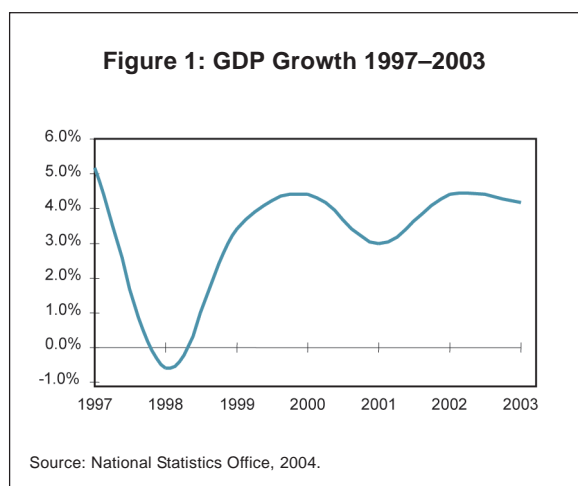


I. THE PRIVATE SECTOR IN THE MACROECONOMIC ENVIRONMENT

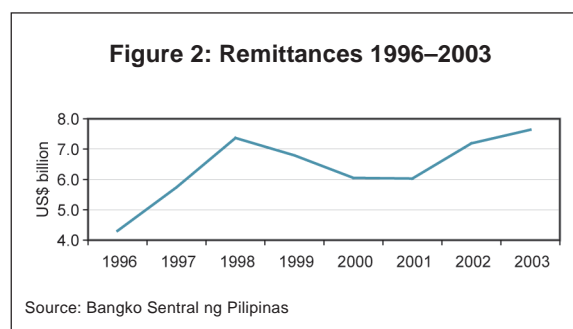
A. Macroeconomic Overview

The Philippine economy has proved quite resilient to external shocks and changes in economic policy over the past 5 years. While many of its neighbors suffered deep recessions during the post-Asian crisis years of 1998–2001, the Philippine economy continued to grow at an average pace of 2.5% per annum. Despite these gains, the rapid pace of population growth has led to the lowest overall per capita gross domestic product (GDP) growth rate in the region from 1990 to 2001 (see Figure 1).¹



¹ Average GDP per capita growth rate in 1990–2001 was 0.5% for the Philippines compared with 3% for Bangladesh and Indonesia, 4% for Malaysia and Thailand, 5.5% for Viet Nam, and 8.2% for the People’s Republic of China.

GDP growth has been largely consumption led, as both national savings and domestic investment rates have fallen since 2000 (Appendix 1). The Philippines has one of the lowest investment to GDP ratios (20%) in East Asia and the lowest capital stock per worker among market economies in the region. The persistent inflows of remittances from overseas Filipino workers (see Figure 2) averaging more than \$6.7 billion² annually in recent years, has helped boost consumption, but the slow rate of new investment raises questions about the overall sustainability of this growth in the coming years.³



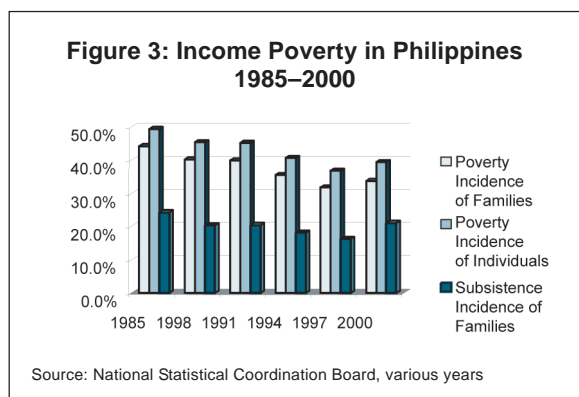
GDP growth has proven to be closely related to poverty reduction in the Philippines where high growth rates⁴ from 1986 to 1997 led to a reduction in the official incidence of poverty from 44.2% of

² Amount flowing through formal channels, according to *Bangko Sentral ng Pilipinas* (BSP); it is estimated that informal transfers add another 50% to this amount.

³ See more on investment trends in sections C and D.

⁴ Per-capita gross national product (GNP) growth during 1995–1997 averaged almost 3% per year.

families in 1985 to 31.8% in 1997. Slow GDP growth since 1998⁵ reversed that trend with the incidence of poverty rising to 33.7% of families in 2000. Similarly, the incidence of poverty among individuals decreased from 49.2% in 1985 to 36.9% in 1997 before rising to 39.5% in 2000 (ADB 2004). These trends are illustrated in Figure 3 that shows data taken from the Philippine poverty assessment report prepared by ADB in July 2004.



National figures mask significant geographical disparities. In addition to urban-rural income disparities, regional differences are also marked, particularly among the three major island groups of Luzon, Visayas, and Mindanao (southern Philippines). The highest incidence of poverty is in Mindanao, where GDP is lowest (see Table 1). As will be demonstrated in subsequent sections of this report, the southern Philippines also has the poorest physical infrastructure and fewest nonfarm employment opportunities, further dampening efforts to stimulate economic growth.

The newly elected government of President Arroyo is acutely aware of the need to foster broad-based economic growth to reduce the levels of poverty in the country. In her July 2004 development agenda, she declared, “Our objective is to improve our economic growth from the current rate of less than 5% and move it up to 7% per annum, or even more, on a sustained basis, up to the year 2010. Through this we will be able to bring the poverty rate from 34% down to a more manageable 17% by the end of the President’s term.”

Table 1: Gross Domestic Product and Poverty Incidence by Region

Region	GDP, 2002		Poverty Incidence, 2000 (%)	
	At Constant Prices (PhP B) (1985–100)	% Share		
PHILIPPINES	1,046,083	100.00	33.7	
NCR	Metro Manila	320,020	30.59	8.7
CAR	Cordillera	25,690	2.46	36.6
I	Ilocos	32,167	3.07	37.1
II	Cagayan Valley	23,402	2.24	29.5
III	Central Luzon	94,117	9.00	18.6
IV	Southern Tagalog	162,841	15.57	25.3
V	Bicol	29,975	2.87	55.4
VI	Western Visayas	74,430	7.12	43.1
VII	Central Visayas	74,895	7.16	38.8
VIII	Eastern Visayas	24,217	2.32	43.6
IX	Western Mindanao	28,382	2.71	46.6
X	Northern Mindanao	39,749	3.80	45.7
XI	Southern Mindanao	64,095	6.13	40.0
XII	Central Mindanao	27,642	2.64	51.1
ARMM	Muslim Mindanao	9,915	0.95	66.0
XIII	CARAGA ^a	14,546	1.39	–

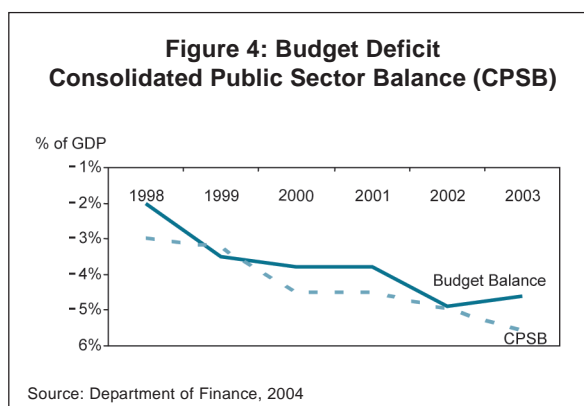
^a Provinces comprising of (CARAGA) region are included in Region X and XI based on the old regional groupings.
AARMM=Autonomous Region in Muslim Mindanao, NCR=National Capital Region, CAR=Cordillera Administrative Region, CARAGA = Agusan del Norte, Agusan del Sur, Surigao del Norte and Surigao del Sur
Source: National Statistical Coordination Board, various years

⁵ Per-capita GNP growth in 1998-2000 averaged 0.8 % per year while population growth remained at 2.2% per year during 1995-2000.

The economy is dominated by the services sector which contributed approximately 50% of GDP in recent years, followed by industry/manufacturing at 32% and agriculture, fishing, and forestry at 15–17%. The services sector has also had the fastest growth rate in recent years, reflecting the fast pace of consumption and demand for telecommunications and food services.

One of the most salient characteristics of the Philippine economy is its rising budget deficit brought on by a combination of poor revenue collection and the rapidly accumulating liabilities of its government-owned and government-controlled corporations (GOCCs), in particular the National Power Corporation (NPC). The budget deficit grew from 1.8% of GDP in 1998 to an estimated 4.5% in 2003 (see Figure 4). Weak tax and customs administration together with poor taxpayer compliance are largely responsible for the decline in tax revenue which fell from 16% of GDP in 1997 to 14% in 2003. The potential for improvements in tax collection is significant given that a change in management at the Bureau of Internal Revenue (BIR) in 2002 succeeded in increasing revenue collection by 13% year-on-year in 2003. Ongoing administrative reforms and computerization will be important steps in further improving the performance of both customs and internal revenue collection. Particular emphasis must be placed on implementing BIR's large taxpayer service that targets those taxpayers whose collective liabilities contribute more than 70% of total income tax revenue.

The persistent deficits in the operations of its GOCCs further weaken the financial position of the government. NPC alone is expected to contribute P73 billion to the consolidated public sector deficit



in 2003, largely due to further mandated reductions in the tariffs in 2003, inadequate capitalization, and onerous offtake obligations with its independent power producers (IPPs).⁶ Restructuring the power sector and addressing the issue of tariff levels is therefore essential in restoring a manageable fiscal balance (see Table 2).

Table 2: Consolidated Public Sector

Billion pesos	2001	2001	2003 estimate
National Government	(147)	(211)	(202)
Capitol Bank Restructuring	(26)	(15)	(20)
Monitored GOCCs	(23)	(46)	(97)
NPC (share of)	(8)	(22)	(73)
NFA (share of)	(2)	(8)	(13)
SSS/GSIS	11	26	11
BSP	5	4	1
GFI	5	5	4
LGUs	4	3	1

GOCC= Government Owned or Controlled Company, NPC= National Power Corporation, NFA=National Food Authority, SSS= Social Security System, GSIS= Government Service Insurance System, LGU= Local Government Unit

Source: Department of Finance, 2004

The government also faces a ballooning national debt that reached \$55 billion in 2003, or 73% of GDP. Approximately 50% of this amount was denominated in foreign currencies. Interest payments were close to 38% of total government revenues in 2003, up from only 17% in 1997. Rising levels of debt service are crowding out other important government expenditures such as much-needed transfers to local governments (LGUs) to support their public service obligations and expenditures in health, education, and physical infrastructure.

Contingent liabilities of the government are estimated at a further P3.1 trillion (\$56 billion), representing maximum exposures under obligations such as (i) unfunded liabilities of pension programs (P1.8 trillion), (ii) direct guarantees on loans to GOCCs (P66 billion), (iii) risk guarantees for build-operate-transfer (BOT) contracts (P45 billion), and (iv) deposit insurance (P352 billion) (ADB/World Bank 2003). With this high level, the government has already maximized its capacity and it would not be

⁶ A more detailed discussion of NPC's financial position and the power sector in general is provided in Chapter III.

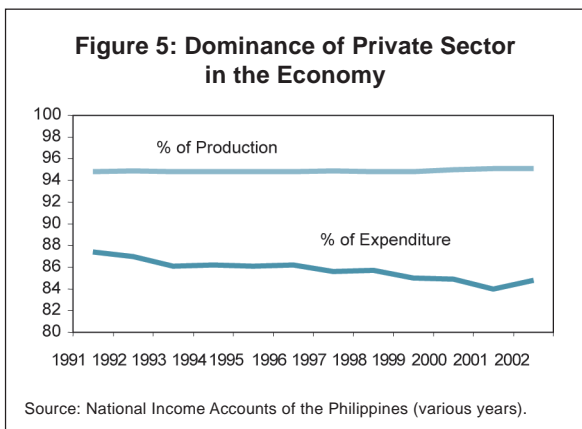
prudent to contract additional exposure without first reducing existing liabilities. Although the risks associated with these guarantees may not materialize, it is imperative for the government to develop a mechanism to accurately account for them and to create corresponding provisions.

In summary, the Philippine government is in a very weak financial position. As it looks to support measures for fostering economic growth and private sector development, it will be very limited in the financial investments that it can make. This may actually be fortuitous. As will be demonstrated throughout this paper, the most important contribution that the national government can make to private sector development is creating better conditions for private investment including more competitive markets, credible regulatory oversight, better administrative performance from supporting government agencies, and a reliable mechanism for dispute resolution.

B. Profile of the Private Sector

1. Contribution to the Economy

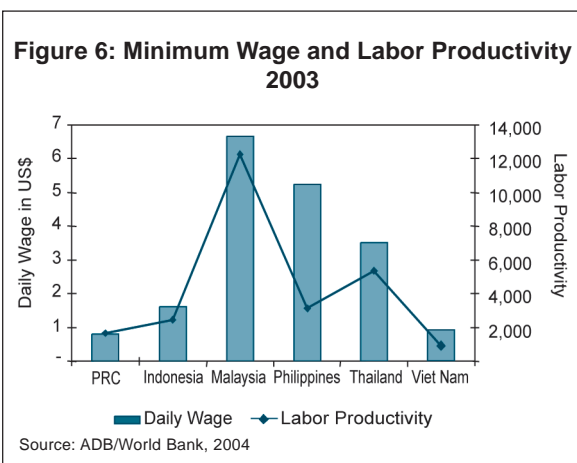
The private sector dominates the Philippine economy generating on average 95% of GDP and accounting for 85% of total expenditure during 1991–2002 (see Figure 5). The private sector also contributes on average 65–75% of total investment, although its share dropped to 66% after the Asian financial crisis as the economy contracted and the government intervened to revive growth.



Private enterprises employ 92% of the registered workforce⁷ but have not been able to keep pace with the growing number of job seekers since the Asian financial crisis. Unemployment rose from 7.9% in 1997 to 10.2% in 2002. The inability of the domestic economy to absorb a large portion of the growing number of new entrants into the labor market and the relatively large differential in pay between local and foreign employment have encouraged many Filipinos to seek employment abroad.⁸

The overall productivity of the private sector is low and declining (see Figure 6). Rising real wages due to successive rounds of minimum wage increases have not been matched by concurrent rises in productivity, such that unit labor cost rose from 1.0 in 1978 to 1.3 in 2000. In contrast, the unit labor cost of Malaysia and Thailand were close to or less than 1 for most of the same period (Jurado 2000). Business efficiency in the Philippines, i.e., the extent to which enterprises are performing in an innovative, profitable, and responsible manner, was found to be one of the lowest among 49 industrialized and emerging economies (Macaranas and Silva 2002). Key factors causing this poor competitiveness relate to the enabling environment for business (e.g., high labor and energy costs, poor infrastructure, weak governance and regulation) and are explored in detail in Chapter III.

In spite of its lack of competitiveness, the Philippines has managed to leverage some of its key resources (educated and English-speaking workforce,



⁷ Averages for 1991–2002; data from the *National Income Accounts 1991–2002* and National Statistical Coordination Board.

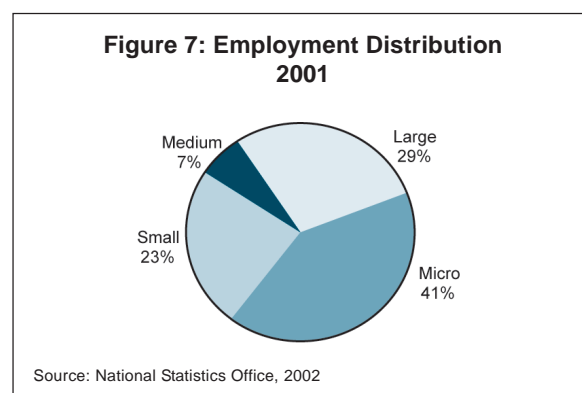
⁸ Approximately 8 million Filipinos reside abroad, including 870,000 foreign workers.

modern information and communication technology [ICT], strategic location) to foster the growth of some new industries. The proliferation of call centers and business process outsourcing activities in recent years has demonstrated the Philippines' competitiveness in these sectors (even in the face of intense competition from India), and the country's location has made it a hub for major air courier companies such as Federal Express. The recognition that these and other industries are attractive to foreign investors as well as the changing manufacturing landscape fostered by the growing weight of the People's Republic of China as an export market should serve to orient the government's efforts to further promote investment.

2. Types of Business Organizations

There are approximately 825,000 registered private enterprises operating in the Philippines: 91% are microenterprises, 8.5% are small and medium-sized enterprises (SMEs), and 0.5% are large companies. It would follow that the largest employers in the economy are microenterprises and SMEs, accounting for 41% and 30% of total employment, respectively (see Figure 7).

Micro, small and medium-sized enterprises (MSMEs) are predominately engaged in wholesale/retail trade and light manufacturing. These types of enterprises also provide the majority of social and personal services, agriculture, real estate, and construction in the country. Employment numbers in these industry sectors show that micros account



for 67% and 57% of employment in the trade and the restaurant sectors while large firms employ almost half (48%) of all employees in the manufacturing sector and 42% of those in the real estate sector (see Table 3).

Despite their predominance in the economy, the contribution of MSMEs to total value added remains low relative to other middle-income Asian countries. In 2002, MSMEs contributed 32% to total value added compared with 46% and 60% in the Republic of Korea and the People's Republic of China, respectively.

3. Shareholding and Market Concentration

The corporate sector is still relatively small accounting for only 26–29% of GDP during 1990–2001, but it is highly concentrated. The sector is

Table 3: Employment by Asset Size, 2001 ('000)

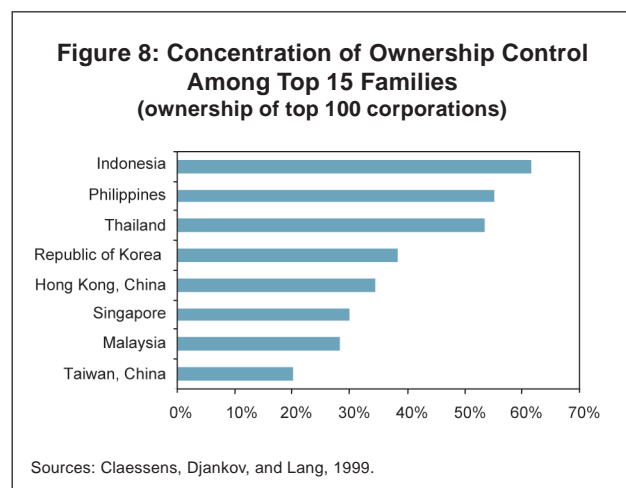
INDUSTRY SECTOR	Micro	%	Small	%	Medium	%	Large	%	Total
Wholesale and Retail Trade	1,109	67	350	21	55	3	138	8	1,653
Manufacturing	353	23	310	20	137	9	734	48	1,534
Hotels and Restaurants	267	57	152	32	19	4	33	7	470
Real Estate and Renting Services	103	25	93	23	41	10	174	42	411
Transport and Communications	40	13	79	26	23	8	159	53	301
Education	21	8	104	38	42	15	104	38	271
Financial Intermediation	74	29	98	39	11	4	70	28	254
Community and Personal Services	105	56	45	24	9	5	26	14	186
Health and Social Work	60	36	34	20	16	10	58	35	168
Total	2,132	41	1,265	24	353	7	1,496	29	5,248

% may not total to 100 due to rounding.

Source: National Statistics Office, 2002.

dominated by large, family-owned businesses operating in diversified sectors (Saldaña 2000). At the end of 2003, 62% of the market capitalization of the Philippine Stock Exchange (PSE) was composed of 23 family-controlled groups (Philippine Center for Investigative Journalism 2004). These companies are typically closely held with the top five shareholders owning more than 50% of the total outstanding shares (Saldaña 2000). If one considers that less than 20% of the largest 1,000 corporations are listed on the PSE and that this pattern of ownership concentration is common throughout the corporate sector, then it would follow that significant portions of the wealth and GDP of the country are in the hands of a few business owners.⁹

Although high levels of ownership concentration are common in East Asia, what is notable in the case of the Philippines (as well as in Indonesia and Thailand) is the degree of concentration across firms (see Figure 8). It can be argued that Philippine conglomerates exhibit many characteristics similar to pre-crisis Korean *chaebols* and Japanese *zaibatsus*: they are family owned; have diversified interests; include a bank among their component firms (or ICT firm, in the case of *chaebols*); very few are publicly traded on the stock exchange; and—according to some researchers—they receive preferential treatment from the government due to the political influence of their directors (Tan 1993).



⁹ Of the 11 categories of publicly listed nonfinancial firms, the highest degrees of share concentration are found in the communication, construction, and property sectors.

Although improving, the Philippine corporate governance regime remains weak which helps to perpetuate ownership concentration in the corporate sector. Practices such as cross-holdings of equity, interlocking directorates of banks and corporations, and pyramid holding structures—quite common in the Philippines—are effective barriers to hostile takeovers and help to prevent productive assets from coming into the hands of those best positioned to manage them efficiently. By limiting the scope for external corporate control, these weaknesses also limit the capacity of (and raise the cost to) firms to raise external finance and to expand in areas where they can compete (World Bank 2002).

The corporate sector has a high degree of market concentration, with the four largest firms in 18 major sectors of the economy comprising 74% of the total value added of the sector (Aldaba 2002). The effects of this market structure on competition and private sector development are discussed in more detail in Chapter III.

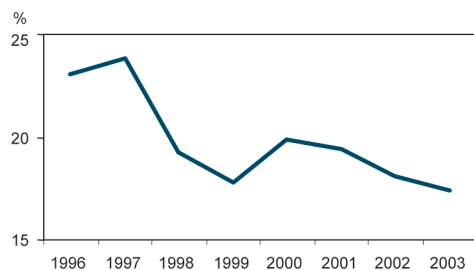
The private sector is also composed of a large segment of informal service providers, i.e., those “businesses” that do not register with the Department of Trade and Industry, do not report income to the BIR, and do not participate in the financial sector. While estimates of the size of this informal economy vary from 20–40% of the formal economy, there is little debate about its importance. A detailed study by the International Labour Organisation, to be published in June 2004, will provide a detailed analysis of the structure of the informal sector.

C. Investment and Sources of Finance

Since 1997, overall investment rates in the Philippines have slowed gradually as a percentage of GDP (see Figure 9). The decline from 2000 to 2003 mirrored the decline in interest rates indicating that investment contraction was not precipitated by high interest rates. The general economic downturn and the decline in the value of the peso are more important factors slowing investment.

One of the constraints to private sector growth in the Philippines is the low level of local debt and equity financing available (see Box 1). It is limited not only by borrowers’ capacity and the shortage of

Figure 9: Domestic Investment as of % GDP



Source: National Statistics Office, 2004.

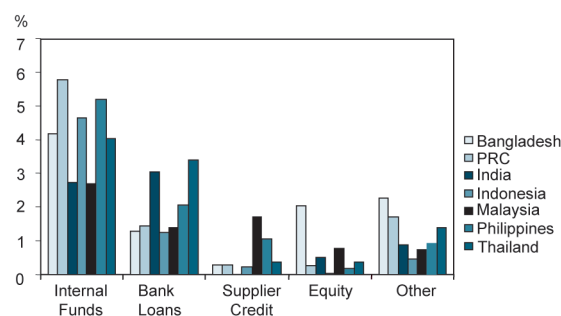
Box 1: Microfinance Sector

While commercial banks tend to cater to larger corporate customers, the 93 thrift and 772 rural banks service small and medium-sized enterprises, essentially with working capital loans. There is also a growing microfinance market (loans under P150,000) that includes formal institutions such as thrift, rural, and cooperative banks and semi-formal institutions, such as credit unions and credit-granting nongovernment organizations (NGOs). A survey conducted by the Microfinance Council of the Philippines in late 2001 indicated that 88 institutions were providing microfinance loans: 41 rural/cooperative banks, 23 NGOs, and 24 cooperatives. The total loans outstanding of these microfinance institutions as of June 2001 amounted to P1,690 million distributed among 397,225 borrowers.

It is estimated that fewer than 20% of the microenterprises in the Philippines contract external financing, and financial institutions are reluctant to enter the market due to high-perceived risks and comparatively high cost of credit analysis. The United States Agency for International Development Microenterprise Access to Banking Service Project has demonstrated that rural microfinance banks that practice effective credit analysis can not only generate profits from this market segment but can also maintain nonperforming loans at below 10%. Given the small share of microfinance loans in the total assets of the sector, these institutions do not pose a systemic risk and could therefore benefit from a more liberal regulatory approach. Relaxing collateral and provisioning requirements, if accompanied by technical assistance to hone credit analysis skills and the establishment of a microcredit information bureau, should help more financial institutions expand into microlending.

collateral assets but also by the preference of commercial banks for short-term loans, the thin capital market, the absence of venture capital, and the relatively undeveloped leasing subsector. Despite a downward trend in interest rates, over 75% of Philippine companies participating in the 2003 ADB-World-Bank investment climate survey and 2000 world business environment survey reported high interest rates¹⁰ as a significant deterrent to obtaining bank financing, followed by onerous collateral and paperwork requirements.¹¹ In general, these companies reported high interest rates as a more significant deterrent than access. As a result, it is estimated that 50% of Philippine companies finance their operations through retained earnings.¹² It should be noted that this low level of bank financing is also common to neighboring Asian economies reflecting their equally dissuasive credit policies (see Figure 10).

Figure 10: Sources of Finance for Average Firm



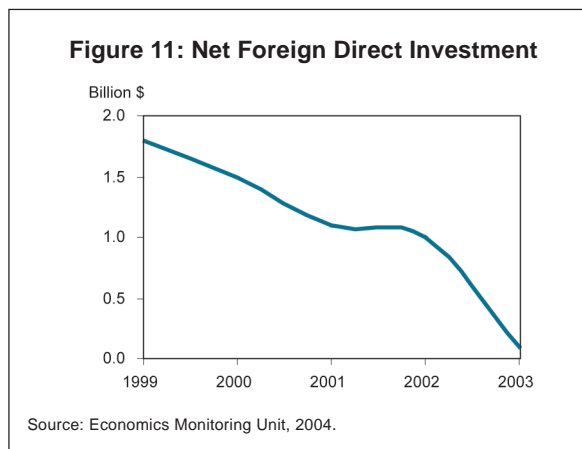
Source: World Bank, 2000.

The equity market in the Philippines is very small and is not liquid. In 2002, only five new issues were listed raising a total of \$3.5 million. While there is an SME board, it has only five listings and is also not very liquid. The weak equity market deters the development of a venture capital industry, further reducing the sources of finance available to small firms. (See Chapter IV for a discussion of the financial sector.)

¹⁰ Short-term lending rates varied between 13–20% for SMEs from 1999 to 2002.
¹¹ These paperwork requirements appear onerous to companies undertaking them for the first time and do not necessarily imply a high level of due diligence and disclosure requirements by the banks.
¹² Despite the mandated allocation of 25% of every bank's net loanable funds for agriculture lending (as per Presidential Decree 717, also known as Agri-Agra Law) and 8% for SMEs, many companies still go without financing as banks prefer to satisfy the requirement with an alternative purchase of government bonds (where possible), as lending to smaller companies entails higher processing costs and risks.

D. Foreign Direct Investment

The Philippines has one of the lowest rates of foreign direct investment (FDI) in the region, an indicator of the perceived risks of doing business in the country and its unattractiveness relative to its neighboring economies. While the country benefited from high levels of FDI¹³ during the 1990s with its push to attract investment into the infrastructure sectors, net FDI dropped to just \$0.1 billion in 2003, or 0.1% of GDP (see Figure 11).



The perceived risks of doing business in the Philippines are rising, deterring foreign investors and encouraging them to seek alternative investment destinations such as People's Republic of China, Republic of Korea, and Thailand. Moreover, the high costs of energy and labor, together with the general inefficiency of the public sector, add to the overall costs of doing business in the country and further depress its competitiveness. Given the high level of competition for FDI in the region, it is unlikely that the Philippines will see a marked increase of FDI inflows without substantial improvements in its investment climate (see Table 4).

The foreign capital that is invested in the Philippines is relatively diversified. Shares of foreign equity in the agriculture, industry, and service sectors were estimated at 19.3%, 50.8%, and 34.3%, respectively, in 2000. Increases in the shares of

Table 4: Comparative Cost of Doing Business

	Business Registration (days)	Contract Enforcement (days)	Insolvency (years)	Labor Flexibility Index
Philippines	59	164	5.7	39
Indonesia	168	225	6	43
Malaysia	31	270	2.2	15
PRC	46	180	2.6	57
Thailand	42	575	2.5	30
Singapore	8	50	0.7	1
Hong Kong, China	11	180	1	1
India	88	225	11.3	45

Source: World Bank, 2004.

foreign equity are highly notable in sectors that have been substantially liberalized, such as manufacturing and electricity, gas and water, wholesale and retail trade, transport, storage, communications, financial intermediation, and real estate.

Foreign investors even dominate selected sectors of the economy such as cement where almost all firms are foreign owned. Nearly 40% or 17 of the 44 commercial banks are foreign branches or subsidiaries of foreign banks, while 19 domestic banks have foreign equity participation ranging from 13–42%. In the life insurance industry, 12 out of 35 insurance companies are foreign owned. Major players in the car industry—such as Toyota, Nissan, Honda, Mitsubishi, and Columbian Motors—have foreign equity participation ranging from 37.5–100%. Two of the three major oil firms are subsidiaries of foreign oil companies and the remaining one has 40% foreign equity participation.

This said, there remain restrictions to foreign ownership of Philippine companies in some sectors designated by the constitution or special laws (e.g., operation and management of public utilities, advertising, and small-scale mining). In these sectors, foreign equity participation is limited to 25–60%. Non-Filipinos are also restricted from owning land. As will be discussed in subsequent chapters, the restrictions on ownership of utilities and land are deterring needed investment in the power sector and slowing down the process of resolving non-performing loans, respectively.

¹³ Averaging \$962 million annually during 1990–1997 and \$1.3 billion annually during 1998–2002.