of both graduate study in, for example, development economics and much shorter courses to impart specific skills. With respect to domestic issues, the system would include programs in development planning (growth projections, input-output analysis, etc.), financial programming and policy, mobilization of savings, and investment promotion. In connection with the export strategy, the system would offer courses in exchange rate management, the effects and elimination of trade protection, and the management of the external debt. Most of the instruction would be carried out locally, with a mixture of Philippine and foreign faculty.

The implementation of SDP II would also benefit from technical assistance and research projects directed at (1) the implications of a long-term export strategy for exchange rate management, trade protection and investment promotion; (2) the further development of the PIDS-NEDA model; and (3) the design of a general system of policy analysis for the Government of the Phillipines and A.I.D., including a more policy- and production-oriented model of the Phillipine economy.

Chapter 2

REVIEW OF SDP DESIGN AND IMPLEMENTATION

In this chapter, the Support for Development Program is reviewed in more detail, and its objectives and design are compared with its implementation and outcome. The first half of the chapter is devoted to the design of SDP I. It is broken down as follows: the first section reviews the objectives; the second covers the design of SDP I, including a summary of its policy matrix; the third summarizes how the design evolved; and the fourth discusses relations with other donors. In the second half, the subject of which is implementation, the first section reviews the effectiveness of the program in carrying out the proposed objectives; the second reviews how the Government of the Philippines organized itself and the administrative problems it encountered.

Original Design

Objectives

The intent of SDP I was to promote administrative and economic reforms aimed at fostering sustainable broad-based, employment-oriented, private sector-led development.

Factors Underlying the Original Design

The policy content and priorities of the SDP at the beginning of 1989 focused largely on administrative and sectoral issues, because macroeconomic performance during 1987-1988 appeared to be satisfactory and in need of less attention. In fact, with the signature of the comprehensive Extended Funds Facility (EFF) program, the IMF had just put its stamp of approval on current Government of the Philippines macroeconomic policy. Only one of the SDP policy areas is directly related to the usual macroeconomic concerns. The others are involved with continuing the reform of the private sector, which had begun in 1986, and with making the public investment and maintenance process more effective, a problem that bedeviled all the donors.

There were three basic goals underlying the policy matrix, as follows:

1. Increasing national government revenues;

2. Rendering public spending more effective, partly by accelerated use of available external resources; and

3. Increasing the scope and competitiveness of the private sector.

The first goal, increased tax revenue, was to be attained essentially by more efficient tax administration. Concerning the goal of increasing the effectiveness of government spending, there were targets for higher maintenance, more rapid completion of feasibility studies, central monitoring of project implementation, and decentralization of operations. The final goal, improving the competitive environment and overall private sector economic efficiency, was expected to result from privatization of selected government-owned or -controlled companies (GOCCs), deregulation of interisland shipping, and trade reform, including the replacement of quantitative restrictions (QRs) with tariffs.

The selection of specific policy and administrative reforms for the policy matrix was made on the basis of judgments concerning their economic urgency and political and technical feasibility at the time. Apart from the measures included in the policy matrix, the agenda for continuing policy dialogue with the Government of the Philippines covered a broad area, including exchange rate policy, the budget deficit, trade and tariff policy, financial sector reform, investment incentives, deregulation, and decentralization.

The SDP program was disbursed in three tranches, with the second and third disbursements linked to the fulfillment of various targets. Following is a summary of the policy matrix relating SDP I targets and tranches. Where no specific tranche targets are indicated, the phrasing of the SDP matrix entries is intended to indicate the targets.

I. Increasing public revenue

Improved tax collection efficiency.

Adoption of measures to improve VAT collections (no tranche target).

Raising the number of paying VAT registrants (second and third tranche targets).

Increasing VAT collections by a specified percentage (third tranche target).

More effective anti-smuggling enforcement procedures (no tranche targets).

Increasing share of imports covered by "fair market values" by specified percentages (second and third tranche targets).

II. Rendering public spending more effective, including improving the use of external resources

Adequate level of operations and maintenance (O&M) expenditures.

Increasing disbursements for Central Government's maintenance and nonpersonnel operations by a specified percentage (third tranche target)

Improved planning of public investment projects through strengthened capability for project identification and preparation.

Increasing budgetary releases for the Project Facilitation Committee (PFC) by a specified percentage (third tranche target)

Number of studies in progress/completed (third credit tranche)

Improved implementation of public investment projects by decentralized monitoring

Issuance of a Memorandum Crder (MO) by Office of the President (OP) to establish the Regional Project Monitoring and Evaluation System (RPMES) (second tranche target)

Creation of a specified number of Regional Project Monitoring Committees (RPMCs) in all regions, except the National Capital Region, to adopt RPMES (third tranche condition)

Improved implementation of public investment projects through greater delegation of authority

Issuance of an order for decentralization of the supervision and implementation of Integrated Area Development (IAD)

projects, including Philippine Assistance Program (PAP) demonstration projects (second tranche target)

Transfer of overall direction, coordination and supervision of specified numbers of IAD projects to provincial or regional levels, and inclusion of private sector participation (second and third tranche targets).

Increased Non-Government Organization (NGO) participation in the delivery of basic services

Preparation and dissemination by NGOs of the Primer on Procedures and Guidelines for Availments of Tax and Duty Exemptions by NGOs (second tranche target)

Establishment of NGO desk or designation of liaison officers in a specified number of line departments at the national level that offer frontline services and were previously involved in NGO consultations (second tranche).

Preparation and dissemination to NGOs of a list of government agencies and their respective NGO units/desks (third tranche)

Preparation of a list of national and regional NGOs, for use by government agencies (third tranche)

Improved implementation of Official Development Assistance (ODA)-funded projects through a faster drawdown of ODA project funds.

Specified percentage increase in annual drawdowns of foreign assisted project funds implemented exclusively by major infrastructure agencies (third tranche)

Department of Public Works (DPWH) progress on the effectiveness of delegated authority for bidding and approval of contracts in improving the implementation of foreign-assisted projects.

III. Increasing the scope and competitiveness of the private sector

Trade Reform

Selection of specified numbers of items for which quantitative restrictions would be replaced by tariffs (second and third tranche targets).

Privatization

Completion of steps to bring specified numbers of GOCCs into vendible form (second and third tranche targets)

Deregulation

Phased liberalization of regulations on interisland shipping.

Adoption of a policy to liberalize entry to shipping routes (third tranche target).

Upgrading of liner freight rates on basic commodities (second tranche target).

Second class passenger rates set free (second tranche target)

Completion of Terms of Reference (TOR) and initiation of study of interisland freight rates (third tranche target).

Evolution of SDP Context and Design

The policy implementation targets (performance indicators) incorporated in SDP I conditionality were carefully formulated to be specific, clear and precise, and limited in scope. In retrospect, given the fulfillment record of the performance indicators, they may be characterized as reasonable and realistic.

The specific policy reform objectives of SDP I, as incorporated in the above policy matrix, have paralleled those of various policy-based programs of the IMF and the World Bank. As examples, the SDP fiscal provisions (tax administration and O&M expenditures) are consistent with those of the IMF's EFF; the SDP trade reform target (replacement of QRs with tariffs) is consistent with the World Bank's Economic Recovery Loan (ERL) and the IMF's EFF; SDP-recommended privatization actions (to put GOCCs in vendible form) are consistent with the World Bank's ERL and GOCC loan and with the IMF's EFF; the SDP promoted deregulation (of interisland shipping rates and entry to routes) parallels the World Bank's recommendations; and the SDP administrative reform measures support the ultimate donor objective of expediting ODA pipeline drawdown with the general consensus of the donors.

In the case of interisland shipping, studies supported by USAID/Manila concluded that the existing system of regulation represented a significant barrier to competition, encouraged inefficiency, and increased the level of costs. SDP I consequently sought to initiate the process of liberalization of entry to shipping routes and of deregulation of passenger and freight rates.

In the design stages, and throughout the duration of SDP I, USASID/Manila carried on a continuing and intensive dialogue with the Government of the Philippines economic team on a broad policy agenda including exchange rate policy, the budget deficit, trade and tariff policy, financial sector reform, investment incentives, deregulation, and decentralization. The policy dialogue, which has been much more comprehensive than the content of the policy matrix, has proved useful to the Mission as an input into the design of other projects such as Private Enterprise Policy Support (PEPS), Agribusiness Systems Assistance Project (ASAP), Local Development Assistance Program (LDAP), etc. Because of its scope, intensiveness and continuity, the USAID policy dialogue with the Government of the Philippines has also been found valuable by other donors (particularly multilateral institutions) in the conceptualization and implementation of their policy agenda.

Coordination With International Donors

In carrying out the policy agenda for SDP, USAID/Manila maintained close coordination in the field with other international donors—especially multilateral agencies and Japan—which, together with the United States, account for the major part of the aid inflows. In particular, the SDP has been drawn up in the context of, and has been supportive of, the policy-based lending programs of the IMF and the World Bank that were in effect at the design stage of the SDP. These include the IMF's EFF and the World Bank's ERL and GOCC loan) and programs soon to be negotiated (such as the World Bank's financial sector reform program). The coordination with Japan has been facilitated by the fact that its policy-based assistance has largely taken the form of cofinancing or parallel financing with the World Bank policy-based programs.

Coordination with the Asian Development Bank (ADB) has been limited by the fact that policy-based lending by ADB to the Government of the Philippines started only in 1988 and that ADB had made such loans only to the forestry and fisheries sectors by 1989. The Mission's coordination with other donors has been greatly strengthened by the consultative process of the Multilateral Assistance Initiative (MAI) which is, in essence, a policy based assistance program launched at U.S. initiative.

Implementation Process

Effectiveness in Terms of Objectives

Several implementation problems in policy targets arose during the course of SDP I, but all except one (increasing the number of VAT filers) were resolved without significant difficulties. Two others were related to the deregulation of interisland shipping.

The first interisland shipping problem concerned the policy target of liberalized entry to shipping routes. The policy was submitted to the Maritime Industry Authority (MARINA) Board well in time for the third tranche (i.e., before September 30, 1990), but it has languished because Congressional input has still not been received (as of mid-March 1991). Pending formal adoption of a liberalization policy, MARINA is already implementing, in practice, key elements of the proposed policies to liberalize entry to shipping routes. Accordingly, USAID/Manila chose to treat MARINA performance as substantial compliance for the third tranche.

The second interisland shipping problem resulted from the late initiation of the study of interisland freight rates, due to delays in Government of the Philippines interagency clearances and in USAID contracting procedures. Since the delay was procedural and not substantive, and considering that the study was initiated soon after the terminal date for the third tranche (September 30, 1990), the Mission decided to regard its initiation as substantial compliance as well.

The only serious implementation problem during SDP I concerned the target of 78,000 paying VAT registrants. Certain Philippine Government officials expressed the view that the target was unrealistic, that it was set without sufficient consultation with the government agencies involved, and that the implications of the definition of paying registrants were not fully explained to the agencies. In this context, it may be useful to point out that this target was adopted from the IMF's EFF that had been accepted by Government of the Philippines, and the number and definition of paying VAT registrants was discussed with NEDA and BIR officials. The most likely cause of the Government of the Philippines having accepted what may appear in retrospect to be an unrealistic target seems to have been a lack of clear communication within the agencies concerned.

In any event, withholding disbursement of the third tranche and finally disbursing less than the full amount may have caused resentment within the Philippine Government out of proportion to the importance of the target (particularly considering that the VAT revenue increase target was met). Alternatively, it may have been a useful lesson to the Government of the Philippines that policy targets are to be taken seriously. The incident might have been avoided, however, if the USAID Mission had confirmed the feasibility of the policy objectives and indicators by more independent investigation and research, including direct interaction with BIR personnel.

The mechanism of transfer of SDP funds involved cash transfer of dollars as well as generation of local currency for budget support. The dollars were used as stipulated, for payment of official debt to multilateral institutions. There were no significant problems with local currency programming or its use to finance already budgeted (not additional) expenditures on basic services in population, education and health areas.

There were some reporting delays because of COA requirements but the problems have since been resolved.

The process of implementation created some frictions. For example, some Philippine Government officials characterized as "micromanagement" the targets for increased O & M expenditures and for administrative reforms to bring about faster ODA pipeline drawdown. A related criticism was that the policy matrix was too long and too detailed.

Organizational Aspects of Implementation

Government of the Philippines Agency Structure

This section discusses the organizational performance of the various agencies of the Philippine Government involved in the implementation of SDP. Organizationally, SDP was implemented at two levels: (1) among agencies, by means of the *ad hoc* joint working committee level constituted specifically to serve as a forum for coordination and monitoring of implementation of SDP; and (2) within the government agencies responsible for the implementation of the policy objectives.

An interagency committee was established as a means of achieving overall control of SDP implementation. The interagency committee was composed of high-level officials (generally from undersecretary to director level) assisted by technical staff from the various agencies assigned to perform SDP specific functions. The Department of Finance (DOF) and the National Economic and Development Authority (NEDA) were the lead agencies.

The major Philippine Government agencies involved in the implementation of the various phases and strategies of SDP I (see Figure 2-1) are as follows.

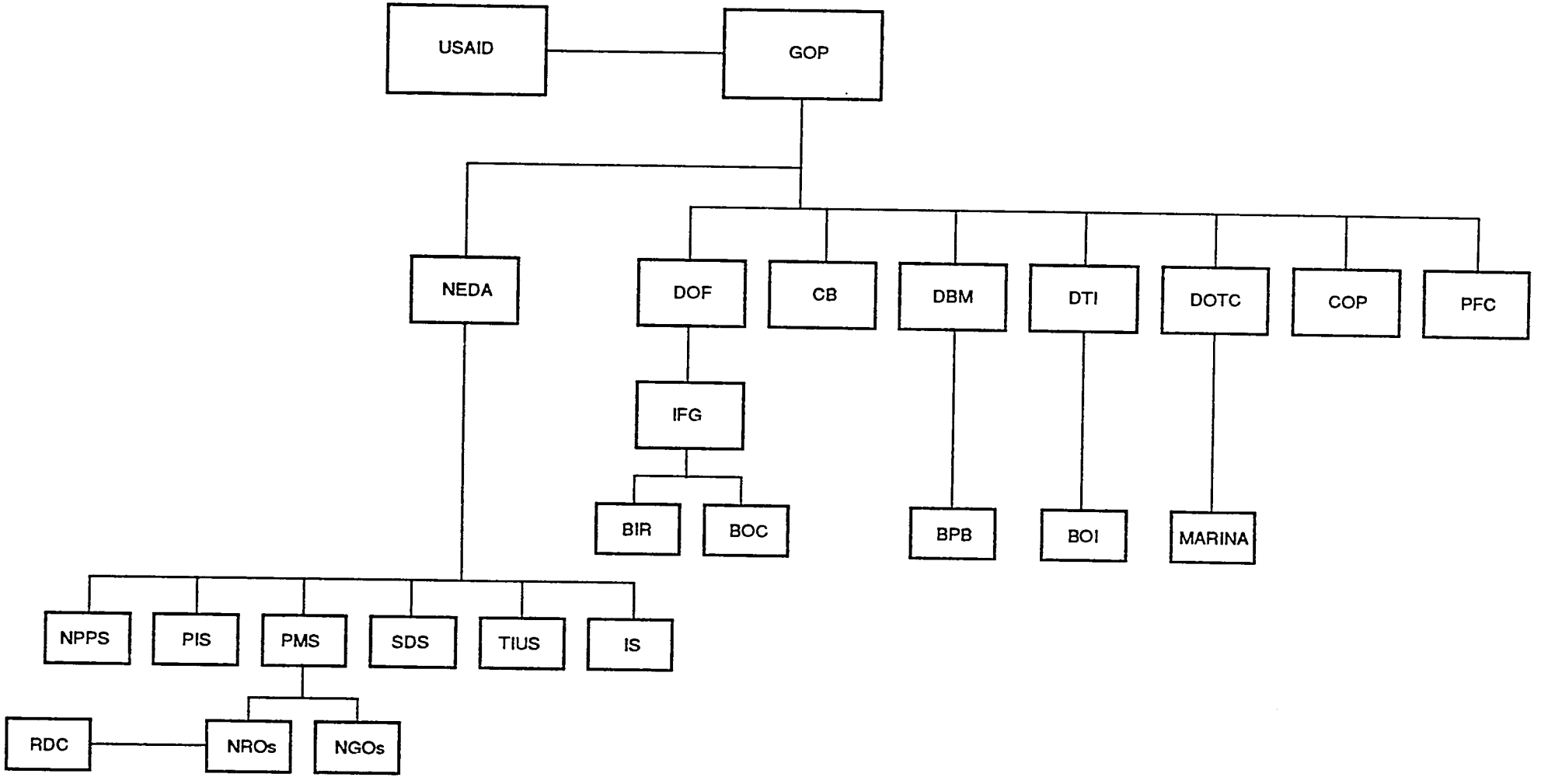
- The Department of Finance (DOF), particularly the following:

  International Finance Group (IFG);
  Bureau of Treasury (BTr);
  Bureau of Customs (BOC);
  Bureau of Internal Revenue (BIR), particularly the
  Value Added Tax (VAT) Division.

- The National Economic and Development Authority (NEDA), particularly the following units:

  National Planning and Policy Staff (NPPS),
  Public Investment Staff (PIS),
  Social Development Staff (SDS),

Figure 2-1
Organization/Implementation Chart of Agencies Involved in SDP I



- The National Economic and Development Authority (NEDA), particularly the following units:

  National Planning and Policy Staff (NPPS),
  Public Investment Staff (PIS),
  Social Development Staff (SDS),
  Project Monitoring Staff (PMS),
  Trade and Industry Utilities Staff (TIUS),
  Infrastructure Staff (IS).

- Department of Budget and Management (DBM), particularly the Budget Planning Bureau (BPB).

- The Department of Trade and Industry, particularly the Board of Investments.

- The Department of Transportation and Communication (DOTC), specifically the Maritime Industry Authority (MARINA).

- The Office of the President (OP).

- The Commission on Audit (COA).

- The Interagency Committee on Privatization (COP), composed of the following members represented at the secretary level;

  Department of Finance (chairman),
  Department of Budget and Management,
  Department of Justice (DOJ),
  Department of Trade and Industry (DTI),
  National Economic and Development Authority.

- The Interagency Project Facilitation Committee (PFC), based at CODA, with the following agencies represented at the Undersecretary level:

  Department of Finance (chairman),
  Department of Budget and Management,
  National Economic and Development Authority,
  Department of Public Works and Highways (DPWH),
  Department of Foreign Affairs (DFA),
  Department of Trade and Industry (DTI).

The DOF, specifically through the IFG, negotiated the dollar disbursement plan with USAID. On behalf of the Government of the Philippines, it submitted to USAID the documents certifying satisfaction of conditions precedent (CPs) to dollar disbursement. With reference to the

disbursement and reporting of tranches, the IFG coordinated with the BTr and the Central Bank (CB) on the following matters: forthcoming tranche disbursements and the special accounts into which they were to be deposited; deposit of equivalent pesos to the peso special account upon receipt of dollars; eligible debt service payments for dollar utilization; and, with DBM and the BTr, the time when pesos can be transferred to the General Fund.

The IFG advised NEDA-PIS when the tranches were expected to be disbursed in order to facilitate deposit of pesos in the USAID trust account and coordinated with the CB, BTr, the DBM and COA concerning reporting and auditing requirements. In addition to the undersecretary who sat in SDP interagency meetings, one project evaluation officer was assigned to monitor all USAID-related matters, including SDP.

Through its various staff offices, NEDA coordinated and monitored SDP implementation. The Public Investment Staff (PIS) worked on the design, the negotiations with USAID in connection with the conditions precedent to the release of the tranches, and the coordination with USAID, DOF, DBM, CB, and the BTr regarding the peso disbursements and dollar payments. Two officials from the PIS were involved, specifically the PIS Director and one Supervising Economic Development Specialist.

The National Planning and Policy Staff (NPPS) played a central role in providing technical assistance and organizational support to SDP by serving as the secretariat, together with the IFG of DOF, of the Joint Working Team. It supported the NEDA Deputy Director General in charge of SDP by: (1) acting as liaison for the various agencies involved in SDP I; (2) monitoring the implementation of government policy commitments; and (3) reporting developments. Among the officials involved in SDP-specific activities provided by NPPS were the Director, the Public Finance Division Chief, a Supervising Development Economic Specialist, and an Economic Development Specialist.

The other major Philippine Government agencies were the DBM and the CB. More specifically, the DBM acted through an undersecretary who responded to all communications and requests from USAID, DOF, and NEDA regarding quarterly disbursement reports and budget disbursements. The CB through its Treasury Department responded to requests of USAID for formal bank statements necessary for refunds to the special dollar account of SDP. It monitored the transfers from SDP peso special account to the Bureau of Treasury's regular demand deposit account.

Agency Performance

This section examines how Philippine Government agencies implemented SDP targets under their responsibility and discusses the policy objectives in

the same order in which they are presented in the policy matrix shown earlier in this chapter.

Increasing Public Revenues. The first such target was increasing tax revenue through the value added tax and through more accurate assessment of import values. As shown below, this policy objective was perhaps more fraught with administrative problems than any other. The DOF through the BIR and BOC, with the support of the DBM, were the lead agencies.

The BIR, through the VAT Division, adopted measures specifically aimed at increasing the number of VAT-paying registrants. The implementation problems that occurred in the VAT division were quite serious, beginning with lack of personnel. Out of 241 authorized revenue enforcement officer (REO) positions in the VAT division, 104 (43 percent) are positions authorized for deployment in the field. In reality, there were only 156 instead of 241 authorized positions (64 percent), with 60 officers (38 percent) actually deployed in the field. The VAT Division had tried to hire additional personnel but was unable to because, according to the BIR's own personnel section, all positions are actually filled. The problem therefore lay in the fact that many positions allocated to VAT collection were actually occupied by other BIR personnel performing functions not related to VAT.

The second problem in the implementation of this policy objective was the lack of both computer hardware and software. The VAT division has only 16 computer terminals linked to 5 microcomputers for data entry purposes to service the entire population of VAT registrants, a population estimated to be around 125,000, eighty percent of whom are in Metro Manila (Guevara 1990:61).

The lack of a clear-cut definition of "VAT-paying filers" was another implementation-related problem, one which arose when the number of VAT returns filed was initially considered the same as the number of VAT-paying filers for purposes of complying with SDP requirements. Such an approach led to an overstatement of the number of paying filers, because not all who file VAT returns actually pay. After discussions with the AID mission, a revised classification of VAT registrants and filers was devised, as follows.

1. Registrants,

2. Paying filers,

3. Filers with even returns (including those with excess input tax credits),

4. Filers of zero-rated returns (those for which the declared transactions are 100 percent zero-rated or effectively zero-rated),

5. Stop-filers (taxpayers who had filed VAT returns, but stopped filing for any reason),

6. Irregular filers (those who file returns "off and on"),

7. Newly registered filers (filing date not yet due),

8. Filers of no transactions returns.

Only categories 2, 3, and 4 were considered as VAT-paying filers for purposes of SDP objectives.

Another implementation problem concerned the targets set by DOF and BIR decision-makers. The targets are actually set by DOF through its Fiscal and Policy Planning Office (FPPO) in coordination with the BIR. The government target setters use what they refer to as an input-output approach in which VAT collection targets are based on a certain percentage of GNP (in 1990 that percentage was 1.3) plus returns from implementation of several administrative measures such as VAT on sugar, the availment of last priority, stamping and registration of receipts, and the raffle of sales invoices. In addition, the FPPO considers that potential collection could be based on projected GNP, the estimated tax base, and elasticity factors.

Officials of the VAT Division believe that, although they were consulted in the determination of targets, these targets assumed an adequate level of availability of personnel and computers in the Division, a level of availability that turned out not to be the case. From this perspective, the VAT targets should have been adjusted subsequently in light of the limited availability of personnel and computers. In part in response to this perspective, the SDP joint working committee has suggested that a scale of compliance should be designed in order that less than 100 percent performance might be given due credit. To strengthen VAT collection, the following recommendations were made by the Statistical Analysis Division: (1) increase the number of revenue enforcement officers assigned to VAT activities; (2) upgrade the VAT division into a VAT service unit of the BIR; and (3) provide additional microcomputers.

The BOC was also asked to improve collections. Under SDP, the BOC increased the share of imports covered under published fair market values as bases for valuation of imports for duty and tax purposes. In early 1987, the Government of the Philippines hired the Société Générale de Surveillance (SGS) to provide the BOC services in the fields of inspection, valuation, and classification of imports in order to prevent misdeclaration. The fair market values of such goods are supposed to be published in order to facilitate uniformity in assessment of duties and taxes to be paid by the importers. The SGS provided such information about once a week.

DBM's role in the attainment of improved fiscal responsibility was in the provision of an adequate level of operations and maintenance expenditures to lead to improved fiscal responsibility. This was in response to the fact that the levels of Maintenance and Other Operating Expenses (MOOE) of the Government of the Philippines had actually declined in real terms since 1976. This was especially true after 1982, as illustrated by Table 2-1.

Table 2-1. Maintenance and Other Expenses (MOOE) of the National Government, 1976-1990 (million pesos)

Year	In Nominal Terms		In Real Terms	
	Amount	Growth Rate	1982 = 100	Growth Rate
1976	8,037		15,104	
1977	9,497	18.17	16,621	10.04
1978	9,289	(2.19)	14,884	(10.45)
1979	8,866	(4.55)	12,328	(17.17)
1980	10,739	21.13	12,918	4.79
1981	11,263	4.88	12,211	(5.48)
1982	13,183	17.05	13,183	7.96
1983	11,942	(9.41)	10,694	(18.88)
1984	12,405	3.88	7,413	(30.68)
1985	13,196	6.38	6,671	(10.01)
1986	15,024	13.85	7,523	12.77
1987	18,882	25.68	8,743	16.22
1988	19,546	3.52	8,258	(5.55)
1989	26,808	37.15	10,241	24.02
1990	30,200	12.65	10,102	(1.36)

Note: Actual disbursements.
Source: DBM.

The level of actual cash disbursements for maintenance and non-personnel operations of the national government was used as a performance indicator in the years covered by SDP. Specifically, the MOOE for 1989 should grow in current terms by at least 15 percent over the 1988 level. To date, as indicated in Table 2-1, the 1989 MOOE for national government increased by 37.2 percent over the 1988 level of ₱19.6B. Furthermore Table 2-1 shows that MOOE levels in 1989 and 1990, in real terms, are beginning to approach 1992 levels.

Rendering Public Spending More Effective. Among the major organizational concerns involved in the general policy objective of improved planning of public investment projects was the poor capability of local governments to undertake project development activities, specifically preparation of feasibility studies required for funding support by the PFC/FS. The major consequence was a poor utilization rate of the PFC/FS. A report prepared by NEDA-PMS in February 1991 cites the following factors (identified by NEDA Regional Offices) in accounting for poor performance: (1) poor preparation of proposals; (2) lack of qualified consultants in the region; and (3) delay in the release of funds.

The most important indicators of organizational performance are the existence of (1) an institutionalized organizational infrastructure, (2) established systems and procedures, and (3) capabilities for utilizing the PFC/FS. With respect to the first two indicators, the role of the RDCs and the support provided by the NROs are crucial. (The latter have been organized since 1972 and are deployed throughout the country.) Though far from perfect, their capabilities and levels of institutionalization have vastly improved since their organization was established in the early seventies, specifically in the areas of regional planning and development. Unfortunately, the same cannot be said at the lower levels of government where the technical support to the LGU is supposed to be provided by the local planning development offices, e.g., the provincial planning and development office at the provincial level, and the municipal planning and development office at the municipal level. The lack of qualified personnel in these lower level offices may therefore explain the poor quality of the feasibility studies submitted to the RDCs and consequently the low utilization of the PFC/FS.

The organizational infrastructure and support aimed at improved planning of public investment projects is in place—at least up to the regional level. Efforts to strengthen the capabilities of LGUs must be given attention. This can be done by encouraging the various development councils to strengthen both vertical and horizontal networking.

The PMS of NEDA followed improvements in the monitoring and implementation of public investment projects by decentralization of the monitoring system and greater delegation of authority in the implementation of projects. Among the major organizational entities involved are the various provincial and municipal project monitoring committees that have been organized by the different LGUs throughout the country. A manual of operations [Regional Project Monitoring and Evaluation System (RPMES)] has been prepared to serve as a guide for the various project monitoring committees in order to support the decentralization policy of the government and provide a scheme linking the monitoring and evaluation systems at the national, regional, provincial, and municipal levels.

However, improved implementation and monitoring of public investment capabilities should be complemented by the strengthening of local development councils (LDCs) whose responsibilities have increased because of the devolution of the implementation of Integrated Area Development Projects (IADs) to them in selected areas under SDP. After all, the LDCs provide the overall organizational framework for the planning, implementation and monitoring of development programs and projects at the local levels. Unfortunately, inadequate manpower and logistics continue to hamper the operations of LDCs, especially at the provincial, municipal, and barangay levels. Additionally, the lack of substantive authority (administrative, planning and financing) is another area of LDC weakness. It is within this context that efforts to strengthen implementation capabilities at the local levels should focus on strengthening the LGUs through their development councils.

Another element of the basic goal of increased public expenditure efficiency was the objective of increased NGO participation in the delivery of basic services. Harnessing the potential of the NGOs to the development process is a high priority objective of the current Government of the Philippines administration, as illustrated by the presidential mandates that local councils allocate at least one-fourth of their seats to NGOs.

The Social Development Committee of the NEDA board was responsible for the implementation of NEDA guidelines in collaboration with government organizations and NGOs. With the cooperation of the Presidential Management Staff (PMS) of the Office of the President, a directory of NGOs in the country was prepared. Other organizational supports and procedures aimed at achieving the general policy objective of increased NGO participation in the delivery of basic services include the establishment of NGO desks or designation of liaison officers among the various line departments of government, and dissemination of the primer on procedures and guidelines for the availment of tax and duty exemptions by NGOs.

Among organizational issues that must be confronted in this context is the misuse of the NGO label. For example, there have been cases where NGOs have been organized by the defeated political opponents of victorious local officials solely for the purpose of opposing the party in power. Others have been organized solely for fund-raising purposes. Thus, issues such as accreditation or registration of NGOs should be addressed.

Overall, the Philippine administrative system is as sympathetic and sensitive to the role of the NGOs in the development process today as it has been traditionally. SDP has supported the attainment of this broader policy objective.

The attainment of the policy objective of improved implementation of ODA-funded projects was the responsibility of NEDA's PMS and DOF's IFG. These agencies monitored the annual drawdowns of foreign assistance project funds by the major infrastructure agencies. Procedurally, the withdrawal of the pre-audit requirement by the COA for project contracts has facilitated the implementation of ODA-funded projects. The DBM has also adopted a "common fund system" which authorizes the project implementor to use funds common to a number or pool of projects, thus allowing flexibility in terms of getting projects moving and minimizing underutilization of funds (SGV 1990:38).

The DPWH plays a central role in the implementation of ODA-funded infrastructure projects. That is why delegation of authority to its various field offices is crucial in the implementation process. The DPWH field offices now have sufficient authority to enable them to respond to bids and approve contracts on their own. Among the different line agencies of the national government, it has the most decentralized operation. This was confirmed by a report prepared by the Decentralization Watch Project (1990).

Increasing the Competitiveness of the Private Sector. This overall SDP goal included three subsidiary policy objectives: trade reform, privatization, and deregulation. The administrative problems involved in implementing these objectives were considerably less serious than those involved in the two prior goals.

The first subsidiary objective was to increase industrial competitiveness, principally through liberalization of import restrictions. The DTI through the BOI implemented trade reforms liberalizing imports as provided for in CB circulars. The decision concerning which items to liberalize was essentially the result of a series of consultations between the Government of the Philippines (led by the DTI and BOI) and private sector counterparts, also referred to as the G-11, a group of 11 industry subsectors that met twice a month with the DTI. These subsectors include the following industry groups: agro-based, forest-based, construction materials, construction industry, mining and metallurgical, metals and engineering, electronics and telecommunications, wearables, service and toys, gifts, and furniture and housewares. Resistance to liberalization involved mostly "List B" products, with objections being raised by the metals and engineering and food products (agro-based) sectors of G-11. After discussions between the DTI/BOI and the G-11, recommendations were forwarded to the committee on Tariff and Related Matters (TRM) of the NEDA Board created by EO 230 on July 22, 1987. The TRM is composed of the Director-General of NEDA, the Executive Secretary, the secretaries of Trade and Industry, Foreign Affairs, Agriculture, Environment and Natural Resources, Budget and Management, the Governor of the Central Bank, and the chairman of the Tariff Commission. After approval by the NEDA Board, the decisions are then forwarded to the CB, eventually to be issued as a circular.

The second objective involved in the goal of increasing private sector competitiveness was privatization, which had two major components: (1) the disposition of transferred assets, and (2) the sale of selected government-owned-and-controlled corporations (GOCCs). The institutional focus for implementing privatization policy was the Committee on Privatization (COP), created earlier by Proclamation 50 of December 1986, which was responsible for putting in vendible form an offer for sale of GOCCs representing a specified percent of asset values. The COP has an inherent "check and balance" mechanism, wherein its members (the Secretaries of Finance, Budget, Justice, Trade, and Industry and Economic Planning) determine general policy, while actual marketing transactions are implemented by the Asset Privatization Trust (APT), National Development Corporation (NDC), or Government Services Insurance System (GSIS). The separation between the policy-making and marketing group is not only a more efficient but also a more transparent arrangement.

Among the major issues raised during SDP I in terms of strengthening the implementation of privatization were (1) developing the capabilities of the

marketing units through technical assistance for preparation of valuation and privatization strategy studies, and (2) assisting the disposition entities to market their assets.

After privatization, the third subsidiary objective for increasing private sector efficiency was deregulating prices and entry in the interisland shipping sector. This was the responsibility of the Maritime Industry Authority (MARINA) and concerned (1) upgrading liner freight rates on basic commodities, (2) deregulating second class passenger rates, and (3) liberalizing entry to shipping routes in 1990.

MARINA completed the Terms of Reference of the interisland liner freight rate study and submitted reports to NEDA on its areas of responsibility, including copies of various memoranda and implementing circulars. Given the need for political support to proclaim a broad policy of sectoral liberalization, and lacking a positive response from the Philippine Congress to its draft liberalization policy, the agency acted up to the limits of its authority, as an agency of the executive branch, in carrying out the policy without proclaiming it formally. After consulting with the organizations concerned, such as the Conference of Interisland Shippers and Operators (CISO), MARINA issued new franchises on routes previously monopolized, in line with the broader policy objective of liberalizing regulations on interisland shipping.

Conclusions Concerning Organizational Aspects

At the coordinating level, the SDP joint working team, which included the key agency actors, was quite effective in serving as a venue not only for coordination, but also for monitoring the implementation of the program. As in any program, normal problems such as the time lag in reporting indicators to the joint working committee (as in the case of the BOC and the BIR and the RDCs) were among the SDP I administrative problems encountered.

Other administrative problems were encountered in the implementation of specific objectives. One was communication and intra-agency consultation, as in the case of the BIR and the attainment of VAT targets. Most concerned insufficient technical qualifications of the personnel charged with carrying out the objectives. The lessons for the future program are that more training will be needed in the following areas: computer training of personnel at the BIR; training of the technical staffs of the various local development councils of the LGUs to improve planning, implementation and monitoring of public investment projects; training of the technical staff in privatization strategies at the COP secretariat and the APT, GSIS, and NDC; and at NEDA, particularly the NPPS that monitored SDP I overall, training of its technical staff in the general fields of public finance, development planning techniques, and tax administration.

Chapter 3

ASSESSMENT OF THE IMPACTS OF THE SDP

In this chapter, the impact of the transfer of SDP resources and of the policy performance required as a condition of this program is traced, analyzed, and evaluated, using three separate methodologies. In the first section of the chapter, the evaluation team measures the impact on the Philippine economy of (1) direct dollar transfers, (2) individual reform objectives, and (3) the combined effects of both. The second section of the chapter presents a cost-benefit analysis of the program, and the third assesses the extent to which USG and USAID/Manila policy goals with respect to SDP have been reached.

On the Economy

The impact of the SDP on the economy of the Philippines may be broken down into (1) the direct effects of dollar transfers, and (2) the secondary effects of policy reform. Although the first set of effects is fairly perfunctory, the second set requires more extended analysis. The evaluation team employed an econometric model of the Philippine economy to capture the quantifiable effect of each policy. Obviously, given the complexity of domestic policy-making and the large volume of resources and policy conditions under other donor programs, the attribution of specific effects to this program can be difficult. Because most of the targets were shared by other donors, the evaluation team's results probably include the partial impact of other programs. In addition, some policy reforms (and their subsequent positive effects) might have been implemented even without donor support.

Direct Effects

Balance of Payments

The first tranche of $104 million under the SDP program was transferred in August 1989, the second tranche of $65 million in December of 1989, and $40 million out of the $49 million originally programmed for the third tranche,

was disbursed in September 1990. These foreign exchange transfers helped reduce a current account deficit that rose to $1,465 million (3.3 percent of GNP) in 1989 and to $2,642 million (5.8 percent of GNP) in 1990 from $423 million (1.1 percent of GNP) in 1988.

The transfer had a considerable impact, particularly in the first year of the program. As a result, the current account deficit was reduced by 10 percent in 1989 and 2 percent in 1990. Measured relative to GNP, the current account deficit was cut by the equivalent of 0.4 percent of GNP in 1989 and 0.1 percent of GNP in 1990. On the other hand, if compared to average monthly imports, SDP transfers amounted to a little over a week's worth of imports in 1989 and about a quarter of a week in 1990.

Public Budget

The peso proceeds from SDP funds were used for budgetary support. They amounted to ₱3,672 million in 1989 and ₱972 million in 1990 at a time when both the national government deficit and the consolidated public sector deficit were rising. The national government deficit was equal to ₱19.6 billion (2.0 percent of GNP) in 1989 and ₱37.2 billion (3.2 percent of GNP) in 1990, while the consolidated public sector deficit reached ₱39.0 billion (4.1 percent of GNP) and ₱55.1 billion (4.9 percent of GNP) respectively.

The national government deficit was reduced by 15.5 percent in 1989 but increased by 89.8 percent in 1990. Similarly, the consolidated public sector deficit increased by 31.1 percent in 1989 and 41.0 percent in 1990.

These calculations can only be taken at face value to the extent that the existence of the SDP program did not lead the Philippine authorities to alter balance of payments and budget policies in the expectation that they would be receiving additional dollar income. For example, if import restrictions were reduced to encourage the use of SDP dollars, we cannot argue that the transfer reduced the current account deficit that otherwise would have occurred. But since the removal of import quotas and net reductions in tariffs seemed to have slowed fairly sharply by the end of 1988, it is valid to assume that the deficit would have been larger.

Concerning the 1989 budget, which was planned and put into execution well before calendar year 1989, the same case can be made. On the other hand, the program came in plenty of time to influence the planning of the 1990 budget so we cannot assume that the reduction of the deficit is equal to 100 percent of the grant.

Impacts of Policy Conditionality

The disbursement of SDP funds was tied to the progress of policy reform in several areas: privatization, deregulation, trade reform, fiscal reform, public investment planning, public investment monitoring and implementation, implementation of ODA-funded projects, and participation of non-government organizations in delivery of basic services.

In assessing the economic effects of policy conditionality, two approaches have been used in the literature: (1) a comparison of the actual values of key economic variables during the program years with their values in the period before the implementation of the program, and (2) a comparison of the actual values of key economic variables with the values that would have prevailed in the absence of the program. In the present evaluation, the "with or without" approach is chosen over the "before and after" approach. The rationale for this choice lies in the fact that the government carried out a broad range of policy reforms in the 1989-1990 period. The SDP policy conditions are only a subset of these policy changes. Thus, if the "before and after" approach were used it would be extremely difficult to quantify the extent to which the SDP policies accounted for the impact of the total policy package actually implemented by the government and, as noted above, it is not easy even using this approach.

To obtain the counterfactual scenario, this study relies on (1) the Philippine Institute of Development Studies PIDS-NEDA annual econometric model, version 1989 (Constantino et al. 1990), and (2) the results of existing relevant policy studies using a noneconometric approach. The PIDS-NEDA model consists of 114 behavioral and structural equations and 53 identities. It is divided into four blocks: real, fiscal, financial and external. Because many of the exogenous variables in the model are policy-oriented, it is particularly suitable for short-term policy analysis. It should be noted, however, that the statistically estimated structural parameters of the economy, given the model's functional specification, are defined by the estimation period. In this sense, it is not appropriate to use the model if the exercise involves policy changes aimed at changing the structure of the economy itself. Thus, there is a need to supplement the analysis with the results of other models that allow the appraisal of the impact of policy-induced structural changes.

Analyzed next is each of the targets that can be quantified by introducing their effects into the model.

Privatization

The performance indicator for the privatization objective under SDP required the government to offer 20 GOCCs for sale within the period covered by the SDP. In fact, 9 GOCCs were sold in full and 7 were partially sold by the Government of the Philippines in 1989-1990. The gross recovery

from these transactions amounted to ₱1,887 million in 1989 and ₱180 million in 1990.

The immediate impact of the privatization efforts will be on the Government of the Philippines budget, inasmuch as the proceeds from the sale of the GOCCs will automatically be reflected in the national government's nontax revenues. At the same time, national government expenditures are expected to be reduced by the amount of subsidies, equity, and loans that the national government would have extended to these GOCCs if they were not privatized. However, there is no data available on the value of national government transfers to the privatized GOCCs, so that only the impact of the sales proceeds on government revenues was taken into account in the present analysis. Thus the effect was to reduce the national government deficit by 11 percent in 1989 and 0.4 percent in 1990.

To the extent that a smaller fiscal deficit, arising from the sale of the 16 GOCCs in this 2-year period, leads to a lesser volume of money creation, the simulation estimates that there was a 0.1 percent reduction in the inflation rate in 1989 and 1990.

In addition to the budgetary and price impact, privatization is expected to lead to increments in aggregate output as a result of improvements in efficiency, as ownership is transferred to the private sector. At this point, it is too early to assess the actual extent of efficiency improvements in privatized GOCCs, and current data is not complete enough for a general comparison between private and public sector productivity. However, the increment in GDP may be quantified based on an existing estimate of the differential in the productivity of capital of the whole economy compared with the public corporate sector.

Manasan et al. (1988) estimated that in 1984 capital productivity (defined as the ratio of gross value added to the book value of fixed assets) in the public enterprise sector was 0.06. Furthermore, the same study estimated that capital productivity in the whole economy was 9.3 times that of the public enterprise sector. The difference was the result of differences in efficiency. In part it arises from the fact that the public corporate sector has a much higher average capital intensity than the private sector as a whole.

The 1985 book value of total assets of the 16 GOCCs privatized in 1989-1990 amounted to ₱30.8 billion. Applying the estimate of the capital productivity ratio for public sector enterprises presented previously, and assuming that capital productivity in the privatized enterprises rises by 50 percent (a conservative assumption compared to the difference in productivity between public and private firms), we estimate that after allowing for a two-year lag for reorganization, GNP growth in real terms will be 0.1 percent higher in 1991 and 1992.

Trade Reform

The Government of the Philippines committed itself to the lifting of quantitative restrictions on at least 90 items in 1989 and an additional 45 items in 1990 under SDP. The measured effects appear to have been negligible, but this apparent lack of impact may be due in part to the inadequacy of the model utilized to measure the impact. Because the econometric model employed for this purpose is demand driven, it measures only the demand-side effects of any given change. Without a model incorporating supply-side (production) effects, we are not in a position to reliably estimate the impacts of the QR target.

Improved VAT Collections

The policy matrix for SDP called for a 25 percent nominal growth in VAT collections in 1989. This was equivalent to a ₱1.8 billion increase in tax revenue. Assuming that the increase represents a permanent upward shift in tax collections, then the counterfactual simulation based on the PIDS-NEDA model shows that the fiscal deficit would have been ₱1.7 billion lower in 1989 (8 percent) and ₱3.1 billion (7 percent) less in 1990. The increase in VAT revenues does not lead to a proportionate decrease in the fiscal deficit because the model assumes that higher taxes paid will reduce consumption, GNP growth and therefore revenue yield. The smaller deficit leads to an inflation rate 0.1 percent lower than it would have been in the absence of higher VAT revenues.

Customs Valuation

The target in this instance was to increase the share of imports covered by published fair market values from the present 30 percent to 65 percent. The IMF estimated that the imports not covered by published fair market values tend to be undervalued by 10 to 20 percent. This policy change was expected to lead to an increase in Bureau of Customs collections.

Counterfactual simulation using the PIDS-NEDA model, based on the assumption that the valuation of imports for tariff purposes increase by 10 percent when these imports are subject to published fair market values, confirm this expectation. As a consequence, tax revenues were 1.5 percent higher in 1989 and 1.6 percent in 1990 and the national government deficit 9. percent and 6 percent lower, respectively. Although this policy leads to a smaller fiscal deficit, it stimulated inflation by 1.2 percent in 1989 and 0.1 percent in 1990. The model assumes that higher import duties push the domestic price of imported goods upward, and consequently, the overall price level. There is also a slight effect on Treasury bill rates, up by 0.06 percentage points in 1989.

Imports declined 0.3 percent in 1989 and 0.5 percent in 1990 because of the policy shift. Similar results were obtained for exports. The apparently puzzling export result occurs because the price rise induced by the higher cost of imports slightly reduces their competitiveness. The net effect on the current account deficit is, however, positive with the deficit falling 0.3 percent in 1989 and 1 percent in 1990.

Public Sector Disbursements for Maintenance

As a condition for the release of the third tranche of the SDP, the Government of the Philippines was required to increase disbursements for MOOE by at least 15 percent in 1989. The effect is to increase total government expenditures, then GNP, employment, national revenue, inflation and imports. Total government expenditures rose 26.4 percent and the national government deficit declined 15.7 percent in 1989. In subsequent years, the deficit rose 90.1 percent because there is only a one-time effect on spending but a multi-year effect on revenue. Because increased MOOE implies increased demand for domestic and imported goods, there is a 16.9 percent and 17.7 percent rise of GNP in 1989 and 1990, respectively.

Drawdown of ODA Funds

The effects of this target, a 50 percent increase in annual drawdowns of ODA funds for major infrastructure projects compared to 1988, although also increasing government expenditure, are a little different because the import content of capital expenditures is higher than that ofthe expenditures cited in the previous section. The deficit is 7 percent higher, but it is partly offset by higher aid disbursements in the financing account. The effects on other variables are too small to review in detail.

Planning and Implementation of Public Investment Projects

The goal of the Government of the Philippines was to take various actions to improve the planning and implementation of public investment projects. Specifically, the policy matrix called for increasing budgetary releases for the Feasibility Studies Fund, undertaking and completing at least 20 project studies during the program period, establishing the Regional Project Monitoring and Evaluation System, creating 13 Regional Project Monitoring Committees in all regions, and decentralizing the supervision and implementation of Integrated Area Development projects. Apart from increasing government investment expenditures (the implications of which are discussed in the previous section), the expected impact of these measures is the promotion of economic efficiency.

The efficiency gains are expected to be reflected in increased output from the implemented public investment projects. First, by providing

government investment programmers with a longer list of possible projects, the additional budgetary allocation for the conduct of project feasibility studies promotes a better allocation of resources. Second, improvements in project monitoring will decrease delays and avoid the deferral of the economic benefits these projects provide.

Following Alonzo and Gamboa (1990), the economic losses arising from delays in implementation were estimated by quantifying the reduction in the projects' net present value if delayed one year. It is further assumed that the project normally has a one-year gestation period and that it would have earned an IRR of 17 percent barring any delays. Under these conditions, the loss in economic benefits is estimated to be 1,448 pesos per 100,000 pesos of investment.

Drawdowns from ODA increased by $166 million in 1989 and by $595 million in 1990, relative to the 1988 level (see the discussion of the Project Facilitation Committee earlier in this chapter). On the basis of the assumptions outlined above (these are conservative assumptions because normally some portion of the investment cost is usually expended in the first year and delays may be longer than a year), the potential loss in economic benefits if the improvements in project planning and implementation were not put in place is estimated to reach ₱52 million in 1989 and ₱209 million from 1990 onward. The analysis assumes that the growth on ODA drawdowns relative to 1988 can be completely attributed to SDP. This assumption seems reasonable because there was little change in the period 1984-1988.

Combined Effects

This section discusses the combined effect of the various policy conditions plus the direct effect of the transfer of resources to the extent that they are quantified in this exercise. The GDP of the Philippines rose less than 0.2 percent in 1989 and declined slightly in 1990, as a result of the temporary negative impact of certain adjustment measures. In 1991 it is projected to rise again by about 0.2 percent and then to increase by 0.25 percent in 1992. If the variations during 1989-1991 can be conservatively interpreted as approximately zero growth, performance during 1992 can be regarded as the permanent effect of the SDP program on the GDP trend. This estimate has been incorporated into the cost-benefit analysis, along with other beneficial effects described in the next section.

The combined impact on employment is also positive. Because of SDP the number of persons employed (full-time equivalent) was 28,000 (or 0.14 percent) higher in 1989, and 26,000 (or 0.13 percent) higher in 1990.

The SDP program increased tax revenues through increased VAT collections and nontax revenues through the ESF proceeds. Relative to a no-SDP scenario, tax yield was 3.4 percent higher in 1989 and 3.9 percent more

in 1990-1992. Government expenditures similarly rose with SDP in 1989. However, the net effect of SDP on the fiscal deficit is favorable. The national government deficit was reduced by an amount equal to 0.6 percent of GNP in 1989 and 0.9 percent in 1990. Moreover, the favorable impact on the fiscal deficit appears to grow over time.

As a result of the reduction in the fiscal deficit under SDP, price stability has been enhanced. The actual inflation rate was 0.2, 0.5, and 0.3 percentage points lower in 1990, 1991, and 1992 respectively.

SDP dampened both exports and imports. However, the net effect on the current account balance is favorable. Thus, without SDP the current account deficit would have been 10 percent higher than its actual level in 1989 and 1.7 percent higher than its actual level in 1990. In 1991 and 1992, the projected improvement in the current account is 2 percent and 4 percent, respectively, of their base line values.

Cost-Benefit Analysis

The SDP funds (valued at the shadow exchange rate) may be thought of as the cost of "buying" a policy package of macroeconomic and administrative reforms. In addition to the SDP funds, the local cost of administering the reform program should also be included. For instance, the ₱5 million additional allocation for feasibility studies as well as the personnel and maintenance and operation expenditure cost of the CODA secretariat, and the RPMCs all comprise the local component of cost.

On the other hand, the change in output arising from the implementation of the SDP policy matrix as outlined in the previous section represents the benefits. The counterfactual simulations end in 1992, but the stream of benefits is extended 10 years on the assumption that they remain constant from 1992 onward. The resulting internal rate of return (IRR) is estimated to be 37 percent, which seems rather high. Such a high estimate might be explained by the fact that some part of the IMF, World Bank, and Philippine government input toward the attainment of the same policy goals should be included in the "investment." Unfortunately it is not possible to estimate such input. Caution in the use of the IRR calculation is therefore urged.

Even if a more inclusive calculation were to reduce the IRR to 15 to 20 percent, however, the analysis would still indicate a highly successful program. In general, our main conclusion is that the overall economic impact of the policies and resources of SDP I was to increase the rate of economic growth and employment in the Philippines, and at the same time improve the economy's stability.

Assessing the Fulfillment of USAID Objectives

SDP can be rated as a successful policy-based project that facilitated progress toward the objectives established by agreement between the Philippine authorities and A.I.D. Its implementation has assisted the Government of the Philippines in undertaking macroeconomic and structural policy reforms. It has also facilitated progress toward the A.I.D./Government of the Philippines shared objectives of promoting efficiency, competitiveness, and privatization. Thus, the SDP objectives have been in line with A.I.D. priorities and have been well-suited to the requirements of the Philippine economic system. The key to the success of SDP has been the selection of limited but achievable objectives related to the implementation of macroeconomic and structural policy reforms already adopted by the Government of the Philippines. In fact, it is a tribute to the SDP concept and design that the SDP was successfully implemented during a period when the IMF's EFF program had gone off the track.

The basic mechanism used to accomplish the SDP objectives has been the incorporation of these objectives in a policy matrix and the use of policy conditionality in second and third tranche disbursements. The performance indicators in the policy matrix have been clear, specific, and precise, and have, in retrospect, proved to be reasonable and realistic, given the good record of fulfillment of all performance indicators except one. The Mission has also carried on a continuing, intensive dialogue with the Government of the Philippines on a wide-ranging policy agenda; as a result of this and other donor efforts, the Government of the Philippines has usually taken public positions in principle in favor of the kind of policy reforms advocated by A.I.D., the IMF, and the World Bank.

The Mission has maintained close coordination with the donors, within the MAI/PAP framework, in selecting issues for the policy dialogue agenda and for the policy conditionality of the SDP. Progress in the implementation of policy reforms has yielded significant economic benefits. The only discordant note was the non-fulfillment of one performance indicator (and relatively minor problems in the fulfillment of two others). The non-fulfillment case demonstrated the need for better coordination among concerned Government of the Philippines agencies, and a need for closer consultation between the Mission and the agencies with respect to definition of the target and feasibility of its implementation. It is to be hoped that the delay and eventual partial release of the third tranche, resulting from a single case of nonfulfillment of a target, will not now complicate discussions concerning SDP II.

Chapter 4

RECOMMENDATIONS FOR FUTURE PROGRAM ASSISTANCE

The design of SDP II should be grounded in the lessons learned from SDP I and a review of the Philippine economy, along with its problems and future prospects, in itself a useful exercise 5 years into the Aquino administration and on the eve of major national elections. This chapter carries out such a review, identifying a range of public policy issues that must be addressed by the current Philippines Government—many of which will be appropriate for new donor-supported policy programs. Out of this review, we will propose a set of policy proposals that can be converted into objectives and performance indicators, which can, in turn, be incorporated into the design of SDP II. Subsequent sections of this chapter will consider the prospective roles of local currency programing, probable economic impacts, and organizational problems on the design of SDP II.

Lessons Learned From SDP I

Although SDP I was a success in the sense that it largely met the goals initially set for it, it has shortcomings as a model for SDP II. Its biggest drawbacks are the lack of a unifying theme, a proliferation of goals and performance indicators, and the overly precise formulation of goals. SDP I had several rationales, as described earlier, but the only theme tying them together was the rather broad-based one of efficient economic development.

A more specific theme is required in the current economic context: SDP II should have a central theme that can be defended and understood publicly, in case a dispute about reaching targets develops in the future. This primary recommendation of the evaluation team is similar in thrust to the second: the SDP II policy matrix should be shorter, with fewer goals; each goal should be related to the central theme, and consistent with a joint USAID/Government of the Philippines order of priorities.

The third recommendation is also linked to public acceptability and implementation. SDP II objectives should help to implement policies to which

the Philippines Government is publicly committed, to avoid the false impression that the government is being constrained to undertake policies to which it might not have otherwise agreed.

Fourth, more flexibility has to built into the matrix in several ways.

- The performance indicators should be set in terms of the effect to be achieved not the instrument used to achieve it.
- In cases in which the release of an entire tranche may be withheld because a quantitative target has not been fulfilled—especially where the shortfall (difference between the target value and the actual value) is small—there should be room for some flexibility so that the Mission may allow partial, substantial, or even full tranche release, depending on its judgment as to whether there was substantial effort or compliance, or there were factors beyond the government's control.
- Where possible, indicators that require legislative approval should be avoided. Government officials have taken this view in the belief that securing such policy commitments would be counterproductive because it would fuel resentment in Congress. However, key policy reforms usually require legislative approval and exclusion of such reforms would detract from the relevance and significance of policy conditionality.

The fifth recommendation is that there should be direct communication between USAID/Manila and the implementing agencies in the Government of the Philippines whenever the performance indicators in the policy matrix are quantitative and this requires the attainment of numerical targets by a specific date as conditions for tranche release. Although this contact may encroach on the relation between NEDA and other agencies, if handled informally, it could avoid the sort of problems that arose during SDP I in the case of VAT-filing conditionality.

Sixth, SDP II policy targets need not be too strictly dependent on those of other donor programs. Unlike SDP I, which followed the IMF's EFF and the World Bank's ERL, SDP II would in some respects move beyond existing IMF-World Bank programs in terms of its policy dialogue agenda. At this time, the multilateral policy-based loans in effect are the IMF's Standby Arrangement and the World Bank's GOCC and Financial Sector Adjustment Credit (FSAC) loans. Some areas proposed for the SDPII policy dialogue agenda would be covered in the forthcoming multilateral policy-based initiatives—which are still in the conceptual stage—such as the World Bank's third Structural Adjustment Loan (SAL III), corporate restructuring loan

(follow-on to GOCC), and export credit loan, as well as the ADB's capital market development loan.

Finally, some changes in the form of the SDP agreement are recommended. The Philippine Government appears reluctant to commit itself to conditionality even if it can plausibly be argued that this is carrying out the government's own policies. One of the alternatives proposed by government officials is the so-called "Indonesian Model," which is said to operate as follows.

- The government takes the initiative and formulates policies with targets and performance indicators, to which USAID agrees.
- These policies and indicators are incorporated in an internal USAID/Manila recording, not in the grant agreement itself, which would make no reference to conditionality.
- The government implements the agreed upon policies, and USAID disburses the grant as the agreed-upon targets and performance indicators are achieved.

There are obvious problems with this deceptively simple approach. Suppose, for example, that the Government of the Philippines does not comply. On what public grounds could A.I.D. withhold disbursement? If the present system of conditionality or tranching were to be retained, the Philippine Government might prefer that policy conditions be incorporated in a side letter (memorandum of understanding), rather than in the agreement itself. This approach seems reasonable enough in the circumstances. In fact, the original SDP I policy matrix, along with the conditionality attached to it, was contained in a side letter from the Government of the Philippines to USAID/Manila, not in the grant agreement itself. Weakening conditionality statements further, however—by mentioning them only in internal A.I.D. memoranda, for instance—would constitute an unacceptably loose and ineffectual means of policy dialogue.

The Macroeconomic Setting: Problems and Issues

The Philippines is a developing economy, based originally on the production of food and other commodities, logging, and mining. Its manufacturing sector, which developed in the 1950s and 1960s, was oriented toward import substitution and was heavily protected. Growth was uneven, depending as it did on the uncertain availability of foreign exchange for imported materials and capital equipment. In the early 1970s a new industrial sector was created, directed exclusively to exporting. To keep production

competitive, this sector was allowed to buy most of its inputs, other than labor, from abroad. While the growth of foreign sales from this sector has been rapid, low value added has limited net foreign exchange earnings.

With mediocre prospects in the long term for foreign demand for its commodity and mineral exports, sustaining the country's future growth will rely mainly on a continued transition to manufacturing and, to a lesser extent, on diversification of its agricultural output to high-value fruit and vegetables. Such growth and diversification will require a greater integration of the export sector into the larger economy, so that more of the goods and services that are inputs into exports can be produced domestically.

There is a paradox in the evolution of Philippine development since independence in 1946. In the 1950s the country's standard of living, relative to other East Asian nations, was second only to that of Japan and Singapore. The population possessed a high level of education and considerable technical skills; the ratio of natural resources, including land, to population was relatively favorable; and there has since been enough entrepreneurial skill and investment capital to take advantage of opportunities. Yet its ranking on a scale of regional standards of living has continually slipped. The most plausible explanation for this dilemma is that economic policies have not produced the incentives most conducive to high productivity growth. In particular, investment incentives are not adequate for the competitive range of exports that have led growth in neighboring economies. The dual industrial sector is the most prominent symbol of this problem. As a consequence, the external constraint (i.e., the lack of a reliable flow of foreign exchange) has periodically created a crisis, typically leading to devaluation and depression, and, more recently, to debt reorganization.

Therefore, the major and overriding problems in Philippine economic development policy are to modify policies that now lower the efficiency with which resources of capital and manpower are used and to provide greater incentives to export goods and services in order to pay for essential imports, service debt, and provide the basis for new borrowing. For analytic purposes, the related issues can be divided into three categories.

- Factors directly affecting the return from exporting

  The competitiveness of the exchange rate

  The degree to which tariffs and quotas are protectionist, favoring production for domestic sale

  The degree to which investment incentives favor production for domestic sale

- Factors affecting price stability and the competitiveness of the exchange rate

  The public sector consolidated deficit

  Monetary policy and the growth of money supply

  The level of interest rates and their effect on the balance of short-term capital flows

- Factors affecting the responsiveness of the private sector to investment incentives

  The current size of the public sector and the extent to which it can be reduced

  Restrictions on foreign private investment

  Price regulation of energy and transport

  Capital markets and investment finance

The subsequent analysis in this section follows the above outline of macroeconomic issues.

Factors Directly Affecting the Return From Exporting

The Exchange Rate

The exchange rate is by far the most important factor determining the salability of exports. A change in the official rate is equivalent to a change in price for the foreign buyer of Philippine merchandise and services and the domestic buyer of foreign goods and services. It also affects the attractiveness of repatriating foreign exchange holdings through official channels. A competitive exchange rate will have a stimulating effect on export sales and a dampening one on imports, will inhibit capital flight, and will attract resident remittances and other hard-to-control invisibles through, rather than outside, the banking system.

The difference between an "appropriate" and a "competitive" exchange rate should be pointed out. The first is essentially a short-term measure of equilibrium in the balance of payments. The criteria with which to judge an inappropriate exchange rate would be a discount in the parallel market, speculative capital flight, and stagnation or decline in the volume of exports. If these phenomena exist, a *de facto* devaluation process will begin that will be followed, sooner or later, by an official one.

The competitive concept tries to assess the adequacy of the exchange rate in the long run in terms of the following elements.

- The country's development objectives
- Its projected debt service obligations and net inflow of capital
- The exchange rates of its competitors
- Its protection policy

To the extent that development objectives require a high level of investment, and that debt service consumes a large part of new loans, competitors have low prices, and protectionist policies divert resources into activities that will not contribute to exports, a country needs a more depreciated exchange rate to earn the foreign exchange that growth will require.

There is no index that can measure competitiveness in this sense at a given moment. It can only be estimated by looking at the behavior of the different components of the balance of payments in conjunction with indices measuring exchange rate change over time. The real effective exchange rate (REER) index is the most accurate measure of change. It is superior to the nominal exchange rate (in this case the ratio of the dollar to the peso), because it takes into account the relation of the peso to nondollar currencies and the difference between the price trend in the Philippines and its principal markets and competitors.

For example, suppose the peso were unchanged against the dollar but appreciating against the yen because the dollar was moving in that direction. At the same time its inflation rate exceeded, by differing amounts, price rise in both Japan and the United States. The apparent stability of the peso-dollar relation would hide the fact that the peso was actually appreciating against both currencies.

The REER can be calculated in several ways depending on the countries and the weights chosen. The usual formula is to include all the principal trading partners and currencies, weighted by trade in a base period, to calculate a nominal effective exchange rate, which is then adjusted by the difference in price rise in the home country and its trading partners. This version gives the position of the peso in relation to its export markets and import suppliers. When discussing Philippine exports, the most useful formula, which is calculated by the IMF, is an index of competitors represented by Indonesia, Malaysia and Thailand.

Philippine exchange rate policy apparently values maintaining the peso-dollar exchange rate as stable as possible, either to avoid stimulating

inflationary expectations or to protect domestic industry against cost increases. There have been periods of up to 5years when little change has taken place in the nominal exchange rate. Then as the effects of overvaluation become too obvious to ignore, the peso is devalued, usually in several steps. Since the dollar started its float in 1971, the value of the peso REER has depended not only on whether the country was inflating faster than its trading partners but whether the dollar was depreciating or appreciating in relation to the yen and the deutschemark (DM).

In the period 1972-1985, the REER tended to appreciate and then depreciate for several years at a time, with a more-or-less flat resultant trend. The years 1986-1990 can be divided into two subperiods. In the first, after the sharp devaluations of the peso in 1983-1985, the peso-dollar rate continued to decline about 10 percent over the 3 years 1985-1988. Using the REER for major trading partners (defined as the United States, Japan, the United Kingdom and Germany) which includes the movements of the nominal and effective rates plus a comparison of inflation, the index average for 1988 had depreciated 25 percent in comparison with 1985 when it was clearly overvalued. The peso benefited from the steep decline of the dollar against the other three currencies. Compared with a narrowly defined group of competitors (Indonesia, Malaysia, and Thailand), the index appreciated 15 percent.

However, during most of 1989-1990, the tendency of the REER to depreciate was reversed. In spite of a peso decline of 9 percent against the dollar, the REER appreciated 8 percent from 1988 through the first half of 1990 because there was an increasing negative gap between Philippine and foreign inflation not offset by U.S. dollar depreciation. The competitor index appreciated by a similar amount. This rise was wiped out by the 20 percent peso/dollar devaluation in the second half of 1990 that depreciated the broad measure of the REER in November to its lowest level in the whole 5-year period. The narrow index fell by a similar amount.

Although the Philippines regained competitiveness against major trading partners, its gains against competitors were not enough to wipe out the deterioration of the past decade. For both indexes 1980=100, but in November 1990 the broad index had a reading of 57 while the narrow one was 108.

The competitive edge is eroding rapidly. By February 1991, the combination of differential inflation trends and dollar appreciation gave readings of 61 and 116 respectively. The March figures, when they become available, should be worse again as the dollar keeps climbing against the other three currencies. The trend will continue the rest of this year. The dollar is more likely to appreciate than depreciate in the next year, and Philippine inflation will go on rising faster than its partners and competitors. By late December, the broad index could easily return to its level of early 1989 and the narrow index to its worst period of early 1990 when it averaged 126.

The apparently large devaluation last year is an overdue correction that does not go far enough. There is little question that at this moment the exchange rate is "appropriate": the difference between the official and parallel quotations is almost zero. Reserves are rising but mainly due to a bunching of foreign loan disbursements. The devaluation, the IMF standby, and the Multilateral Assistance Initiative (MAI) pledges all have a calming influence on speculation. Imports are low in part because of restraints on letter of credit openings last year and the anticipation that the 9 percent surcharge will be reduced in the near future. Interest rates remain exceptionally high: treasury bills have a current yield of 23 percent, or 8 percent in real terms.

Nevertheless, the Central Bank is clearly anxious about the situation and has required the commercial banks to balance their external liabilities and assets, that is, sell to it their "surplus" foreign exchange. By the second half of the year, pressures will build up again and, unless the peso is adjusted against the dollar promptly, a substantial discount will reappear.

If the exchange rate is only momentarily appropriate, it is not competitive. During the past 5 years, the Philippines has substantially increased its investment effort: it raised its net capital inflow from zero in 1986 to 4.4 percent of GNP in 1989 and 5 percent in 1990; at the same time its level of protection was reduced. It also suffered from such exogenous events as a typhoon, an earthquake, and late in the year the Gulf crisis with its effect on oil prices and remittances. (See table 4-1). Even before these disasters, however, balance of trade figures were not promising. Given the economy's limited capacity to generate foreign exchange, and in light of past experience, it is likely that a 6 percent GNP growth rate would lead to a serious distortion in the balance of payments.

Whether the balance of payments crisis would have been avoided if there had been no REER appreciation is not clear. The results would have been better. Export earnings are responsive to exchange rate movements and import increases would have been moderated. The most important policy lesson for the 18 months that ended in August 1990 is that the unwillingness to fully implement a flexible exchange rate policy to adjust the external balance to the changing international situation has only led to a more abrupt devaluation, provoking the very inflationary consequences that motivated the too cautious policy of adjustment.

Table 4-1. Macroeconomic Indicators, 1986-1991 (percent)

	1986	1987	1988	1989	1990	1991
GNP growth	1.8	5.8	6.7	5.6	3.1	1-2
Investment[a]	13.2	16.2	17.2	18.7	18.5	18.7
Balance of payments						
Current account[a]	3.2	-1.3	-1.1	-3.3	-5.8	-4.5
Net capital inflow[a]	1.0	1.8	2.7	4.4	5.0	5.0
Export volume[b]	16.6	6.5	11.3	8.2	5.4	NA
Import volume[b]	19.7	31.0	21.0	20.4	10.2	NA
Exchange rate movements						
REER[c]						
(1980 = 100)						
Partners	69	65	65	72	59	68[d]
Competitors	115	114	120	128	111	130

[a]Percent of GNP.
[b]Percent change.
[c]Actual values, December.
[d]Estimated.
Source: IMF and Central Bank of the Philippines.

Protectionism

The Philippines began promoting import substitution industrialization in the 1950s and 1960s, behind a wall of quantitative restrictions and high tariffs. Onto this structure it grafted, in the 1970s, new industries designed for export and relying mainly on imported inputs to stay competitive. From the early 1980s it has begun, in response to the requirements of the IMF and World Bank, to rationalize and reduce the level of protection built into this system. Since 1986 the Aquino administration has continued to take measures that have reduced protection for sectors of the Philippine economy.

Quantitative restrictions on 1,323 items were removed in the period 1986-1988, while the government also raised and lowered about 200 tariff rates. In the year ending February 1990, restrictions on another 100 products were lifted and tariffs on 190 more items lowered. In July 1990, the President proposed a more radical reform of the tariff system—Executive Order 413 (EO 413)—which would reduce the level and dispersion of nominal rates from a 0 to 50 percent range to a 3 to 30 percent range. In the face of considerable opposition, that measure is being modified to provide for at least one other category of tariff for luxury items and imports on which quantitative restrictions have been removed.

Currently, 237 products that were originally designated, in principle, to be liberalized remain on List B. Of these, 41 have recently been certified by the Monetary Board as suitable for the next tranche of liberalization. The prospects for further reductions in effective protection in the remaining 18 months do not appear terribly favorable.

There are various ways to provide protection, the more obvious ones being tariffs, quotas, prohibitions, and exclusive franchises to import. A technique to measure how changes in each of these policies modify protection levels is to trace the evolution of effective rates of protection (EPR). This approach calculates the degree to which valued added domestically is protected, by comparing domestic and foreign prices of inputs with those of final products.

This technique has been applied to measuring the net effect of tariff and quota removal in the Philippines during the 1986-1988 period. It has also been used to measure the effect on tariffs that the original version of EO 413 would have had if it had been put into force. Table 4-2 summarizes the change in EPRs that resulted from the 1986-1988 reduction in quotas and tariffs. "Exportables" are defined as products that are predominantly exported and "importables" as products for which importing substantially exceeds exporting.

Table 4-2. Changes in Effective Rates of Protection (1985-1988) (percent)

	1985	1988
All sectors	49	36
Exportables	-7	-4
Importables	102	75
Agriculture	9	5
Exportables	-8	-6
Importables	80	49
Mining	0	-2
Exportables	-8	-9
Importables	24	19
Manufacturing	73	55
Exportables	-4	-1
Importables	107	80
Food	34	30
Exportables	-10	-5
Importables	51	43
Textiles	70	22
Exportables	0	0
Importables	262	84
Paper, rubber, etc.	240	108
Exportables	-7	-11
Importables	290	131
Basic metals	180	55
Exportables	-4	-8
Importables	185	57
Machinery	240	169
Exportables	0	0
Importables	405	287

Sources: PIDS and Medalla, Erlinda (1986).

As Table 4-2 indicates, the degree of protection has declined but production for domestic sale is still heavily shielded from import competition, while export sales are burdened by expensive inputs. The overall indicator falls from 49 percent to 36 percent. Protection of importables declined from 102 percent to 75 percent. For the import sector in all the major categories—agriculture, mining, and manufacturing—the trend is similar. For imports within the manufacturing subcategories the picture is more mixed. For food the decline is moderate, whereas for textiles and basic metals, protection is cut by two-thirds. The fact remains that protection was very high at the end of 1988 in all categories, ranging from 50 percent in agriculture to 287 percent for machinery.

Exports, overall and in most sectors, suffer from negative protection—that is, value added is lower than it would be if world prices for some inputs were available to the local producer. This price difference is equivalent to an export tax. While the average burden fell slightly in the 3 years observed, some sectors show an increase, including the mining, paper and rubber products, and basic metals sectors.

Although there has been no study that took into account the 1989-1990 changes in tariffs and quotas on EPRs, analysts who follow this sector believe that the level of protection has not basically changed since the end of 1988.

EO 413, if it had been put into effect, would have created a new high water mark of the liberalizing movement. It consisted of a four-tier tariff: 3 percent for previously exempt products or products being charged 5 percent, 10 percent for raw materials, 20 percent for intermediate goods, and 30 percent for finished products, as compared with the present range of 0 to 50 percent. There would also have been a 50 percent tariff for items removed from quantitative controls. Table 4-3 illustrates the change in effective protection (i.e., on value added) strictly as a result of tariff change. It does not, like the previous Table 4-2, allow for other restrictions on imports, so that the levels of protection are understated.

Effective tariff protection would fall by about one third. That change is concentrated almost entirely in manufacturing where all the subsectors share more or less the same proportionate change.

The order would have two effects. One would be to reduce the level and dispersion of tariff protection. The second would be to avoid using very high tariffs on liberalized imports to maintain high effective protection. While we do not have a complete picture of the current 413 measure, the modifications are believed to be in the form of more tariff categories and possibly the use of rates in excess of 50 percent for luxury and liberalized items so that the reduction in effective protection will be smaller than the estimates below.

Table 4-3. Hypothetical Changes in Effective Rates of Protection Assuming Decree No. 413 Was Implemented (percent)

	1990 EPRs	
	Before	After
All sectors	22	17
Exportables	-3	-3
Importables	44	33
Agriculture, etc.	2	1
Exportables	-5	5
Importables	30	29
Mining	-2	1
Exportables	-2	-3
Importables	18	18
Manufacturing	33	24
Exportables	0	0
Importables	46	33
Of which for importables:		
Food	43	32
Textiles and shoes	63	49
Paper, rubber, etc.	83	50
Basic metals	68	53
Machinery	38	32

Source: PIDS/Tariff Commission.

Investment Incentives

Investment incentive laws have been in force in the Philippines since 1946. While the original legislation has since been superseded or amended by new law, the general thrust has remained unchanged: fiscal inducements in the form of tax exemptions or deductions for "new and necessary" or basic industries. In 1970, the Export Incentives Act was enacted, granting tax advantages to export industries. It complements the Investment Incentives Act of 1967, which provided fiscal incentives to investment in preferred activities geared to the domestic market.

Philippine investment incentive legislation has been amended and codified three times since then. In 1987, a new Omnibus Investments Code (EO 226) was put in place. The major fiscal incentives offered under this Order are the income tax holiday and tax and duty free importation of capital equipment. The tax holiday is for a period of 3 to 7 years for "nonpioneer" firms and 6 to 8 years for "pioneer" firms. (A pioneer firm is one introducing a new product or technology). Unlike preceding investment incentive legislation, EO 226 provides uniform incentives to exporters and nonexporters.

The potential benefits to registered firms from the fiscal incentives are substantial. Estimates show that the internal rate of return of registered

firms is 5 to 9 percentage points higher than otherwise, depending on the life of the project and on the type of firm (i.e., pioneer or nonpioneer).

Given that one of the objectives of EO 226 was the promotion of exports, it is important to note that its implementation has actually diminished the support given to export activities. While the previous legislation was barely adequate in providing compensating adjustments to exporters for the overvaluation of the peso, EO 226 has exacerbated this deficiency by reducing by half the potential benefits given to exporters (Manasan, 1990).

Firms proposing to export at least 50 percent of their output are allowed to register with the Board of Investments (BOI) and take advantage of the investment incentives, even if their activities are not explicitly listed in the Board's Investment Priorities Plan (IPP). However, the IPP itself is biased in favor of highly protected sectors. Of 236 items listed under the IPP in 1988, more than half were subject to tariff rates in the range of 30 to 50 percent and practically all were subject to import controls (Power, "Investment Incentives in a Protectionist Regime: the Philippines," 1989). Thus, it is not surprising to find that the share of export projects in total approvals has fallen in recent years (World Bank, 1990).

Although no consensus has yet been reached, the executive branch is currently considering several alternative plans for providing universal application of investment incentives, including the provision of accelerated depreciation and net loss carry forward and a reduction of the tariff on capital equipment to 10 percent. Under these proposals, while the BOI would continue to grant tax concessions in preferred areas, the IPP would be shortened and the discretionary power of the BOI would be reduced. Because these measures would apply equally to both domestic and exported-oriented production, they would not reduce existing biases against investment mainly for export.

Conclusions Concerning Export Returns

- The peso-dollar exchange rate is not competitive enough to provide the foreign exchange needed to sustain current growth targets.

- The system of protection hinders export efforts by favoring import substitution production, which is often too high-cost to supply export industries.

- Government promotion of investment also favors import substitution because the structure of protection makes production for domestic consumption more profitable.

Factors Affecting Price Stability

The Public Sector Consolidated Deficit

The government has had difficulty in keeping the consolidated public sector deficit within limits that would not threaten price stability. As a consequence, the monetary impact of deficit financing and credit expansion to the private sector has led to a rapid growth of money supply and prices. Periodic attempts to bring about greater stability has produced high real interest rates, particularly when speculation against the peso has been active. Table 4-4 presents the relevant statistics.

Table 4-4. Indicators of Fiscal and Monetary Policy (percent)

Particulars	1986	1987	1988	1989	1990	1991
Consolidated public[a] sector deficit, o.w.	(4.8)	(2.2)	(3.6)	(4.1)	(4.9)	(3.6)
(Central Bank)	(3.0)	(1.5)	(2.1)	(2.2)	(2.0)	(2.4)
(DPSF)	0.0	0.0	0.0	0.0	(0.7)	0.3
National budget[a]						
Current expenditure	10.9	13.6	13.6	14.8	15.7	15.7
Tax revenue	10.7	12.2	11.0	12.7	13.4	15.6
Money[b]						
Base money	19.8	11.0	15.1	35.7	23.5	10.9
M3	13.5	11.3	23.1	25.9	16.6	10.0
Consumer prices[b]	(0.3)	7.5	9.1	14.1	14.2	9.5
Interest Rates[c]						
91-day treasury	9.4	13.9	14.7	20.5	26.5	25.0[d]

[a]Of GNP.
[b]Change, end of period.
[c]Level, end of period.
[d]Full year projection.
Source: DBM

The public sector deficit has three parts: the national budget; the government corporate sector; and other nonbudget operations, such as the Oil Price Stabilization Fund (OPSF) and the Central Bank, each of which is governed by different factors. The national budget deficit is determined mainly by the extent to which tax revenue pays for current expenditure. That ratio went from 100 percent in 1986 to an average of 85 percent in the past 2 years. Although revenue performance was stronger, the desire to increase salaries and maintenance expenditures and the rising cost of servicing the internal debt pushed up spending even faster. The IMF program assumes a 95 percent coverage in 1991.

The second component of the public sector deficit is the collective balance of all the nonbudget entities of the government except the Central Bank. Until recently the government-owned and -controlled corporations (GOCCs) were in surplus, but a decline in profits on current operations and

increased self-financed capital spending put them into deficit. The OPSF, whose deficit had been essentially zero, rose to 0.8 percent of GNP per year in 1989-1990, when domestic petroleum product prices were not raised as the price of crude oil increased. The IMF projection assumes that the outstanding deficit balance (about ₱16 billion at the end of 1990) will be paid off and a surplus of ₱4 billion accumulated by the end of 1991. The swing from deficit to surplus is equal to 1 percent of GNP, or about two-thirds of the improvement in the public sector deficit.

The third component of the deficit is the Central Bank's net loss on all operations. In most countries the Central Bank is highly profitable and pays a dividend to the Treasury. However in the Philippines it was given various tasks where it acts in place of the government and, as a consequence, has incurred a loss equal to 2 percent of GNP on the average since 1986. These losses resulted mainly from exchange rate guarantees extended by the Central Bank. The repeated devaluations of the peso in the last decade required an increasing peso counterpart fund to service the same foreign currency obligation of the Central Bank, other parts of the public sector, or private activities that the government had decided to subsidize.

The loss has remained this lerge and stable because the underlying obligations are too big to pay off without great difficulty in raising the necessary funds. The IMF's rough estimate is about ₱200 billion. That makes the Central Bank's deficit the least tractable part of the public sector's deficit. The 1991 estimate rises again to a level which is equal to two-thirds of the public sector deficit, presumably because of the 1991 devaluation.

Monetary Policy

Monetary expansion, which was steady and moderate at 10 to 12 percent annually in 1986-1987, accelerated to 25 percent per annum through the last quarter of 1990. This expansion is based on credit to the private sector throughout and the increase of exchange reserves until 1990. The public sector deficit was financed largely outside the banking system, but indirectly. By taking such a large volume of resources, the public sector pushed the private sector more heavily into the banking system for loans.

Price rises followed with a lag. Philippine inflation was mainly home grown until late in 1990, when the rise of oil prices provided an additional push. The effects of oil price increases are still being felt in the first quarter of 1991.

Interest rates, particularly the treasury bill quotation, were high in real terms throughout (1986-1990), ranging from 5 percent to 15 percent in 1990 when the Central Bank was fighting speculation against the peso with credit restrictions. The series has fallen from a peak of 33 percent in December 1990 to about 23 percent in March 1991.

Conclusions Concerning Price Stability

- In spite of a major inflow of aid amounting to 5 percent of GNP, the Philippines has been unable to mobilize sufficient resources to finance a relatively modest investment effort (less than 19 percent of GNP).

- In the public sector, current expenditure has steadily exceeded tax revenue; nothing has been done to seriously reduce Central Bank losses; new subsidies for petroleum products were created when the deficit was already large; and the attempts to raise tax revenue have been inadequate for the size of the problem.

- The consequence has been a growth in liquidity to sustain growth, leading to inflation and a spilling out of demand into imports, and making a substantial devaluation of the exchange rate inevitable.

- The 1991 program commits the Government of the Philippines under the IMF agreement, to substantially reduce its public sector deficit and monetary expansion. This process should have the effect of moderating inflation in 1991.

Factors Affecting the Responsiveness of the Private Sector

The Size of the Public Sector

This section is concerned with the impacts of the privatization process on private sector investment behavior. (The specific targets of the government's privatization program were discussed in Chapter 3). At the time the decision to privatize was made, a group of 78 companies was designated to stay under government control. Those companies, plus those from the privatization list that are not sold in the next couple of years, plus sequestered firms (not discussed here), are the businesses in which the state intervenes directly as manager and entrepreneur.

In addition, there exists the gray area of partially denationalized companies, such as the Philippine National Bank. Because this evaluation is concerned with complete privatization, including private sector ownership and control, partial privatization is irrelevant, having the effect of turning private investment over to public sector management. A similar alternative—"build, operate, and transfer"—may be a useful device for making the public sector more efficient, but it does not further the net expansion of the private sector.

The plan to reform the public corporate sector, drawn up by the Philippine Government in 1986, divided disposition into a number of categories. The most important were retention and privatization. Of the roughly 300 entities, omitting such unshakable parts of the public sector as the Central Bank and the Social Security System, 57 percent of the assets were retained and 32 percent were to be made ready for privatization. The rest were to be integrated into the regular governmental structure. Each segment had roughly 50,000 employees.

In some of these sectors, the state is a monopolist; in others it is competing with the private sector. An example of the first is power generation, of the second, banking and petroleum product distribution. Table 4-5 lists the major activities expected to remain in the public sector, by asset values of 1985 (the date of the survey). In addition, it includes important enterprises in the privatization group that have not yet been sold.

Table 4-5. Assets of the Philippine Public Corporate Sector (billions of pesos)

Name	Assets
Major entities to be retained	
National Power Corporation	108
Development Bank	10[a]
Philippine National Oil	16
National Development Company	12
Total	146[a]
Major entities to be privatized	
Philippine National Bank	32[a]
Philippine Phosphate Fertilizer	11
Philippine Airlines	11
Association Smelting and Mining	9
Petrophil Corporatiion	7
National Steel Corporation	6
Philippine Exchange Company	6
Republic National Bank	6
International Corporation Bank	5
PNOC Energy Development Corporation	5
Union Bank	4
Bataan Refining	3
Century Bank	1
Manila Hotel Corporation	0.3
Total	109[a]

[a]1985, except for the adjustment to 1987 values for the Development Bank and Philippine National Bank.
Sources: Committee on Privatization and the World Bank.

There are only three large enterprises in the public sector in areas where activities could be carried out by private companies. The obvious one is the oil company. The director of the Office of Energy has made the interesting point that if energy is to be closely regulated there is no need for

a national oil company. The status of the Philippine National Oil Company (PNOC) should be part of the plans for energy deregulation discussed below.

Although it appears to be taken for granted that electric power generation should be in the public sector, the patchy history of the National Power Company (NPC) suggests that decision should be reviewed if the Philippines is to have any assurance that growth will not be held back by power shortages. At a minimum, selected regions or enclaves might be turned over to private investors.

The Development Bank was a disaster during the Marcos Administration. In 1985, its theoretical asset value was ₱72 billion. Two years later it was reduced to ₱10 billion with the failed loans transferred to the Asset Privatization Trust (APT). When another administration is in power, this process could begin again. It is a mistake to use the technical expertise of the institution to create a "wholesale bank" as the World Bank is arguing.

The conclusion is that there should be no permanent dividing line between the public and private sector. The 1986 plan was a way of facilitating privatization by drawing such a line. Further privatization should be reconsidered in terms of sectoral development requirements.

Privatization, even in the terms it was defined in 1986, may not be realized for several years. While smaller companies and separate assets have moved well, few of the larger companies have been sold. There are, of course, good reasons for this slow progress: drawing up accurate accounts, the difficulties of valuation, the smaller number of buyers after the attempted coup in 1990, and so forth. There may also be less defensible reasons for delay, including administrators who want to keep their perks or wish to influence their sector policy. Whatever the reasons, the privatization process has clearly slowed down.

The group of major enterprises designated for privatization may be broken down as follows.

- Financial: four smaller commercial banks plus the Philippine National Bank, which is still the largest
- Transport: Philippine Airlines
- Energy: Petrophil, PNOC Energy Corporation and Bataan Refining
- Metals: National Steel and Philippines Smelting
- Fertilizer: Philphos
- Hotel: Manila Hotel

Except for the last item, whose significance is purely symbolic, the companies are important parts of their respective sectors. Their sale even at heavily discounted prices will make a contribution to public revenues. More importantly, they will enlarge the private sector in key areas. Completion of the program in a reasonable time period, perhaps 2 years, would indicate that official statements on the primacy of the private sector in development are meant to be taken seriously.

Currently, the authority and institutions set up to carry out privatization will expire at the end of 1991. However, understand that the government apparently intents is to continue the program. The government is negotiating with the World Bank for a follow-on to its "Reform Program for Government Corporations," which will include assistance for and a commitment to continuing the privatization program. The most serious problem for some companies is the high level of liabilities, which, in some cases, leads to a negative net worth. The World Bank loan help remove and transfer these liabilities, so that the companies might become viable.

Restrictions on Foreign Private Investment

There are two kinds of restrictions on foreign investment: those that are banned or limited by the constitution or by legislation and those in the remaining sectors, where equity participation is greater than 40 percent. Direct foreign investments (DFI) with foreign equity participation equal to or less than 40 percent are, in principle, unrestricted. They are required to register their articles of partnership or incorporation with the Securities and Exchange Commission (SEC) as other domestic companies are, but, unlike their domestic counterparts, they must report their existence to the Board of Investments (BOI) and to the Central Bank to qualify for repatriation of profits.

Permanently prohibited sectors are rural banking, public works and construction for national defense, retail trade, and mass media. These are open only to Philippine nationals. Foreign participation in firms engaged in government contracts and recruitment and placement of workers is limited to 25 percent; foreign ownership of banking institutions (other than rural banking) and advertising agencies is restricted to 30 percent; and foreign equity participation in utilities and land and natural resource exploitation cannot exceed 40 percent.

In other sectors, the Board of Investments may permit equity investments in excess of 40 percent. These restrictions are governed by Book II of the Omnibus Investments Code of 1987. The BOI uses five criteria in its evaluation of DFI applications.

1. The DFI should be in activities that are not inconsistent with the Investment Priority Plan (IPP).

2. Investment should contribute to the sound and balanced development of the economy on a self-sustaining basis.

3. The business should not conflict with the Philippine Constitution and various laws of the country.

4. The business activity should not be one that is already adequately exploited by Filipinos.

5. The business should not promote monopolies or combinations in restraint of trade.

Like other investments, DFIs must be registered with the Central Bank for monitoring and repatriation purposes and with the SEC.

However, in areas declared as "pioneer" activities by the BOI and in activities where 70 percent or more of output is exported, 100 percent foreign ownership is allowed, provided foreign equity is reduced to a maximum of 40 percent within 30 years.

The Philippines is perceived to be the East Asian country least open to investments with regard to foreign ownership requirements. Singapore does not impose any restrictions on the relative size of foreign equity except in banking, media, and companies owning residential properties. Indonesia, Malaysia, and Thailand, on the other hand, generally require that local capital control at least a majority of the shares, that is not less than 51 percent.

At present, the Philippine Congress is considering two bills providing for less restricted direct investment. The Teves bill originated and has been passed in the House. More recently, the Senate passed its version, the Paterno bill. Both create a negative list. In sectors not specifically named, 100 percent foreign ownership would be permitted without the approval of the BOI. Equity in industries on the negative list would be restricted to 40 percent unless a lower level is specified in existing nationalization laws.

The bills differ in other ways, however. The Senate version includes a restrictive, variable negative list while the House version has no negative list at all for the first 5 years following enactment. That is, the House bill would allow up to 100 percent foreign ownership in all areas except those where more stringent restrictions are imposed by the Constitution or by nationalization laws. After 5 years, new investments would be regulated by the negative list. The Senate version has no holiday provision.

The key issues in the legislation are the role of the BOI and the existence of a negative list. Because of the BOI's proclivity for micromanagement and its wide discretionary power, any arrangement that gives BOI a role to play will be dominated by protectionist forces. BOI's idea of focusing more narrowly its promotion effort was to reduce its annual IPP from several hundred to 93 priority areas. There is no role for BOI as an investment vetting organization without a negative list. The House Teves bill in effect abolishes the negative list by suspending it for 5 years, by which time the pattern of foreign investment could be basically changed.

The Senate bill simply makes the present system a little easier for the investor by drawing up a negative list instead requiring permission for everything. But the criteria for the list are not a great improvement over those now used to approve individual applications. NEDA, which would now be in charge of the list would be an improvement over the BOI, but the difference may be negligible over time. The House bill is a real change in policy while the Senate proposal is a sleeker version of the present policy.

Price Regulation

The most important prices the government regulates—exchange and interest rates—have been discussed earlier. This section is concerned with the prices of energy and transportation, which have almost as powerful an impact on incentives.

Oil is the most important original energy source in the economy and the main determinant of the price of electric power. Not only is the price of crude established as the basis of product prices, but the differentials among prices are set in terms of social policy rather than market demand. The price of diesel fuel is kept low as a subsidy to mass transportation and to power generation while premium gasoline is relatively expensive on the grounds that car owners can afford to pay more.

The result is that in an energy and capital poor country in a world economy in which the relative price of oil will almost certainly rise over time, the local incentive system favors waste and capital intensive processes that use more power than less intensive ones. In addition, the existence of the OPSF allows the administration to subsidize, temporarily, by not allowing the domestic price of crude landed in the Philippines to reflect its world price in local product prices.

The government has stated its policy in a letter of intent to the IMF, noting that it accepts the eventual deregulation of oil prices in principle, once the OPSF debt is paid off and a cushion of ₱10 billion is built up. This latter stipulation suggests that the timing of deregulation is well after the liquidation of the debt and may in fact be quite indefinite.

The decision on what to do about OPSF involves three sets of considerations: fiscal revenue and the realism of absolute and relative prices of petroleum products. With respect to revenue, having made the adjustment to a world crude price of $30 per barrel, considerably higher than present or expected levels this year, the current price structure would contribute to a reduction in the public sector deficit once outstanding liabilities are paid off. This is the IMF assumption at least for 1991. A moderate devaluation of 10 to 15 percent over the next 18 months would still leave a surplus at current crude and product prices. In effect, the government would be collecting additional taxes on petroleum products without congressional approval. This arrangement might be consolidated at a later date by asking Congress to approve the difference in the form of taxes.

With respect to pricing, the government is apparently working on a formula that would require automatic adjustments in the level of product prices when the price of crude changed, with the relative prices being set according to the ratios prevailing in the Singapore market. There are also provisions relating to maximum deficits and surpluses which suggest that some time lag between crude and product prices is assumed.

The best formula from the point of view of economic policy would be complete deregulation with excise taxes set at fairly high levels to minimize energy use and environmental impact. The next best alternative would be a flexible ceiling price, revised perhaps once a month, like the one proposed in the previous paragraph with a fund with a very limited overdraft ceiling and with relative product prices based on the world market. The existence of a fund is a threat in the short run to price stability. Over the longer run, the most important issue is aligning product prices on the world market.

Interisland Shipping

Maritime transport is the most important form of cargo transport in the country. Its cost can influence whether investment is attracted to those regions where their link-up to capital and natural resources will lead to the most efficient production. In the last year, in part because of the target in SDP I, passenger rates for other than third class have been freed as have rates for certain cargo, such as products requiring refrigeration. While MARINA was understandably unwilling to formally liberalize entry into the industry without congressional blessing (which still has not been obtained) it did increase competition on many routes through individual decisions. This liberalized policy should now be instituted more formally and more broadly.

Progress toward greater competition in shipping must take place on two fronts simultaneously: freeing entry and freeing prices. If entry is liberalized but price regulation maintained, there may be little incentive to invest more. If prices are liberalized without freer entry, instead of more competitive prices, there could more cartel pricing exploiting customers. Two

additional elements in this market are the level of port charges, which seem to bear little relation to costs in the publicly run harbors, and the possible inadequacy of infrastructure if traffic were to increase.

Fortunately USAID/Manila has supported a recent study of the interisland transport system, completed in 1990, and another on shipping rates and cargo movements, which will be available this year. These studies can provide the technical basis for formulating entry and deregulation targets.

Capital Markets and Investment Finance

Like most developing countries, the Philippines does not have a well-developed capital market allowing the extensive use of the public issue of stock shares and bonds as an important source of long-term finance. Two stock exchanges exist, however, with some large corporations listed for trading, and the Securities and Exchange Commission does offer some protection to investors. The country is thus equipped with basic institutions to channel savings, but they can only be effective if there is a substantial flow of savings seeking long-term placement in institutions with which the investors have no personal connection. That flow is small for various reasons.

- Private savings as a percentage of GNP is low (12 percent).
- Much of that savings is generated by and reinvested in enterprises.
- Short-term interest rates are high, making it unattractive to lock up money long term.
- Most larger investors have other outlets, such as real estate or enterprises, to which they have a personal connection.

In other words, the Philippines is simply not rich or stable enough to have a large class of middle-ranking investors seeking stock shares and corporate bonds.

The more difficult challenge is to develop institutions to mobilize savings from small savers. Two groups that may be interconnected—overseas contract workers and the more affluent farmers and businessmen of the rural areas—need creditable institutions they can trust to give them a reasonable return on their savings. Such an institution might require official support or, at least, guarantees.

Conclusions Concerning Private Sector Responsiveness

- The government still controls a large number of activities that should be transferred to the private sector to promote the efficient use of resources.
- The prices of petroleum products and interisland transport continue to be closely regulated and therefore frequently deviate from market values.
- The incentive system continues to favor production for domestic use where the availability of protection favors uncompetitive costs.
- Potential sources of savings from the rural areas and overseas contract workers are not being mobilized to support the level of savings the Philippines needs to grow at an acceptable rate.

Recommended Conditionality and Indicators for SDP II

As already mentioned, the recommended list of issues for SDP II is limited to macroeconomic problems, on the grounds that they are currently the most urgent. Having slid into inflation and balance of payments crisis during 1990, with the usual denouement of a devaluation, the Government of the Philippines has committed itself to the IMF as it did at the beginning of SDP I, to the IMF to carry out a more rigorous policy. The role of SDP II would be to reinforce those commitments as well as to carry out other elements of policies begun during SDP I and earlier.

The policies chosen as conditions for SDP II should meet the following criteria.

1. They should be based on a priority ordering of economic issues.
2. Their link to this program should be necessary for their implementation.
3. They should be perceived by the government as consistent with its stated goals and drawn from the shared agenda of the government and donors.
4. They should to be logically related to one another so that they can be justified as a program.

The previous section reviewed the basic macroeconomic issues from which the goals will be drawn. That list will then be reduced by applying Criterion 2: if, for example, a given goal is fully covered by another USAID or international donor program, it would be superfluous to include it in SDP II. In addition, Criterion 3 indicates that the specific measures targeted by SDP II should be regarded as helping to carry out more general goals to which the Philippine authorities have committed themselves, either to MAI or the IMF or in World Bank project agreements.

The last criterion may be the most important in terms of implementation. By stressing the achievement of the program as a whole, some of the inevitable wrangling about whether targets are reached or not can be detoured into whether or not the program is working. Finally, it will make internal presentation and justification problems on both sides much easier.

NEDA has proposed "export promotion" as a theme. A more comprehensive formulation, evoking underlying policy issues and avoiding the connotation of marketing, would be a "strategy for export development." The following list of goals, in priority order of importance, represents different elements of the strategy.

- Restructuring the foreign exchange market so that the exchange rate is a more accurate reflection of the supply and demand for foreign exchange
- Reducing effective protection rates on imports to increase competition and to cut or eliminate negative protection on exports
- Increasing tax revenue to reduce the budget deficit
- Completing the privatization program
- Deregulating petroleum product prices
- Liberalizing entry into interisland shipping and deregulating cargo rates
- Assigning highest priority to investment in exporting rather than investment for domestic sale when authorizing tax and other incentives

The recommendation is not that SDP II include all these issues as goals but that it include a consistent, coherent package of perhaps four or five of them. In some cases a given goal might have several possible performance indicators. Note that the list does not include the liberalization of foreign investment, which will be made a condition of the PEPS program or of

capital market reform, a sector for which the Asian Development Bank is formulating a project.

Exchange Market Reform

An appropriate macroeconomic environment (which means, in the Philippine context, a substantially smaller consolidated public sector deficit, significantly lower inflation, and a sizable reduction in interest rates) is the most important ingredient of success in maintaining realistic and competitive exchange rates in an exchange system free of restrictions. In a given macroeconomic framework, the exchange rate is more realistic when it is freely determined by market forces.

The following paragraphs describe a proposed series of technical improvements in the foreign exchange market that will make it more responsive to market forces and less easy to manipulate to maintain an overvalued exchange rate. These recommendations are based on intensive study by the IMF, and any work on them should be done in collaboration with that organization. These modifications in themselves will not change deeply rooted policy views, but a dialogue in this area might have some positive influence. No legislation would be required.

The main problems of the Philippine exchange market are market segmentation (which inhibits the equilibrating role of market forces) and the fact that the interbank market (which sets the official exchange rate) lacks both breadth and depth. The market structure is not conducive to the evolution of a genuinely competitive environment and therefore inhibits determination of a realistic exchange rate.

The exchange market is divided into three major segments (the official interbank market, the customer market, and the unofficial or "parallel" market), with only a tenuous linkage among them. In the interbank market, most peso-foreign exchange transactions among banks (including intervention by the Central Bank) take place in the Foreign Exchange Trading Center of the Bankers Association of the Philippines (BAP), where the "BAP reference rate" is determined. The official exchange rate is based on the BAP reference rate; the two rates are identical in practice but can, in principle, be different at the discretion of the Central Bank.

The exchange rate set in BAP floor trading also serves as the basis for the exchange rate in the customer market. However, there are two major structural problems with the interbank market, which detract from efficient market determination of the exchange rate. First, it has a limited number of participants and these participants depend on Central Bank guidance in setting the exchange rate. Market transparency and full disclosure make it easier for the Central Bank to use moralsuasion effectively. Second, it is a thin market, in which a relatively small volume of transactions determines the exchange

rate. Central Bank intervention, generally small in volume, accounts for more than one-half of the transactions; the rest, commercial interbank turnover, amounts to approximately $1 billion per year. According to a detailed study of the exchange market carried out by the IMF, this commercial bank residual represents no more than 1 to 2 percent of the country's total foreign exchange transactions. The market is open only half an hour each business day and no operations at all take place on many business days.

In the customer market, transactions take place between commercial banks (and other authorized dealers, which account for a very small volume of transactions) and their customers who represent a wide range of economic agents engaged in international transactions. The volume of transactions in this market is quite large, since most recorded balance-of-payments transactions are channeled through it. The absence of a large interbank market leads to compartmentalization, with banks trading mostly with their own customers and hoarding foreign exchange so that they can meet their demands. While the interbank market is possibly too transparent, the customer market is not transparent enough.

The third major segment of the exchange market, the parallel market, is the channel for a wide range of unofficial transactions not recorded in the balance of payments. The size of this market is believed to be several billion dollars a year, with remittances a major component. Of an estimated total of some $3 billion, only about $1 billion of remittances are channeled through the banking system. This market serves as the safety valve for the overflow of transactions from the other two in times of strain on the balance of payments. The last episode was in the second half of 1990, when the divergence between the official and parallel rates led to a formal devaluation. Other than this occasion, the parallel exchange rate has not diverged from the official exchange rate by more than a few percentage points since 1986.

Therefore, while the exchange rate may now be said to be market-determined in a narrow and formal sense, the imperfections of the market have inhibited free interplay of the forces of supply and demand. The record indicates that the Central Bank has been successful in restraining exchange rate movements, has pre-set exchange rate targets, and has managed to achieve these targets mainly through strong guidance reinforced by small amounts of foreign exchange intervention in the narrow and thin interbank market. The Central Bank even fixes the rate for authorized exchange dealers.

The measures proposed below will contribute to the correction of foreign exchange market imperfections by broadening and deepening the market, bringing about a more competitive environment, and improving the capacity of the market to perform a smooth and efficient intermediation of foreign exchange flows in the economy. The measures should be implemented in two phases.

- Phase I: Reopening of off-floor trading among commercial banks. Off-floor trading was permitted when the present exchange system was established in 1984, but was prohibited in late 1987 when demand for foreign exchange expanded as the economy revived. Off-floor trading, if accompanied by adequate regulation as well as measures to broaden the market and other supportive measures (see below), would lead to the deepening of the market, more efficient and active trading, the use of more sophisticated techniques, and less hoarding of foreign exchange.

- Phase II: Authorizing offshore banks and foreign exchange brokers/dealers to participate in the foreign exchange market. Allowing the entry of additional participants would broaden the market, bring in the experience and expertise of offshore banks, increase the volume of transactions, and promote efficiency through increased competition.

In addition, the elimination of the documentary stamp tax on interbank transactions is recommended. Elimination of this tax would contribute to the deepening of the foreign exchange market by reducing intermediation costs, and the revenue loss would be small.

Reduction of Effective Protection

The export development strategy suggests that the most serious problem with protectionism is that it perpetuates the dual export-oriented/import-substitution industrial sector by inhibiting the ability of exporters to increase the value added content of their products. Earlier in this chapter three points were made with regard to trade policy.

- The only measure of protectionism that is comprehensive is the rate of effective protection which measures the effect of both tariffs and quotas on the domestic value added.

- Effective protection has declined very little since the end of 1988.

- Many categories of exports suffer from negative protection, that is, their cost of production is higher than that of their foreign competitors because they must buy from high-cost protected domestic producers.

The ongoing trade liberalization effort now consists of the draft EO 413 and a small number of quota removals that have been processed by the Monetary Board. The tariff measure will be attached to the PEPS program,

which is in a more advanced stage of negotiation than SDP, as a performance condition. That leaves a continuation of import liberalization as a possible target. At a time when it is increasingly difficult to free imports from quotas, a repetition of the SDP I approach might prove impossible to negotiate or, if a suitable number of items could be assembled, might result in a package with little real impact.

The alternative, building on the export theme, would be to examine a selected group of exports suffering from negative protection. That is a form of export tax from which the Treasury does not profit. A few years ago, it was the accepted opinion in the Philippines that export taxes should be removed from agricultural commodities to allow them to compete better with foreign products. To do the same thing for industrial products will require an analysis to determine which tariffs, quotas or other trade restrictions are causing negative protection and then to decide whether it is feasible to modify their impact.

Compared with the approach that weighs the increase in consumer welfare against the loss of producer income when deciding whether a tariff or a quota should be altered, this method addresses the effect on other producers who are exporters. It will reveal in the most concrete manner the way the protection of local production affects exporting. It may also have the useful political effect of bringing the exporter to bear on the decision.

There is another advantage to the suggested approach. The problem of high-cost inputs for exports is not new. The way the problem is currently being solved is by giving certain exporters access to supplies at world market prices. That procedure, which amounts to creating two production systems, one for exports and another for imports, leads to the weak backward linkages and relatively low valued added that have often been noted. The suggested approach seeks to integrate the two production systems and push investment into areas the export market has determined to be viable.

The policy indicators on which the second tranche of SDP II would depend would be agreement on the selection of export products to be considered for action, and production of a quantitative estimate of the various elements of protection applying to those products. Export products in this case would be defined to include (1) goods currently being exported but not benefitting fully from the provisions of export processing zones or duty drawbacks and (2) importable inputs required by exporters and currently manufactured and protected in the Philippines at uncompetitive prices.

The indicator for the third tranche would be the removal of all negative protection on selected products. No legislation appears to be required for the proposed targets for either the second or third tranches.

Increasing Public Revenue

The goal of higher public revenue results from the export development strategy through lower inflation and a more realistic exchange rate. Currently the Philippines is committed to the IMF to undertake the following revenue measures: (1) generate an additional ₱20 billion (roughly 2 percent of GNP) so that the 9 percent import surcharge can be removed, and (2) maintain domestic petroleum prices at present levels so that the accumulated OPSF debt can be paid off and a small surplus created.

The SDP I program had conditions relating to VAT as a new tax that needed a strong administrative underpinning to get collections off to a good start. Given the variety of economic activities covered by VAT, the increase in revenue should be proportionate to the increase in GNP in current prices once it is well established. Growth should be much more rapid in the initial stages.

Congress is currently considering numerous tax proposals, mainly advanced by the Aquino Administration as substitutes for the import levy. The yield of all the tax increase measures, if they were to be approved, would amount to 3 percent of GNP. To the extent that the new taxes were synchronized with a gradual phaseout of the import levy, their macroeconomic impact would be negligible. Also under consideration are administrative measures intended to produce incremental income, including the following.

- Legislative/VAT: broadening VAT coverage to services, lifting exemptions for some professional services, and eliminating certain zero-rated transactions

- Administrative/Technical Assistance: computerization of (the Bureau of Internal Revenue) BIR (including the VAT section), together with training and software (The World Bank and ADB are providing technical assistance.)

- Legislative/Income Tax: increasing taxes on individual business and professional incomes (currently subject to individual income tax rates) by establishing a separate rate schedule of 25 percent for the first ₱200,000 of income and 35 percent for incomes above that level; introducing an additional 2 percent tax on the gross incomes of corporations

- Administrative/Customs: strengthening anti-smuggling enforcement procedures by increasing the share of imports covered by fair market values, as a basis for the CIF valuation of imports for duty and tax purposes. (By September 1990, 131,753 items or 85

percent of the 155,000 traditionally imported items were so covered. SDP I required a 65 percent coverage.) Also, extending the Comprehensive Inspection and Surveillance System (CISS) to nearly all ports of origin for Philippine imports.

- Legislative/Excise taxes: introducing an affluent consumption tax in the form of an additional sales tax on certain luxury goods—or a variant thereof, namely, higher excises/tariffs on non-essential/ luxury products/imports; increasing excise taxes on soft drinks and petroleum products

Among these measures, the VAT and excise taxes on petroleum products are those where a link to SDP II might make a difference in the degree of success achieved. These are alternative measures having the effect of reducing support disproportionately for import substitution projects which would generally be less risky than those in the export sector. Also, the list should be reexamined keeping in mind the criterion of actively pursuing new products and markets in the export trade and giving those projects priority over most import substitution projects. The formulation and execution of either of these policies could serve as conditions for the second and third tranche disbursements.

Local Currency Programming

Under SDP I Philippine authorities deposited the equivalent in pesos for each transfer of dollars in a "peso special account," with the resulting local currency allocated to certain categories of already authorized budget expenditures. Although in principle this earmarking did not increase public spending over the level it otherwise would have been, it may have done so in practice. To that extent the mechanism may have been inflationary.

In addition, the administration of local currency programs is administratively burdensome: the attachment of conditionality or Conditions Precedent (CP)s to such programs requires auditing, by either A.I.D. officials or by government auditors reviewed by A.I.D. Since auditing standards and procedures differ significantly among public agencies, and even more so among countries, such requirements can lead to confusion, misunderstandings, and delay of program activities. Under these circumstances, and given the fact that both resource transfer and conditionality are already linked to dollar disbursement, there should be no requirement for local currency deposits under SDP II.

Hypothetical Economic Impact of SDP II

This section provides an estimate of the economic impact of the transfer of SDP II funds and the potential policy reforms outlined above, to the extent they can be quantified. In contrast to our analysis of the economic impact of SDP I, these results are illustrative, because there is as yet no agreed-upon SDP II program. We have assumed a program size of $160 million, coupled with five of the seven prospective SDP II policy commitments discussed above. The methodology is the same as in SDP I (PIDS-NEDA model), and the analysis is subject to the same limitations we presented in the section on economic impact in Chapter 3. Because it is difficult to separate the effects of various policy initiatives from the effects of those supported by the SDP, this analysis relies on the most conservative impact assumptions available.

Note that the following analysis is not a repetition of the earlier SDP I impact analysis, despite being presented in the same format: these hypothetical SDP II impacts supplement the SDP I estimates presented earlier.

Direct Effects

Balance of Payments

The transfer of SDP II funds will increase the inflow of capital and help finance the large current account deficit, which the IMF projects to be 4.5 percent of GNP in 1991 and 3.9 percent of GNP in 1992.

Assuming that SDP II funds will amount to $60 million in 1991 and $120 million in 1992, the projected current account deficit will reduced by 3.0 percent in 1991 and 6.4 percent in 1992 as a result of SDP II transfers. Measured relative to GNP, the current account deficit will be cut by 0.1 percent of GNP in 1991 and 0.2 percent of GNP in 1992.

Public Budget

The peso proceeds from SDP II funds are reflected as grants under nontax revenues of the national government according to the accounting convention currently being followed by the Government of the Philippines. Thus, the inflow of SDP II money is expected to increase nontax revenues and, consequently, to reduce the deficit of the national government.

Under the most recent IMF program, the national government deficit is projected to decline from 3.2 percent of GNP in 1990 to 2.0 percent of GNP in 1991 and 3.0 percent of GNP in 1992, while the consolidated public sector deficit is expected to drop from 4.9 percent of GNP in 1990 to 3.6 percent and 2.4 percent of GNP in 1991 and 1992, respectively. If a local currency equivalent deposit were required, the SDP II grant would be equal to 6.7 percent of the projected 1991 national government deficit and would bring the

national government deficit in balance in 1992. On the other hand, SDP II funds are expected to improve the consolidated public sector position by 3.7 percent in 1991 and 12.5 percent in 1992.

Hypothetical Effects of Specific SDP II Policy Reforms

Restructuring the Foreign Exchange Market

Given the present overvaluation of the peso, the proposed technical improvements in the foreign exchange market are expected to result in a depreciation of the real effective exchange rate. For illustrative purposes, the real exchange rate is assumed to depreciate by 10 percent in 1991 and 1992 as a consequence of the liberalization of the foreign exchange market. The PIDS-NEDA model predicts, in that situation, that real GDP would decline by 0.1 percent in 1991 and 0.9 percent in 1992 but would increase gradually from 0.1 percent in 1993 to 0.9 percent in 2000. On the other hand, inflation would increase by 1.6 and 9.6 percent relative to baseline values in 1991 and 1992 and would decline gradually by 2.0 to 10.0 percent from 1993 to 2000.

Imports are projected to decline while exports are projected to increase with the devaluation. Consequently, the current account balance improves with the proposed policy reform.

The contractionary effects of a devaluation in the short run is in line with the results of (Krugman and Taylor, 1978) and others. In this case, the decline in imports, brought about by the devaluation, pulls down output since there is some lag before exports respond to the prospects of higher profits. In the longer run, however, the contractionary impact of lower imports is swamped by the expansion of exports as the economy adjusts to the more depreciated exchange rate.

Reduction of Negative Protection on Exports

It will be recalled that a negative protection rate on an export is, in effect, a tax caused by protectionism in the economy that forces the exporter to buy inputs at prices not competitive with those prevailing in the world economy. The way to reduce negative protection on exports is to reduce effective protection on imports that are used in or compete with the inputs required to produce the export.

The impact of the reduction of negative EPRs on selected exportables can be illustrated by the Philippine food processing sectors, which contributed 15 percent of total exports in 1989 (See Table 4-6.) Most of the exportables from these sectors (like input-output Sectors 37 through 41) have negative EPRs. If the implicit tariff on the major inputs to these sectors were reduced, then their negative effective protection rates would decline. This exercise reduces the implicit tariffs on I-O sector 3 (corn) from 20 percent to

10 percent, on I-O sector 28 (rice and corn milling) from 22 percent to 10 percent, on I-O sector 33 (refined oil) from 30 percent to 20 percent, on I-O sector 36 (flour) from 20 percent to 10 percent, and on I-O sector 41 (cocoa processing) from 34 percent to 20 percent. The EPR of the target sectors improves by roughly 30 percent on the average, that is the negative EPR falls by that amount.

Table 4-6. EPR of Selected Exportables Before and After Tariff Reduction (percent)

O Sector	Before	After
37	-18.5	-10.2
38	-10.2	-7.9
39	-7.4	-6.7
40	-13.1	-7.3
41	-16.6	-11.0

The higher incentives to these exportable sectors are expected to lead to an increase in their output (Medalla, "Impact Effects of Tariff Reform Program, 1986). However, the impact on overall output from this experiment is imperceptible, 0.02 percent of GDP. A tariff cut or the removal of QRs quantative restrictions covering more sectors would have a larger impact.

Increase in VAT Revenues

The performance indicator for this policy condition is such that the elasticity of the VAT with respect to GNP equals 2.0 as opposed to a 1.7 average in 1989 and 1990. This implies that the rate of growth of VAT would be twice that of GNP if the target is to be met.

The immediate impact of such a policy change would be on total tax revenues. The improvement in total tax revenues would be 0.3 percent and 0.7 percent in 1991 and 1992, respectively. In turn, the fiscal deficit would be reduced by 1.8 percent in 1991 and 6.6 percent in 1992. The improved fiscal position then lessens pressure on money creation and lowers the rate of inflation. The rate of inflation is projected to decline by 0.02 and 0.07 percent in 1991 and 1992.

Completion of the Privatization Program

The proposed privatization program under SDP II is assumed to result in sales proceeds of ₱1 billion in 1991 and 1992. The first-round effect would be a reduction of the national government's fiscal deficit, inasmuch as the proceeds from the privatization of the remaining GOCCs would automatically be reflected as increments in the government's nontax revenues. The projected fiscal deficit would improve by 2.7 percent in 1991 and 4.7 percent in 1992 because of the divestiture program. In turn, the lower fiscal deficit would lead to a 0.03 and a 0.06 percent reduction in the inflation rate.

In addition to its budgetary and price level impacts, privatization is expected to increase real output because of efficiency improvements arising from the transfer of ownership to the private sector. Using the actual ratio of gross recovery to the 1985 book value of total assets in the 1989-1990 privatization experience, the book value of total assets that will be sold in 1991 can be projected to reach ₱16.6 billion in 1991 and 1992. Assuming that the productivity of capital in the privatized enterprises improves by 50 percent over that of public sector firms and allowing for a 2-year lag for reorganization, then the real GDP is expected to increase by 0.05 percent in 1993 and from 0.1 percent in 1994 onwards.

Deregulation of Interisland Shipping

The economic benefits from the deregulation of the shipping industry are perhaps best exemplified by the impact on the shipment of corn from Mindanao. Earlier studies show that an inadequate supply of shipping services from Mindanao, together with poor drying and storage facilities in the area have resulted in spoilage. In addition, corn prices there are depressed both during and immediately following the harvest season, as traders reduce their corn purchases because their "working capital was tied up in inventory and there was little storage space remaining" (USAID Corn Marketing Study, 1987). At the same time, corn prices in the major consumption areas are expected to be higher than they would have been if better transport facilities were available.

Mindanao produces about 60 percent of the total corn output in the country. Assuming that 10 percent of Mindanao's output is spoiled because of the lack of vessels to transport the grain to the deficit regions, then if deregulation of interisland shipping eliminates this problem, about 0.1 percent of GDP would be saved. Also, the higher corn prices in the corn-producing regions following an improvement in the interisland shipping is expected to increase the incentives to the farmers and consequently their output. The elasticity of corn supply with respect to the corn price is estimated to be 0.34 (Intal and Power, 1988). This implies that if corn prices in Mindanao rise by 10 percent, the supply of corn will rise by 3 percent and aggregate output will rise by some 0.03 percent. On the other hand, if corn prices in the major

consumption areas decline, then the incentives to corn-processing industries will improve as will output. However, because of lack of data the effect cannot be quantified.

In summary, aggregate output is projected to increase by some 0.13 percent because of the realignment of incentives in corn production as well as elimination of spoilage as a result of the deregulation of interisland shipping.

Combined Effects

For a program which incorporates five of the seven policy areas discussed earlier in this chapter, the impact would be to reduce real GDP by 0.1 percent in 1991 and 0.8 percent in 1992. GDP would then increase by 0.3 percent in 1993 and 1994, and by 0.7 percent annually from 1995 onwards.

The impact on government revenues is positive. Thus, the fiscal deficit is reduced 12 percent and 80 percent in 1991 and 1992. The deficit reduction then leads to a substantial reduction in the inflation rate from 1993 onwards, although in 1991 and 1992, the adverse effect of the devaluation on prices dominates the opposite effect of a smaller fiscal deficit.

Overall and over time, the proposed policies are expected to increase exports, reduce imports, and improve the current account balance.

Administrative Issues

Which agencies are involved in the implementation of SDP II will depend on what policy objectives are included in the matrix agreed to by the U.S. and Phiiippine governments. This section takes two agencies as examples of the organizational issues and problems involved in carrying out two policy reforms: (1) the improvement of tax collection (i.e., the Bureau of Internal Revenue); and privatization (i.e., the Committee on Privatization and the Asset Privatization Trust).

Increasing Tax Revenues

The agency responsible for collecting domestic taxes is the Bureau of Internal Revenue (BIR). In August 1990, the Department of Finance (DOF) conducted a strategic planning seminar wherein the BIR commissioner was designated "owner" of a special project to implement "modernized systems and procedures" in the BIR. Computerization, simplification, and decentralization were identified as key features in the implementation of a modernized systems and procedures program for the BIR. The BIR will undertake the major areas of reform to work toward the broad goal of increasing tax revenues.

- Decentralizing to the level of the revenue district offices (RDOs), many important functions, including refund operations, auditing of large taxpayers, review of RDO audit reports, and data entry of tax returns

- Streamlining to improve coordination and eliminate duplication

- Simplifying procedures to enable staff to devote more time to effective audit and enforcement activities

Among the short-term reforms are the following.

- Completing the review and simplifying collection procedures

- Introducing of a new unique taxpayer identification numbering system, with VAT taxpayers being given priority

- Using the banking system for filing returns and tax collection

Recognizing the key role of computerization in the improvement of the agency's ability to collect tax revenues, the BIR has formulated a 5-year (1991-1995) Information Systems Plan that contains hardware and software, including strategies for using information technology at the central, regional and revenue district offices.

This plan, in conjunction with a revenue target, could be the basis of performance indicators to be incorporated into SDP II.

Privatization

The completion of the privatization program is another potential policy objective of SDP II. During SDP I, the privatization program was implemented through the cabinet-level Committee on Privatization (COP). However, the COP, created by Proclamation Number 50 in December 1986, together with its primary implementing arm, the Asset Privatization Trust (APT), was authorized for only 5 years. There is concern therefore over whether the existing organizational infrastructure to implement privatization will still be available for SDP II.

However, steps have already been taken to extend the life of the COP, including the proposed bill of Representative Teves of the House of Representatives. The World Bank has assumed that the life of the APT will be extended and has recommended that it be strengthened. A related issue is whether the APT should not be put in charge of all sales. This agency appears to have been effective precisely because, unlike other agencies that

may be operating in the same sector, it has no vested interests in holding on to corporations.

Under privatization, to work out targets and performance indicators, the organizational issue may have to be resolved first. In general, the organizational infrastructure to implement SDP II is already in place. However, it is still necessary to identify aspects that would serve as basic performance indicators, for example, decentralization in the BIR. Such an approach would be not only practical, but also supportive of Philippine policy.

Technical Assistance and Policy Analysis

The Philippine government is faced with several difficult economic problems, each of which is at least partially amenable to long-term solution through a number of different public policies. The assessment and implementation of such policies involve a wide range of analytical, statistical, and administrative techniques. Although senior government officials are highly competent and have many well-trained assistants at their disposal, it is the view of the Philippine authorities that additional staff training is needed. This section explains where more training might be appropriate and how it could be undertaken. The object is to formulate a proposal with which a training expert could develop a plan and a budget to put it into effect.

Fields of Training

Two types of policy training might be appropriate for SDP II implementation: instruction of a general nature at the graduate school level, whether or not a formal degree is obtained; and shorter, practical programs for acquiring specific technical skills. In the second case, because a wide range of skills could be improved and resources are limited, programs that directly aid the implementation of policy goals in the SDP II program should be given priority.

For graduate study NEDA has proposed the following fields.

- Development economics
- Public policy and administration
- Development management
- Industrial development and planning

Training would take place in the United States and would be especially useful for younger staff with 4 to 5 years experience, who show promise for the future but who have done little or no graduate work. The purpose of this kind of education would be to provide perspective so that staff members could see beyond their necessarily narrow duties to some of the larger issues involved. Of these subjects the most useful would probably be development economics, because it is the broadest and, by definition, oriented to the problems of developing economies. The other subjects would be less useful, because they are either nontechnical and excessively general—public policy, for instance—or almost vocational in nature, as in the last two items.

With respect to more narrowly focused technical training, many areas would benefir from specific, hands-on courses, most involving the subjects of macroeconomics and finance. The following topics, selected from an outline prepared by NEDA, are among the most useful for a specialist designing a program.

- Domestic growth

  Development planning techniques: model building, input-output analysis, and short-term forecasting

  Financial programming and policy: formulation of a financial program, the choice of variables, and the analysis of their impact

  Savings and investment policy: medium-term growth projections, demand management, and the mobilization of domestic savings for investment

  Investment promotion policy: effectiveness of investment promotion incentives compared with minimal bureaucratic procedures, low taxation, and a stable economic environment; within that framework, techniques that have proven effective in the Philippines or in other countries of the region

- Export strategy

  Exchange rate policy: the exchange rate as a tool to promote exports, techniques of determining competitiveness, different types of exchange market management, comparison of Philippine experience with the Asian Newly Industrialized Countries (NIC)

Trade policy: a major element in development strategy that affects the direction of investment, both domestic and foreign, and the ability of exporters to compete; importance of three types of skills (a) the measurement of the effective protection provided by tariff and nontariff barriers, (b) how import protection makes some investments profitable that might otherwise not be, and (c) and how import protection creates negative protection for exports

External debt management: the costs and benefits of various debt reduction schemes, both those that would be negotiated with creditors and others that might be promulgated unilaterally

Organization of Training

Graduate training should take place abroad so that the participants can be exposed to alternative analytical approaches and differing cultural and economic assumptions. Although younger staff may benefit from formal degree programs, a conventional program is probably not the most effective way to train mid-career staff members. A judicious selection of courses, related to professional interests, combined with a research paper, approximately equivalent to a master's thesis, would better combine relevance with perspective. In most cases such programs should be limited to 1 year, so that participants can return to their career paths without too much disruption.

Non-degree, practice-oriented technical training should be based on the following principles.

- The participants for the most part will be government staff members chosen by their agencies, with perhaps a few graduate students sponsored by their universities.
- Training should take place in the Philippines to the greatest extent possible, except as noted below.
- The instructors should be drawn from both foreign and Philippine sources.
- The Philippines government should take the greatest advantage possible of practical courses offered by international donors and counterpart agencies in the United States, including the IMF, the Federal Reserve Board, and the U.S. Treasury.

- Courses should be intensive but not lengthy.

With respect to the first point, even though the proposed training is essentially for government staff, some graduate students might benefit from specialized, hands-on experience and skills not available at their universities, and government may benefit from the "enriching" effect of including a few recent graduates.The second point is designed to minimize cost and maximize the number of participants. Third, a reasonable proportion of foreign instructors should be involved in all the courses, in order to present a variety of approaches which might challenge local orthodoxy, not for reasons of expertise. For similar reasons, practical courses offered by foreign governments and international agencies should be included in the instructional program. Finally, to enhance learning and reduce work disruption, students should participate full time, but practical nondegree courses that should be relatively short, usually 2 to 3 months and no more than 6.

An initial package of courses should be designed to take place more or less simultaneously, perhaps at the same location. If the course mix proves to be effective and popular, it could be repeated for another group of participants, budget permitting.

Related Research and Technical Assistance

The following research proposals have resulted from the analysis necessary to evaluate SDPI. They are designed to provide information that the evaluation team found was lacking and which, had it been available, would have strengthened and complemented the policy analysis. The first proposal concerns what is implied for a number of economic policies by an export-led strategy. The second and third deal with shortcomings of the PIDS-NEDA model for measuring the effects of trade protection when analyzing supply-side effects on the economy.

A Policy Environment for Export-Led Growth

As indicated earlier, Philippines public policy is characterized by an import substitution strategy onto which has been grafted an export promotion program. A research project addressing this issue would identify which changes in exchange rate, trade protection, and investment policy would be necessary to convert the economy to export led growth. The results would include four components.

- A current survey of trade protection and the position of the exchange rate in relation to other currencies to determine to what degree they are barriers to exporting

- A brief history since 1970 of Philippine export performance in the major markets in relation to regional competitors; and, in the same period, a breakdown of industrial and agricultural investment by market orientation, domestic market, or exports

- A summary of how Korea, Singapore, Thailand, Hong Kong, and Taiwan have addressed these issues

- Recommendations on how to design an appropriate export-oriented policy program

The first component of this project could draw on the exchange rate and trade studies USAID/Manila has already commissioned, which should be completed in the next 2 months. The third component could be based largely on the existing development literature on the countries being compared (the Philippines and Korea, Singapore, Thailand, Hong Kong, and Taiwan) both countries, complemented by short trips to confer with relevant public policy specialists in the comparison case countries.

A complete project of this sort would take some time and would not be available to influence the choice of targets under SDP II. Its value would lie in the longer term, providing perspective to the Philippine authorities on the broader ramifications of an export-led development strategy. It would help them construct a framework for designing future public policy in a manner more consistent with the export objective.

Measuring Supply-Side Effects

While trying to measure the effects on the Philippine economy of the reduction in trade protection that took place under SDP I, and in seeking to estimate the impact of lower interisland transport rates and a more realistic price for heavy grades of oil on the cost of production, the SDP evaluation team discovered that the PIDS-NEDA model is not extensively developed in terms of production equations and relative prices. It would be worthwhile to provide funding for PIDS analysts to modify the structure of the model and to increase the number of production-relevant equations, not only to measure the above effects but to induce users to think more about the issues of relative prices and their impact on output and efficiency.

Ongoing Statistical Modeling and Analysis

Reliable assessment of the impacts of government economic policy, as well as of external economic events, requires a more complete set of analytical tools than is currently available in the Philippines. The requirements of Philippine analysts have surpassed the capacity of the PIDS-NEDA model, even if modified as recommended above. Moreover, this model and others

like it are not always available to all researchers and in particular are not always available to A.I.D. USAID/Manila should support the development of a more complete econometric model of the Philippine economy, along with related economic and statistical studies. Such an effort might include the following elements.

- Pre-modelling design and analytical studies specifying the policy content and objectives of later studies to be performed with the new model. These studies would not only specify the required structure of the model, but would produce policy-relevant output in themselves.

- The collection of relevant quarterly data on the subsectors to be included in the model. Such data, some of which is available and some of which must be generated, would be much more detailed than that included in current models of the Philippine economy.

- Estimation of relevant equations in blocks that would include not only demand activity but production as well. In particular, the model should include production equations disaggregated by subsectors, permitting estimation of output and employment effects.

- Testing of policy impact analyses and comparison with the results of alternative models and analytical approaches. This component of analysis would require runs of prior models with roughly consistent databases. Local analysts familiar with prior models and studies should be more heavily involved at this stage of analysis.

This long-term analytical effort should involve USAID/Manila staff economists at every stage, so that the Mission may make full use of the resulting models for ongoing policy analyses. For the same reason, local academic and consulting professionals should be involved in the model design and related projects. In order to enrich the approach and eventual uses to which this analytical system will be put, the design and construction team should include both academic and practical policy analysts.

Finally, what we are proposing here is not a grand modeling effort, but the development of a policy-analytical system. Such a system almost certainly would include a full-scale quarterly econometric model, but it would also include smaller-scale, partial equilibrium analyses, some of which may not necessarily involve statistical estimation. What is required here is the implicit inclusion of policy-relevant, production-relevant considerations in the public discussion of Philippine economic behaviour. Statistical modelling is simply one way (albeit an admirably complete, cogent, and consistent way) of reaching this goal.

Chapter 5

CONCLUDING COMMENTS AND RECOMMENDATIONS

SDP I has proven to be a model program directed at reinforcing policy targets that are part of the shared government/donor reform agenda by attaching them to a phased transfer of resources. SDP II should follow the same pattern, with a somewhat different set of goals. The various government operations targets of SDP I are less appropriate for SDP II, in part because significant progress has already been made and in part because the macroeconomic framework now seems more fragile than it did 2 years ago and therefore in greater need of reinforcement.

The policy proposals discussed in the previous chapter can be divided into two categories. The first might be labeled "the inner core export strategy" while the second would be "the eclectic export strategy." The former would include those policies that have the greatest impact on export pricing, as follows.

- Establish a competitive exchange rate
- Eliminate negative protection
- Increase tax revenues (thus producing less inflation)
- Provide incentives to promote export-oriented investment rather than import substitution investment

The eclectic package would choose two to three items from this group and one or two from the following policy areas.

- Privatization
- Deregulation of petroleum products

- Deregulation of interisland shipping

The "inner core" strategy is recommended, but the need to reach agreement on what is feasible given Philippine and A.I.D. preferences could lead to a more eclectic approach.

Appendix A

SCOPE OF WORK

A. Review/Evaluation of SDP Design and Implementation Toward Attainment of SDP's Objective

The contractor shall review the design and implementation of SDP. Central to the evaluation is the identification and subsequent discussion of the strengths and weaknesses of the design and implementation process of SDP. Contractor's evaluation will have to account as well for the GOP's role and contribution to the implementation process.

A.I.D. Evaluation Handbook; A.I.D. Evaluation Guidelines for Nonproject Assistance and CIP-like Activities; and A.I.D. Evaluation Occasional Paper No. 13: Information Planning for Policy Reform Programs set forth the general policies and requirements to prepare evaluation plans and conduct program evaluations.

Specific tasks include, but are not limited to, the following:

1. Review and assess the appropriateness of SDP design given the various relevant factors at the time of the design.

2. Review SDP implementation and assess its effectiveness vis-a-vis the attainment of its planned objective.

3. Evaluate the implementation proces, taking into account organizational and management as well as external aspects affecting SDP implementation. External aspects may well refer to GOP's role and performance in the SDP implementation, including factors that affected the GOP's compliance with the requirements of SDP.

4. Assess the degree of complementarity/overlaps of SDP with other donor projects/programs (e.g., World Bank, IMF) impacting on the macroeconomic policy agenda of the GOP.

B. Determination of Impacts of and Benefits From SDP

Qualitative and quantitative assessments shall review on the impacts of

1. SDP resources; and

2. Implementation of SDP Policy Reform Agenda on the economy.

It is expected that the impact analysis would contain estimates of the short-term and long-term effects of SDP (resources and policy agenda), in conjunction with other donor projects/programs, on GNP, inflation, exchange rate, BOP, interest rates, and other pertinent macroeconomic variables and GOP targets.

The quantitative assessment will include an economic cost and benefit analysis of the SDP resources and GOP compliance with the SDP policy reform agenda.

To the extent possible, impacts of SDP in relation to U.S. foreign policy objectives, A.I.D. and Mission initiatives, GOP requirements and sensitivities, and Philippine structural adjustment and economic development should also be assessed.

A review and assessment of the status of Philippine development, structural adjustment and economic prospects, macroeconomic and policy interventions by other major donors (e.g., World Bank, IMF) just prior to and during the period of SDP design and implementation, will also be conducted. This general review and assessment of Philippine policy performance and the country's short and long-term economic prospects will serve as background for the SDP impact analysis and benefit measurements.

C. Recommendations for Future Program Assistance

Specific activities include, but are not limited to the following:

1. Prepare overall lessons learned and implications derived from the evaluation of the SDP design and implementation processes.

2. Identify and assess potential policy options, including policy objectives and indicators, for future programs, particularly for SDP II. Potential policy areas for investigation include fiscal, monetary, trade, financial, regulatory, investment, privatization and industrial policies. Areas of concentration will be specified by the Mission during the field work.

3. Assess and prepare recommendations on technical assistance and training needs for and approaches to improving the policy analytical capacity of the GOP in selected areas such as fiscal, monetary, trade, industry, energy, science, technology and development policy, and for such institutions as the National Economic and Development Authority, Central Bank of the Philippines, Energy Regulatory Board and Departments of Finance, Budget and Management, Trade and Industry, and Science and Technology. The Mission will provide more guidance during field work.

4. Prepare recommendations on the appropriate design, implementation, policy foci, technical assistance and training components of future program assistance in relation to the expected status of Philippine structural adjustment, economic prospects, and GOP development efforts in the medium term.

Appendix B

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Appendix C

LIST OF PERSONS INTERVIEWED

Agency for International Development

Ravi Aulakh, ENE/PCAP
Malcolm Butler, Director
John C. Chang, Program Economist
Bruno Cornelio, Jr., Chief Private Enterprise Support Office
Paul R. Deuster, Program Economist
Gil R. Dy-Liacco, Senior Economist
Gary M. Imhoff, Project Development Officer
Richard Johnson, Deputy Director
Richard D. McLaughlin, Chief Program Officer
John Patterson, Associate Director
Barry Primm, Senior Agricultural Economist
Cameron L. Pippitt, Project Development Officer
Manuel M. Villanueva, Private Enterprise Support Office

International Monetary Fund

Markus H. Rodlauer, Resident Representative

Government of the Philippines

Department of Budget and Management

Emilia Boncodin, Assistant Secretary
Fe Canillas, Chief, Resource and Debt Management Division, Budget Planning Bureau
Benjamin Diokno, Undersecretary
Helen Montalbo, Officer-in-Charge, Foreign Assisted Projects Division, Budget Planning Bureau

Central Bank of the Philippines

Elisa Bengco, Associate Director, Treasury Department
Amando Tetango, Senior Economist, Department of Economic Research-International
Edgardo Zialcita, Deputy Governor for Economic Research

Department of Finance (DOF)

Gil Beltran, Assistant Director, Fiscal and Policy Planning Office
Romeo L. Bernardo, Undersecretary
Jose Dimayuga, Director
Cristina Guevara, Staff Member, International Finance Group
Cris Legaspi, Head, Committee on Privatization (COP)
Modesta Margallo, Director, Fiscal and Policy Planning Office
Ma. Cecilia Soriano, Assistant Secretary

Bureau of Customs

Noemi Ribaya, Officer in Charge, Valuation and Classification Division

Bureau of Internal Revenue

Victor Borromeo, Chief, Statistical Analysis Division
Bernardo Frianeza, Chief, Value Added Tax Division (BIR-VAT)
Rebecca Guiao, Assistant Chief, Value Added Tax Division
Melchor Ramos, Assistant Commissioner

Department of Trade and Industry

Tomas Alcantara, Undersecretary
Ofelia Bulaong, Executive Director, Board of Investments
Letty Ibay, Director, Board of Investments
Emma Mijares, Staff Member, Bureau of Export and Trade Promotion

Maritime Industry Authority (MARINA)

Ricardo O. Romero, Director
Philip S. Tuazon, Director
H. R. Vitasa, Deputy Administrator for Planning

National Economic & Development Authority (NEDA)

Rita Bustamante, Division Chief
Irma Corales, Director, Public Investments Staff
Cielito F. Habito, Assistant Director-General, Office of National Policy and Planning

Ponciano Intal, Deputy-Director-General
Sharon Lazatin, Economic Development Specialist
Cesarina Rejante, Director
Tito Santos, Director, Infrastructure Staff
Rina Tanhueco, Supervising Development Specialist

Office of Energy Affairs

Bert Dalusong, Head of Planning
Wenceslao de la Paz, Executive Director

Philippine Facilitation Committee (PFC)/ Coordinating Council of Philippine Assistance Program (CCPAP)

Ernesto de Castro, Undersecretary and Executive Director of Committee on Official Development Assistance (CODA)

Project Monitoring Staff

Athena Rose Baquizal, Supervising Development Specialist
Jun David, Chief, RPMES

Others

James Balfour, Shipping Operations/Team Leader, Nathan Associates Inc.
Cesar E. A. Virata, C. Virata & Associates