

II. FRAMEWORK AND KEY IMPEDIMENTS TO PRIVATE SECTOR DEVELOPMENT

The enabling environment for private sector development in any economy is a combination of physical and financial infrastructure, government policies, legal and regulatory frameworks, and the institutional capacities for their implementation. The following discussion focuses on those aspects of the enabling environment that continue to inhibit private sector development to highlight needed reforms. It is instructive to briefly note efforts by the Philippine government to date to improve the environment for private enterprise. These have included the outright privatization of 50 GOCCs since 1987 and the sale of minority stakes in a further 29, passage of the BOT law facilitating private sector participation in the infrastructure sector, price liberalization measures,¹⁴ and elimination of interest rate caps and import tariffs on most nonagricultural goods.¹⁵ The government has also introduced measures to encourage investment and to promote the growth of MSMEs¹⁶ and allowed the establishment of export processing zones.

While progress is being made to liberalize trade,¹⁷ much remains to be done to fully open up markets to foreign investment, to create a level playing field for participants within the markets, and to reduce the market distortions created by government intervention. As the following section

will demonstrate, sustained investment and economic growth will depend on effectively addressing these structural impediments to private sector growth.

Chief among these impediments is the weakness of the government in establishing a rule-based business environment that fosters fair competition. Creating such an environment requires not only effective legislation but also the institutional capacity to monitor and enforce it. In the Philippines, institutional weaknesses exist in all three branches of the government: executive, legislative, and judiciary. Vested interests (in particular the close relationships between members of government and business owners) serve to encourage monopolies and deter the establishment of a more objective, market-based competitive environment. While rules and regulations addressing various micro impediments to private sector growth can be developed, these measures will not have lasting effects if the fundamental, structural weaknesses in the ability of the government to create and maintain a rule-based business environment are not addressed.

Second, the physical infrastructure of the Philippines is one of the poorest in the region.¹⁸ Despite an estimated \$4 billion of private investment in infrastructure in 1993–1997, investment contracted to \$1 billion in 1997–2001 and has yet to recover. It is estimated that 20% of the population lacks access to power, 17% to safe drinking water,

¹⁴ Lifting of price controls on basic commodities except rice.

¹⁵ The average nominal tariff for all sectors stood at 7.5% in 2004 with the agriculture sector posting 11.9%, the mining sector 2.5%, and the manufacturing sector 6.9%.

¹⁶ These include directed lending (of limited effectiveness), the establishment of the SME Guarantee Finance Corp. to guarantee loans, and various tax incentives.

¹⁷ The November 2003 rollback of import tariffs in selected sectors has raised effective protection levels and reversed some of the gains of the third tariff reform program.

¹⁸ A survey of investors by the World Economic Forum ranked the Philippines 68th out of 75 economies.

and 14% to adequate sanitation services. The poor condition of roads and rural transport infrastructure adds to the cost of doing business, as does the price of electricity, which is the highest in the region. Here again, attracting private investment into the capital-intensive infrastructure sector will require the definition and enforcement of fair and predictable rules of engagement.

Third, the weak financial sector has inhibited the efficient flow of investment resources to the private sector. High levels of nonperforming loans in the banking sector and the underdevelopment of capital markets have meant that access to external finance remains restricted for most enterprises. The presence of banking arms in most large business conglomerates allows them to access funds with relative ease while smaller enterprises have to rely largely on retained earnings. While improving, the poor corporate governance practices among both banks and businesses combined with the limited supervisory capacity of the Bangko Sentral ng Pilipinas (BSP) and the Securities and Exchange Commission (SEC) have inhibited the development of the financial sector as an efficient source of business funding.

The following paragraphs detail the three major categories of impediments to private sector development presented in their relative order of importance. In each category, suggestions for reforms are made which in the case of the infrastructure and financial sectors are further elaborated in Chapter IV.

A. Absence of a Rule-Based Business Environment

1. Weak Framework for Competition

The high degree of market concentration that exists in many sectors of the economy deters both new entrants and the growth of existing, smaller competitors. The four largest firms in 18 major sectors of the economy generate 74% of the total value added of the sector (Aldaba 2002). It is widely believed that these groups obtain and maintain protected market access through collusion with regulatory authorities, legislators, and other licensing authorities (Philippine Center for Investigative

Journalism 2004). These practices not only limit growth opportunities for smaller firms but also remove the incentives for efficiency in freely competitive markets.¹⁹

While the effectiveness of business groups in allocating resources and fostering growth has been well documented historically (World Bank 2002), these groups serve the public interest most in lower-income economies with undeveloped financial and executive labor markets and restricted foreign investment. In the Philippines, it is argued that the economy is open and developed enough to support free competition and that implicit or explicit market protection afforded to large business groups should be removed.

The roots of this market structure may be found in the government's historical policy of fostering economic development through import substitution leading to highly protected markets with significant sector inefficiencies. Investment incentives for domestic industries and price fixing²⁰ of selected outputs have further deterred foreign investment and have contributed to the development of the oligarchic structure of the Philippine manufacturing industry. While these trade and investment restrictions are slowly being dismantled, the dominant industry players that they created still largely retain their market shares.

It would appear that most Philippine corporations view dominant market share as the most desirable competitive advantage. Where market share can be protected by regulations, as was the case with the telecommunication and domestic airline industries before the introduction of limited competition in the 1990s, monopoly rents can be extracted. A recent Philippine study found that concentration ratios in most sectors were positively correlated with the price-cost margin, which serves as an indicator of profitability, suggesting that monopoly rents were indeed being exploited by incumbent firms (Aldaba 2000). The degree of relationship between these two variables has weakened over the years,²¹ however, suggesting that the increasing concentration in some industries is due to the exit of inefficient firms. Despite this progress, there are several major indus-

¹⁹ Collusionary practices have been noted to occur in the cement, shipping, sugar, and flour-milling industries (Aldaba 2002).

²⁰ In sugar and cement, for example.

²¹ From 0.42 in 1988 to 0.27 in 1994 and then to 0.14 in 1995.

tries, such as shipping, tobacco, glass, upstream telecommunications and cement, among others, where in effective competition still remains weak.

The Philippine Institute of Development Studies and the United States Agency for International Development (USAID) have conducted studies since 1995 to assess the effects of market concentration and to identify collusion (Medalla 2002 and Aldaba 2002). These studies have concluded that despite reforms undertaken by the government to increase access to markets by removing trade and other barriers to entry, a high degree of concentration still exists particularly in the manufacturing sector.²² This finding suggests that barriers to competition continue to exist and prevent the sector from maximizing gains from trade liberalization (Aldaba 2002). It can further be argued that the structure of family-dominated conglomerates, which often include major banking arms, leads to unfair competition for finance and adds another impediment to the growth of smaller firms.

The existing legal framework for managing competition includes various laws²³ addressing anticompetitive behavior as well as the regulatory and contractual parameters for managing monopolies (e.g., utilities, telecommunications). This legal framework has proved to be largely inefficient as the antitrust provisions that are found in separate laws have not been codified and are inadequate to address various forms of anticompetitive behavior such as restrictive vertical and horizontal agreements, abuse of a dominant position, and cross-subsidization. Moreover, the responsibility for enforcing the laws is unclear as a number of government agencies are ostensibly involved and strict accountability is lacking (Foundation for Economic Freedom, Inc. 1999). Lastly, the requirements of some of the laws make them difficult to prosecute, as the amount of evidence required for the case to prosper—"proof beyond reasonable doubt"—is difficult to obtain (Lamberte et al. 1992).²⁴ Knowing the long and costly legal processes involved, aggrieved parties typically settle for an injunction or for a cease and desist order rather than fully prosecuting violators.

In sum, while the Philippines has undertaken major reforms to introduce competition through trade liberalization and deregulation, this has not proved sufficient to create a level playing field in many sectors. Further measures need to be undertaken to facilitate the identification and prosecution of anticompetitive behavior. One such measure could be establishing practical, nonpenal antitrust legislation with clearly stated enforcement responsibilities of government agencies. While the government could also consider establishing a centralized antitrust commission or enforcement agency such as those created in the Republic of Korea and more recently in Indonesia, it should be recognized that such agencies are charged with highly complex legal analyses that require input from experienced professionals. Moreover, the decisions of such a body often have a substantial economic impact on the firms and sectors involved which makes the body highly susceptible to outside influence. Protecting the independence and integrity of these bodies (both in their decisions and in setting their agendas) is critical to their effectiveness in defending the public interest. Lastly, it should also be noted that the functioning of such a commission or agency is further complicated when, as in the case of the Philippines, the legislation that it is intended to enforce lacks clarity. It is therefore recommended that careful consideration be given to all these parameters before proceeding with the creation of a new body in the context of the current Philippine institutional framework.

2. Systemic Corruption

The Philippine government suffers from widespread corruption that weakens its institutional capacity and significantly raises the costs of doing business for private enterprises. Worldwide surveys consistently rank the Philippines among the lowest in the world in terms of transparency and adherence to the rule of law.

²² See Appendix 6 for an illustrative list of market liberalization reforms.

²³ RA 3815 (Revised Penal Code of 1930), RA 3247, and RA 386 are the major pieces of legislation addressing anticompetitive behavior.

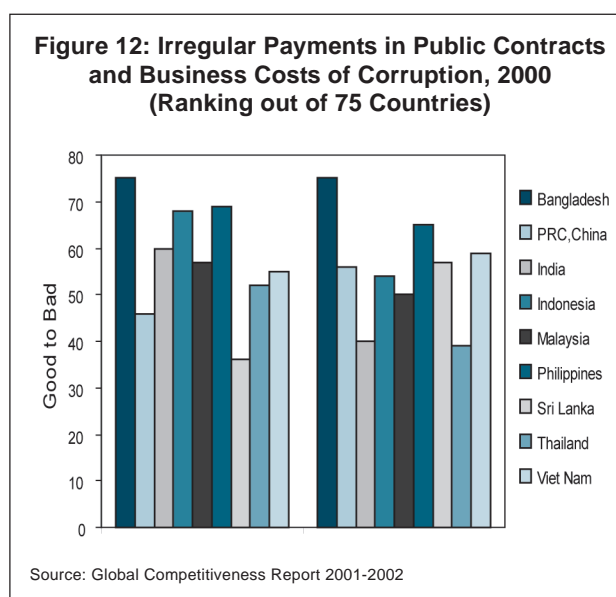
²⁴ To date, there have been only two cases defining monopoly decided by the Supreme Court.

- In a survey of 49 developed and developing countries, the Philippines, together with Colombia, Indonesia, and Peru ranked lowest in terms of adherence to the rule of law.²⁵
- In a 2000 global competitiveness report, the Philippines ranked 74th out of 75 countries in terms of frequency of irregular tax payments (behind all Asian countries except Bangladesh).
- The *Global Competitiveness Report 2002–2003* released by the World Economic Forum in January 2003 ranked the Philippines 70th among 80 countries in the public institutions index.²⁶
- The Gallup survey commissioned by the American Chamber of Commerce (AmCham) and AmCham’s follow-up survey found that corruption is the “most negative problem” in the country (AmCham 2003).
- Transparency International ranked the Philippines 92nd out of 133 in its 2003 corruption perception index.
- The Economist Intelligence Unit gave the Philippines a score of 53 out of a lowest possible score of 100 in terms of overall risk and 35 out of 60 globally in terms of business risk.

The investment climate survey completed in January 2004 by ADB and the World Bank further underscored the costs of doing business in a corrupt environment. Participating firms listed irregular payments in taxes, customs, and licensing as systemic. Most firms agree to irregular payments to facilitate processing goods through customs or to secure needed licenses. In addition to the added costs of doing business, these practices have resulted in substantial losses of revenue to the Philippine government. Indeed, the Office of the Ombudsman estimated the losses over the last 20 years at \$48 billion (Office of the Ombudsman 1997).

Payment of bribes is also common in government procurement. The *Global Competitiveness Report 2001–2002* rates the Philippines as worse than Indonesia, Malaysia, and Thailand in terms of

irregular payments in the securing of public contracts (see Figure 12). The apparent high level of discretion in the award of public contracts also affects their security as reported in a recent advocacy paper by AmCham indicating that some public sector contracts are renegotiated or become controversial after a change in administration, further increasing the risk of doing business (AmCham 2002). Indeed, the ongoing dispute over the Philippine International Air Terminals Company contract is a highly visible example of poor practices in awarding concessions. In the specific area of procurement, a study by Procurement Watch, Inc. estimated the potential loss due to procurement corruption at P95 billion in 2001.



The *Medium-Term Philippine Development Plan, 2001–2004*, has pointed out that the country’s recent economic crisis was partly caused by crony capitalism and by graft and corruption. Several initiatives have been launched to address these problems, including the enactment of a procurement reform act in late 2002,²⁷ phasing in of a new government accounting system, the introduction of lifestyle or asset consistency checks for government employees, and increased computerization among government agencies. Pursuing these reforms in earnest, while embarking on fundamental civil service reforms as

²⁵ See La Porta et al. (1998). The study uses the assessment of the law and order tradition in the country produced by the country-risk rating agency International Country Risk. The index was constructed using the average of the months of April and October monthly index between 1982 and 1995. The scale ranges from 0 to 10, with lower scores for less tradition for law and order.

²⁶ This index covers contracts/laws (i.e., independence of the judiciary, fair bidding on public contracts, and the impact of organized crime on business) and corruption (i.e., perception of bribes paid for import and export permits, connections to public utilities, or in connection with tax payments).

²⁷ Rules and regulations for implementation were issued in September 2003.

proposed in the new civil service code (e.g., recruitment policies, merit-based pay schemes, strengthening accountability) will be components in a serious effort to eradicate corruption.

3. Inadequate Dispute Resolution Mechanisms

The cost of dispute resolution in the Philippines is one of the highest in the world (World Bank 2004). The inadequacies of the judicial system present a significant obstacle and disincentive to doing business in the Philippines. These inadequacies concern issues of efficiency, integrity, and competence. As shown in Table 5, the number of pending cases in the court system is very high and is rising as more cases are filed each year than are resolved. The backlog of cases can be attributed to several factors: the lack of judges, shortage of courtrooms, complicated legal procedures that allow protracted delays, and the propensity of citizens and banks to use the courts as collection agents for unpaid checks. Indeed many cases clogging court dockets are small money claims involving violation of *Batas Pambansa blg 22* (otherwise known as the bouncing checks law).

More fundamental weaknesses in the judicial system involve its integrity and competence. Perceptions of judicial corruption are widespread.²⁸ The Supreme Court's decision to dismiss or sanction 230 judges during 1998–2001 for graft or corruption, representing 10% of the judges working in the system, indicates that the perception may have a basis in fact. The low compensation levels of the judges increase their susceptibility to graft. The judiciary receives only 0.8% of the national budget in 2003–2005 although it represents the third branch of government and employs 25,000 court personnel in addition to its 2,300 judges.

The excessive numbers of temporary restraining orders issued by the judiciary is seen by many as another indicator of corruption. Moreover, despite a law (LRA 8795) prohibiting issuing temporary restraining orders against government projects and programs, trial and appellate courts have continued to issue injunctive writs effectively discouraging both local and foreign investors from partnering with the government in development projects (ADB 2005).

Through a series of diagnostic studies from 1998 to 2000, the Supreme Court identified major challenges that it is now proposing to address through an action program for judicial reform:

Table 5: Number of Pending Cases by Type of Court 1993–2001

Court	1993	1994	1995	1996	1997	1998	1999	2000	2001
Supreme Court	4,124	4,453	5,066	7,021	5,526	4,780	5,089	5,543	5,837
Court of Appeals	14,024	15,094	15,325	15,727	16,201	16,173	18,381	18,492	18,667
Sandiganbayan	3,683	3,618	2,540	2,752	3,109	3,272	3,513	3,356	3,196
Court of Tax Appeals	541	485	426	391	350	285	359	410	394
Regional Trial Court	230,305	216,607	194,939	199,501	214,453	225,188	251,351	265,957	279,241
Metropolitan Trial Court	21,749	65,048	82,148	134,085	185,242	183,024	186,799	185,192	200,271
Municipal Trial Court in Cities	24,602	56,475	83,878	131,031	165,194	177,310	180,456	157,199	143,211
Municipal Trial Court	44,109	66,553	77,133	102,109	134,861	121,214	118,255	117,010	108,519
Municipal Circuit Trial Court	27,025	31,850	36,311	43,011	50,698	64,153	66,191	67,454	67,865
Shari'a District Court	103	123	135	145	150	182	179	168	173
Shari'a Circuit Court	208	204	193	218	236	227	222	239	302
Total	370,473	460,510	635,991	776,020	795,808	830,795	821,020	827,676	

Source: Philippine Statistical Yearbook, National Statistical Coordination Board, 2002.

²⁸ The recent investment climate survey conducted by ADB and the World Bank revealed that more than 50% of the firms surveyed had confidence in the judiciary's ability to uphold contract and property rights.

- case congestion and delay;
- severe judicial budget deficiencies;
- politicized system for judicial appointments;
- lack of judicial autonomy;
- inadequate human resource development;
- dysfunctional administrative and financial structures;
- deficient court technology and facilities;
- inadequate public information and collaboration with civil society.

The action program seeks to address these issues and to achieve judicial autonomy; speedy and fair dispensation of justice for all; improved access to judicial and legal services; improved quality of external inputs to the judicial process; and efficient, effective, continuous improvement to judicial institutions. Its mission is to develop a judiciary that conducts its business with dignity, integrity, accountability, and transparency and that is worthy of public trust and confidence.

These reforms are being implemented with the support from ADB²⁹, the World Bank, USAID, and other funding agencies. Parallel to these reforms, measures will need to be taken to upgrade the technical capacity of judges to review cases involving complex commercial and economic issues as an increasing number of cases will be brought involving matters of recent legislation, e.g., asset securitization, anti-money laundering, electronic commerce, and special-purpose vehicles.

As implementation proceeds, it is recommended that alternative dispute resolution mechanisms be further encouraged to address the case backlog and to provide a viable and expeditious alternative to the court system. Some government agencies have launched mediation projects with encouraging results (Abaya 2003),³⁰ and over 300 mediators have been trained by the Supreme Court. Moreover, the bill institutionalizing alternative mechanisms has been passed by Congress, and the Supreme Court has recently passed rules requiring the use of mediation prior to any hearing on a civil case. These important advances can now be leveraged to further decongest the court system.

²⁹ ADB TA 3693-PHI: Strengthening the Independence and Accountability of the Judiciary

³⁰ Includes the Supreme Court, Department of Justice, Bureau of Trade and Regulation and Consumer Protection, Department of Environment and Natural Resources, and Department of Agrarian Reform.

In rural areas, there is a *barangay*³¹ justice system that allows barangay officials to amicably settle disputes among family members and residents before bringing them to regular courts. As the competence of barangay officials in dispute resolution is often in question, training will be required to encourage petitioners to use this alternative system.

4. Weak Creditor and Property Rights

Security of credit and property is essential for private sector development. Weak protection of these rights significantly increases the risks of doing business and often makes required compensation prohibitive. The three types of security liens under Philippine law are the real estate mortgage, chattel mortgage, and pledge. When formally perfected, these liens bind specific property, and the world, in accordance with their terms.

Real estate and chattel mortgages may be foreclosed by selling the collateral at public auction. This may be done judicially (with court intervention) or extra-judicially (through a sheriff or notary public). Because of the inconvenience, time, and expense involved in judicial foreclosures, almost all mortgage deeds contain a clause authorizing extra-judicial foreclosures. In either case, the proceeds of the foreclosure sale are used to settle the obligations secured by the mortgage. The creditor may bring an action against the debtor for any deficiency in case the proceeds of the foreclosure sale are insufficient to cover the secured obligations.

In the case of a pledge, personal property (or the document evidencing the incorporeal right) is delivered to the creditor or to a third party trustee. The pledge may be foreclosed by having the property sold at a public auction through a notary public. If the proceeds of sale are less than the secured obligation, the creditor is not entitled to recover the deficiency and the obligation is deemed to have extinguished.

Any creditor that does not benefit from any of these security liens is an unsecured creditor. In case the debtor defaults, the unsecured creditor has to file an action for specific performance and may ask the court to grant the provisional remedy of

³¹ Smallest local government unit in the Philippines and is very similar to a village. Municipalities and cities are composed of barangays.

preliminary attachment. The debtor's property will then be attached or garnished to secure satisfaction of whatever judgment might be obtained.

While these rights appear clear and well defined, their enforcement through judicial proceedings have become problematic. Trial court proceedings may last up to 4 years. If the judgment is appealed all the way to the Supreme Court, the entire proceeding may take 8 to 10 years. Extra-judicial foreclosures, on the other hand, are sometimes hampered by temporary restraining orders or writs of injunction.

Rights of creditors are treated differently in case of insolvency or rehabilitation. After a debtor is declared insolvent by a court, credits are paid in the order of preference set forth in the civil code. As a rule, secured creditors enjoy preference over unsecured creditors, but taxes and assessments on specific property enjoy absolute preference. Other liens on specific property enjoy no priority among themselves but must be paid concurrently and *pro rata*. On the other hand, the *pro rata* rule for other liens does not apply to judicial attachments and executions annotated in the registry of property. These are generally preferred over later credits.

In the case of corporate rehabilitation, all claims against the corporation, whether secured or unsecured, are suspended upon the appointment of a rehabilitation receiver. Secured creditors retain their preference, but enforcement of such preference is stayed. It is only when the petition is dismissed (i.e. petition is found to be defective or no rehabilitation plan is approved within 180 days from the date of initial hearing) that the secured creditor can foreclose on the mortgaged or pledged property.

The absence of a modern insolvency law makes debt relief proceedings in the country inefficient. The current Philippine insolvency regime is still a cacophony of laws, jurisprudence, and rules of procedures. The first basic law is the 96-year-old Insolvency Act that vested the courts with jurisdiction over petitions for insolvency and suspension of payment. Presidential Decree No. 902-A was then issued in 1976 (and amended in 1981). It vested SEC with jurisdiction over corporate rehabilitation petitions and transferred to SEC jurisdiction the petitions for suspension of payments. In August 2000, a code for regulating securities transactions transferred corporate rehabilitation and returned suspension of payments to the regular courts. Interim rules on corporate rehabilitation that

attempt to hew closely to international standards have been issued by the Supreme Court to govern these debt relief proceedings. However, because of the absence of a comprehensive legislative framework, some gaps cannot be and have not been addressed by the interim rules.

Tedious and protracted court proceedings have proved to be major deterrents to effective rehabilitation and insolvency proceedings. While certain branches of the regional trial court were designated as commercial courts to hear debt relief cases, their heavy case loads from other types of cases, and the piecemeal trial system in the country make it difficult for the rehabilitation court to grant speedy remedies. This imperils the preservation of value, of both the enterprise and stakeholder claims. Commercial court judges likewise did not initially have the requisite expertise or "feel" for the complexities of the various hierarchical, proprietary, and valuation claims of the various stakeholders.³²

Recognizing the need to address this weakness in its insolvency legal framework, the Philippine government drafted a corporate recovery and insolvency law. This draft law, prepared under the previous Arroyo administration but not yet passed, will now have to be resubmitted to the new legislature. In its current form, the proposed law is much closer to international standards.³³

Beyond the context of corporate recovery, the Philippine collateral system requires strengthening on additional fronts. As noted above, only three mechanisms exist today to secure credit. Expansion of the forms of security is needed. In today's global economy with cross-border transactions, there is a need for other security options. Legislation along this line should be pursued. The passage of the Securitization Bill, for example, is a step in this direction. With the Securitization Act, it is envisioned that the secondary market can be developed, particularly residential mortgage-backed securities and other housing-related financial instruments. This could contribute to generating investment and accelerating growth in the housing finance sector.

There is also need for a modern registration system for secured transactions. At present, there is

³² The Philippine Judicial Academy (PHILJA) has since then conducted a number of training seminars on corporate rehabilitation for commercial court judges.

³³ Criticisms of the draft law center on its lack of clarity regarding the condition of exit of nonviable firms and rehabilitation of viable ones.

no central registry for mortgages; the registries for chattel mortgages in particular are almost impossible to search. The current system for registering land titles on which the real estate mortgage registry is based is inadequate. Large tracts of land remain untitled. In addition, although searching the land registry is easier than searching the chattel mortgage registry, it is still not easy. Even where computers are used for registering secured transactions, the data are not centrally filed nor are they fully accessible by the public online.

Shareholders' rights, in particular those of minority shareholders, are not effectively protected in the Philippines. While existing laws contain standard provisions for protecting minority shareholders, the presence of dominant shareholders in so many Filipino companies makes these provisions more difficult to uphold. Saldaña (2000) found that minority shareholders were often vulnerable to expropriation of their interests by controlling shareholders and management. For example, a few who exercised their appraisal rights were offered below-market values for their shares.

Minority shareholders were often not able to participate actively in annual meetings due to the dominance of controlling shareholders in shaping the agenda and the discussions.

Loopholes in the corporation code allow a company to waive the preemptive rights of shareholders in the articles of incorporation upon registration or in a subsequent amendment. The code also does not require disclosure of transactions involving potential conflicts of interests. SEC has attempted to address these governance deficiencies with the 2002 code of corporate governance that aims to protect the following for shareholders: voting rights, pre-emptive rights, rights to dividends, rights to obtain relevant information on the corporation on a timely and regular basis, and appraisal rights. The securities regulation code also empowers the SEC to protect minority stakeholders by its power to compel the officers of any registered corporation under its supervision to call meetings of stockholders. (See Box 2 for a summary of recent corporate governance reforms.)

Box 2: Recent Corporate Governance Reforms

The important role of corporate governance in enhancing a country's investment climate is increasingly recognized in the Philippines. The government has therefore initiated a number of reforms designed to strengthen corporate governance including the following:

- Passage of securities regulation code (2001)
- Passage of the general banking act (2000)
- Promulgation of code of corporate governance (SEC Memo Circular 2 - 2003).
- Implementation of the self-rating system on corporate governance (SEC Memo Circular 5 - 2003).
- Adoption of Philippine standards on auditing (SEC Memo Circular 10 - 2003).
- Clarification of extent of SEC supervision over all registered corporations (SEC Memo Circular 11 - 2003).
- Requiring corporations to rotate external auditors (SEC Memo Circular 8 - 2003).
- Adoption of code of corporate governance for banks
- Strengthened prudential regulations for banks
- Strengthened financial sector supervision
- Adoption of code of corporate governance for insurance companies and intermediaries
- Adoption of general disclosure of corporate governance practices form for insurance companies, professional re-insurers and insurance intermediaries.

Other notable efforts to strengthen the corporate governance regime include the pending corporate reform act that seeks to regulate corporate abuses by, among other things: (1) banning accounting firms from providing most consulting services to companies they are auditing; (2); prohibiting any issuer from extending or maintaining credit in the form of a personal loan to or for any director or executive officer of publicly listed companies.

Property rights include both intellectual and physical property. In the case of intellectual property, a modern legal framework exists³⁴ but poor enforcement has led to one of the highest rates of software piracy in the region. In 2001, an estimated 63% of software in use was pirated.³⁵ Patents and trademarks are also protected under the law, but suffer from the same deficiencies in implementation. The Philippines remains on the United States' watch list of intellectual property rights violators.

The Philippines adheres to the Torrens system of titling land. A Torrens title is generally conclusive evidence of ownership of the land referred to therein as well as any interest annotated therein (e.g., a real estate mortgage, or a lease contract). A strong presumption exists that a Torrens title was regularly issued and valid. However, the absence of reliable cadastral surveys leaves much land without enforceable title. Where title does exist, legislation protecting squatters³⁶ often makes the land difficult to sell or to mobilize for efficient use. Squatting is in fact widespread on public and private lands. As is discussed in Chapter IV, policies and procedures surrounding resettlement have significantly complicated the development of infrastructure projects.

Under the comprehensive agrarian reform law that is designed to redistribute approximately 55% of existing agricultural land, farmers will gain ownership of land but will not be able to transfer it for 10 years. This in effect strips lands transferred to farmers of their collateral value and consequently further limits farmer-beneficiaries' access to credit from formal financial markets. There are now bills in both houses of Congress proposing to restore the collateral value of agrarian reform land, but they are expected to encounter significant resistance.

Lastly, it should be noted that foreigners are not allowed to own land in the Philippines though they may lease property for 50 years renewable for an additional 25. This ownership restriction further complicates nonperforming loan (NPL) recovery. Consideration should be given to relaxing these restrictions for asset restructuring.

5. Government Obstruction of Markets

The Philippine government intervenes in commercial markets on several notable levels: setting trade tariffs; regulating utility and physical infrastructure tariffs; setting the price of selected commodities; and operating over 100 GOCCs, many of which operate in commercial markets and compete against private companies. Many of these interventions effectively inhibit private sector development.

The trade liberalization that began in the 1980s significantly reduced tariff and nontariff import barriers resulting in a fall in the average effective protection rate from 38% in 1985 to 14.4% in 2004. A reversal of these measures has been under way since November 2003, however, with import tariffs on cement, petrochemicals, glass, and vegetables returning to their 1998 levels. Pressure to increase public revenues is said to be driving this movement, although its effect in protecting domestic markets (and their dominant market players) from foreign competition is also evident.

The government, through its sector regulators, is tasked with ensuring that utilities and infrastructure are delivered and priced in a manner that balances the interests of both providers and users. While these regulators are intended to be entirely independent from political influence and free of conflicts of interests, none has fiscal autonomy, and—in the case of the toll road, port, and airport sectors—some have commercial as well as regulatory responsibilities. Given the high investment capital demands of the infrastructure and utility sectors, it is imperative to strengthen the regulatory bodies so they can impartially implement regulations.³⁷

In the area of price fixing, the government has removed mandated prices on all commodities except rice. The government in effect controls the distribution of rice through the monopoly of the National Food Authority (NFA). The price of NFA rice is more than twice as high as rice from exporting countries like Thailand and Viet Nam thereby making rice smuggling a very lucrative business (Tolentino 2001). This approach to rice price stabilization has proved very costly without

³⁴ RA 8293 (1997) and international conventions such as the World Trade Organization's agreement on trade-related aspects of intellectual property rights; ³⁷ special courts have been designated to handle intellectual property cases.

³⁵ Business Software Alliance estimate.

³⁶ Thelina law obligates landowners to find relocation areas for squatters before evicting them.

³⁷ More on these issues in Chapter IV.

achieving its objectives of lowering food prices to consumers, raising producer prices, and providing market stability (David 2002). The actual effect is that rice consumers are paying more while producers receive less due to inefficiencies and noncompetitive elements in rice marketing (David 2002). NFA has incurred huge losses annually (P4.3 billion in 2000). Roumasset (2000) estimated that the total cost to the economy in 1999 was approximately P48.8 billion broken down as follows: foregone tariff revenue (P3.7 billion); foregone consumer tax revenue (P18.5 billion); foregone producer tax revenue (P7.9 billion); tax friction (P9.0 billion); excess burden for consumers (P6.4 billion); and excess burden for producers (P3.3 billion).

With the concurrence of the government, USAID and ADB have engaged significant technical assistance resources over the past 5 years to help restructure and privatize NFA. While progress was made in defining workable restructuring scenarios, privatization was not deemed feasible by the government and has since been sidelined.

The government still operates over 100 GOCCs, many of which are fully commercial enterprises that compete with the private sector. Others have dual functions as operators and regulators, for example, the Air Transportation Office (ATO), Philippine Ports Authority (PPA), and the Transport Regulatory Authority; that inhibits potential market efficiencies. While the government made significant progress in privatizing GOCCs in the 1990s, efforts have slowed of late. A renewed push to carve out the commercial functions of government agencies and regulators and renew the timetable for GOCC privatization is recommended.

B. Poor Physical Infrastructure

The Philippines has one of the poorest infrastructure sectors in the region. Despite government efforts to enhance the quality of infrastructure in the poorest regions of the southern Philippines, the 2003 World Competitive Yearbook ranked the Philippines last among 30 countries in terms of basic infrastructure quality.³⁸ Regional

³⁸ Also in 2003, the World Economic Forum's Investor Survey ranked the Philippines 68th out of 75 economies in terms of infrastructure quality.

comparisons (see Table 6) also place the Philippines among the lowest scorers. Notable geographic disparities exist with urban areas benefiting from relatively better access to infrastructure than rural populations.³⁹ The dismal state of infrastructure is largely due to poor sector management and inadequate maintenance over the years, but recent deterioration is due to the decline in public funding for capital investment and maintenance that has not been offset by increases in private participation. Indeed, private investment in infrastructure totaled less than \$1 billion during 1997–2001, compared with an estimated \$4 billion in 1993–1997.

Table 6: Infrastructure Regional Comparison

Country	2000	2001	2002
Republic of Korea	28	34	28
PRC	34	39	35
Indonesia	47	49	49
Malaysia	32	38	26
Thailand	37	40	38
Philippines	41	41	44

Note: Infrastructure includes five subfactors: (i) basic infrastructure, which includes roads and railroads, air transportation, water systems, arable land, energy infrastructure including indigenous energy and self-sufficiency in non-energy raw materials; (ii) technological infrastructure; (iii) scientific infrastructure; (iv) health and environment; and (v) value system. Lower score means better infrastructure system. For basic infrastructure alone, the Philippines scored 49 out of all 49 countries in 2002.

Source: Macaranas and Silva, 2002.

The close correlation between the quality of physical infrastructure, economic growth, and poverty reduction is well documented. Poor infrastructure adds to the cost of doing business as is underscored in the 2004 ADB-World Bank investment climate survey that identified the inadequacy of the road network as one of the major obstacles to efficient business operations. Philippine businesses also pay the highest commercial power rates in the region,⁴⁰ more than three times higher than those in Indonesia and Thailand.⁴¹ In addition, it is estimated that 40% of companies operate their

³⁹ This situation is especially true in the transport and water sectors where LGUs are responsible for operation and maintenance yet have very limited resources.

⁴⁰ Average of \$0.09/kW.

⁴¹ This is partly due to the government's policy of selling power at the same rates to both consumers and commercial users, allowing the higher margins in commercial distribution to offset the losses in retail.

own generators and have their own back-up water supplies in case of outages; maintenance of that equipment further adds to the cost of doing business.⁴²

It is estimated that about \$35–45 billion is needed to rehabilitate and modernize the infrastructure sector over the next 10 years (World Bank 2002). Given the weak fiscal position of the government, private sector participation in the sector is imperative. The recent experience of the Philippines with this⁴³ is mixed. While private investors have brought much-needed capital to the power sector in particular, the lack of an adequate institutional, legal, and regulatory framework for these investments has led to significant market distortions, waste, and the possibility of a renewed power shortage. In transport infrastructure, lack of coordinated planning and the presence of government entities serving dual roles of regulators and operators have deterred both rational investment and private sector participation. In the water sector, the recent experience of one of the Manila Water concessionaires has highlighted the need for better contingency planning, supervision, and tariff management.

Disputes involving large infrastructure contracts, such as the Ninoy Aquino International Airport (NAIA) Terminal 3 concession and the Meralco distribution contract, have highlighted the risks of doing business in the Philippines and have effectively deterred much-needed future investment (see Box 3).⁴⁴ Restoring confidence in the sector (and the country) will require a credible demonstration of reforms to strengthen the institutional, legal, and regulatory framework for investment (see Chapter IV for a more detailed discussion of the infrastructure sector).

C. Weak Financial Sector

The weak financial sector has inhibited the efficient flow of investment resources to the private sector. High levels of NPLs in the banking sector

⁴² In ICT, the Philippines ranks quite favorably as it has a high density of penetration and modern telecommunications infrastructure.

⁴³ Since the promulgation of the BOT law in 1993.

⁴⁴ While disputes in large infrastructure projects are often unavoidable, mechanisms for their speedy and equitable resolution are critical for investor confidence.

Box 3: Ninoy Aquino International Airport Terminal 3 Concession Dispute—Raising the Risks of Doing Business

The recent dispute over the \$500 million build-operate-transfer contract for the new terminal at the Ninoy Aquino International Airport (NAIA) has highlighted for many foreign investors the risks of doing business in the Philippines. The concession contract, awarded to Philippine International Air Terminals Co. (PIATCO), a consortium of local investors and the Frankfurt Airport Authority, was declared void by the government less than a year before its completion date. This invalidation was upheld by the Supreme Court in May 2003 on the basis of (i) the alleged deficiencies in the consortium's eligibility as an original bidder, (ii) the substantial changes made to the terms of the final amended concession agreement (CA) as compared with the terms of the original agreement that had been competitively bid, and (iii) the government guarantee of PIATCO debt included in the CA terms, in violation of the BOT law.

The net result is that the airport terminal, which is almost complete, now lies abandoned, a highly visible reminder to all incoming foreign investors of the risks of doing business. The suggestion that political interference and/or judicial activism had a role to play in the cancellation of the contract, whether justified or not, certainly exists and only serves to further damage the reputation of the Philippines as a highly volatile investment destination.

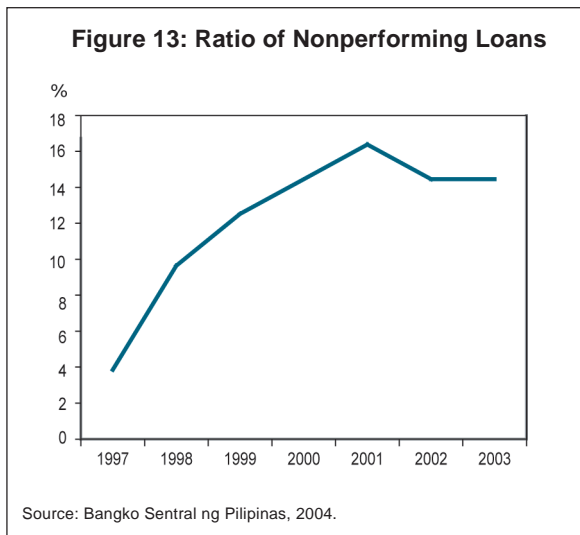
and the underdevelopment of capital markets have meant that access to external finance remains restricted for most enterprises. It is estimated that less than half of Philippine SMEs contract external finance from the banking sector, and only five do so from equity markets. While this can be partly explained by the deterrent effect of high interest rates (13–20% during 1995–2002), it is also due in part to the difficulty of smaller companies in securing credit. Poor accounting and disclosure practices, high collateral requirements, and limited capacity of the banks to assess SME risks have limited the amount of funding available.

Beyond bank credit, few formal alternative sources of funding exist. The PSE is very small (238 listed companies, total market capitalization of 24% of GDP) and thinly traded. Most listed companies float only 10–20% of their shares on the exchange.

The corporate debt market is virtually nonexistent, but the volume of government debt is substantial, equal to twice the value of PSE market capitalization in 2003. Investors in debt and equity markets are predominately corporations with strategic holdings and institutional investors including pension funds, banks, and insurance companies. An SME board exists but counts only five companies.

Growth in banking credit has been contracting over the past 5 years due to reduced demand and to mounting levels of NPLs. Banks are now rationing credit, despite relatively high levels of liquidity. The steady stream of risk-free government securities has given banks an alternative source of investment to offset the decline in corporate lending.

NPL ratios in the banking sector remain one of the highest among the crisis-hit Asian economies and were estimated at 15% of outstanding bank loans at the end of 2003, or 53% of capital (see Figure 13). If real and other properties owned or acquired (ROPOA) are factored in, total net nonperforming assets (NPAs) are estimated at 14% of total banking assets, or 64% of capital and 12% of GDP. Efforts to resolve NPLs have been stifled by a general reluctance of bank owners to recognize the inherent losses and by an unfavorable legal regime.



The passage of the special purpose vehicle (SPV) act in 2002 provides a new legal framework for the establishment of privately owned asset management companies that will purchase, hold, and sell NPAs to interested parties. To date this vehicle has not been used, but some NPL transactions have been completed outside of the SPV law. Weaknesses in the insolvency regime (as stated in Chapter III, A4) continue to limit the ability of banks to restructure potentially viable debts.

Funds that are available from the banking sector are predominantly short term, i.e. of 90 days or less. Long-term, fixed-interest-rate loans are rare given the absence of long-term peso-denominated sources of funds for the banks and high tax rates on secondary market trading of debt securities. Enterprises needing long-term funds, particularly for project finance, have contracted them in foreign currency, exposing them to severe exchange rate risks if their future revenues are to be in pesos.

The absence of long-term funding from the banking sector has not been compensated by alternative funding sources in capital markets. The small size of the stock market, relatively onerous listing requirements, and poor corporate governance practices have deterred potential new listings and investment. The corporate bond market remains virtually nonexistent and will require substantial improvement of the trading infrastructure,⁴⁵ the establishment of a long-term benchmark rate, and improved disclosure and corporate governance practices before more institutional investors take part.⁴⁶ Major efforts to modernize the capital market and non-bank financial sector institutions are under way and should be encouraged so that long-term funds available within the non-bank financial institutions (e.g., pension funds, insurance companies) can be channeled to productive use in the business sector and thereby facilitate growth.

⁴⁵ The proposed establishment of the fixed income exchange in 2004 will provide some of this infrastructure.

⁴⁶ The tax disincentives on corporate bonds will also need to be addressed if corporations are to favor bond issues over 5-year commercial paper.