

Executive Summary

The Philippines has a long tradition of private sector-led growth, and indeed its entrepreneurial culture, skilled workforce, and pro-business economic policies have led to consistently high levels of private sector involvement in the economy.¹ The efforts of successive administrations to liberalize the economy in the 1980s and 1990s resulted in large inflows of private investment, including foreign participation in previously closed sectors such as retail trade, telecommunications, banking, and infrastructure.

Despite the political upheaval and recession of the mid-1980s, economic liberalization has largely remained on track fueling an average real gross domestic product (GDP) growth rate of 2.5% from 1980 to 1997, and allowing foreign investors to become significant players in such industries as banking,² life insurance,³ and manufacturing.⁴ Moreover, the liberalization of the power sector in the early 1990s resulted in over 35 new power projects and the current dominance of the private sector as the owner and/or operator of 70% of the generating capacity in the country.⁵

In other infrastructure sectors, private companies have also taken a leading role such as in the development of the telecommunication network (cellular networks, cable, Internet, and other related services), water supply (e.g., Manila Water Company and Manila Water Services, Inc.), and toll road development. Private investment flows slowed after the 1997 Asian financial crisis, however, and have yet to recover. Gross domestic investment steadily

declined from 23.8% of GNP in 1997 to 18.1% in 2002, and foreign direct investment (FDI) dropped from a high of \$2.1 billion in 1999 to \$0.1 billion in 2003.

The drop in both domestic and foreign investment is largely due to the deteriorating investment climate in the Philippines.⁶ Growing fiscal deficits have weakened the economy, vested interests appear to increasingly influence both legislative and judicial proceedings, and the weakness of the public sector in creating and enforcing freely competitive and/or regulated markets acts as a deterrent to prospective investors and as a drag on economic growth. While private enterprises dominate the economy, effective competition does not exist in many sectors.

For foreign investors, the perceived risks of doing business in the Philippines are rising, encouraging them to seek alternative investment destinations such as the People's Republic of China, the Republic of Korea, and Thailand. 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. Add to these the high costs of power and labor, and the costs of doing business in the Philippines become comparatively greater than in alternative regional destinations.

Aggravating this loss of competitiveness is the increasingly weak financial position of the central government. Consistently low revenue collection, mounting government-owned and government-controlled corporation (GOCC) losses, and high external debt servicing costs have aggravated its accumulated deficit. Poor tax and customs administration together with poor taxpayer

¹ In 2003, the private sector generated 95% of GDP and employed 92% of the registered workforce.

² Out of the 44 commercial banks, 17 are foreign branches or subsidiaries of foreign banks, and 19 domestic banks have foreign equity participation.

³ Twelve out of 35 insurance companies are foreign owned.

⁴ Major players in the car industry (e.g. Toyota, Nissan, Honda, Mitsubishi, and Columbian Motors) have foreign equity participation ranging from 37.5–100%.

⁵ Of the 70% of total generating capacity operated by private parties, 82% is owned by the National Power Corporation but operated by private parties under independent power producer contracts; the remaining 18% is owned by private parties.

⁶ FDI has been on the decline for all of Asia since 2000, with only the People's Republic of China recording a net year-on-year increase.

compliance are largely responsible for a decline in tax revenue which fell to 14% of GDP in 2003. The national debt reached \$55 billion in 2003, or 73% of GDP, with interest payments absorbing close to 38% of total government revenues. 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 that are 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 that which exists.

In this context, restoring investor confidence to fuel investment needs and economic growth is increasingly urgent. The newly elected Arroyo administration recognizes its unique opportunity to demonstrate its commitment to establishing a rule-based business environment that encourages investment and rewards fair competition. The President's development agenda has ambitious targets for job creation and fiscal management that are key elements of long-term growth but which are achievable only with governance reforms to remedy key weaknesses in the investment climate.

The government has taken steps towards improvement in governance; this needs to be continued. In the context of investment,

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, but significant progress can be achieved with sustained political commitment.

If a favorable business environment is the most fundamental requirement for sustained private sector development, adequate physical infrastructure and the availability of finance are key supporting factors as they allow businesses to operate, access markets, and finance growth. 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 stronger legal, regulatory, and institutional frameworks within each sector as well as in support of the economy as a whole.

Therefore the central tenet of the Asian Development Bank's sustainable private sector development strategy for the Philippines will be governance reform. The two pillars of assistance will be for development and modernization of the physical infrastructure and financial sectors underpinned by governance reform.

Development Agenda—July 2004

"To create a higher economic growth path, we will need to bring investments from 19% of GDP to 28% of GDP, and increase our exports of goods and services from \$38 billion to \$50 billion within two years."

"To achieve these objectives, government will provide the policy environment that will reduce the costs and risks of doing business and nurture globally competitive enterprises that will produce goods of high quality in a cost-efficient manner. It will also provide the marketing and logistical support to facilitate domestic and international trade and effect transfer of knowledge that will increase the productivity of our people."

Source: Development Agenda: Our Task for the Next Six Years. National Economic Development Authority. June 2004.

Introduction

This private sector assessment was undertaken to provide essential background for the development of a coherent strategy for private sector development (PSD) in the Philippines. As with other private sector assessments developed for Asian Development Bank (ADB) member countries, the analysis aims to identify ways to promote a strong and dynamic private sector that will contribute to the country's long-term economic growth and to sustained poverty reduction. Private sector assessments also serve as key inputs to ADB country strategies and programs.

This assessment is organized into five main sections: (i) an overview of the macroeconomic environment and the role of the private sector in the economy; (ii) the framework for and key impediments to PSD; (iii) an analysis of key economic sectors affecting PSD (physical infrastructure, financial sector, social sectors, and agriculture); (iv) an overview of the experience of ADB in funding PSD initiatives in the Philippines; and (v) a proposed PSD strategy for ADB addressing the key impediments identified in the previous analysis and taking into consideration the past experience of ADB in the Philippines and the limited absorptive capacity of the Philippine government, both financial and institutional.