USAID - PHILIPPINES

PRIVATE SECTOR DEVELOPMENT STRATEGY

April 1990

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The private sector development strategy is to be founded on the USAID country development strategy of supporting:

(a) sustainable economic growth through furtherance of open markets and an increasingly open society; and

(b) a policy and institutional framework stimulating market-based private sector growth.

Under this broadly stated development strategy, USAID is strongly committed to the integration of the program themes of policy dialogue, decentralization, and use of the private sector, both indigenous and U.S., in designing and implementing programs and projects.

An assessment of GOP policy performance indicates an evolving environment that can be increasingly conducive to accelerated private sector growth and development. A major shift has been made in GOP policy from regulatory, rent-seeking and government-led approaches to those of liberalized, market-based and promotional policy initiatives directed to achieve sustained, private sector-led economic growth.

This relatively radical shift in policy, however, is fairly recent and not yet fully articulated within government. Major problems of implementation and consistency at the detailed policy and program levels within government still remain as evidenced by:

(a) the lack of understanding, acceptance and support of policies primarily in government agencies and related institutions;

(b) the limited use of private sector-based implementation methods; and

(c) the lack of innovation and integration of implementation programs and projects.

An analysis of the private sector (defined as privately owned, for-profit firms) would show a wide disparity between the development of large firms and small enterprises -- with a missing middle category which should be occupied by medium sized private enterprises. The large firms consist of only two per cent of the total number of registered industrial firms but account for more than half of total employment in the formal sector. Public extension and support services do not reach the very large number of small enterprises. The combined phenomena of the missing middle category and the slow growth and inability of small scale enterprises to graduate into the medium size category can be traced to the long-standing policy and regulatory constraints which favored growth of large, capital-intensive firms while creating serious biases against labor intensive SMEs. This structure has also created sectoral and geographical imbalances since most SMEs tend to be agriculture-based, or agriculture related, and located outside the National Capital Region (NCR).

The private sector may also be classified into those businesses with a clear plan for growth and development, with means for accomplishing such plans; and those which only survive on a "hand-to-mouth" basis. Only those with strong strategic orientation, whether large firms or small enterprises, appear to be capable of accepting and utilizing resources effectively for overall private sector development.

The proposed private sector development strategy addresses itself to these problems and seeks to define the guiding principles and opportunities for USAID assistance.

STRATEGIC CONCEPT

The primary strategy for USAID's role in private sector development is that of promoting the greater involvement of, and a more active role for, the private sector in the effective implementation of private sector development policies. The scope of activities must be extended to include not just the for-profit firms but also relevant non-profit institutions, non-government organizations and selected agencies within government that are demonstrably organized, tasked and operating primarily in support of private sector enterprises.

Policy dialogue should continue to aim at addressing the remaining policy requirements for private sector development growth, such as financial market reforms, investment regulations, and incentives without size, factor or location biases. This should go hand in hand with continued liberalization of trade and industrial policy. Programs should be designed to enhance adoption of policy reforms, active use of private sector-based implementation approaches, and integration of private sector assistance packages.

The prevailing gap between GOP policy and successful implementation of reform to make the private sector the main initiator and prime mover of development can be partly explained by the weaknesses of the entities comprising the private sector as defined above. USAID's project experiences indicate the need for stronger associations between business enterprises and non-government organizations. USAID will need to target for assistance private institutions which can strengthen the delivery mechanisms to the private sector, as well as be involved in the identification and elimination of constraints to private sector development, particularly at the local level.

This strategic orientation is in line with USAID's program theme of decentralization and promoting increased influence of local constituents.

STRATEGIC FOCUS

To strengthen the private sector capacity to provide and sustain employment and income it is proposed that the main focus of programs should be on assistance that promotes (or alleviates the constraints to) the growth of private enterprises, particularly small and medium enterprises (SME). Given the structure of the Philippine economy, and consistent with current GOP priorities, the focus will generally cover agro-industries and related/support services (generally referred to as agribusiness).

The strategic focus of dealing with the constraints to the development of SMEs and promoting their growth will help ensure that more direct private sector assistance efforts will occur and can provide further direction to policy dialogue that will be consistent with decentralization.

To maintain this strategic focus, USAID should provide for calibrated withdrawal from assistance that involves expansion of government institutions and their role in servicing or otherwise relating to the private sector. And although programs and assistance can, and in some cases need to be done through government agencies, project implementation should be carefully designed to ensure clear delineation between government and private sector roles and their respective contributions to performance targets.

GOAL OF USAID-PHILIPPINES PRIVATE SECTOR PROGRAM

The goal of the USAID Philippine mission private sector program is to increase the magnitude and accelerate the growth rate of the private sector's economic contribution to overall Philippine economic and social development by strengthening the requisite market-oriented mechanisms and directly promoting the development of private enterprise. This goal is consistent with the Philippine development strategy of sustainable growth through open and competitive markets and the objective of establishing a policy and institutional framework stimulating market-based private sector growth. The benefits that come out of effective programs supportive of this goal are increased income, investments, employment, exports and achievement of sustainable growth.

The fundamental strategy elements that can be derived from the above statement are: assistance toward strengthening the market-oriented mechanisms serving private sector activities; and, direct promotion of private enterprises.

The first element relates to programs that lead to policy and institutional reforms which would progressively reduce impediments to private sector operations and growth. Included in this strategy are programs that directly expand the private sector equity in industry and trade, such as the reprivatization of government-owned or controlled corporations (GOCCs), and those programs that serve to develop more competitive markets. Financial market reforms, consisting of policy and institutional changes to mobilize capital for private sector, particularly small, investments, also need to be promoted.

The second element involves programs which increase access of private enterprises to various forms of external assistance in the technical, financial, managerial and marketing areas. An associated activity is the strengthening of private and selected public institutions that provide assistance to the private sector. Integrated assistance to private enterprises can be programmed using innovative channels and primarily private sector mechanisms.

OBJECTIVES, STRATEGIES AND PROGRAMS

In support of the broad private sector development goal, several major objectives are derived. Strategies specific to these objectives are then formulated, identifying the principal participants, points of intervention and possible mechanisms. Potential program or project forms serve to provide alternatives for implementation of the strategies.

OBJECTIVE NO. 1

ASSIST THE GOP IN THE STUDY, FORMULATION AND IMPLEMENTATION OF POLICY AND INSTITUTIONAL REFORMS THAT REDUCE THE IMPEDIMENTS TO THE OPERATIONS AND GROWTH OF THE ENTIRE PRIVATE SECTOR BUT WITH RELATIVE EMPHASIS ON SMALL AND MEDIUM-SCALE ENTERPRISES.

The intended effect of the strategies outlined below lies in continuing deregulation and liberalization -- a reduction in the role of government in the business environment. In the process, the size of the government bureaucracy should be reduced, or, at the worst, maintained at its current level. The programs developed should lead to a shift of the involved government agencies from excessively traditional, regulatory functions to more promotional roles. An overriding consideration in the design of programs and projects supporting these strategies is to maximize the use of private sector participation in assessing the nature of impediments and identifying implementation mechanisms. The emphasis should be on the measurable or demonstrable impact of revised government functions and administrative systems on private sector growth, rather than the efficiency that may be attained in performing current or revised government functions.

STRATEGY A

Continued support of policy dialogue to achieve policy reforms in the incentives to investments, tariff rationalization and exchange rate determination, in order to correct the policy biases against small businesses and to promote the continuing deregulation policies of GOP.

Programs/Projects

1. **Rationalization of GOP Investment Policies and Revitalization of the Board of Investments as an Investment Promotion Agency**

In line with the Investment Policy Proposal adopted during the 15th Philippine Business Conference in November 1989, there is need to re-examine the investment promotion policies of the government and lead these toward areas reflective of consumer interests. In order to address the needs of consumers with adequate supply of goods at low prices, investors should be given maximum opportunity to enter industries that they perceive to offer appropriate financial rewards. Subsidies and price controls should be avoided as a matter of basic policy.

The country, consistent with the recommendations of the Philippine Chamber of Commerce and Industries, "should develop and position its industrial sector in line with its resource endowments and agricultural programs." In a policy environment with no subsidies, in whatever form, the BOI should be reoriented to a promotional role. The focus of BOI should be industries which are export-oriented, foreign exchange-saving, high domestic content and employment-generating but not "employment-intensive" industries. The BOI should be stressing the promotion of industries outside the NCR. Considering the relatively large companies in the BOI roster at this time, some emphasis should be done for SMEs.

The re-orientation of the BOI should be signaled by the elimination of incentives and related regulatory functions and the launching of a long-term promotional program for domestic investments. The investment and market promotions activities of BOI should be private sector - driven and open to foreign private investments. It should work through industry associations and individual firms to assure full impact at the industry level.

Grants and technical assistance can be given to the BOI to support rationalization of its functions and to embark on a thoroughly promotional, rather than regulatory agency.

2. **Policy Dialogue/Support for Various Legislative Initiatives Affecting the Private Sector**

Among the most significant developments in the legislative area is the increasing recognition of the need for a policy environment that would promote and encourage the viability of the SME sector. There is growing awareness in Congress that the newly industrialized countries in the region laid the foundation for their economic growth upon their private sector. Toward this end, Congress has a pipeline of legislative initiatives that seeks to coordinate the efforts for developing the SME sector. Central to this coordination is the search for appropriate mechanisms for entry of assistance and development intervention.

USAID should continue to monitor the legislative front using SME focus and mechanisms for proposed intervention as main criteria for its evaluation.

Efforts are being made to provide Countryside Business Enterprises (CBE), also known as Kalakalan ng 20, with access to financial resources. In support to this thrust USAID can provide grant assistance to increase domestic resource mobilization. Private financial institutions come in as a possible conduit for this government financial assistance to smaller enterprises. In addition, additional incentives for bank lending to these enterprises are contemplated in the form of non-taxability of interest income for such loans. To qualify for this tax incentive on loan interest income, the financial institutions must lend at prime rate or less. USAID can provide grant assistance to increase participation in the scheme.

There is a House bill creating a Small and Medium Enterprise Policy Council which would be tasked to integrate and coordinate national efforts in development programs affecting SMEs. The functions of the council are currently stated in very broad terms. The positive aspect of the idea lies in establishing a focal point for coordinating assistance on SME policies. There is also private sector participation in the council.

There is also a Senate Bill that proposes to establish a credit and guarantee corporation for small enterprises. The proposal focuses on the small business as beneficiaries of government assistance. However, this bill may be an example of where good intentions by government may not provide the intended results. Many of the recommendations for providing credit tend to run counter to on-going financial market reforms, e.g., mandatory allocation of credit by financial institutions, and intervention in market mechanisms like interest rates. Policy dialogue will be needed on the part of USAID to resolve any potential inconsistencies with the policy of no bias, market-based, and minimum government-backed long term programs.

3. <u>Buy into the Private Investment and Trade Opportunities(PITO) Project</u>

The plan to participate in the PITO project is a sound one. While BOI might be reoriented, government could use further assistance from separate project efforts like PITO to provide impetus to trade and investment promotion. Ideally, these efforts should be conducted by the private sector itself. While there are many trade and manufacturing associations within industries, these associations have remained weak and uncoordinated.

The focus of USAID's buy-in approach is also appropriately centered on trade and investment promotion, policy analysis and capital markets development. The newly deregulated environment is yet to be tested on specific trade and investment issues requiring the policy analysis component. USAID should attend to the support of policy problem resolution since this is an area where the GOP requires independent review. The parallel project to set up PITO-Philippine component projects in Manila, Cebu and Davao could provide the transactional basis for USAID's involvement and possibly promote linkages of U.S. firms directly to those three areas.

STRATEGY B

Assist selected GOP agencies in the study, formulation and implementation of changes in their roles and their administrative systems which currently impede the growth of the private sector.

Programs/Projects

1. <u>Support Studies and Implementation Measures Leading to Liberalization of Regulatory and Licensing Functions of Government Agencies Dealing with the Private Sector</u>

There are still many constraints to the growth of the private sector, particularly SMEs, that are due to excessive regulation by government agencies. Examples are the regulatory and licensing functions of the Department of Agriculture, the

Department of Environment and Natural Resources and the Department of Trade and Industry/BOI. USAID can be involved in supporting technical assistances to identify and eliminate regulatory constraints and to streamline the remaining regulatory requirements. The studies should include an internal evaluation of the agency staff and seek alternative use of existing personnel. Subsequently the assistance can extend to the implementation of the change, including installation of new or streamlined regulation and licensing systems.

OBJECTIVE NO.2

PROMOTE THE EXPANSION AND GROWTH OF THE PRIVATE SECTOR.

STRATEGY A

Continue support for GOP's policy of privatization. Assistance in accelerating the privatization of the smaller corporate holdings and non-performing assets of government agencies and non-performing assets of the government.

The current privatization effort primarily covers the big ticket government holdings. While the Committee on Privatization (COP) and the Asset Privatization Trust (APT) anticipate some problems in fully accomplishing the privatization targets within their mandated period (ending in 1992), technical expertise has been established, procedures involving various agencies have been set in place, and a concept for enforcing the transfer of assets to the private sector has been developed. An expansion of the privatization effort to cover remaining enterprises operated by the government should be explored using this capability. The benefits lie in the transfer of entities from the public to the private sector and the new private equity capital this generates.

Programs/Projects

1. . **Continue Support for the Privatization of Remaining Smaller Corporate Holdings of Government**

The privatization through COP/APT has slowed down, especially in the sale of big-ticket holdings. From about 400 accounts which were entrusted by the government to the APT for disposition, 182 accounts have been sold (127 fully and 55 partially) as of the end of 1989. About P10 billion from the disposition of these assets has been remitted to the Treasury and earmarked for the Comprehensive Agrarian Reform Program (CARP). An additional remittance of P6.7 billion is expected in 1990 from disposed assets.

The problems faced by COP/APT are mostly legal questions (and unique to each account) and related to the requirements of the Commission on Audit. The APT recognizes the problems with COA but appears slow in responding with changes in procedures or proposals. It is strongly recommended that a review of the rationale for some of COA's requirements be made. A portion of the USAID grant could be used for non-legal technical assistance to address the constraints encountered by the APT during its remaining period of operation (to year end 1991). A more effective way may be to provide program assistance as an incentive to actual sales.

STRATEGY B

Strengthen public and private institutions that provide assistance to the private sector.

There is a need for institutions which facilitate the delivery of assistance to the private sector, particularly in targeting or focusing on priority groups and in undertaking initial assistance efforts to beneficiaries. Private institutions include business firms, non-government organizations and civic groups involved in socio-economic assistance programs. Consistent with decentralization, public institutions in direct contact with the private sector should also be given priority.

Programs/Projects

1. <u>Provide Grants to Selected Institutions Providing Development Services to the Private Sector</u>

USAID should continue to provide grant assistance to institutions which are involved in the promotion of small and medium-scale countryside development projects. The likely institutions which are of sufficient scale and breadth of operations are PCCI, PBSP and a number of foundations.

PCCI has a few advantages in its organization as it is decentralized, has private business membership, and is countrywide in scope. PBSP has an extensive, nationwide network of extension workers with a good track record in service to SMEs development. Among the many types of foundations operating throughout the country the corporate foundations appear to be more successful in carrying out assistance to private business as they are built on the basic strengths of corporations.

PCCI, though its foundation, can be assisted in its services to SMEs like technology transfer, business search, and domestic financial mobilization. These three areas have been clearly identified as the main requirements of SMEs. PCCI's strength lies obviously in its inherent understanding of how businesses operate. For example, its assistance methods include: (a) being involved in projects which pass the prefeasibility test; (b) conduct of buyer search for products of proposed projects including exports; and (c) linking beneficiaries to formal financial institutions. It can also undertake projects on a counterpart funding basis.

PBSP's Institution Building Program and Micro-Enterprise Development and Promotion Program are directly relevant to private sector development. Its strength lies in the way its programs are carried out through local private voluntary organizations whose participation is based on expressed local needs. PBSP's methods are based on the principle that local institutions should be helped to become capable of carrying on the development tasks by themselves. In addition to providing its own funds to assist these organizations, PBSP has a good track record as an effective intermediary of various donor funds.

STRATEGY C

Assist those private enterprises that can help undertake the production of public services and infrastructure which support private sector development.

This strategy would move assistance efforts from the government to the private sector and thereby promote efficiency, decentralization and local involvement.

The most often cited impediment to private sector investment and growth has been the lack of adequate services and infrastructure. This addresses the most urgently felt need for improvements in infrastructure particularly in transportation, communications and power generation in order to open up opportunities for, and support the activities of, the private sector. This is an activity which can be undertaken with some USAID assistance, by the private sector itself, and in particular represents an opportunity for U.S. private sector participation.

Metro Manila has been declared as overcrowded for industry. The GOP is now, correctly, focusing on development of centers outside the national capital region.

Initially this will be undertaken through development of 12 regional industrial zones where siting of industrial and agri-business companies will be encouraged.

However, to ensure the success of this scheme development of the necessary physical infrastructure is essential. Business cannot operate without access to road systems, telephones, power and water. Government must provide these services. Either through construction by the relevant Department or through promotion of BOO or BOT projects.

USAID can assist in this by encouraging prioritization of infrastructure projects, not only for the industrial zones but, as far as funds allow, nationwide. Particularly for farm-to-market roads.

The Mission can also assist by developing programs and dialogue that attract private sector, both local and foreign, companies to invest in identified infrastructure projects.

Technical assistance to review projects and to demonstrate the financial and socio-economic benefits should be undertaken particularly those that can assist the easier entry of the US private sector into BOO and BOT projects.

Programs/Projects

1. The on-going liberalization of the transport industry requires private sector investment. There are efforts to organize transportation cooperatives and channel financial assistance for investments in transportation units to these cooperatives. For example, the Office of Transportation Cooperatives (OTC) initiated a program that would enable the driver of an individually-operated public utility vehicle to own his vehicle after about 3 years under a lease-purchase agreement with his cooperative.

USAID's intervention can come through grants tied to the policy reforms toward liberalization in the transportation industry. And financial assistance, through the appropriate government or private institution conduits, for the funding of front-end investment in schemes similar to OTC's. A perennial complaint of countryside businesses is the lack of transportation facilities for goods. USAID should look into encouraging formal financial sector lending to institutions that can address the goods transport problems.

2. Technical assistance and grants, including front-end studies, for indigenous and U.S. private sector groups undertaking projects in transportation, telecommunications, power generation, delivery of health services, etc.

3. Technical assistance and grants for management training.

4. Technical assistance for decentralized agencies that want to adopt administrative systems that allow private sector involvement in decision making and that want to implement infrastructure projects that serve the private sector.

OBJECTIVE NO. 3

SUPPORT PRIVATE SECTOR INVESTMENTS AND ACCESS TO ASSISTANCE, WITH SOME EMPHASIS ON SMALL AND MEDIUM-SCALE ENTERPRISES (SME).

STRATEGY A

Encourage mobilization of financial resources and flow of credit financing to small and medium enterprises, including selected micro enterprises.

Financing remains a priority requirement and major problem of the private sector, particularly for small- and medium-scale enterprises. Until the rural financial system becomes more efficient, there are transaction costs, informational and project size barriers that block the direct servicing of these enterprises by rural financial institutions. A program of domestic resource mobilization for SMEs is needed.

Programs/Projects

1. <u>Reorient the Small Enterprise Credit Project</u>

USAID's Small Enterprise Credit Project is aimed at providing quick but transitional solution to fundamental constraints to SME growth. The choice of PBSP as a channel for organizing NGO's and for monitoring the accreditation of private development banks is appropriate. However, a weakness in the project design concerns the problem of additionality and the lack of direct linkage to technical assistance for the project. A common problem in past credit assistance programs by government was the tendency of beneficiary banks to submit existing loan portfolios (e.g., SMEs) for financing under the project and then, rechanneling funds so freed to other types of loans.

The present design of the USAID project can potentially lead to problems of this nature. The alternative at this time is for PBSP to expend much effort in detailed monitoring of bank loan accounts. While this may still be within the scope of its responsibilities, an alternative approach would be to establish a linkage between credit facilities and technical extension support to SMEs. This is again where PBSP would be an appropriate institution to work with. The design of the project should incorporate the relationship between the supply of credit under the Project and the demand for credit which might, for example, be generated by a technical assistance program conducted in the same area as the beneficiary bank. Alternatively, the accreditation process might be redesigned to incorporate and evaluation of potential excess demand for credit by SMEs in an area. Such a redesign of the project might require a low-cost, rapid appraisal survey prior to accreditation of banks for the project. Another approach is to utilize existing extension data available within the PBSP network to conduct this appraisal of credit need. These are extra activities which can help ensure that the project attains the "additionality and sustainability" goal of credit assistance under this Project.

Another model which might be considered in the Small Enterprise Credit Project is to encourage formal institutions to fund on the basis of technical pre-screening of projects. This approach may be more appropriate where the NGO would be prepared to provide technical assistance in making the project succeed. Local chambers and associations, e.g., PCCI at the regional level, may find this model appropriate. Under the scheme, the association can generate project proposals for pre-screening, technical and management advisory assistance, and finally credit. The package then becomes an assurance of additionality and benefit to the growth of SMEs.

2. <u>Technical assistance and grants to NGOs undertaking pre-loan evaluation, feasibility studies (for financing), and advisory assistance to SMEs.</u>

STRATEGY B

Increase access of SMEs to new technologies, markets and training.

While financing is important to SMEs, there is as much a need for a package of assistance to increase the efficiency and sustaintability of capital utilization.

Program/Project

<u>Provide Direct Financial and Technical Assistance to Medium-Scale Private Sector Projects with Potential Regional or Local Area Impact</u>

There are a number of private sector investment proposals which could warrant grant and technical assistance by USAID. While these projects are generally for investments by private investors, they possess features which are consistent with USAID's private sector development strategy, namely,

(a) they provide benefits to other private sector groups in the region, rather than only to the specific enterprise involved, and

(b) they serve as possible models for future intervention in other sectors.

One possible project is the establishment of a foundry for production and training in metalworking in the Cagayan de Oro - Iligan City industrial corridor. There is need for a steel alloy foundry to support the industrial base in the area, since most foundry requirements are currently serviced by firms in Cebu and Manila. Industrialization in the region would remain too (regional) import-dependent and would not be utilizing available local skills if this project is not developed. The project could serve as a training ground for metalworking and other foundry-related industrial activities that support agro-industrial activities in this area.

Another example is the proposal of the San Carlos (Pangasinan) Chamber of Commerce for investment in tomato production and processing. If private sector financing can be provided, private sector groups can purchase, rehabilitate and operate the two processing facilities under privatization by the government. San Carlos Fruit Co., the only industrial buyer of tomatoes for processing in Pangasinan, is one of the government-owned companies for privatization under APT. Northern Foods in Ilocos Norte, which is an even larger facility, is likewise offered for privatization under the Office of the Presidential Management Staff. In terms of impact, these companies can provide the country with fully integrated facilities -- from farm production to final processing. This capability does not otherwise exist in the country. Twenty years ago, processed tomato was largely confined to the U.S. and a few countries in Europe. Since then it has become a developed industry in many countries, the most notable being Taiwan from which the Philippines has been importing its processing tomato requirements. With investments in processing plants and in agricultural production technology, these companies are apparently failing under continued government control. A private sector approach might reverse the situation. The reasons for failure would, however, need to be carefully evaluated before proceeding with this project to ensure they were not endemic to the business and could not be corrected.

Various other investment possibilities can be found in project investment proposals generated under PCCI initiative from its local chambers. The proponents are a variety of private sector groups in the different regions. Out of this list it is possible to review projects according to criteria set by USAID and employ existing conduit arrangements for various non-financial forms of development assistance.

OBJECTIVE NO. 4

SUPPORT THE BUILDING OF THE INFRASTRUCTURE REQUIRED FOR THE DEVELOPMENT AND GROWTH OF THE PRIVATE SECTOR.

STRATEGY A

Promote financial market reforms.

Recommended programs and projects are already presented in the Capital Markets Project Study and hence will only be briefly outlined below.

Programs/Projects

Policy dialogue to reduce the excessive intermediation costs of financial resources and eliminate restrictions on branching and other constraints to savings mobilization.

Institutional support and training for the Philippine Deposit Insurance Corporation to build depositor confidence in the banking system and mobilize savings.

Technical assistance for research and training to support the continuing liberalization of the financial system.

Financing is a crucial component of private sector development. Aggressive development of the rural financial system has been identified as a priority requirement for growth of business in the rural areas. The financial market strategy for USAID/Philippines is one built around policy dialogue, institution-building, and research to remove the remaining constraints to the development of rural financing and the mobilization of savings.

STRATEGY B

Support specific changes in policies and administrative systems in the public sector that will result in more effective delivery of government services to the private sector.

Many public sector institutions have clear mandates to provide public services (such as technology and market information assistance) to private business enterprises. But they have problems in increasing their effectiveness and in decentralizing the delivery of these services. Furthermore, the government has not adequately explored various public service delivery activities which involve private sector participation. USAID/Philippines should promote policy dialogue, technical assistance, and training for specific approaches to decentralization of public services related to business development and encourage more private sector participation in the delivery process.

Programs/Projects

1. **Provide Grants and Technical Assistance for Evaluation and Monitoring of Decentralization of Key Government Agencies**

The decentralization policy of the government has been slowed down by the inability of Congress to enact the Local Governments Code or of the President to issue executive orders on decentralization. Consequently, decentralization of government agencies has largely proceeded as "pilot decentralization measures", using selected agencies and provinces.

The process involves the preparation of Memoranda of Agreement between executive departments/agencies and the provincial governments. An examination of these Memoranda indicates that the common measures adopted involve creating Consultative Councils for each area of concern or Department (e.g., natural resources), chaired by the governor, with the executive department provincial official as vice-chairman and members of the government and private sectors as members. This Council becomes the main implementation arm of the department in the province.

There is currently no provision in the agreements for evaluation and monitoring of decentralization measures, even for the pilot agencies and provinces. USAID can provide technical assistance or grants to study and devise models of decentralization out of the on-going experiment in selected agencies and provinces. This would require an assessment of the present process. There is a current plan to expand the pilot decentralization program to involve all agencies and at least one province in each region. The implementation of such a plan could be the basis for USAID's intervention/assistance and would speed up nationwide decentralization for key government agencies.

2. **Provide Grants/Technical Assistance for Technology Transfer to Filipino companies**

Aside from access to financing, improved technology is one of the major requirements to support the growth of industry. It is clear that the country, through the Department of Science and Technology, has a ready resource of available improved technologies for adoption by businesses, especially SMEs. However, these improved technologies are not effectively being disseminated to business enterprises because: (a) the technology generators are not market-oriented; (b) the potential users of the technology remain traditional and resist adoption of new methods, and (c) the traditional agent of change is the government extension system.

The current leadership at DOST is quite receptive to using NGO's and PVOs (rather than its own or other government extension workers) as instruments of change, e.g., technology packaging, communications fora, etc. As an example, the Design and Engineering Center was created with the help of 33 private companies. Its task is to package technologies around products and services so as to help modernize industry and increase productivity. USAID can lend assistance and provide grants to the NGOs and PVOs which are thus tasked with technology assistance to the private sector.

RATIONALE FOR A PRIVATE SECTOR DEVELOPMENT PROGRAM

The Environment and the Private Sector

Philippine development was set back during the economic, political and financial crisis of the early to mid 1980s. It was a period of heightened problems of poverty, unemployment and under-employment, income and regional disparities and public sector inefficiencies. With the change to the government of President Aquino, the decline of the economy was checked and reversed for positive growth. However, the underlying structural weaknesses in the economy present development challenges for the country's economic managers.

In the past, macroeconomic policies on trade and exchange rates, in combination with the incentives and regulatory structure governing investments, led to an inefficient manufacturing sector. Tariffs and import controls that favored domestic manufacturing industries resulted in industry attracting more resources than agriculture. However, the inefficiencies of industry due to this protection prevented it from adequately absorbing surplus labor from agriculture. The capital-intensive and pro-big business orientation of the investment incentives system persist up to the present. To some extent, this situation has contributed to the low rate of employment and absorption of surplus labor from agriculture. The overvalued currency depresses the domestic prices of major crops and the income of farm families. The regulatory structure of government was biased against the promotional needs of private business, deterred entrants, and resulted in high transaction costs.

Financial markets remained underdeveloped, as government policies emphasized selective credit controls, preferential allocation of credit, and subsidized interest rates to selected sectors. In general, these policies did not achieve their intended development impact. Selective credit controls proved to be difficult to implement and were circumvented to a large extent. The essence of the agri-agra regulations, for example, was easily circumvented by financial institutions through investments in government securities and loans to large companies with agribusiness components. These were technically allowed under the scheme. Another example, the required retention of loans in rural areas was also circumvented by bank branches. Preferential credit allocation and subsidized interest rates may have encouraged participation by target sectors, especially the SMEs. However, there may be no additionality involved in such special credit programs because private sector investments may have been made anyway without such programs. The thriving informal credit market is an indication of such private sector financing activity. The more fundamental problem of savings mobilization should be a more fruitful area where policy should focus on.

In recent years policy reforms have been started in these macroeconomic areas. The import liberalization program required a shift from qualitative restrictions to tariffs or import duties that gradually reduce over time. Investment incentives and privileges, previously embodied under separate laws, have been consolidated and tax holiday incentives have been added. The exchange rate system, while supposedly a free floating system, remains partially controlled by the Central Bank to avoid wide market fluctuations. Nevertheless, a gradual depreciation of the peso relative to the US dollar has been experienced and is expected to continue into the near future.

Implementation of reforms in the financial system is in progress. Participation by government banks in the banking system declined substantially with the restructuring of the PNB and DBP, the partial privatization of PNB, and sale of government-acquired banks to the private sector. A major concern of the government is the reform required of the rural financial system. Steps have been taken toward the rehabilitation of rural banks, consolidation of agricultural credit programs, and design of mechanisms to strengthen rural financial institutions with the assistance of government financial institutions (e.g., the Land Bank liquidity pool).

The net results of these macroeconomic policies on the private sector are reflected in the slow and unbalanced growth that occurred, with most potential remaining unharnessed due to policy, incentives and regulatory constraints. Some liberalization has been started but the private business sector has not yet fully absorbed these changes and hence has been unable to provide significant results in terms of employment, income and growth.

The human resource, institutional and physical infrastructure characteristics of the private sector provide some explanation for the nature of the development issues facing the country. The human resource picture specifies the problem: government estimates that about 700,000 additional workers are being added to the labor market each year (4.5 per cent growth between 1980-87) but insufficient new productive jobs are being created. Because agriculture has been unable to create the necessary new employment opportunities, the non-farm sector has to take up the excess employment demand. In this regard, the structure of the industry sector requires a broad systemic review.

The Department of Trade and Industry statistics show the following structure as of 1986:

Category	No. of Firms	(Per Cent of Total)	employment
1) Large (assets greater than P10 Million)	588	(1.9%)	411,905
2) Medium (assets less than P10 Million)	568	(1.8%)	79,993
3) Small (assets less than P2.5 Million)	30,558	(96.3%)	330,268

Since the labor force in 1986 was estimated at 22.1 million, a large proportion of labor must be in the remaining classifications, e.g., micro-enterprises, agriculture, government service, and the un- and under-employed. Micro enterprises are those with assets of P250,000 or less, and their workers are likely to be living on a daily subsistence income. By 1988, the labor force estimate was 23.8 million with a unemployment rate of 9.6% Agriculture took up about 47% of the labor force.

Off-farm private sector enterprises are predominantly of the small and micro categories, with a disproportionately thin medium-scale category. Micro enterprises is a sector which is largely not captured in government monitoring of industry. These enterprises are usually unregistered, unregulated and not accessed by public extension and promotional services. Many of these enterprises operate on a subsistence basis or provide only marginal employment.

The overall development issues of income and employment are reflected in the structure of the private business sector. The greater majority of private enterprises in terms of number and employment belong to the small and micro enterprise categories. The growth of the small enterprise group needs to be accelerated in order to strengthen the far smaller medium-scale enterprises group. At the same time, there may be an equally large number of micro-enterprises which need to be taken out of the "underground economy" in order to become more accessible to public services and eventually join the ranks of the small and medium-scale enterprises. However, it is likely that a good proportion of these micro enterprises require welfare type of assistance in combination with other services.

The Small Enterprise Credit Project Paper characterized the structure of the industrial sector in the Philippines as one where progressive SMEs are missing. The term "progressive SMEs" referred to SMEs with plans for expansion and possessing coherent strategies for implementing their expansion plans. Many of the SMEs are located in provincial centers and rural areas, a situation which continues to be associated with the "long standing policy constraints that have led to the growth of capital intensive firms while limiting the growth and development of more labor-demanding SMEs in the country". There is clearly a need to formulate policies that shall increase the ranks of "progressive SMEs."

Opportunities and Constraints to Private Sector Development

The government expects the real growth of the manufacturing sector to lead the overall economic growth with a rate of 7.6% per year. Exports of goods and services are expected to grow annually by 9.4 %. Exports are expected to be increasingly diversified toward processed and manufactured products.

Economic growth targets are set by the government based on a rural development strategy, a plan that emphasizes the mobilization of the rural sector by modernizing agriculture and developing the SMEs. The government is resolved to make the private sector the initiator and prime mover of development.

Given the development objectives of broad based, sustainable growth, employment and income/efficiency, the major opportunities for development intervention for USAID-Manila are a subset of those identified by the overall GOP strategy -- the off-farm sector, mostly the SMEs. This sector covers post-harvest business activities (agri-business) and include those with export potential, as represented in the sizeable group of SMEs.

The off-farm private sector consists mainly of micro- and small- to medium-scale enterprises. The equity objective is better served if the business sectors outside of the large-scale enterprise category are given assistance. Similarly, it is widely accepted that an economy with a strong small- to medium-scale enterprise group tends to be more growth-oriented and more resilient to environmental adversity. These enterprises are also known to be much more labor-intensive than large firms.

The fourth objective -- efficiency -- serves to limit the opportunities for investment even within the off-farm, SME group. With advantages due to economies of scale, compounded by abilities to put up barriers to entry (a policy imperfection in some sectors), large enterprises can readily attract new investments. In the case of SMEs, their investment efficiency is often hampered by external/environmental constraints as well as difficulties inherent in the enterprises or the industry sector in which they belong. Consequently, efficiency considerations often imply that investments are attractive only for the progressive SMEs -- to finance the implementation of their growth strategies. Investors tend to come into partnership with "successful" SMEs, i.e., those with a good track record. To some extent, the same opportunities for investment and growth apply to progressive micro-enterprises.

Constraints to private sector development, when properly focused on off-farm SMEs and progressive micro-enterprises, fall into 3 general categories: (a) government initiatives, policies, regulations and infrastructure; (b) capital markets; and (c) capacities available at the enterprise and industry level. Fundamental findings on the dominant factors constraining the off-farm SME sector development are summarized.

Private business enterprises cite a long list of restrictive policies, uneven incentives, regulatory barriers, government requirements (which result in high transaction costs to business), and a lack of adequate infrastructure that inhibit business activity. The SME sector is especially vulnerable to these government service-related constraints because of their size, limited resources and relatively weak political power. Growth, as well as entry, of SMEs are thereby restricted. The lack of basic infrastructure increases the cost of doing business by the private sector, but, due to their cost structure, may be a very serious viability issue for SMEs. The net result of these constraints is the limited ability of the private sector, especially SMEs, to operate profitably. Further, due to the differential impact of such constraints on large firms relative to SMEs, disparities in development across these two sectors can be expected and has led to the current situation described earlier.

The underdeveloped state of the capital market limits financing and growth of the private sector, especially SMEs and rural enterprises. The USAID-Manila Capital Markets Study has properly identified the problems facing the financial sector, which include incomplete liberalization of financial markets, continued bias in the credit allocation for industry, weak market institutions and inappropriate policy and regulatory features of the financial system. There are also indications that not all sectors fully understand the principle of financial market liberalization policy which has already been set in place by the government. For example, the Congress and the Department of Trade and Industry continue to sponsor and lobby for legislation which are in the nature of credit allocation (e.g., to rural enterprises), new credit subsidies (e.g., to Kalakalan 20) or new guaranty schemes (e.g., to SMEs). While these initiatives may produce have some immediate impact, there is a need to learn from past experience about the costs to long-term private sector development.

The constraints facing the enterprise which are inherent to its business and industry are somewhat simpler to address. Many of these barriers to growth and profitability are related to size and limited access to formal markets and institutions. These can be classified as: (a) uneconomic size so that the company cannot support internal specialization or activities like pre-investment studies, relationships with financial institutions, information transfer, etc., (b) limited access to technology, information and government services; and (c) lack of management skills.

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