

# V. PROPOSED ADB PRIVATE SECTOR DEVELOPMENT STRATEGY

## A. Key Findings

The private sector dominates the Philippine economy, generating on average 95% of GDP and employing 92% of the registered workforce.<sup>146</sup> Although the Philippine government still retains control of over 150 state-owned enterprises, the majority of productive assets are in private hands. By far the largest employers in the economy are microenterprises and SMEs, accounting for 36% and 33% of total employment, respectively.<sup>147</sup> These firms are generally engaged in low value-added activities contributing an average of 32% of total value added per annum.

The Philippine corporate sector is dominated by large, family-owned businesses operating in diversified sectors. At the end of 2003, 62% of the market capitalization of PSE was composed of 23 family-controlled groups (Philippine Center for Investigative Journalism 2004). These groups are typically highly diversified, combining financial sector institutions with various manufacturing and service arms. Moreover, a high degree of market concentration exists with the four largest firms in 18 major sectors of the economy contributing 74% of the total value added of the sector (Aldaba 2000). It is widely accepted 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 incentives for efficiency of freely competitive markets.<sup>148</sup>

In the absence of a rule-based business environment and the institutional capacity to enforce it, vested interests (in particular the close relationships between members of government and business owners) continue to exert undue influence and to preserve quasi-monopolistic structures. Disputes concerning private contracts in the power, water, and airport sectors have highlighted the weakness of the legal and regulatory framework, the limited recourse available to resolve disputes, and the high level of political intervention in the commercial sector. These factors significantly increase the risks of doing business in the Philippines and have largely contributed to the decline in FDI in recent years.<sup>149</sup>

Despite a GDP growth rate averaging 4.2% during 2000–2003, high population growth has eroded these gains on a per capita income basis. Unemployment is on the rise,<sup>150</sup> and the incidence of poverty in the country remains high at 34% with the greatest concentration of poor people in the rural areas. Significant geographic disparities in income persist with the regions of the southern Philippines experiencing the highest levels of poverty, the poorest

<sup>146</sup> Averages for the 1991–2002 period; data from the National Income Accounts 1991–2002 and National Statistical Coordination Board.

<sup>147</sup> 1999 Annual Survey of Establishments, National Statistics Office.

<sup>148</sup> Collusionary practices have been noted in the cement, shipping, sugar and flour-milling industries (Aldaba 2002).

<sup>149</sup> \$100 million in 2003, or 0.1% of GDP, down from 1.75% in 1999.

<sup>150</sup> 12.7% in 2003, according to National Statistics Office with an additional 20.8% underemployed.

levels of public service and infrastructure quality, and the highest unemployment.

The Philippines also has one of the poorest infrastructure sectors in the region.<sup>151</sup> 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 continues to lack access to power, 17% to safe drinking water, and 14% to adequate sanitation services. It is further anticipated that without added capacity, the current power infrastructure will be insufficient to meet the needs of connected users by 2007.

The poor investment climate is also aggravated by the weak financial system with limited funds available from the banking sector due to high levels of NPLs, thin capital markets, and very few financial instruments to diversify risk. Pension funds and insurance companies hold long-term liabilities that cannot effectively be channeled through the financial system. While progress has been made to strengthen and deepen the capital markets over the past several years, the development of a long-term debt market, asset-backed securities, and introduction of more equities together with strengthened market oversight will be critical to supporting economic growth.

The Philippine government no longer has the financial resources to support the development needs of the country. Consistently low revenue collection, mounting GOCC losses, and high external debt servicing costs have left it in a very weak financial position. Poor tax and customs administration together with poor taxpayer compliance are largely responsible for a decline in tax revenue that fell from 16% of GDP in 1997 to less than 12% in 2002. The national debt reached \$55 billion in 2003, or 73% of GDP with interest payments absorbing close to 38% of total government revenues, up from only 17% in 1997. GOCCs contributed another P97 billion (\$1.76 billion) of losses in 2003 with few signs of a turnaround.

Adding to this fiscal burden are substantial contingent liabilities estimated at a further P3.1 trillion (\$56 billion) representing maximum exposures under pension, risk, debt, and deposit guarantees. With this high level of contingent

liabilities, the government has already exceeded its capacity and cannot feasibly contract additional exposure without first reducing liabilities that exist.

## **B. Overall Approach and Recommendations**

The focus of ADB's strategy in support of private sector development is to (i) create enabling conditions for business, (ii) generate business opportunities in ADB-financed public sector projects, and (iii) catalyze private investment (ADB 2000c). While all three "strategic thrusts" have important roles to play in fostering private sector development, creating the enabling conditions for business is the fundamental component for sustainability. Indeed, it can be argued that where enabling conditions exist, there is no need for donor interventions as market forces suffice to create business opportunities and to attract private investment.

The Philippines still needs considerable improvement in many fundamental enabling conditions for private sector-led growth. While private enterprises already dominate the economy, effective competition does not exist in many sectors. Lack of independence, objectivity, and efficiency of regulatory bodies significantly increases the risks of doing business in the infrastructure sectors. Corruption and bureaucratic inefficiencies plague the civil service and judiciary, further increasing the costs of private enterprise. In this environment, it follows that without squarely addressing these governance and regulatory weaknesses, further ADB assistance, whether in the form of equity investment, cofinancing, guarantees, or lending, is unlikely to have the maximum potential impact.

Governance reforms should therefore form the central tenet of ADB's sustainable PSD strategy for the Philippines. In the current context, governance reform essentially means establishing and enforcing a rule-based business environment that encourages investment and rewards fair competition. In the Philippines, vested interests and systemic corruption will continue to make this process very challenging. Particular care will need to be taken in the design, implementation, and monitoring of programs to ensure that sufficient political will exists to support them.

<sup>151</sup> A survey of investors by the World Economic Forum ranked the Philippines 68<sup>th</sup> out of 75 economies.

If a favorable business environment is the most fundamental requirement for sustained private sector development, adequate physical infrastructure facilities and the availability of finance are key supporting factors as they allow businesses to operate, access markets, and finance growth. In the Philippines, however, it is recommended that ADB support for the development and modernization of the physical infrastructure and financial sectors should also emphasize fundamental governance reforms. While it is recognized that the country is in need of immediate private investment to address looming power shortages, deteriorating roads, poor water supply, and rising unemployment, the long-term benefits of these investments, and indeed their impact on poverty reduction, will depend on the implementation of a much stronger legal, regulatory, and institutional framework in each sector and in support of the economy as a whole.

## 1. Creating a Rule-Based Business Environment

ADB's support to the Philippines for creating a rule-based business environment should include the following components:<sup>152</sup>

- **strengthening the legal framework for competition** by further liberalizing protected markets, clarifying anticompetitive provisions of existing legislation and making them part of the commercial code, considering further antitrust legislation, and strengthening the capacity of the courts to adjudicate;
- **pursuing corruption eradication efforts** including procurement reforms, increased computerization, phasing in of the new government accounting system, the introduction of lifestyle or asset consistency checks for government employees, and implementation of the new civil service code;
- **strengthening the competency, efficiency and integrity of the judiciary** by supporting

the action program for judicial reform including the establishment of alternative dispute resolution mechanisms such as arbitration and mediation (see also section 2);

- **strengthening the legal framework and enforcement mechanisms for protecting credit and property rights** by supporting the adoption of a corporate recovery and insolvency law that would clarify the rights of parties involved in bankruptcy, restructuring, and/or liquidation; supporting the implementation of the corporate governance code and international accounting standards; strengthening the capacity of SEC to enforce compliance with both; completing the cadastral titling of all lands in the Philippines; and establishing a central registry for land titles and secured transactions that is fully accessible by the public online.
- **reducing political interference in the markets** by strengthening the independence of sector regulators and giving them sole authority over utility tariffs, privatizing the remaining nonstrategic GOCCs and unbundling the commercial and regulatory roles of government agencies wherever they coexist (e.g., ATO, PPA).

## 2. Attracting Private Sector Investment into Physical Infrastructure

Adequate physical infrastructure plays a vital role in facilitating private sector development and poverty reduction. In the Philippines, significant investments are required to meet looming power shortages, to rehabilitate water supply, and to improve transport infrastructure, yet few public funds are available. While the private sector has invested more than \$28 billion in the sector to date, significant problems have arisen that have underscored the current deficiencies of the enabling environment for PPI. Investment has therefore slowed considerably, and if it is to return to the sector in a sustained manner, the following key elements must be in place.

<sup>152</sup> A more detailed discussion of the rationale and requirements for each component is presented in section III.

- **Coherent investment planning and implementation.** In the absence of coherent development plans with supporting implementation mechanisms, private sector participation will necessarily remain chaotic with ad hoc proposals made and no systematic means to evaluate them in terms of economic benefit or alignment with the government's economic development priorities. This is particularly true in the transport sector where the medium-term Philippine development plan (National Economic Development Authority 2001) does lay out a broad sector strategy, but the existing institutional framework makes it almost impossible to translate this into a coordinated, intermodal investment plan (ADB 1996 and 1999).
- **Credible and independent regulatory oversight.** Due to the natural monopolies associated with many infrastructure investments, economic regulation is necessary to balance the public interest. To be effective, regulating bodies must be independent of policy-making agencies and free of any conflict of interest when implementing sector rules. In the Philippines, regulators exist for each major infrastructure sector, but none is financially independent or effectively free from political influence. In the case of the transport sector, ATO and PPA combine policy, regulatory and operational responsibilities, thereby undermining their impartiality vis-à-vis private investors. This weak regulatory framework has resulted in formal legal challenges to almost every major regulatory decision and investment transaction.

In addition to their independence and credibility, regulators need to have the expertise and resources required to execute their complex mandates. Lack of capacity can raise the perceived risk for investors as well as the costs for the government as decisions are delayed or are based on flawed legal bases. In the case of the ERC, the scope of its responsibilities for enacting the EPIRA has not been supported with adequate resources contributing to delays in implementing the restructuring of the sector. Similarly, the National Water Resources Board has a significant backlog of licenses and other approvals due to the current mismatch between its scope of responsibilities and

internal capacity. Measures to address this problem could include the use of outside advisors until adequate capacity can be built internally.<sup>153</sup>

- **Clear rules and regulations for the solicitation and evaluation of PPI proposals.** While the 1993 BOT Law provided the framework for PPI, there have been challenges to the law due to ambiguities in its implementing regulations. The law allows for unsolicited projects to be considered by the Investment Coordination Committee and sector agencies concerned, but is not clear on the role of the president in the final approval process. The recent and very high-profile invalidation of the NAIA 3 concession was facilitated by the ambiguous nature of these regulations. Clarifying the regulations would be an important step in reducing the risk factors for potential BOT investors. The proposal, evaluation, and award process should also be of the utmost transparency and should involve independent technical specialists who can add expertise and help depoliticize the process. Finally, improvements can be made to the "Swiss challenge" clause that allows any challenger to make a counter bid on an unsolicited proposal. While sound in principle, this clause raises the risks of preparing BOT proposals in the Philippines as the substantial costs involved in preparing such proposals are lost in the event of a successful challenge. One mechanism to address this risk would be to allow reasonable project preparation costs to be reimbursed to the preparer of a project that is ultimately awarded to another bidder.

Beyond strengthening the process of awarding contracts, mechanisms should be developed to protect the integrity of contracts under implementation, specifically, to restrict the review of private sector participation contracts from one generation of elected officials to the next. Reviews of such contracts should be allowed only on a strictly technical basis and should relate to provisions prescribed therein.

<sup>153</sup> Other measures include training such as that received by the Metropolitan Waterworks and Sewerage System and now National Water Relations Board under ADB's sponsorship.

- **Tariff regimes based on cost recovery.** Investors in any infrastructure project must be assured that they can earn a reasonable rate of return on their investments. In most infrastructure sectors, this means charging a price for the service that allows full cost recovery plus a profit margin. In the water, power, and toll road sectors, this has proved difficult to implement due to political interference. It is therefore recommended that sole authority for setting tariffs rest with the independent sector regulator. If the authority of the Congress to approve tariff increases cannot be removed, then some form of compensation is required when normal tariff adjustments (supported by pre-agreed modes of calculation) are refused by the legislature. In scenarios where tariffs are judged too onerous for the target population, compensation schemes can be built into the operating contracts of service providers, be they public or private. The key element of this process is transparency in setting tariffs and reliability in implementation.
- **Efficient mechanisms for dispute resolution.** The frequency of legal challenges to infrastructure investments in the Philippines has highlighted the need for strengthened dispute resolution mechanisms. The weakness of the lower courts has meant that a large number of contractual disputes have been sent to the Supreme Court for resolution. Further, decisions by the Supreme Court have had significant consequences on the sustainability of private investments and have called into question the genuine independence of the Court. Examples of this are the use of an obiter dictum in its decision to uphold the Energy Regulatory Board's decision to use accounting rules contrary to international standards to calculate rates of return for Meralco forcing Meralco to refund P28.15 billion to customers for overcharges, and the cancellation of the air terminal company's contract for NAIA once construction was almost completed. Outside the traditional channels of the court system, which on the whole lacks the capacity to effectively deal with complex contractual issues, alternative dispute resolution mechanisms such as mediation or arbitration could be considered.

While these are not a substitute for the need to strengthen the judiciary, they can serve as a complement and help to relieve the significant case backlog in the court system.

These reforms, which involve legislative input and significant capacity building, will require time to be fully implemented. Yet the needs for large-scale infrastructure investment, particularly in the power sector, are immediate. While it has been proposed that ADB help mitigate the risks<sup>154</sup> for PPI in the short term with the use of its political risk guarantees, it may be unreasonable to expect that the government will issue a counter guarantee. The exceedingly high levels of contingent liabilities of the government (estimated at up to P 3.1 trillion) may make such counter guarantees unfeasible.

If ADB is to provide immediate financial assistance to the infrastructure sector (in particular to power), it is recommended that this only be undertaken as part of an overall sector reform program with credible commitments (indeed some of these commitments could be in the form of predisbursal conditionalities) from the government to address the fundamental issues listed above.

### 3. Mobilizing Finance for Private Sector Development

Financial sector strengthening is needed to facilitate the mobilization of funds to support MSME development, infrastructure investment, and the more efficient provision of public services. High levels of NPLs in the banking sector and underdevelopment of the capital markets<sup>155</sup> have limited the supply and distribution mechanisms of funds to most enterprises. While improving, poor corporate governance practices among banks and businesses combined with the limited supervisory capacity of BSP and SEC have inhibited the development of the financial sector as an efficient source of business funding.

Increasing the efficiency of the financial sector as a source of business finance will require

<sup>154</sup> In particular the exposure of foreign investors to expropriation and breach of contract, two key considerations in the current Philippine environment.

<sup>155</sup> Including the very limited risk capital markets.

fundamental reforms in the legal, regulatory, and corporate governance regimes in practice including the following:

- **Legal means.** strengthening the legal framework for NPL resolution by adopting the corporate recovery and insolvency law and removing remaining tax disincentives; providing immunity from prosecution and harassment for BSP and SEC in the enforcement of regulations;
- **Regulatory reform:** strengthening the independence and capacity of SEC, BSP, and IC in regulating the markets in accordance with international standards including monitoring of related-party lending, risk-based capital adequacy, and corporate governance; harmonizing the regulations and tax treatments of similar financial instruments; eliminating directed lending programs and commercializing the terms of mortgage finance;
- **Corporate governance:** supporting the implementation of the corporate governance code and international accounting standards and strengthening the capacity of SEC to enforce compliance with both. The tightly held nature of many Philippine companies makes good corporate governance all the more important as accurate disclosure and the enforcement of minority shareholder rights is key to reducing investment risk, instilling investor confidence, and broadening the use of capital markets.

#### 4. Facilitating the Growth and Development of Micro, Small, and Medium-Sized Enterprises

In the Philippines, as in most middle-income countries, the engines of job creation in the economy are MSMEs. Facilitating the creation and growth of these enterprises, particularly in rural areas most affected by poverty, must remain a development priority.<sup>156</sup>

<sup>156</sup> SME development is a key poverty reduction strategy of the government under the Medium-Term Philippine Development Plan.

While the limited access to funding of many MSMEs is a reality, many have reported that prohibitive interest rates are the real reason for their reliance on self-financing.<sup>157</sup> More important constraints to growth are the poor state of infrastructure, the existence of protected markets and/or dominant market players crowding out new entrants, and the pervasive corruption within the tax, customs, and licensing administrations. In supporting the establishment of a rule-based business environment and attracting new private investment into the infrastructure sector, ADB would be directly serving the interests of MSMEs and creating the necessary conditions for their growth.

#### 5. Local Implementation Approaches

The scope of the needed reforms outlined above is daunting, and their fundamental nature will require resources as well as substantial political will for implementation. Given the weak financial position of the government, there are limitations on its ability to contract new liabilities, both actual and contingent. There are also limitations on the absorptive capacity of government institutions, even the most willing, to implement reforms.

While engagement with the national government on policy, legal, and regulatory issues is and will remain essential in addressing private sector development issues, working with LGUs may present greater opportunities for focused governance reform. LGUs have responsibility for managing a large number of public services that directly affect the operating conditions of private enterprises, most notably the provision of infrastructure (water, power, roads, ports, airports).

Given the scope of their responsibilities and their direct impact on many enabling conditions for private sector development, LGUs could prove good candidates for piloting institutional reforms. ADB has been working with LGUs on various regional infrastructure, health, and agricultural programs and has a good understanding of their administrative capabilities and limitations. It is therefore

<sup>157</sup> This is particularly true of SMEs, while microenterprises generally have fewer internal resources.

recommended that ADB explore the possibility of “partnering” with LGUs willing to embark on a holistic set of reforms addressing (i) public procurement, (ii) tax collection, (iii) business licensing, (iv) infrastructure planning, (v) PPI, and (vi) alternative dispute resolution mechanisms.

It may also be possible to involve regional courts in an LGU-ADB partnership, and support their efforts to improve efficiency and transparency. The feasibility of this option was not explored while preparing this private sector assessment but warrants further review if a regional approach is adopted.