Philippines:

Moving Toward A Better Investment Climate

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Good investment climate—critical to economic growth

One of the prominent globalizers in Southeast Asia with a high ratio of trade to gross domestic product (GDP). Yet a weak performer in terms of economic growth compared with the other globalizing developing economies that grew annually at 5% per capita during the 1990s. "Boom and bust" cycles of economic growth. Low rate of gross capital formation compared with Asia's other globalizers. Practically stagnant labor productivity accompanied by a rapid growth of the labor force. These basically characterize the Philippine economy over the past two to three decades.

Given these, it is therefore crucial to take stock of and systematically address all constraints that have blocked the building of a sound investment climate to pull out the country from such stagnation. The Asian Development Bank, in collaboration with the World Bank, examined the institutional factors and policies that make up the investment climate by probing, at the firm level, the stumbling blocks and constraints to private investment and productivity growth. A sample survey that targeted 800 establishments representing the four major manufacturing sectors in three prime locations in the Philippines was scientifically designed and conducted in 2003. While most of the results from 716 responding establishments have been generally well known to the government and the public, the study provided scientific and quantitative basis to support these observations. Recommendations on the specific areas/measures needing reform to improve competitiveness as well as an analysis of the effect of easing the investment constraints on firm productivity and growth were drawn from the survey.

Box 1. What is investment climate?

It consists of three broad sets of factors, namely: (i) macro fundamentals, (ii) infrastructure, and (iii) governance and institutions. Having a good set of macro fundamentals include achieving reasonable fiscal and external balances, realistic exchange rate, low inflation and interest rates, competitive markets, and social and political stability. Infrastructure has to do with availability and quality of physical infrastructure, such as roads and ports, telecommunications, power and water supply. Governance and institutions refer to transparency and efficiency in regulation, taxation, and legal system, strong and well-functioning financial sector, labor market flexibility, and skilled labor force.

What led to such a lackluster performance?

To a large extent, the poor investment climate brought about by macroeconomic instability, poor infrastructure, excessive regulation, and corruption, among others. This in turn stymied capital formation, productivity improvements, and competitiveness of firms. Addressing the weaknesses of the investment climate, complemented by appropriate policy reforms, should therefore be of top concern to enhance the economy's productivity and long-term growth, and to eventually contribute to poverty reduction.

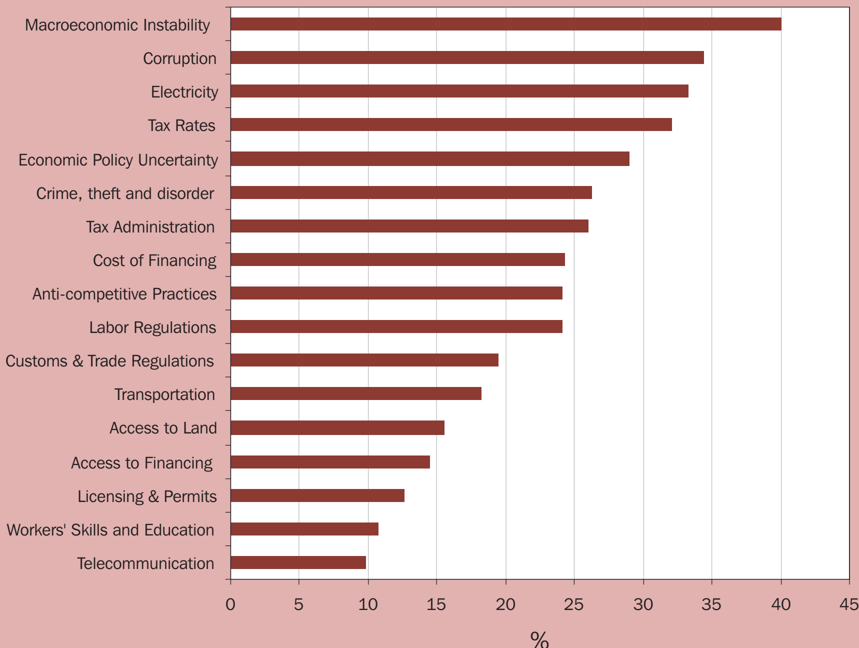
What's the story—looking at the current investment picture

To get a clearer picture on what assails the entry of foreign investors and what affects the business decisions of entrepreneurs, the chief operations officer or general manager of the establishments surveyed was asked to identify what he/she thinks are the stumbling blocks or constraints in doing business in the Philippines. The top constraints identified are shown in Figure 1.

Macroeconomic instability and economic policy uncertainty fall under macro fundamentals while electricity, transportation, and telecommunications are under infrastructure. Corruption, tax rate and administration, crime and theft, access to and cost of financing, labor regulations, skills and education of available workers, business procedures and regulations, and anticompetitive or informal practices—these constitute concerns about governance and institutions. The country's investment climate profile will be described according to these three broad sets of factors. To gain some international perspective, a comparison of the survey results with those of other countries in which similar surveys were conducted will also be presented.

Macro fundamentals

As gleaned in Figure 1, 40% of the surveyed establishments rank macroeconomic instability as a major obstacle while 29% consider economic policy uncertainty as a major constraint. Medium-sized establishments appear to be the most affected by these constraints with 51.5% and 43.4% of them ranking macroeconomic instability and economic policy uncertainty, respectively, as severe constraints.



In terms of inflation, its 2.9% level for 2003 is a significant improvement from the chronically high inflation rates of earlier years. On the other hand, the total debt of the national Government rose to 78% of GDP in 2003 and the total public sector debt, including liabilities of the national government and those of the government-owned or controlled corporations (GOCCs), stood at 138% of GDP (Table 1). Of the total debt service made, 48% are for interest payments. Meanwhile, the Government's severe fiscal deficit has placed it in a very restricted position in implementing programs that could counter the unemployment rate which has remained high at 10.1% in 2002 and 2003, compared with single digit rates of neighboring countries. Moreover, these persistent fiscal and debt problems, together with affected perceptions of country risks, greatly influence interest rates and a firm's cost of borrowing.

Politics in the Philippines remains problematic, with political upheavals taking place during the turn of the millennium in relation to then incumbent President Joseph Estrada's impeachment trial for plunder and corruption, and with divisive campaign pressures for the 2004 election running through the entire 2003 and the first half of 2004. The current administration is also faced with increasing electricity and oil prices, causing more erratic movements in commodity prices.

Table 1. Selected Philippine Economic Indicators

Indicators	1990–1999	2000	2001	2002	2003
Real GDP Growth	2.8	4.4	3.0	4.4	4.5
Inflation (%)	9.1	4.4	6.1	3.1	2.9
Unemployment (%)	8.6	10.1	9.8	10.2	10.1
Fiscal Balance (% of GDP)	–1.2	–4.0	–4.0	–5.2	–4.6
External Debt (% of GDP)	65.9	76.0	80.0	76.0	78.0[a]
Total Public Sector Debt (% of GDP)	116.5	130.8	121.5	130.4	137.5

[a] Figure for 2003 is the total debt of the national Government as % of GDP from the Bangko Sentral ng Pilipinas website.

Sources: ADB. *Key Indicators 2004.*
Paderanga, Cayetano Jr., Recent Fiscal Developments in the Philippines, University of the Philippines School of Economics Discussion Paper 2001-2010, October 2001.

Infrastructure

Investments are naturally attracted to areas with adequate roads, ports, and other essential infrastructure because such facilities affect a firm's profitability due to the reduction in production costs and ability to reach wider markets.

In general, around 62% of the firms rate public infrastructure and services in the Philippines as "somewhat inefficient to very inefficient." This is borne by the poor shipping services in the country which lead to a 4.7% loss in production, compared with 2.2% in Indonesia and around 1% in Bangladesh and the People's Republic of China (PRC). At the same time, firms experience delays 5.6% of the time, on the average, when picking up goods for delivery to the domestic market or delivering supplies from the domestic market. Firms in the National Capital Region (NCR) experience longer delays than those in CALABARZON (Cavite, Laguna, Batangas, Rizal, Quezon) and Cebu/Davao areas in picking up goods for the local market, which can be attributed to the greater traffic congestion within the NCR and the inadequate transport network linking NCR to other regional domestic markets.

Public works in the Philippines (54%), just like in India (69%) and Bangladesh (49%), appears to be one of the most unsatisfactory

infrastructure services. In contrast, only around 20% perceive public works as a problem in both PRC and Malaysia. The proportion of paved roads shows in particular the relatively poor state of the roads in the country, with only 20% of roads paved, compared with Thailand's 98%, Sri Lanka's 95%, and Malaysia's 76%. This makes it more difficult to access inputs, transport goods, and reach markets in a timely manner.

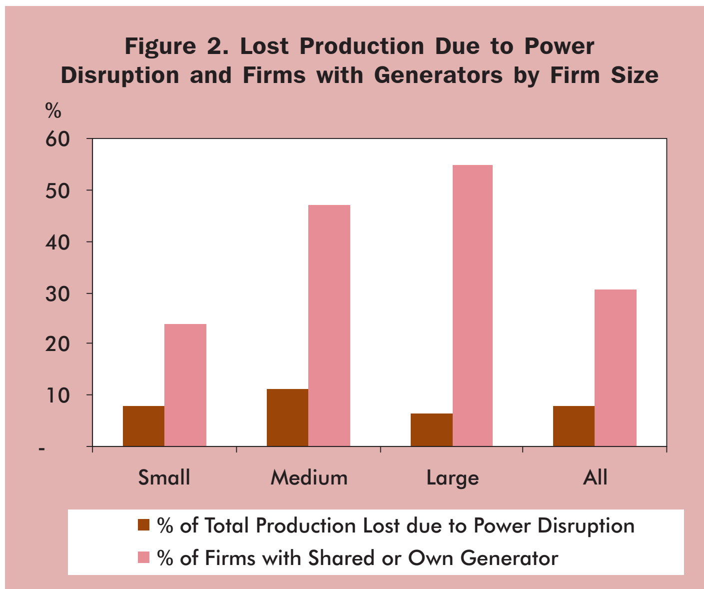
It typically takes firms an average of 13 days to obtain telephone lines and 10 days to acquire an electrical connection, with firms in CALABARZON getting faster telephone and electrical connection services than those in NCR.

Electricity appears to be a more critical concern (33% of firms), compared with transportation (18%) and telecommunications (10%), with losses owing to power failure amounting, on average, to 8% of production—higher than in Indonesia where the frequency of power outages is similar. Power outages hurt small and medium-size firms most, costing them an equivalent of about 8% and 11% of production respectively, compared with 6% for large firms (Figure 2).

Bottlenecks in water supply also impose a heavy cost to business operations, especially in the food and food processing industry, averaging at 7% of production. Among food and food processing firms in NCR, losses due to insufficient water supply are equivalent to about 10% of production, though 36% of them have their own or shared sources.

Insofar as technological innovations are concerned, a majority of firms have, since 1998, undertaken steps in (i) upgrading an existing product which, along with cost reductions, appears quite important to firms' ability to enter new markets (61% of firms); and (ii) upgrading machinery and equipment (51%). What is surprising, though, is that given the Philippines' relatively well-developed university system, only one of the 716 firms attribute universities and other public institutions as the most important source of new technology. Moreover, only three firms rate universities as the second; and two firms, as the third most important source of their new technology. New technology seems to have been sourced more from the technology embodied in new machinery and equipment as well as from the hiring of key personnel.

Figure 2. Lost Production Due to Power Disruption and Firms with Generators by Firm Size



Governance and Institutions

Causing delays and adding costs to business firms are factors related to governance and institutions. For example, significant delays are experienced by firms in securing government licenses or permits. On the average, obtaining an operating license takes about 14 days. To shorten bureaucratic red tape, firm managers often find it necessary to personally transact with government authorities, spending an average of about 9% of management time weekly in dealing with government regulations. This is particularly acute for electronics firms, averaging at 12%.

Corruption affects 34% of the firms, ranking it as a major or severe burden. The problem is of particular concern to the electronics and textiles industries, with over 41% being severely affected. On the whole, corruption affects exporters more than non-exporters, and foreign firms more than domestic firms. Transactions at the customs bureau are especially and commonly perceived to be riddled with corruption, with more than 50% of exporting and foreign firms surveyed in the Philippines regarding customs administration as a moderate to major obstacle to business. Delay in getting goods cleared through customs is a major bottleneck for firms relying on imported inputs.

Informal payments or gift-giving to government officials also appear to be a pattern in securing services or permits. These average around 2% of the value of public contracts or firm sales. Electronics and garments firms shoulder the most in informal payments at over 2% of sales; electronics firms also pay the equivalent of 3% of public contracts.

Table 2 reveals that gifts are far more required in obtaining regulatory permits and licenses than in obtaining infrastructure-related services. As for those establishments in the Special Economic Zone (SEZ), while no gifts or informal payments are asked in obtaining telephone and electrical connections, 39% admit making such payments to secure import permits. The fact that the delivery of physical infrastructure services appears to be less plagued by corruption than that of regulatory licenses is important for policy purposes as it suggests where more attention may have to be given in terms of strengthening governance.

What induces firms to indulge in such practices? Largely, firms try to avoid bureaucratic red tape caused by burdensome and complex regulations. Although the Philippines fares better than other Asian developing countries in terms of the extent of bureaucratic red tape, the burden of regulation, however, is more severe.

For the electronics industry, where majority are importers and exporters, 39% of the firms regard customs regulations as a major or severe constraint. About 47% of these firms are located in CALABARZON. It takes these firms an average of 9 days to clear imports through customs, with the longest clearing period having a mean of 21 days. On the other hand, electronics firms can clear exports through customs in just 4 days, compared with an average of 7 days for all firms. Food and food processing industries appear to experience the longest customs clearing period, 14 to 22 days for imports, and 8 to 15 days for exports. Overall, customs clearing period seems longer in the Philippines than in the PRC and Indonesia.

Table 2. Pattern of Gift–Giving for Services or Permits

Gift required for obtaining	Percent Saying "Yes"
Telephone connection	2.3
Electricity connection	2.8
Construction permit	14.1
Import license	20.1
Operating license	14.8

Corruption is equally prevalent in the tax system with its more painful costs reflected in the continuing insufficient collection of government revenues. Around one third of firms find taxation a major or severe strain. The food and food processing industry appears to be particularly burdened by the tax system, with 48% of the firms in Cebu and Davao provinces complaining about tax rates. By evading payment of more taxes, firms within the same industry undermine competition. On the other hand, the slow and overburdened courts work in the favor of noncompliance because even if the government pursues cases against them, settlements are normally made at a compromise that could, in fact, result in savings for the firm.

While 64% of firms agree that the legal system would enforce contracts and property rights, only 49% believe that officials would interpret regulations consistently. Thus, although basic property rights may be respected, enforcement of regulations is often viewed as unfair or uneven.

The Philippines is known to have a relatively well-educated and skilled workforce. Thus, a large majority of firms have no major complaints about the education and skills of available workers, particularly those in the food and food processing, and textile industries. However, greater skills development of workers in the electronics industry seems to be called for, with nearly one fifth of firms finding the skills deficiency of their workforce to be a major to severe constraint to productivity.

The Philippines is found to have higher labor costs than several of its Asian neighbors. Confirming this is the response of three fourths of the firms surveyed which consider mandated minimum wages as a major or severe impediment. This issue seems to be of greater concern for the food and food processing and garments industries.

Compounding the issue of high labor costs are the regulations relating to the hiring and firing of workers. Roughly about 11–12% of the surveyed firms consider these as a major to severe obstacle, with the problem appearing to be of great concern in the garments industry, thereby making the firms in the industry resort to subcontracting.

Labor unions are relatively active in the Philippines. The presence of labor unions—most prevalent in the textiles industry (38% of firms)—is associated with less flexibility in hiring and firing. Thus, the textile industry has higher overmanning, where the existing workforce is greater than the optimal level of employment—9% of workforce, compared with a mean of 4% for all firms. Textiles also lose on average 4 days of production during the year owing to labor strikes, compared with almost zero for the electronics and a day for the other industries.

Overall, labor regulations seriously affect a higher proportion of firms in the Philippines (24%) than in Bangladesh (8%), Pakistan (15%) and PRC (19%), but are comparable to Indonesia (24%).

In terms of financing, internally generated funds account for 60% of the working capital of establishments while only 9% of working capital is being sourced from commercial banks. In the electronics industry, trade credit provides 16% of the financing needs.

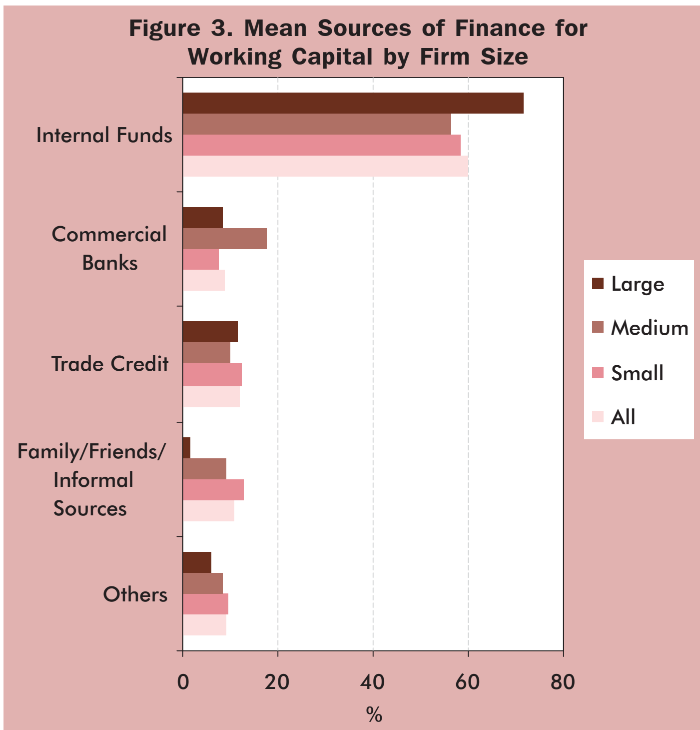
To domestic firms, the cost of financing appears to be the more serious constraint than access to financing. The average loan rate for domestic firms is about 11%, compared with 6% for foreign firms. The large differential could be because foreign firms, including those that have located at the SEZs, have access to foreign loans or foreign-denominated loans. If they are exporting, they also have a natural hedge against foreign exchange risk. Moreover, domestic firms are less able to access loans owing to collateral requirements. Overdraft facility or credit line benefits only about 28% of local firms.

Are the small establishments worse off?

Interestingly, small firms—establishments with less than 100 employees—feel less constrained than large firms on virtually all aspects of the investment climate posing as potential obstacles to operations and growth —including telecommunications, electricity, transportation, regulatory burden and corruption, customs and trade regulations, labor regulations, political instability.

The notable exception relates to the access and cost of finance. Only 8% of financing is sourced from commercial banks. As such, there is a growing reliance on family, friends, and informal sources (Figure 3). The rigid bank credit requirements limit small firms from sourcing the needed capital as they are most unlikely to produce the collateral requirements for the loan. Moreover, since they are perceived to have minimal technical capacity in undertaking feasibility studies, the cost of borrowing is usually higher.

A part of this pattern of responses may reflect industry characteristics. It is important to note that most of the surveyed small firms belong to the food and food processing and garment industries (206 and 184 firms, respectively) while only 33 and 32 firms belong to the textile and electronics industries. Since electronics firms, in particular, tend to be not only bigger but also more internationally integrated, such firms may be applying benchmarks based on international conditions and best practices. Thus, they would, for example, be more sensitive to problems with the power supply than smaller firms, which operate in a less competitive local market (controlling for industry effects). Similarly, if small firms are less dynamic—that is, they are less likely to expand production, get into new product lines and markets—they may well feel less constrained by the business climate.



Beyond the perceptions of surveyed firms, however, it is interesting to note that deficiencies in infrastructure and weak governance seem to affect small firms adversely. Smaller firms tend to report higher losses in production due to failures in infrastructure services. They report average losses of 8% of production versus 6% for large firms from power failures. Small firms also report 6% losses on average, owing to transportation inconveniences or insufficient water supply, compared with 4% for large firms. Financial statements are audited in only 61% of the small firms, far from the 95% of large firms. This can be expected from the more informal set-up of small firms where company policies are less defined and standards more lenient, as compared with the big firms.

Somewhat unexpectedly, large firms report longer waiting time in obtaining operating permits and import licenses, partly because bigger projects have more complex technical requirements. Giving informal payments or bribes is also more prevalent among large firms in securing almost all permits/licenses (except for import license). However, this does not necessarily mean that the burden of corruption is less for small firms. Small firms spend as much as large ones for informal payments to public officials at 2.2% of sales, and devote about 5 days in inspections or required meetings with local authorities. Small firms also have to contend with much longer delays in getting delivery of imports (from the time goods arrive at their point of entry) and in clearing customs (after the goods arrive at their point of exit). But this clearing period delays should not be alarming as most inputs and supplies of small firms are sourced locally (more than 80%) and 86% of output is sold in the domestic market.

Is locating in the Special Economic Zones better?

Special economic zones (SEZs) are defined in Republic Act (RA) 7916, known as the Special Economic Zone Act of 1995, as areas which are highly developed or have the potential to be developed into agro-industrial, industrial tourist/recreational, commercial, banking, investment and financial centers. Over the years, the number of SEZs in the country has gradually increased, boosting employment in the provinces within their vicinity and nearby locations. As of September 2003, there were about 96 SEZs throughout the country, employing around 900,000 workers.

SEZs can help promote balanced regional growth by serving as an attractive destination for foreign investors by providing the following incentives: (i) income tax holiday or exemption from corporate income tax for 4 to 8 years; (ii) exemption from duties and taxes on imported capital equipment, supplies, and raw materials; (iii) domestic sales allowance equivalent to 30% of total sales; (iv) exemption from wharfage dues and export taxes; and (v) lenient immigration laws. In addition, firms in SEZs can also avail of other incentives under the Omnibus Investment Code of 1987, as may be determined by the board of the Philippine Economic Zone Authority (PEZA), a government corporation attached to the Department of Trade and Industry and established through the legislative enactment of RA 7916, to formulate and implement the policies, rules, regulations and standards governing economic zones.

Out of the total firms surveyed, around 72 are in SEZs, and majority are large firms. By sector breakdown, most or 70% of the firms are in the electronics industry; the remaining are in the garments (28%) and food and food processing (3%) industries. About 88% are located in CALABARZON, while the rest are in Cebu.

Locating in SEZs can offer firms important advantages, from better infrastructure facilities to less regulatory constraints. Still, one serious setback is that some transactions of SEZ firms with the Government are marred by corruption, considered as a major or severe obstacle by around 40% of the firms in SEZs. Firm managers in SEZs are reported to spend about 17% of their time dealing with the Government, compared with only 9% for those in non-SEZs. However, such longer government

Box 2. What makes Special Economic Zones special?

Apart from their strategic locations and the incentives received, special economic zones (SEZs) generally have adequate infrastructure facilities such as transportation, telecommunications, electric power supply, and water supply. The survey findings confirm that SEZ firms have more efficient infrastructure facilities than those in areas outside SEZs. For start-up firms, waiting time for electricity connections is less burdensome among SEZ firms at only 5 days, compared with about 10 days for non-SEZ firms. Water supply problems do not appear to be as serious for SEZ firms, with only 29% of SEZ firms having their own wells, compared with 38% among non-SEZ firms. This indicates that public water supply is more adequate in SEZ areas.

Even in terms of financing, SEZ firms have advantages over firms outside. About 36% of SEZ firms have overdraft facility or credit line, compared with only 28% of non-SEZ firms. Moreover, the collateral is only 30% of the loan value for SEZs while for non-SEZ firms, this is about 44%. SEZ firms also face lower borrowing costs, averaging at 7%, as against the 11% for non-SEZ firms. Transactions in SEZs are likewise facilitated by faster clearing periods for check and foreign or domestic currency wire.

Regulatory licenses and permits such as those for construction, operations, and imports are issued to firms in SEZs by the Philippine Economic Zone Authority (PEZA) and in the process, SEZ firms wait for only 7 days to get construction permits, nearly one third the duration of delays experienced by non-SEZ firms; and only 9 days for operating licenses as compared with 14 days for non-SEZ firms.

SEZs are treated as a separate customs authority directly managed by PEZA. They benefit from simplified export and import procedures, evident through fairly quick clearing periods for imports and exports. The number of days to clear imports at SEZs averages at 5 days, less than one half that for non-SEZ firms. The release of export goods in SEZs is 6 days, while that for non-SEZ firms is 8 days.

transactions among SEZ firms may be necessary in seeking clarifications regarding the use of government incentives. Nonetheless, firms in SEZs report making informal payments or bribes amounting to 5% of the contract value, or 4% of annual sales. The corresponding percentage for non-SEZ firms is only about 1–2% of contract value or annual sales. This somewhat indicates that the gains from operating in economic zones are significant for firms to be more willing to offer bribes. While no informal payments are asked from SEZ firms in obtaining telephone and electrical connections, there are some cases of irregular payments in obtaining operating licenses or import permits.

While firms in SEZs appear to have a better investment climate than those outside, it is critical to put in place more implementing measures to improve the investment climate in SEZs to lure more investments. Note that when firms were asked to rate certain investment climate indicators from "no obstacle" to "very severe obstacle," more SEZ firms than non-SEZ firms felt constrained by telecommunications, electricity, and transport issues. Moreover, over 40% of firms in SEZs are still hampered by customs and trade regulations, as well as labor regulations. However, in terms of tax rates, SEZ firms are better off than firms outside.

On the whole, what do SEZs signify? Simply, that if the overall investment climate could be improved to a level as exemplified by the special economic zones, the labor productivity of firms could double. And while part of such productivity increase is attributable to certain characteristics of firms that typically locate in SEZs, an appreciable extent is due purely to the superior investment climate. Of course, this does not necessarily imply that SEZs should be set up all over the country. It simply means that SEZs can be regarded as a model in terms of the quality of infrastructure, simpler regulatory system, and availability of skilled labor and finance. Putting it differently, if the country's investment climate is significantly improved, SEZs may be superfluous and the economy's performance would be much better.

What are the factors of investment climate that significantly affect the productivity of firms?

To help pinpoint where special attention should be given in corrective measures and reforms, the study probed deeper into the survey results to determine what factors relating to the investment climate affect the productivity of firms, and how. Through regression analysis carried out for each of the investment climate indicator (e.g., corruption, finance, labor, etc.), the study examined the impact on firm performance measures such as sales growth, employment growth, labor productivity, and total factor productivity.

The results of the regression analysis show that gift-giving or informal payment (bribery) is associated with slower growth in sales (approximately 7% lower). A 10% increase in gifts (as share of sales) is associated with 3% lower labor productivity. An increase in management time spent dealing with regulatory issues is associated with a decline in sales growth. There might be an issue, however, on the direction of causality between management time and sales growth. Management, it is said, may find it necessary to spend more time with government regulators when sales growth is slower.

Meanwhile, an increase in the number of days lost due to infrastructure bottlenecks (i.e., electricity, water, transport, and telephone) has a negative impact on employment growth. Water especially comes out as a salient factor, with supply inadequacy associated with lower employment growth and total factor productivity. More frequent power outages also reduce employment growth.

A larger than optimal workforce or overmanning due to labor regulations is associated with lower employment growth and labor productivity. Similarly, a higher share of temporary workers (signifying flexibility in hiring and firing) is linked to 18% higher total factor productivity. Moreover, firms with some skills development programs tend to be appreciably more productive.

Firms with easier access to credit (through overdraft facility or credit line) appear to have 77% higher labor productivity than those without such access. Firms having a higher finance index, measured in terms of access to banks for working capital and new investments, tend to have 19% higher labor productivity. Further, having an external auditor is associated with better labor productivity because it is assumed that the presence of an outside auditor to make an objective review of a firm's financial records promotes greater transparency of firm operations.

The regression results also show that firms which are internationally integrated (either as exporters or importers) tend to have higher labor productivity and total factor productivity than those which are not. Exporters tend to be twice more labor productive than domestic market-oriented firms. Establishments in the upper half of the productivity distribution [as measured

by either labor productivity or total factor productivity (TFP)] tend to be exporters and/ or importers. For example, 58% of importing firms versus 46% of non-importing firms are in the upper half of the total factor productivity distribution; the corresponding percentages for exporters and non-exporters are 55% and 49%, respectively. This result implies that trade represents an important channel through which firms can improve their productivity, with imports allowing the rise of productivity by adopting new technologies embodied in imported machinery and inputs and via the discipline of import competition on domestic firms. Learning by exporting is also possible as foreign buyers transmit important information on production technology and best practices.

Can the Philippines catch up? And how?

At no time in the country's post-World War II history is the public's desire so strong to see a complete turnaround of fortune take place, as it is at present. For the general public perception—which coincides with the key findings of this study—is that (i) the Philippines has weak macroeconomic fundamentals that impede investment and productivity growth; (ii) the existing infrastructure is a serious constraint to doing business, especially the transportation and power sectors; (iii) corruption is the most serious concern of establishments; (iv) business procedures and regulations need to be streamlined; and (v) small enterprises tend to suffer more from these shortcomings than do medium-size and large firms. And if these are not properly and quickly addressed by the Government and other concerned parties, the country's rebound may prove to be very difficult, if not impossible, to achieve.

So what has been done? And what more needs to be done?

Various measures have already been initiated by the current and previous government administrations to address the issues identified. For example, the Government is implementing lifestyle checks on government officials to curb corruption. Local governments are encouraged to reduce and standardize business requirements and application procedures, set a more reasonable cap on fees and set a deadline for the release of licenses and permits. In this regard, the Barangay Micro Business Enterprises Act was passed in November 2002 granting income tax exemptions, special credit facilities from government financial institutions, exemptions from minimum wage law, and reductions in local business taxes.

The Government is also currently carrying out dialogues with the academe and industry to set up research and development initiatives with the objective of promoting industry competitiveness. To improve the dissemination of credit information, efforts have been undertaken toward establishing an effective credit information bureau. The government financial institutions also provide credit facilities to small and medium establishments through the Small and Medium Enterprise (SME) Unified Lending Opportunities for National Growth (SULONG).

While most of the interventions are from the government side, cooperation from the private sector is indispensable. Addressing corruption requires the public sector to exercise greater transparency in its rules and procedures, but the private sector, for its part, must also refrain from resorting to irregular payments in transactions with government officials. A mechanism for institutionalizing consultations between the Government and the private sector is, therefore, necessary to clearly spell out the actions required on both sides to improve the country's investment climate.

In line with this, the Department of Trade and Industry Secretary is undertaking consultations on a quarterly basis with the heads of the different chambers of commerce

and industry associations to look into their issues and concerns. A technical working group, composed of concerned government agencies, is tasked to address the issues raised during the meetings. If the issues remain unresolved, these are elevated to the undersecretaries and secretaries for resolution. Among the issues discussed in the meetings and which have been, or are currently being, addressed include taxation and tariff, security, environment, government procedures, infrastructure, and labor.

Macro fundamentals

Macroeconomic instability ranks first among the major constraints enumerated by the firms in the survey. Clearly, when compared with the macro fundamentals of neighboring countries, this is considered as very critical. And with the chronic fiscal deficit problem, the country's credit rating has deteriorated significantly, posing alarming concerns on necessary expenditures foregone as a result. Political instabilities and global terrorism also contribute to a worsening investment climate. Timely remedial measures should therefore be undertaken.

The Government is exploring possible approaches to contain the fiscal deficit, including new taxes, substantial reduction of the priority development assistance fund for congressmen and senators, and implementation of austerity measures in government offices. Alternative measures such as outsourcing and privatization of some bureaucratic services can be taken to streamline government operations. Some government-owned or controlled corporations (GOCCs) such as the Food Terminal Incorporated, Center for International Trade Expositions and Missions, and Philippine International Trading Corporation, could be privatized. Ditto with the commercial functions of GOCCs such as the National Food Authority and the Philippine Ports Authority. The Government should also refrain from absorbing debts and losses of GOCCs and compel these corporations to guard their financial positions.

Infrastructure

A majority of firms surveyed consider public infrastructure and services in the Philippines as inadequate to highly inadequate. Of the infrastructure services, electricity ranks as the most serious concern among business establishments. Given that the medium to long-term prognosis for power sufficiency is not good, especially in certain regions like the Visayas, investment in power generation and distribution merits utmost urgency.

To improve the performance of the power sector, RA 9136 or the Electric Power Industry Reform Act (EPIRA) was passed in 2001 to deregulate this sector and attract private sector investments. Although the implementation of EPIRA is behind schedule, some structural reforms have already been established, and the current administration has declared its commitment to pursue the reforms. Technical advisory services could be provided to the Energy Regulatory Commission—the independent quasi-judicial regulatory body created under RA 9136 to set tariffs in the noncompetitive transmission and distribution subsectors, and regulations on the participants in the industry—so that it can build its resources and capacities to pursue and implement the power sector reforms.

Roads and maritime transport also require significant improvements. Costly cargo-handling and inadequate port services are among the complaints of firms. Even casual observation suggests that transport infrastructure in the Philippines has lagged considerably behind those in Indonesia, Malaysia, and Thailand. Public-private joint investments (through build-operate-transfer or other cost-effective arrangements) in transport infrastructure need to be revitalized.

Telecommunications is one relatively bright aspect of infrastructure services. The liberalization of this sector in the early 1990s resulted in expansion and improvement of telecommunications, such that current services are comparable to those in the PRC and Thailand, though lagging behind Malaysia's. This outcome should provide insight to the Government on how to improve the power and transport sectors.

Governance and Institutions

There are specific areas under this component that call for immediate and drastic reforms as outlined below.

Easing Regulatory Burden. The regulatory system is cumbersome, costly to doing business, and acts as a strong deterrent to investment and productivity growth. Customs and trade regulations are especially burdensome to firms.

Excessive regulation typically results in corruption which is considered by close to half of the firms as a moderate to severe burden. Larger firms have to contend more with corruption than do smaller ones; so do exporters and foreign firms, compared with non-exporters and domestic enterprises. However, smaller firms appear to incur bigger losses (relative to sales) than larger companies from having to offer irregular payments or gifts.

Mandated minimum wages are also regarded as a major constraint to business, especially for the food and food processing and garments industries. Overall, labor regulations affect a higher proportion of firms in the Philippines than in Bangladesh, the PRC, and Pakistan, though comparable to Indonesia.

Clearly, there is a need to simplify and streamline the regulatory system to significantly reduce its burden on the conduct of business. Models of more efficient regulatory systems from the more advanced countries should not be too difficult to adopt. Simpler and more transparent regulations also reduce corruption.

Facilitating Finance. While access to finance does not appear to be a salient concern, cost of financing seems to be a major or severe obstacle, particularly for textile firms. The upshot is that over half of working capital is typically sourced from internally generated funds, compared with just under 10% from commercial banks and a slightly higher fraction from trade credit. Small firms especially find it hard to borrow from commercial banks and, hence, have to resort to family, friends, and informal sources of finance apart from internal funds. Nevertheless, on the whole, access to and cost of finance appears to be a lesser constraint in the Philippines than in Bangladesh, Indonesia, and Pakistan.

The lack of reliable credit information hampers smooth credit provisioning, especially to the SME sector, thereby increasing intermediation cost. Ongoing efforts to improve credit information should be sustained toward establishing an effective credit information bureau. At present, there are two credit bureaus in the country, but their effectiveness as credit reporting agencies is fairly limited because they mainly cater to the needs of commercial banks. They also keep only a negative list of borrowers and exclude nonbank credit institutions. There is also a perceived unwillingness among banks to share information.

The Bangko Sentral ng Pilipinas' (Central Bank) proposal to pass a law that would lead to a creation of effective credit information bureau system—wherein credit institutions share negative and positive information about potential borrowers—needs to be given top priority in the reform agenda of the Government. Another issue related to SMEs' access to finance is their inadequate institutional and managerial capacities. Moreover, banks have imposed more stringent requirements as a reaction to increasing nonperforming loans (NPLs), thus further limiting credit access for SMEs.

The Government has attempted to address the high NPLs problem of banks by passing the Special Purpose Vehicle (SPV) Act in 2002. As of September 2004, the Securities and Exchange Commission has approved the registration of 36 SPVs. However, only a small proportion of the total outstanding nonperforming assets have so far been transferred from banks to SPVs. Considering that the incentives given to idle asset buyers will expire in April 2005, there is a need to amend the law to extend said deadline and possibly introduce additional improvements to hasten the transfer of banks' nonperforming assets to SPVs.

Credit must be eased to encourage businesses. Borrowing from commercial banks must be made more affordable. In addition, the capital market, especially the bond market, needs to be developed. This would also help raise the savings rate in the Philippines which is among the lowest in Southeast Asia.

Curbing corruption. A system of lifestyle checks is being undertaken by the current administration on high-ranking government officials to curb corruption. However, corruption is already perceived to be systemic and widespread across all levels of the bureaucracy and, therefore, a system of lifestyle checks alone would not be adequate to combat this problem.

Simpler and more transparent regulations should be implemented. Streamlining the regulatory system will also significantly reduce its burden on the conduct of business. Since corruption associated with obtaining an import license appears to be the most serious concern of the establishments, the Government should focus on how this business procedure and regulation could be streamlined and be made more transparent. Moreover, to abate the perception that tax rates and tax administration are also major constraints, stricter implementation of the penalty system for noncompliant taxpayers and tax collectors accepting bribes should be observed.

The Government should intensify initiatives such as conducting tax compliance verification drives, auditing exempt entities, and conducting special operations on high-profile tax evaders at the Bureau of Internal Revenue. At the Bureau of Customs, an Import Classification Monitoring and Review Board (ICMRB) has been formed to serve as parallel window that could receive inputs from the private sector about anomalous transactions. However, a more proactive strategy is needed to rid the Bureau of Customs of corrupt officials.

Since the survey reveals that 95% of the time for inspections and meetings related to regulations are held with local officials, possible intervention could be focused on the local government units (LGUs). A pilot LGU could be identified and provided advice in planning and implementing a set of reforms that will curb corruption. This could involve the following: (i) simplifying and streamlining business procedures and issuance of licenses and permits; (ii) transparency in implementing business procedures; (iii) planning and monitoring infrastructure development; (iv) imposing simpler taxes and stricter tax collection strategies; and (v) holding regular dialogue with the private sector. If the interventions in this pilot LGU prove to be successful, then the implementation of these practices in other LGUs could be promoted.

Finally, given that corruption has long been an outstanding issue, the critical missing factor to effectively come to grips with it is firm political will and commitment to implement the required policies and civil service reform.