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MAKING GROWTH WORK FOR THE POOR

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PREFACE

The *Philippine Economic Update* (PEU) provides an update on key economic and social developments, as well as policies over the past 3 to 6 months. It also presents findings from recent World Bank studies on the Philippines. It places them in a longer term and global context, and assesses the implications of these developments and policies on the outlook for the Philippines. Its coverage ranges from the macroeconomy and financial markets to indicators of human welfare and development. It is intended for a wide audience, including policymakers, business leaders, financial market participants, and the community of analysts and professionals engaged in the Philippines.

The PEU is a report of the World Bank's Macroeconomics and Fiscal Management (MFM) Global Practice, with contributions from other global practices. It was prepared by Karl Kendrick Chua (Senior Country Economist and Task Team Leader [TTL]), Joseph Louie Limkin (Research Analyst and Co-TTL), Paul Mariano (Research Analyst), Christine Ablaza, Justin Chan, and Noel Del Castillo (Research Assistants), and Gabriel Roque and Miro Capili (Junior Research Assistants). In addition, Alan Townsend (Senior Energy Specialist) prepared the special focus on power, while Roberto Galang (Operations Officer) and Beatrice Tanjangco (Research Assistant), together with Karl Kendrick Chua, prepared the special focus on congestion. The team worked under the guidance of Rogier van den Brink (Lead Economist and Program Leader) and Mathew Verghis (Practice Manager).

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The Manila Communications Team, comprising Leonora Gonzales (Senior Communications Officer), David Llorito (Communications Officer), Justine Letargo (Online Communications Officer), and Geralyn Rigor (Program Assistant), prepared the media release, dissemination, and multimedia products for the web.

The report benefited from the advice, comments, and views of various stakeholders in the World Bank, the government, business, labor, academe, and civil society. The team is very grateful for their time and inputs.

The findings, interpretations, and conclusions expressed in this *Update* are those of World Bank staff and do not necessarily reflect the views of its management, executive board, or the governments they represent.

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For information about the World Bank and its activities in the Philippines, please visit www.worldbank.org/ph.

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EXECUTIVE SUMMARY

In the third quarter of 2014 (Q3 2014), the Philippine economy expanded by 5.3 percent—its slowest pace in 11 quarters. Growth slowed down due to the contraction of government spending on the demand side and agricultural production on the supply side. The services sector—the main engine of growth—also slowed to its lowest level in 11 quarters. For Q3 2014 and for the first 3 quarters of 2014, Philippine growth is about average when compared to the major economies in the East Asia region. Capital outflows resulted in a full-year balance of payments deficit of about USD 3.4 billion, the first in a decade. However, the current account remains in strong surplus, supported by robust remittances, while international reserves continue to be at comfortable levels at more than 10 months of imports.

Inflation started to moderate, with positive impact on both households and businesses. Lower inflation in 2014 was driven by monetary tightening on the demand side and falling inflation of key commodities on the supply side. Food prices are still rising, but at a slower pace than before. The deceleration in food inflation was driven by stabilizing rice prices on account of stable supply following the importation of 1.8 million metric tons over the past year – the largest in 4 years. Rapidly declining oil prices by more than 40 percent between January to December 2014, due to weaker global demand, stable production of oil, and more competition from natural gas, also contributed to lower inflation. These have strongly benefited households and businesses as the Philippines is a major importer of oil.

Government spending contracted significantly in Q3 and constituted a further drag on growth. Government consumption shrank by 2.6 percent, while infrastructure spending fell by 6.2 percent. Contributing factors included budget execution bottlenecks, slow disbursement for Typhoon Yolanda reconstruction, and the “chilling” effect of the supreme court decision which found some provisions of the Disbursement Acceleration Program to be unconstitutional. As of October 2014, only PHP 52 billion out of the PHP 100 billion reconstruction budget for 2014 was released to various government agencies.

Lower government spending and delays in private investment are likely to limit economic growth to 6 percent in 2014 but growth can rebound to 6.5 percent in 2015. For 2014, the revised growth projection takes into account lower-than-expected government spending in Q3 and the limited opportunity to increase spending in Q4. For 2015, growth of around 6.5 percent is not out of reach if the government fully executes the 2015 budget and the recently approved Yolanda master plan. Moreover, strong remittances, falling oil prices, and upbeat consumer and business sentiments indicate stronger growth in 2015. Risks to 2015 growth include delays in public-private partnership (PPP) projects and a tepid global economy.

Sustaining government spending in the near-term will require significant improvements in budget planning and execution as the current 28-year old system, already at capacity, is hard pressed to support higher spending. To this end, the government is addressing spending and

procurement bottlenecks, while also drafting a new organic budget law, which would clarify, streamline, and harmonize the various pieces of legislation and executive orders.

In recent years, economic growth has become more inclusive as it is translating into stronger job creation and faster poverty reduction. In October, more than a million jobs were created since the same month last year, while unemployment rate fell to its lowest level in 10 years at 6 percent. The reduction in poverty incidence between 2012 and 2013 also indicates that growth is becoming more inclusive. Furthermore, the 2013 Annual Poverty Indicators Survey (APIS) suggests that the real income of the bottom 20 percent grew much faster than the rest of the population. The survey also confirms that the government's conditional cash transfer (CCT) program is well targeted and reaching the poor, as indicated in the substantial growth of domestic cash transfers to the bottom 20 percent. Moreover, underemployment among the poor significantly decreased in the same period.

Going forward, the Philippines needs to accelerate reforms that can translate higher growth into more inclusive growth—the type that creates more and better jobs—so that poverty can be reduced massively and prosperity shared by more people. Already, between 2012 and 2013, the growth elasticity of poverty—the rate at which economic growth reduces poverty—improved significantly to -2.02 from -0.24 between 2006 and 2012. If these trends are sustained, the government's target of reducing the incidence of poverty to 18-20 percent by 2016 is attainable. Over the long-term, if growth is sustained at 6 percent per year, per capita income can double within 1 decade, grow 5 times in 2 decades, and reach 11 times in 3 decades. If the growth elasticity of poverty remains high, this means that poverty can be eradicated within a single generation. However, this requires a more aggressive approach to addressing the stubbornly high overall rate of underemployment. For instance, the recent contraction in agricultural value-added and employment risks undermining the government's poverty reduction efforts because agriculture is where most of the poor find a livelihood.

Eradicating poverty and boosting shared prosperity requires implementing an already well-known policy agenda of structural reforms. The key reform areas are i) increasing investments in infrastructure, health, and education, ii) enhancing competition to level the playing field, iii) simplifying regulations to promote job creation, especially by micro and small enterprises, and iv) protecting property rights to encourage more investments. This policy agenda, which benefits from a wide consensus among local and international policy analysts, is discussed in detail in the 2013 Philippine development report "Creating more and better jobs."¹ This edition of the PEU elaborates on the first 2 recommendations.

¹ The Philippine development report (PDR) "Creating more and better jobs" is available at: <http://www.worldbank.org/en/country/philippines/publication/philippine-development-report-2013-creating-more-and-better-jobs>.

Over the medium to long-term, higher investments in infrastructure, health, and education, are key to achieving inclusive growth. The effects of lagging infrastructure investment and some policy recommendations are discussed in detail in the following special focus sections:

- **Congestion in Metro Manila and its impact on the economy:** In the last decade, Metro Manila experienced high and sustained economic growth, but infrastructure deficits have led to worsening road congestion. This costs the economy around 8 percent of GDP annually. To address the worsening congestion, the national government and various city governments have implemented ad hoc measures to limit the number of vehicles on the road, sometimes with inadvertent and occasionally severe consequences, as the Manila port congestion of 2014 demonstrated. However, the real solution lies in taking measures to create new and better road networks and mass transit systems.
- **Potential power sector shortages in Luzon and the way forward:** Luzon may suffer power shortages between April and May of 2015, brought about by aging generation plants, lack of reserve capacity, and the deficiency in alternative sources of power, such as natural gas. With good planning, conservation, and favorable weather, Luzon can avoid a catastrophic power crisis in 2015. However, the country still faces many issues around high power cost and supply constraints. In order to address these issues, the country needs to encourage more investments in a mix of energy sources to enhance energy security, and strengthen competition in the power retail sector to improve service and bring prices down, among other essential reforms.
- **Reviving Philippine electronics exports:** Between 1980 and 2008, Philippine electronics exports grew exponentially, becoming the key export product in the 2000s. However, since the 2008 global financial crisis, electronics exports have not fully recovered. Regaining the country's position as a leading exporter of electronics products require a concerted effort to i) improve power cost and reliability, ii) raise infrastructure and human capital investment, and iii) reduce non-tariff trade barriers.

Overall, the country has an investment gap (both physical and human capital) of around 6.8 percent of GDP as of 2014. Improvements in tax administration (i.e., efficiently collecting existing taxes) can generate about 3.8 percent of GDP in fiscal space over the medium-term to finance the investment gap. The balance of 3 percent needs to come from tax policy reforms. Tax administration reforms include simplifying tax procedures and processes to facilitate compliance, and lifting the excessively restrictive bank secrecy laws, which makes it very difficult to catch tax frauds. Globally, excluding offshore financial centers, only Switzerland and Lebanon have similar restrictive bank secrecy provisions but the former is committed to relaxing it soon.

A more equitable, efficient, and simpler tax system should be the aim of any tax policy reform. The following reforms can be considered. First, tax incentives should be rationalized by making them more targeted, transparent, performance-based, and temporary. This should

include the timely release of a tax expenditure statement, which enumerates all existing tax incentives and who benefits from them. Second, tax rates and valuations which have not kept up with inflation should be adjusted to improve the equity of the tax system. Examples are petroleum excise taxes and property valuations, which have not been updated for decades. Rapidly falling oil prices provide an opportunity to adjust petroleum excise taxes to make the tax system more equitable. This should be enacted with utmost urgency.

Only if new revenues are raised should reforms to reduce tax rates be considered. These could include i) lowering the top marginal income tax rate to 25 percent, ii) reducing the gap between regular and special corporate income tax rates, and iii) simplifying the tax regime for micro and small enterprises. Details of these reforms are also discussed in the August 2014 edition of the Philippine economic update² and the upcoming report “Tax policy for more inclusive growth.”

For tax policy reforms to be successful, reforms to improve the transparency and accountability of government spending and to strengthen tax administration are essential. These would allow the public to make a clear link between taxes and public services. A key reform is the passage of the Freedom of Information Bill. This would also institutionalize “open data,” which means making government data publicly available in user-friendly forms. In addition, enhancing budget reporting to allow the public and the government itself to track spending from appropriations to results on the ground is a key reform to institutionalize. In turn, this requires adopting an automated and government-wide financial management and information system.

Public sector reforms need to be complemented by economic reforms, in particular reforms to increase competition. While the country has a historical inclination towards protectionism, a number of successful reforms in the 1990s opened up key sectors of the economy to more competition, in spite of staunch opposition. These reforms, notably in telecoms and air transport, helped sustain growth in the succeeding decade and subsequently generated millions of jobs.

Drawing from this experience, the country needs to push for more competition to level the playing field between firms of all sizes and origins. This will raise productivity and create more jobs. Essential reforms include i) continuing to liberalize key sectors of the economy that directly impact poor Filipinos, ii) further opening up the economy to more foreign competition, iii) strengthening regulatory capacity, and iv) crafting and implementing a clear competition policy. These are discussed in the medium-term reform section. Two sectors recommended for liberalization, rice and domestic shipping, have significant impacts on the poor and are discussed in the last 2 special focus sections:

² The August 2014 edition of the Philippine economic update (PEU) is available at: <http://www.worldbank.org/en/country/philippines/publication/philippines-accelerating-public-investment-to-sustain-growth-that-benefits-the-poor>

- **Liberalizing rice policy in the Philippines:** The country's agricultural sector has been underperforming for over 30 years, characterized by low growth and productivity, and high food prices. Policies that keep prices of food items, particularly rice, artificially high have hurt the poor (including most farmers), increased child malnutrition, and distorted the market, slowing down agricultural diversification into higher value crops. High food prices also put upward pressure on real wages and other inputs, thereby lowering the competitiveness of manufacturing. The Aquino Administration has begun to address some of the problems in the rice sector, such as opening up the importation of rice to the private sector and allowing more rice to be imported, but more reforms to liberalize rice policy are needed to achieve more inclusive growth. These include replacing the current quantitative import restrictions with an import tariff and in the process eliminate the opportunity for rent-seeking. Complementary reforms to increase investment in public goods, such as farm-to-market roads, irrigation, and storage, are also needed.
- **Enhancing competition in the domestic shipping industry:** Being an archipelago, the Philippines requires an efficient water transport system. However, the domestic maritime industry is characterized by high costs, low quality of service, and a poor safety record. In the last 2 decades, several reforms were enacted to promote more competition. The reforms appear to have been effective in fostering more competition in the market, but it still limits the entry of new players into the market. The government is working on these remaining entry constraints, as well as removing constraints on dry docking, repair, and chartering to help bring down shipping costs. However, domestic shipping reforms only address part of the weaknesses of the maritime sector. Complementary reforms to open the market to foreign competition by liberalizing cabotage and improve port efficiency and transport networks are also needed.

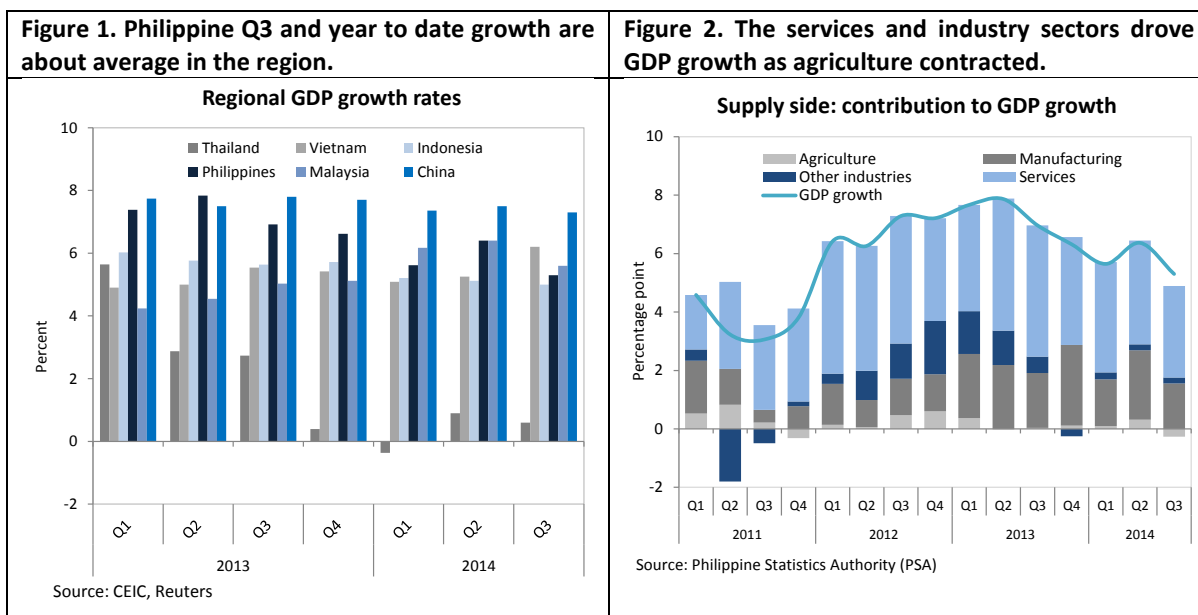
RECENT ECONOMIC AND POLICY DEVELOPMENTS

Output and demand

- 1. In the third quarter of 2014 (Q3 2014), the Philippine economy expanded by 5.3 percent—its slowest pace in 11 quarters.** Growth slowed down due to the contraction of government spending on the demand side and agricultural production on the supply side. The services sector—the main engine of growth—also slowed to its lowest level in 11 quarters. For Q3 and for the first 3 quarters of 2014, Philippine growth is about average when compared to other countries in the region (Figure 1).
- 2. On the production side, industry grew the fastest but services continued to be the main driver of growth given its sheer size** (Figure 2). The industry sector grew by 7.6 percent and contributed 2.4 percentage points (ppt) to GDP growth. Manufacturing grew by 7.2 percent, significantly lower than its 12.1 percent growth in the first half (H1), as shipments of raw materials were delayed by road and port congestion (see Special Focus 1). Food manufacturing continued to drive overall manufacturing growth, followed by beverage, petroleum, and electronics manufacturing. The services sector grew slower than industry at 5.4 percent but accounted for 3.1 ppt of overall growth, given its large share of the economy. All services subsectors, except for government services, expanded. High domestic liquidity and strong demand for office and residential spaces sustained the growth of the finance and real estate subsectors, at 7.7 and 6.2 percent, respectively. Meanwhile, agriculture contracted by 2.7 percent as rice production fell by 10 percent and corn by 5.8 percent. The agriculture sector's low productivity, the result of decades of underinvestment and policy distortions, was exacerbated in Q3 by a series of extreme weather conditions.³ Among these were Typhoon Glenda, Luis, and Mario which hit major agricultural production areas in July and September, and strong monsoon rains.
- 3. On the demand side, GDP growth was driven by private consumption, private investment, and net exports, but was pulled down by anemic government consumption and infrastructure spending** (Figure 3). Despite the impact of Typhoon Yolanda on household income, private consumption grew by a respectable 5.2 percent, suggesting that many households are recovering. Sustained growth of remittances, at 6.6 percent in Q3, continued to support private consumption. Net exports in Q3 turned positive compared to a year ago, contributing 2.1 ppt to overall growth. This is the result of stronger export growth amid artificially low import growth due to port congestion.
- 4. Growth of fixed capital formation was driven by the private sector and supported by a significant increase in foreign direct investments (FDI).** Both durable equipment and private

³ The country's main crops, such as rice, corn, and sugar, are mainly harvested between August and November, coinciding with the typhoon season.

construction growth accelerated. The strong growth of manufacturing equipment suggests a near-term expansion of the manufacturing sector. After a lull spanning 3 quarters, private construction recovered strongly in Q2 and further accelerated in Q3. This implies that the real estate sector may have yet to reach its peak.⁴ Higher growth of private investment was supported by stronger FDI inflows, which reached USD 4.9 billion in the first 9 months of 2014, the highest in the country’s history. This is largely attributed to the Aquino Administration’s “good governance is good economics” platform. In fact, average annual FDI under the current Aquino Administration is the highest since 1986 (Figure 4). However, Philippine FDI inflows still lag behind that of its Asian neighbors.⁵

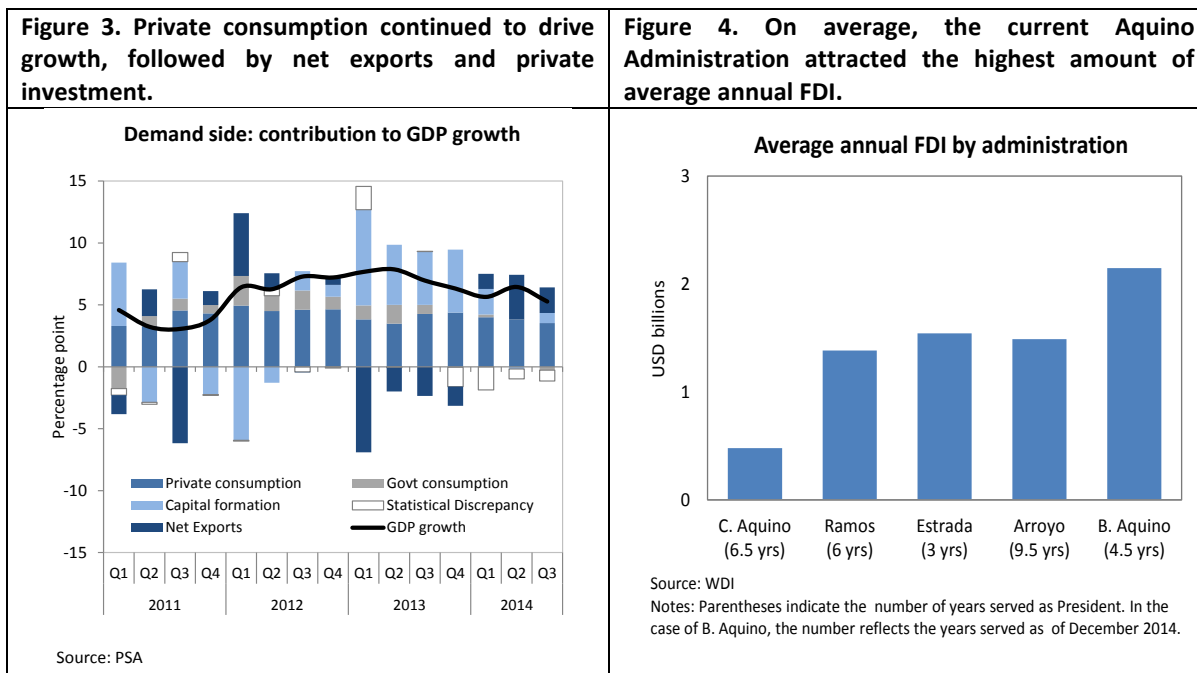


5. **Government spending contracted significantly in Q3, driven in part by the “chilling” effect of the supreme court decision, which found some provisions of the Disbursement Acceleration Program (DAP) unconstitutional.** Government consumption, which grew by only 0.9 percent in H1, contracted by 2.6 percent in Q3. Apart from the court decision, contributing factors to weak government spending include budget execution bottlenecks (e.g., procurement delays), and slow disbursement for Typhoon Yolanda reconstruction. These led to a contraction in infrastructure spending by 6.2 percent. As of October 2014, only PHP 52 billion out of the PHP 100 billion reconstruction budget for 2014 was released to various government agencies.

⁴ The August 2014 edition of the Philippine economic update (PEU) reported that the real estate boom may be around its peak. This was based on the observation that private construction had been decelerating for 5 quarters, from growth of over 40 percent in Q4 2012 to less than 2 percent in Q3 2013 before entering negative territory by Q4 2013. Moreover, the number of building permits issued declined in 3 out of the past 5 quarters. However, the acceleration of private construction in Q2 and Q3 seems to suggest that the earlier contraction was only temporary.

⁵ From January to September 2014, according to their respective local media, Indonesia attracted USD 18 billion, Vietnam USD 11 billion, and Thailand USD 11 billion in foreign direct investment (FDI).

Actual spending could accelerate, however, given recent approval of the Yolanda master plan and the 2015 budget.



Employment and poverty

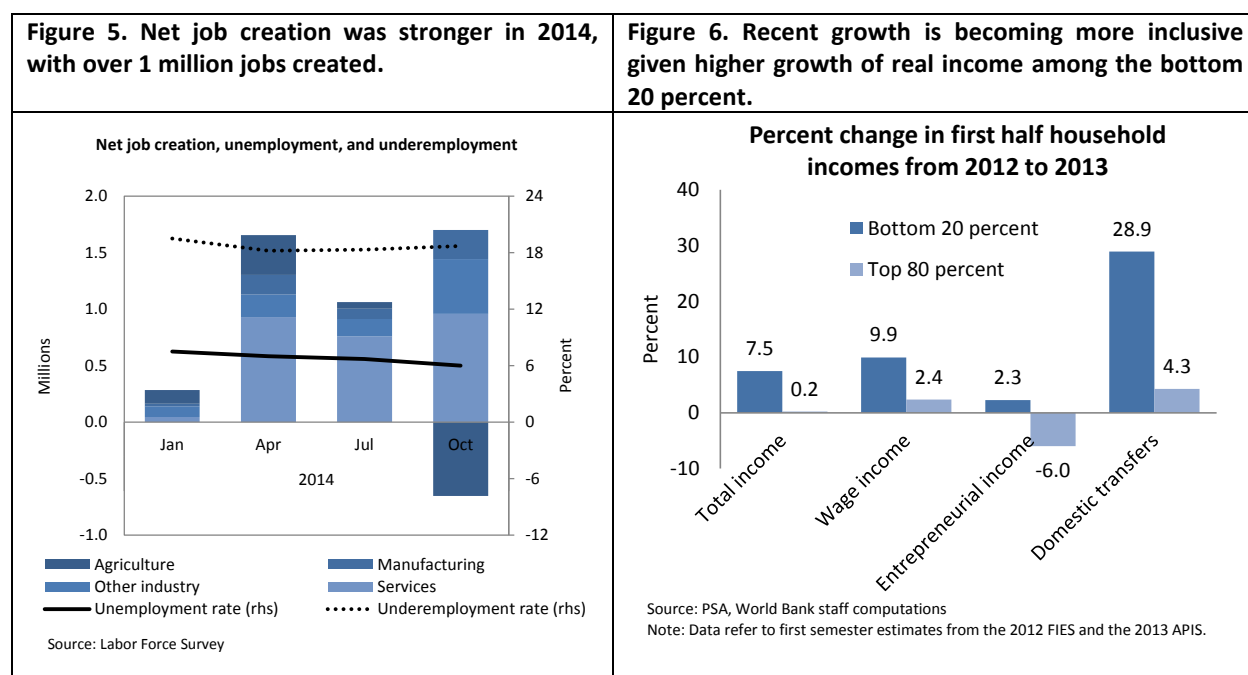
6. **Sustained high economic growth in recent years has begun to translate into stronger job creation.** The latest round of the Labor Force Survey (LFS) in October 2014⁶ reported that net job creation reached over 1 million compared to the same month in the previous year. Furthermore, unemployment fell to 6 percent, the lowest in 10 years, from 6.4 percent a year ago (Figure 5). The bulk of job creation was in the services sector with 958,000 jobs, although most of these jobs are in the informal sector. Meanwhile, 742,000 jobs were created in the industry sector, with manufacturing accounting for 258,000 of the total. However, agriculture shed 654,000 jobs, corresponding with the contraction in agriculture recorded in roughly the same period.⁷ Moreover, the quality of employment remains a challenge as the rate of underemployment increased from 18.0 to 18.7 percent.

7. **The reduction in poverty incidence between the first half of 2012 and 2013 also indicates that growth is becoming more inclusive, although more recent data suggest risks to**

⁶ Results of the October 2014 Labor Force Survey (LFS) are not fully comparable to the same period last year since the Province of Leyte in Region VIII, which was devastated by Typhoon Yolanda, was not included in the October 2014 round. To make the 2 periods comparable, Leyte was also excluded in the October 2013 data.

⁷ The contraction in agricultural employment may have been partially offset by the increase in employment in agribusiness, which is captured in the manufacturing sector.

poverty reduction.⁸ The 2013 Annual Poverty Indicators Survey (APIS) suggests that real income of the bottom 20 percent grew faster than the rest of the population (Figure 6). This is true for both wage and entrepreneurial income. For instance, real wage income of the bottom 20 percent grew by 9.9 percent compared to only 2.4 percent for the upper 80 percent. Much higher growth of domestic cash transfers⁹ of the bottom 20 percent, at 29 percent, suggests that the government’s conditional cash transfer (CCT) program is well targeted and reaching the poor. Faster growth of real income of poorer households is corroborated by significant improvement in underemployment¹⁰ among the poor. For instance, in the third income decile, underemployment fell from 32 to 26 percent, the highest among all income deciles. However, the stubbornly high rate of overall underemployment, and the recent contraction in agricultural value-added and employment, where most of the poor find their livelihood, may risk undermining the government’s poverty reduction efforts.



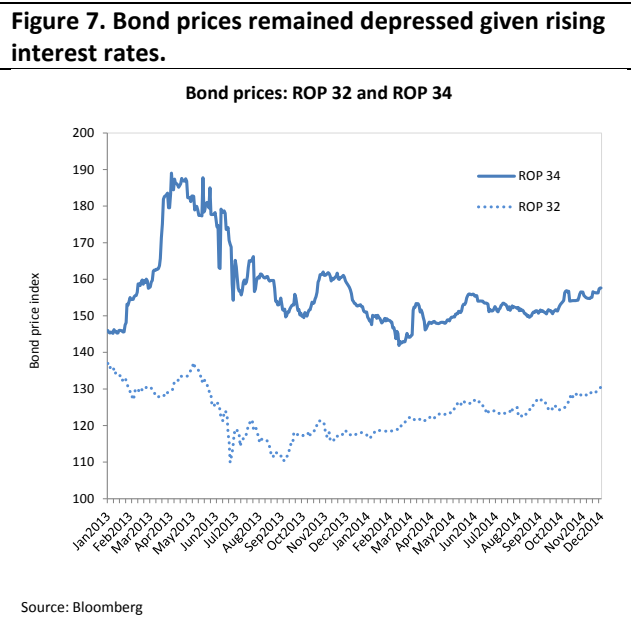
⁸ In 2013, the government announced a policy to release poverty estimates annually. The source data of the 2013 poverty incidence is the Annual Poverty Indicators Survey (APIS), while the source data of the 2012 poverty incidence is the Family Income and Expenditure Survey (FIES). Both surveys share the same income module. The FIES is conducted every 3 years, while the APIS is conducted in between FIES years. However, there are some limitations when comparing results from the 2 surveys. First, poverty incidence is only available for the first semester of the year and is therefore not comparable to the earlier series. Second, the sample size of the APIS is only a fourth of the sample size of the FIES. This means that poverty incidence is only available at the national level. Third, differences in the position of the income modules in the survey questionnaires could be a source of non-sampling error. At the national level, however, the error is manageable.

⁹ According to the APIS-FIES methodology, domestic cash transfers refer to transfers from the government or the private sector. They include cash transfers from the CCT program. It excludes remittances, which is a separate category.

¹⁰ An underemployed worker is one who wishes to work more hours, but is unable to find additional work.

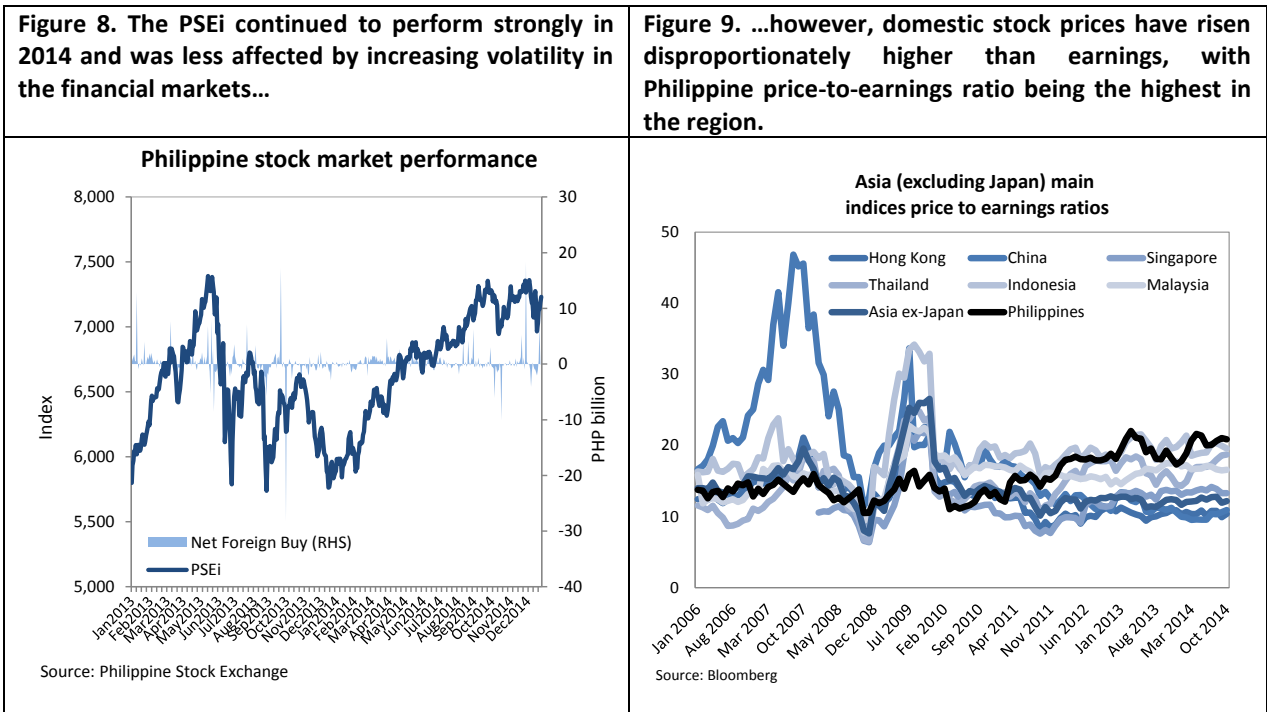
Financial markets

8. **Foreign portfolio investment (FPI) yielded net inflows in November, but it was not enough to counter the year to date net capital outflows, a result of increased financial volatility.** Coming from a net outflow of more than USD 2 billion in the first 3 months of 2014, FPI inflows registered with the central bank reached USD 1.7 billion between April and August, and USD 370 million in November. However, in September and October, outflows amounting to USD 500 million were recorded. In this period, FPI outflows to the US accounted for the majority of the total, coinciding with the stronger-than-expected recovery of the US economy and the end of its quantitative easing program. FPI outflows, together with outflows in other capital accounts, resulted in a full-year balance of payments deficit of USD 3.4 billion, the first in a decade. Notwithstanding financial market volatilities, the economy, in particular the financial sector, remains solid and was recently recognized with another credit rating upgrade by Moody's to 2 notches above investment grade.



9. **The stock market was less affected by increased volatility, given the preference to hold equities rather than fixed-income instruments as interest rates rise.** Bond prices have remained depressed given rising interest rates (Figure 7). Meanwhile, in end-2014, the Philippine Stock Exchange index (PSEi) reached 7,230, or 23 percent higher compared to end-2013 (Figure 8). However, elevated stock prices are not fully supported by earnings data. Philippine price-to-earnings (PE) ratio, already among the highest in the region since 2012, rose further to become the highest in the region in 2014 (Figure 9). This may suggest the formation of an asset bubble. Similarly, there are concerns about a property bubble, as capital prices continue to rise faster than rental prices in some segments of the residential sector. Moreover,

lending to the real estate sector further increased by 16 percent in November, not including shadow lending.¹¹ In response to growing concerns about asset bubbles, the central bank announced that it will soon release a real estate price index that will monitor prices starting from 2008.



Prices and monetary policy

10. **CPI and core inflation have begun to moderate starting September.** From a peak of 4.9 percent in August, CPI inflation continued its decline to 2.7 percent in December, bringing full year inflation to 4.1 percent (Figure 10). A number of factors explain this decline. On the supply side, lower inflation was largely driven by the deceleration of food inflation to 5.8 percent from a peak of almost 9 percent. The deceleration in food inflation was driven by stabilizing rice prices on account of stable supply following the importation of 1.8 million metric tons over the past year – the largest in 4 years. Rapidly declining oil prices due to weaker global demand, stable production of oil, and more competition from natural gas, also contributed to lower inflation. Core inflation, which excludes certain food and energy items to better capture underlying price volatilities, also decelerated to 2.3 percent in December from its peak of 3.4 percent in September, bringing full year core inflation to 3 percent.

¹¹ See the March 2014 edition of the PEU for more discussion. This is available at: <http://www.worldbank.org/en/country/philippines/publication/philippine-economic-update-2014-pursuing-economic-growth-through-sustainable-reconstruction-and-job-generation>

11. **Aside from falling commodity prices, lower inflation is also the result of several demand-side policy adjustments.** Earlier in the year, with inflation approaching the upper bound of the central bank’s 3 to 5 percent inflation target for 2014, the monetary board tightened monetary policy. In July, policy rates were increased by 25 bps and were hiked by another 25 bps in September, bringing overnight borrowing and lending rates to 4 and 6 percent, respectively. The interest rate on special deposit accounts (SDA) was also increased in September by 25 basis points to 2.5 percent. As a result, money supply (M3) growth continued to ease through November, growing by 9 percent from above 30 percent for 10 consecutive months earlier in the year (Figure 11).

Figure 10. Inflation decelerated to 2.7 percent in December due to slower increases in food prices and rapidly falling oil prices, bringing full year inflation to 4.1 percent.

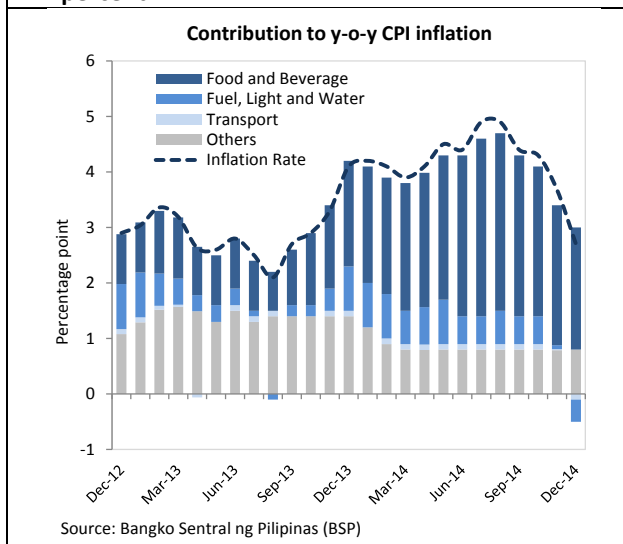
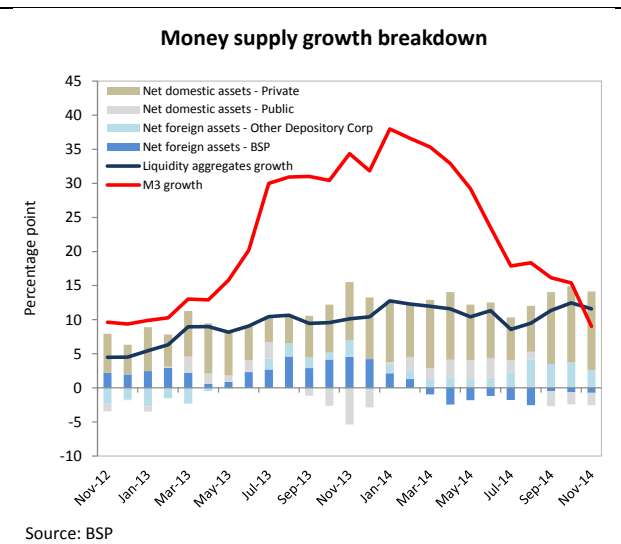


Figure 11. Money supply growth continued to decelerate, as the central bank undertook measures to curb liquidity growth.



Fiscal policy

12. **The contraction in government spending has had a negative impact on near-term growth.** In July 2014, the supreme court ruled that certain provisions of the DAP were unconstitutional. This resulted in the freezing of a number of projects funded by the DAP. It also partly removed the executive’s discretion to use savings for other projects, which had supported growth in the last 2 years. This, together with budget execution bottlenecks (e.g., procurement delays) and slow disbursement for Typhoon Yolanda reconstruction, led to the contraction of government spending in Q3. As discussed earlier, government consumption contracted by 2.6 percent while infrastructure spending fell by 6.2 percent. To quickly resume critical projects affected by the DAP ruling and to fast-track Typhoon Yolanda reconstruction, congress passed in December 2014 a PHP 22.5 billion (0.2 percent of GDP) supplemental budget on top of the approved 2015 budget.

13. **Tax effort continued to improve due to higher economic growth and improved tax administration.** In Q1 to Q3 2014, tax revenues reached 14.1 percent of GDP from 13.7 percent of GDP in the same period last year. Revenues from both the Bureau of Internal Revenue (BIR) and the Bureau of Customs (BOC) increased by around 16 percent in the first three quarters of 2014, despite port congestion, which drastically reduced imports in Q2. Absent new tax policy measures, the increase in revenues is attributed to both economic growth and better revenue administration. To improve tax audits and adhere to international agreements, the Department of Finance (DOF) is seeking to ease the restrictions on bank secrecy (Box 1). This can potentially raise tax effort by around 2 percent of GDP as personal income taxes from self-employed and professionals exhibit the largest tax gap (i.e., the difference between potential and actual revenues). DOF has also tied up with the Securities and Exchange Commission to share corporate financial data to improve tax audits. On the other hand, the BOC is pushing for the passage of the Customs Modernization and Tariff Act. Speedy passage of the bill, which is currently awaiting its third and final reading, would allow the BOC to further improve its collection efficiency, reduce smuggling, and lower non-tariff barriers. These, in turn, can help the country improve competitiveness and promote a more level playing field between importers and domestic producers.

14. **Higher tax revenues and weak spending resulted in an unwelcome budget surplus in Q3.** As a result, national government fiscal deficit for the first 9 months fell to just 0.3 percent of GDP, way below the full-year target of 2 percent of GDP. In October and November combined, a slight budget surplus was recorded, further narrowing the fiscal deficit. This lower deficit points to an improving debt profile. However, it also indicates missed opportunities to use the growing fiscal space brought about by stronger revenue collection to make growth more inclusive.

Box 1. Bank secrecy in the Philippines

The Philippines has very strict laws on bank secrecy. Republic Act 1405 or the Bank Secrecy Law, enacted in 1955, declares that all bank deposits and investments in government bonds are confidential subject to very limited exceptions. The law prohibits banks and other financial institutions from disclosing client information to external parties, including government authorities, except for the following cases: i) upon written permission or consent in writing by the depositor, ii) in cases of impeachment of government officials, iii) upon order of a competent court in cases of bribery or dereliction of duty of public officials, or iv) where the money deposited or invested is the subject matter of litigation (e.g., deposits of a deceased person to determine estate taxes). Globally, excluding offshore financial centers, only the Philippines, Switzerland, and Lebanon have very restrictive bank secrecy provisions. Switzerland, however, is committed to relaxing its law on bank secrecy.

The Department of Finance (DOF) has urged Congress to enact a law to ease the restrictions on bank secrecy.¹² While DOF is not seeking to have the law repealed, it has asked legislators to provide clear-cut conditions under which bank secrecy can be lifted. If enacted, the law would put the country in line with international standards, where financial information can be provided to the authorities for fiscal purposes.

Aside from improving compliance with international standards, easing the bank secrecy law can also enhance the government's revenue-generating capacity. At present, the BIR has little or no basis to audit taxes collected on interest income earned from bank deposits and government bonds. It also has little basis to audit income taxes of self-employed and professionals as third party data to cross-check their ability to pay taxes are limited. The DOF is looking to include the amendments to the bank secrecy law in its comprehensive tax reform package.

Source: Department of Finance

¹² See <http://business.inquirer.net/182177/dof-wants-bank-secrecy-laws-eased> for more details.

PROSPECTS, RISKS, AND POLICIES

Prospects and risks

15. **In spite of the weaker global environment, growth prospects for the Philippines remain positive.** Uneven recovery in high-income countries and slower growth in the East Asia region will adversely affect Philippine growth. Despite this, the Philippines has the means to sustain high growth in the near-term. The country is still benefiting from low and stable inflation, healthy current account surplus, and a falling debt burden. It has a dynamic private sector (e.g., business process outsourcing (BPO), real estate, finance, and some manufacturing sectors) that is seizing global opportunities. With supportive monetary and fiscal policies, in particular, taking advantage of the growing fiscal space, the country can achieve growth of around 6.5 percent in the near-term and make it more inclusive.

16. **Going forward, the Philippines needs to accelerate reforms that can translate higher growth into more inclusive growth—the type that creates more and better jobs—so that poverty can be reduced massively and prosperity shared by more people.** Sustaining high growth and making it more inclusive can help the government achieve its 18 to 20 percent poverty reduction targets by 2016 (see Box 2). In the long-term, if growth is sustained at 6 percent per year, per capita income can double within 1 decade, grow 5 times in 2 decades, and reach 11 times in 3 decades. This means that if the growth elasticity of poverty remains high, poverty can be eradicated within a single generation. Achieving this requires a commitment to implement much needed structural reforms.

Table 1. Growth and inflation projections

	2014	2015	2016
Philippine GDP growth			
Previous projections	6.4	6.7	6.5
Revised projections	6.0	6.5	6.5
Philippine CPI inflation			
Previous projections	5.0	4.5	4.0
Revised projections ¹³	4.1	3.0	3.5
Global growth			
Previous projections	2.8	3.4	3.5
Revised projections	2.6	3.0	3.3

¹³ Since inflation data is released ahead of national accounts data, CPI inflation for 2014 refers to actual data.

17. **In the near-term, lower government spending, including investment delays and slowdowns, combined with weaker exports, are likely to limit economic growth to 6 percent in 2014, but it can rebound to 6.5 percent in 2015.** These represent a 0.4 and 0.2 ppt downgrade from the August 2014 projections of 6.4 and 6.7 percent, respectively (Table 1). For 2014, the revised growth projection takes into account lower-than-expected government spending in Q3 and limited opportunity to improve spending in Q4. Growth in 2015 will benefit from a base effect, given weak government spending in 2014, but further delays in major public-private partnership (PPP) projects and the slowdown in approved investments would constrain growth of private investment. Unexpected supply crunches in the power sector in April to May 2015 could also dampen economic growth (Special Focus 2).

Box 2. Poverty projections through 2016

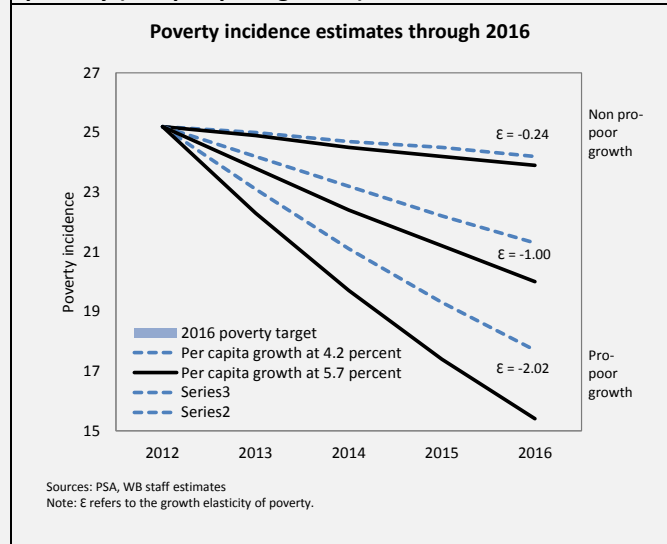
Higher growth in recent years has begun to uplift more people out of poverty. Between 2012 and 2013, poverty incidence declined by 3 ppt to 24.9 percent (and is supported by falling underemployment among the poor).¹⁴ This is in sharp contrast to weak poverty reduction between 2000 and 2009, when poverty incidence declined by an annual average of only 0.05 ppt. If strong poverty reduction in 2013 is sustained in the near-term, it is very likely that the government will achieve its poverty target of 18 to 20 percent by 2016.

A straightforward method to project poverty incidence is to estimate the growth elasticity of poverty. The growth elasticity of poverty refers to the percent change in poverty incidence for every percent change in GDP per capita. The growth elasticity of poverty between 2006 and 2012 is estimated at -0.24 while it is -2.02 between 2012 and 2013. The latter is not unrealistic as the country was able to achieve an elasticity of -2.17 between 1985 and 2000.

The combination of higher growth and stronger elasticity between 2013 and 2016 can result in much faster poverty reduction. Box Figure 2.1 shows a combination of growth and elasticity scenarios. It shows that a 4.2-percent per capita growth (equivalent to 6 percent GDP growth) coupled with an elasticity of at least -1.50 can help the government achieve its poverty target of 18 to 20 percent by 2016. If per capita growth were higher, say at around 5.7 percent (equivalent to 7.5 percent GDP growth [average of the government's growth target in 2015-2016]), the poverty target can be reached even with an elasticity of just -1.00

¹⁴ In 2013, the government announced a policy to release poverty estimates annually. The source data of the 2013 poverty incidence is the Annual Poverty Indicators Survey (APIS), while the source data of the 2012 poverty incidence is the Family Income and Expenditure Survey (FIES). Both surveys share the same income module. The FIES is conducted every 3 years, while the APIS is conducted in between FIES years. However, there are some limitations when comparing results from the 2 surveys. First, poverty incidence is only available for the first semester of the year and is therefore not comparable to the earlier series. Second, the sample size of the APIS is only a fourth of the sample size of the FIES. This means that poverty incidence is only available at the national level. Third, differences in the position of the income modules in the survey questionnaires could be a source of non-sampling error. At the national level, however, the error is manageable.

Box Figure 2.1 Poverty targets can be achieved through a combination of high growth and high growth elasticity of poverty (i.e., pro-poor growth).



Strong poverty alleviation efforts in the last 4 years suggest that the strong elasticity can be sustained. For instance, in its first 4 years in office, the Aquino Administration more than doubled social services spending. It has implemented sweeping reforms to improve transparency and accountability of the budget. It has also moved towards universal health care (UHC) and significantly ramped up the conditional cash transfer (CCT) program. Between 2012 and 2013, UHC coverage increased from 5 to 8 million poor households, covering the bottom 40 percent of the population. This is expected to significantly increase protection of poor and vulnerable households from health-related shocks. Similarly, the coverage of the CCT program has expanded by 3.2 million households since 2010, now reaching 4.2 million poor households.

18. **On the external front, the weaker global economy will also affect Philippine growth, albeit modestly.** The accompanying Global Economic Prospects report (January 2015 edition) explains that global growth projections have been downgraded from 2.8 to 2.6 percent in 2014 and from 3.4 to 3.0 percent in 2015.¹⁵ The main reasons for the downgrades are the likely slowdowns in the Eurozone and Japan, which are key trading partners of the Philippines, as well as slowdowns in Latin America, Eastern Europe and Central Asia regions. These can pull down growth of Philippine exports further. In addition, road and port congestion (Special Focus 1), which became more evident in recent months, could hamper trade and manufacturing, given that a third of imports consist of raw materials and intermediate goods.

19. **On the other hand, rapidly falling oil prices will benefit the Philippines.** The country is a net importer of oil and its key trading partners, such as China and Japan, are also net importers

¹⁵ The January 2015 Global economic prospects “Having fiscal space and using it” is available at: <http://www.worldbank.org/en/publication/global-economic-prospects>.

of oil. Crude oil prices have fallen by more than 40 percent between January and December 2014 (7.7 percent year-on-year average) and are expected to decline further in 2015 by an average of 31.9 percent, giving rise to higher household and business purchasing power, which can support consumption growth in 2015. Moreover, lower oil prices can boost the economy of the Philippines' oil importing trade partners, thereby increasing demand for Philippine exports. On the other hand, remittances from the Middle East may decline, but this is likely to be more than offset by remittances from net importing countries.

20. **Achieving growth of around 6.5 percent in 2015 is within reach if the government executes the 2015 budget as planned.** With private consumption growth steady at around 5 to 6 percent,¹⁶ GDP growth of around 6.5 percent hinges primarily on the ability of the government to spend the budget as planned. However, this has proven to be challenging in recent years. In the last 4 years, the government fell short of its planned primary and infrastructure spending by an average of 1.8 and 0.5 ppt of GDP, respectively.¹⁷

21. **Sustaining government spending in the near-term will require significant improvements in budget planning and execution as the current 28-year-old system, already at capacity, is hard pressed to support higher spending.** To this end, the government is addressing spending and procurement bottlenecks, while also drafting a new organic budget law, which would clarify, streamline, and harmonize the various pieces of legislation and executive orders.

22. **A commitment to fully utilize the budget, in particular, reaching the 5 percent of GDP target for infrastructure spending by 2016 and fully implementing the Yolanda master plan,¹⁸ will not only raise the contribution of public spending to GDP growth, it will also encourage the private sector to invest more, thereby boosting GDP growth further.** Higher overall investment can be supported by timely implementation of the PPP program (Table 2), which is projected to raise investments by 0.6 and 0.8 ppt of GDP in 2015 and 2016, respectively.¹⁹ The remaining sources of growth can come from a faster global recovery, leading to improvements in the country's export sector. In this regard, reforms that will enable the country to regain its edge in electronics exports are needed (Special Focus 3).

23. **Meanwhile, inflation is expected to stabilize at 3 percent in 2015 and 3.5 percent in 2016.** Inflationary pressures are subsiding due to rapidly falling crude oil prices, which have

¹⁶ This is supported by positive consumer and business confidence indices for 2014 and beyond, as reported by the central bank.

¹⁷ In recent years, the discrepancy between budgeted government spending and actual spending widened from 0.5 percent of GDP in 2010 to more than 2 percent of GDP in 2012 and 2013.

¹⁸ President Aquino recently approved an 8-volume, 8,000-page, PHP 170 billion (1.5 percent of 2013 GDP) rehabilitation plan for areas hit by Typhoon Yolanda. Around 80 percent of the projects under the plan are expected to be completed by the end of President Aquino's term in June 2016.

¹⁹ A number of PPP projects have been delayed. For example, the PHP 35 billion Cavite-Laguna expressway project, which should have started in 2013, will be rebid in 2015.

declined by an average of 7.7 percent in 2014 (over 40 percent between January and December 2014) and are projected to further decline by 31.9 percent in 2015. This, together with slower food inflation and decelerating liquidity growth, could give the central bank room to revert to a more accommodative stance that can further support growth.

Table 2. Status of PPP projects in the pipeline

PPP projects in the pipeline	Project amount (PHP billion)	Contract award/ projected construction start date	Projected completion date	Status/cause of delays
Total cost of projects in the pipe line	435.0			
Contract awarded	116.2			
LRT Line 1 Cavite extension and O&M	64.9	Oct 2014	2019	No delays
Mactan-Cebu International Airport Passenger Terminal Building	17.5	Nov 2014	2020	Awarding delayed because of accusations of conflict of interest
NAlA expressway project (Phase II)	15.5	Jan 2014	2016	Bidding was delayed due to deadline extension as requested by bidders
PPP for school infrastructure project (Phase II)	8.8	Sep 2013	2014	Only 3.3% completed and 18.8% under construction as of Nov 2014
Modernization of the Philippine Orthopedic Center	5.7	Oct 2014	2017	No delays
Daang Hari-SLEX link road project	2.0	Dec 2011	2015	On track for completion
Automatic fare collection system	1.7	Apr 2014	2014	Awarding delayed because of protest by losing bidders
At the bidding stage/for bid submission	207.8			
Laguna lakeshore expressway dike project	122.8	Sep 2015	2021	No foreseen delay in project implementation, notwithstanding the deadline extension for pre-qualification bids
Cavite-Laguna expressway	35.4	Jul 2015	2017	Delayed due to failure of bidding
Bulacan bulk water supply project	24.4	Jun 2015	2016	On track for bidding in 2015.
New centennial water source - Kaliwa dam project	18.7	Feb 2015	2020	On track for bidding in 2015.
Intergrated transport system - south terminal project	4.0	July 2015	2017	No delays
Intergrated transport system - southwest terminal project	2.5	July 2015	2017	Delayed due to revision of terms and deadline extension at request of bidders
Other projects for Implementation	111.0			
MRT line-7	63.1	2015	2018	Delayed due to various hurdles such as the dispute on the location of the common station with existing rail lines
Skyway stage 3 project	26.7	Apr 2014	2016	On track for completion by 2016
NLEX-SLEX connector road	21.2	Feb 2015	2017	Delayed due to Swiss challenge

Source: PPP center

Note: Some contract award/contruction start and projected completion dates were estimated from various press articles in the PPP center website.

Policies

24. **Eradicating poverty and boosting shared prosperity requires implementing an already well-known policy agenda of structural reforms.** The key reform areas are i) increasing investments in infrastructure, health, and education, ii) enhancing competition to level the playing field, iii) simplifying regulations to promote job creation, especially by micro and small enterprises, and iv) protecting property rights. This policy agenda, which benefited from a wide consensus among local and international policy analysts, is discussed in detail in the 2013 Philippine development report “Creating more and better jobs.”²⁰ This edition of the Philippine economic update (PEU) highlights the need to underpin higher investment by stronger revenue generation and elaborates on the second reform area, enhancing competition.

25. **Higher investments need to be supported by tax policy reforms, since tax administration reforms are inadequate to fully fund the investment gap.** The August 2014

²⁰ This report is available at: <http://www.worldbank.org/en/country/philippines/publication/philippine-development-report-2013-creating-more-and-better-jobs>.

edition of the PEU shows that the country has an investment gap of around 6.8 percent of GDP, 2.5 percent of GDP for infrastructure and 4.3 percent of GDP for social services. Worsening port and road congestion, and possible power shortages in 2015 exemplify the need to urgently raise investments (Special Focuses 1 and 2). More investments in infrastructure can help the country become more competitive, and in the process revive key export sectors, such as electronics (Special Focus 3). Tax administration reforms, alongside strong economic growth, can generate about 3.8 percent of GDP in fiscal space over the medium-term. The balance of 3 percent of GDP needs to come from tax policy reforms.

26. A more equitable, efficient, and simpler tax system should be the aim of any tax policy reform.²¹ This is currently not the case in the tax system of the Philippines. Take for example the following:

- Many large corporations benefit from unnecessary tax incentives, such as income tax holidays or perpetually reduced tax rates. On the other hand, many small and micro enterprises, where the poor work, pay much higher taxes relative to their income. In fact, on average, manufacturing firms receiving tax incentives pay only PHP 0.8 for every PHP 100 in revenue, while firms not receiving incentives pay around PHP 2.3 for every PHP 100 in revenue. Among services, it is around PHP 4 compared to PHP 12, respectively.
- Taxes that are not adjusted for inflation also worsen the equity of the tax system since the rich pay less and less for certain goods as their incomes rise. For example, the gasoline excise tax rate has remained at PHP 4.35 per liter since 1996, whereas the income of the top 10 percent has tripled²² in the same period. Since they consume nearly 60 percent of gasoline, the amount of tax that they pay today relative to their income has fallen drastically. In addition, property valuations in the richest cities have not been adjusted for inflation in over 10 to 20 years, yet market values have increased by almost 3 times.
- The complexity of the tax system, in which small and micro enterprises have to file and pay a multitude of taxes almost every month, means that they spend a considerable amount of time and money falling in line and trying to comply with complex tax rules, instead of doing more productive things and earning more. This indirectly increases their tax burden relative to the rich.

27. A two-phase tax policy reform can be considered to improve the equity, efficiency, and simplicity of the tax system.

²¹ For more discussion on the tax reform package for more inclusive growth, please see the August 2014 edition of the PEU available at: <http://www.worldbank.org/en/country/philippines/publication/philippines-accelerating-public-investment-to-sustain-growth-that-benefits-the-poor>

²² This estimate is generated using FIES income data, adjusted for underreporting.

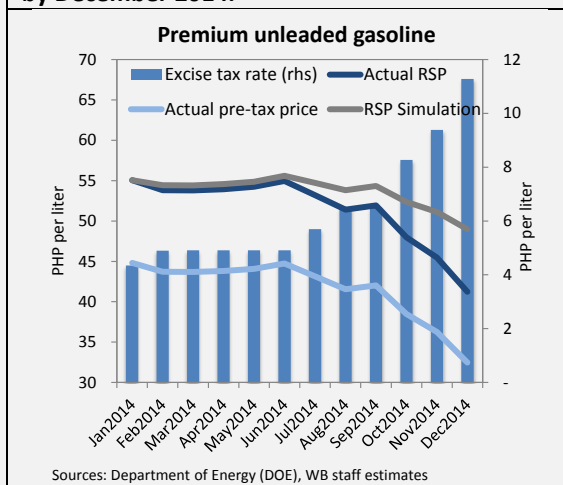
- Phase 1 can focus on raising tax revenues equitably.** The following reforms can be considered: i) rationalize tax incentives by making them more targeted, transparent, performance-based, and temporary, ii) broaden the VAT base by reducing the number of VAT exemptions that have little economic basis, iii) centralize and increase the valuation of real properties and, if needed, levy a national surtax of up to 2 percent on real properties to improve the equity of the tax system, and iv) raise petroleum excise taxes while oil prices are falling (Box 3).

Box 3. Raising petroleum excise tax as prices fall

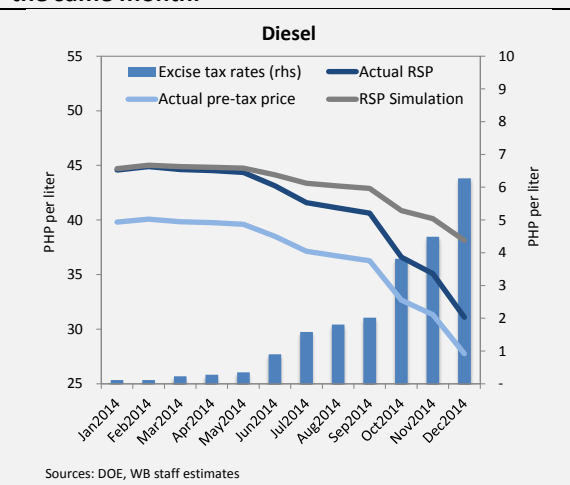
Rapidly falling oil prices presents an opportunity to revisit fuel excise taxes. In recent months, retail oil prices have declined by more than 25 percent²³ given rapidly falling crude prices. The World Bank expects crude oil prices to fall an average of 31.9 percent in 2015 given slower global growth and ample supply of oil and natural gas.²⁴

Gasoline and diesel excise tax rates may be gradually increased whenever crude oil prices fall. One option would be to increase excise tax rates whenever pre-tax retail prices fall, while keeping it constant whenever pre-tax retail prices rise or stay the same. This way, the benefit of lower oil prices is equally shared by the government (in terms of higher excise tax rates) and by consumers (in terms of lower retail prices). For instance, excise tax rates can be increased by PHP 0.50 for every PHP 1 decrease in pre-tax retail price.

Box Figure 3.1. Premium unleaded gasoline excise would have risen to PHP 11.28 per liter by December 2014.



Box Figure 3.2. Diesel excise, meanwhile, would have increased from zero to PHP 6.27 per liter by the same month.



²³ Further decline in retail prices (adjusted for exchange rate movement) is expected since the total decline in crude prices between January and December 2014, at more than 40 percent, has yet to be passed on to consumers.

²⁴ This is defined as the simple average of the Dubai, Brent, and West Texas Intermediate oil prices.

Had the proposal been adopted in January 2014, the government could have collected PHP 19.1 billion (0.2 percent of GDP) in additional excise revenues. Following the trend in pre-tax retail price, gasoline excises would have increased from PHP 4.35 to PHP 11.28 per liter and diesel from zero to PHP 6.27 by December 2014 (Box Figures 3.1 and 3.2).

This scheme would have no adverse impact on household real income. As excise tax rates would never increase faster than the fall in oil prices (in fact increasing by only half the decline in oil prices), real income would not be reduced. Moreover, there is no pass-through to other goods, thereby keeping overall inflation low (or declining).

- **Phase 2 can focus on reforms to reduce tax rates and further broaden the tax base.** The following reforms can be considered: i) reduce the corporate income tax rate from 30 to 25 percent while converting the 5-percent gross income earned (GIE) tax into a 15-percent tax on net income, ii) reduce the highest marginal tax rate on personal income from 32 to 25 percent and reduce the number of brackets to at most 5 to simplify the tax system further, instead of increasing exemptions on bonuses, which only benefits richer taxpayers (Box 4), iii) harmonize all tax rates of capital income at around 10 percent to reduce distortions from favoring certain types of capital, and iv) simplify the tax regime for micro and small firms (i.e., annual sales of less than PHP 3 million) by imposing a single tax on turnover in place of income, local business, and percentage taxes.

Box 4. Increasing the 13th month and bonus exemption threshold

A bill seeking to raise the tax exemption on workers' 13th month pay and other bonuses has been passed by Congress and is waiting for the President's signature. The bill proposes to increase the exemption threshold from PHP 30,000 to PHP 82,000. This increase takes into account inflation between 1994 and 2014. Once signed, the law is expected to take effect by June 2015 when part of the bonus is normally released to workers.

The bill will negatively impact revenues and equity. Revenue loss is estimated to fall by PHP 21 to 31 billion, equivalent to 0.20 to 0.29 percent of GDP.²⁵ Moreover, it will erode the progressivity of the tax system as only the top 14 percent²⁶ of wage workers would benefit from higher exemption threshold. Other workers will not benefit. In particular, workers earning the minimum wage or below, who

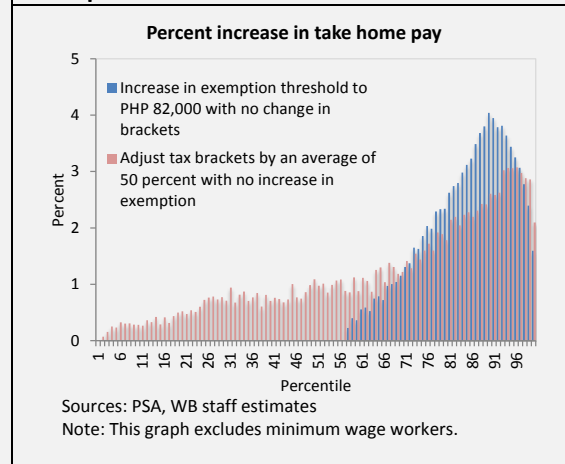
²⁵ This is estimated using merged data from the 2012 Labor Force Survey and the 2012 Family Income and Expenditure Survey. Income is adjusted for underreporting. It assumes that bonuses are equivalent to 2 extra months of pay and collection efficiency between 70 to 100 percent, among other assumptions. Detailed methodology is available upon request.

²⁶ Assuming an 80-20 basic pay-to-bonus ratio, only 3.3 million wage workers out of the total 23.8 million workers would benefit.

comprise around 64 percent of all salary earners, will not benefit from the proposed bill. Using after-tax income, the Gini coefficient²⁷ is estimated to increase by 0.5 points.

Instead of giving more tax breaks to the highest-paid workers, a better policy would be to give all wage workers higher take home pay. This can be done by adjusting the income tax brackets so that workers currently facing higher marginal tax rates (MTRs) will face lower MTRs after the reform.²⁸ Box Figure 4.1 shows that the alternative reform, which increases tax brackets by an average of 50 percent, would result in the same revenue loss as the increase in exemption threshold but would improve the equity of the tax system as *most* taxpayers would benefit.

Box Figure 4.1. More people will benefit from a bracket adjustment instead of an increase in the exemption threshold of bonuses.



28. **For tax policy reforms to be successful, reforms to improve the transparency and accountability of government spending and to strengthen tax administration are essential.** These would allow the public to see more tangible improvements in governance and convince them that their taxes are being spent wisely. On enhancing transparency and accountability of government spending, institutionalizing ongoing reforms beyond this administration is crucial. These include:

- Passing of the Freedom of Information Bill; this would institutionalize “open data,” which means making government data publicly available in user-friendly forms.
- Enhancing budget preparation and reporting, in particular allowing the public and the government to track spending from appropriations to results on the ground, including timely release of a tax expenditure statement. In turn, this requires

²⁷ The Gini coefficient is a measure of inequality. A Gini of 0 means perfect equality, while a Gini of 1 means perfect inequality.

²⁸ For instance, workers currently facing an MTR of 25 percent could face an MTR of 20 percent after the reform.

- adopting an automated and government-wide financial management and information system.
- Limiting the use of lump-sum funds to improve transparency of large budget items.
 - Making public procurement fully transparent through mandatory posting of bids and awards on government websites.
 - Enhancing the role of the Commission on Audit (COA) in ensuring efficient use of taxpayers' money through both financial and performance audits.

On tax enforcement, measures to improve public trust in the revenue agencies and in the quality of their services could include the following:

- Simplifying tax procedures and processes so that paying taxes becomes easier.
- Further enhancing the integrity of revenue officials by publicly posting, as a start, the net worth of top revenue officials on government websites to send a strong signal to the public that the revenue agencies are committed to good governance.
- Strengthening the COA's internal and external audits of BIR and BOC activities, in particular the adherence of the BIR and BOC to their own audit rules, to improve transparency and accountability of tax administration.
- Publicizing key performance indicators of the BIR and BOC in their websites to allow the public to scrutinize the performance of the BIR and BOC.
- Requiring all government agencies and selected private sector groups (e.g., electric and phone companies, professional associations) to share their data automatically with BIR and BOC to improve tax audits. In relation to this, the bank secrecy law needs to be relaxed in cases involving tax fraud. This is practiced in almost all countries but not in the Philippines.

29. **Higher investments in infrastructure, health, and education need to be complemented by reforms to enhance competition.** While the country has a historical inclination towards protectionism, a number of successful reforms in the 1990s opened up key sectors of the economy to more competition, in spite of staunch opposition. These reforms, notably in telecoms and air transport, helped sustain growth in the succeeding decade and subsequently generated millions of jobs.

30. **Drawing from this experience, the country needs to push for more competition and level the playing field between firms of all sizes and origins.** This will raise productivity and create more jobs. Essential reforms include i) continuing to liberalize key sectors of the economy that directly impact poor Filipinos, ii) further opening up the economy to more foreign competition, iii) strengthening regulatory capacity, and iv) crafting and implementing a clear competition policy. Two sectors recommended for liberalization, rice and domestic shipping, have significant impacts on the poor and are discussed in the last 2 special focus sections.

MEDIUM-TERM REFORM AGENDA

Enhancing competition²⁹

A history of protectionism

31. **The Philippines has had a long history of protectionism that fostered the proliferation of a largely oligopolistic economy.** Many Philippine industries were controlled by a few firms. For instance, in the manufacturing sector, the average four-firm concentration ratio³⁰ across all subsectors rose from 71 percent in 1988 to 81 percent in 1998.³¹ Most subsectors with a high concentration ratio involve the production of intermediate and capital goods (Aldaba 2008). Unsurprisingly, this tendency towards oligopoly resulted in high price-cost margins in the manufacturing sector. Prior to some liberalization in the 1990s, the utility, transportation, communication, and agribusiness industries operated with little or no effective competition. These sectors provided inputs and vital logistics support to manufacturing. These oligopolies therefore increased manufacturing output costs and undermined its international competitiveness. This is one of the major reasons why overall manufacturing exports never really took off.

32. **Inadequate competition policy partly explains why the country's oligopolistic market structure persists.** While a number of sector or industry-specific competition laws exist, as well as institutional arrangements to regulate natural monopolies, they do not consistently deal with the wide range of anti-competitive behaviors that have emerged or could emerge. Moreover, the Philippines lacks a strong and independent central institution for enforcing competition policies, fair trade, and consumer rights.

33. **In some sectors, trade reforms beginning in the mid-1980s have introduced greater competition and have limited the potential for abuse of market power.** The increase in competitive pressures in sectors such as agricultural machinery as well as metal and paper-based industries has had the dual effect of decreasing firm concentration and lowering domestic prices toward international levels.³²

34. **However, many industries have not been liberalized. A number of key industries still enjoy high protection from foreign competition.** For example, the glass and cement industries

²⁹ This section draws from the PDR "Creating more and better Jobs" (World Bank 2013). It was prepared by Karl Kendrick Chua (Senior Country Economist).

³⁰ The four-firm concentration ratio refers to the proportion of an industry's output accounted for by the 4 largest firms.

³¹ Preliminary estimates for 2008 using BusinessWorld's top 15,000 corporations (an alternative data source), however, show that this ratio declined to 68 percent. This may be the outcome of past liberalization reforms.

³² See Aldaba (2008) for more discussion.

still enjoy high levels of protection from foreign competition in the form of substantial import restrictions,³³ while other industries show signs of collusion, either due to structural barriers or behavioral constraints (Table 3).³⁴

Table 3. Selected sectors with barriers to entry and competition

Sector	Source of barrier to entry
Agriculture	
Rice	Import licenses or tariff quotas
Corn, sugar	Cartel behavior by dominant producers
Agribusiness	Restrictions on foreign land ownership, restrictive land use policies
Downstream oil	Cartel behavior by oligopolistic producers, large capital requirement
Pharmaceutical drugs	Licensing/registration restrictions, cartel behavior by dominant firms
Cement	Cartel behavior by oligopolistic producers, large capital requirement
Electricity distribution	Monopoly, limited regulatory capacity
Water	Local monopoly, multiple fragmented/overlapping administrations
Drug stores	Economies of scale and scope
Telecommunications	Congressional franchise, limited regulatory capacity
Ports	Monopoly, limited regulatory capacity
Water transport	Cabotage Law, cartel behavior by local oligopolies
Air transport	Cabotage Law, congressional franchise, limited regulatory capacity

Source: Aldaba (2008)

35. **Lack of competition in agriculture and services that provide vital inputs and logistic support to manufacturing hampers the growth of many sectors.** For instance, competition in the ports industry is weak and marred by conflict of interest. The regulator, the Philippine Ports Authority, is also a major operator. Competition in domestic shipping is likewise limited, thus contributing to large-scale inefficiencies, frequent accidents, and higher prices of many goods, especially food (Special Focus 5). Logistics costs account for 24 to 53 percent of the wholesale price in the Philippines³⁵ compared to less than 20 percent in other countries in the region. Shipping and port costs are estimated to account for an average of 35 percent of logistics cost, 8 percent (to as high as 30 percent) of wholesale price, and 5 percent of retail prices, all

³³ The glass and cement sectors are characterized by high industry concentration ratios, trade and non-trade barriers, and high markups. The glass industry has been heavily protected from imports through quotas and tariffs, and 3 dominant firms contribute 84 percent of the total industry value-added. The flat glass sub-sector, a capital and skill-intensive industry, has only 1 domestic producer. The Philippine cement industry has historically been heavily cartelized, with firms colluding to set production quotas and prices as well as to geographically distribute markets among themselves. With the introduction of more import-driven competition in the domestic market from 2000 to 2001, the industry filed anti-competition suits, initially without success. Subsequently, however, the industry succeeded in obtaining protection through safeguard measures, which eliminated import competition.

³⁴ These structural barriers refer to the presence of very high up-front investment expenditures required to enter the market or the existence of economies of scale conducive to natural monopolies. See Aldaba (2008) for more discussion.

³⁵ These figures are based on data from Japan Bank for International Cooperation (2002) and University of Asia and the Pacific Industry Monitor (2002) as cited in Japan International Cooperation Agency and Maritime Industry Authority (2005).

depending on the goods and routes.³⁶ Philippine domestic shipping is generally more expensive than in Malaysia or Indonesia—2 other archipelagos. In addition, the water utility sector is operated by local monopolies, many of which are highly inefficient. Moreover, multiple, fragmented, and overlapping administrations make regulatory oversight difficult, resulting in poor water supply and high prices in secondary cities and rural areas. Finally, in the agriculture sector, the marketing channels for rice, sugar, and corn face limited competition because of restrictions in acquiring import licenses, high tariffs, and the imposition of quotas.

36. Freer competition is also hampered by foreign ownership restrictions, which constrain FDI. The country's foreign investment negative list comes with a 40 percent cap on foreign equity ownership in most sectors. Restrictions are particularly tight in the media sector (zero percent), followed by mining, agriculture, transport, and telecommunications (40 percent). Controlling interests are allowed in non-bank financial services (60 percent)³⁷ and the electricity sector (66 percent). In all these sectors, restrictions in the Philippines are more stringent than in other countries in the region. Across sectors, there are restrictions on land and skilled labor (i.e., professional practice). Even when long-term leasing of land is allowed, regulations and red tape can provide significant *de facto* constraints, thus inhibiting foreign companies from investing. US investors cite land ownership restrictions as one of the main reasons why Americans do not invest much in the Philippines.³⁸ Finally, with respect to skilled labor, almost all licensed professions are *de facto* shielded from foreign entry despite laws allowing reciprocity. As a result, FDI inflows to the Philippines are among the lowest in the region. In fact, annual FDI has rarely exceeded PHP 2 billion in the past 4 decades.

Yet also a history of successful liberalizations

37. Notwithstanding the history of protectionism, liberalization of key industries in the services sector did happen and was the main catalyst of faster growth and job creation in the succeeding decade. As a result of these reforms, several industries, such as telecommunications, BPO, and tourism, grew rapidly and created around 5 million jobs. In particular, the BPO industry has been driving overall growth in the last decade. Its total (i.e., direct plus indirect) contribution to gross value-added through services exports, real estate, construction, retail trade, and telecommunications is estimated at around 10 percent of GDP in 2012,³⁹ roughly equivalent to the total value-added of merchandise exports as a share of GDP.

³⁶ These estimates are derived from Arnold and Villareal (2002), Bureau of Agricultural Statistics (2011a and 2011b), Japan Bank for International Cooperation (2002), Japan International Cooperation Agency and Maritime Industry Authority (2005), and University of the Philippines Mindanao (2013).

³⁷ The banking sector was fully liberalized in 2014.

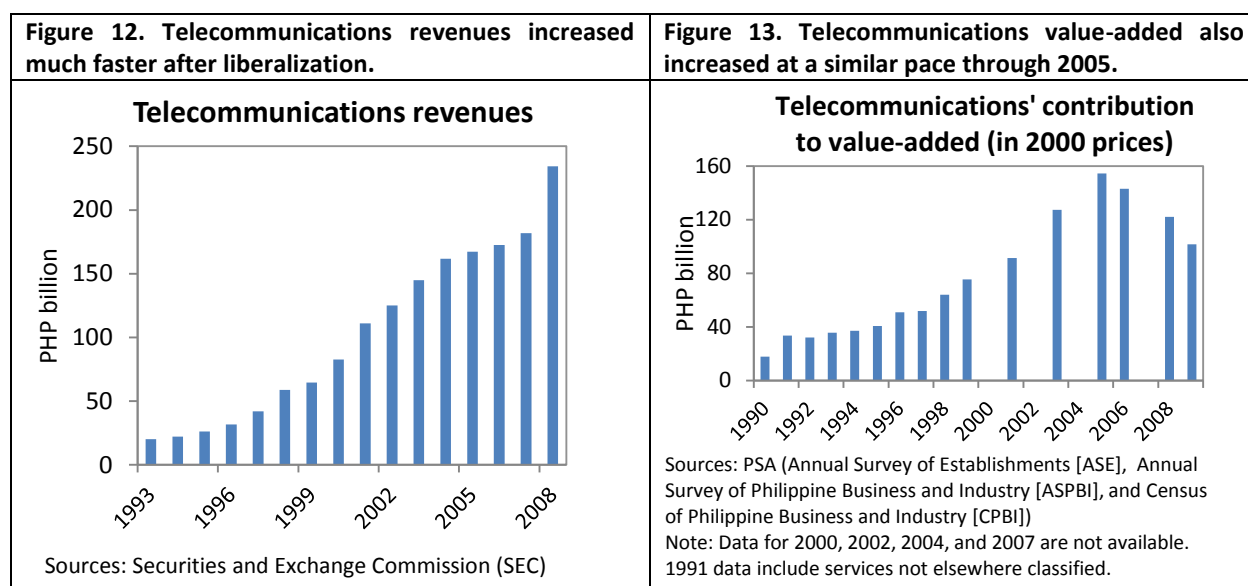
³⁸ Source: "US envoy gives reasons why Americans not investing in country." *Business World*, October 3, 2012.

³⁹ This is estimated as 60 percent of gross value-added (GVA) of renting and other business activities, 60 percent of real estate and ownership of dwellings (since 90 percent of office spaces are built for business process outsourcing (BPO) and around 50 percent of condo units are purchased by the new BPO middle class), 30 percent of construction, 10 percent of retail trade, and 10 percent of transportation and communications, all as percent of their respective gross value-added.

Telecommunications reform⁴⁰

38. **The telecommunications reform is arguably the most important reform in the 1990s and is largely responsible for fueling economic growth in the last 15 years.** The deregulation of the telecom industry in 1993 not only transformed the industry — from a virtual monopoly to a more competitive market, and from having a limited network and poor service to an expanded network at much lower prices and better service — but also facilitated the growth of new non-traditional and non-captured industries, such as contact centers, back-office support, and other IT-enabled services. These new industries, collectively known as the BPO industry, have become the main drivers of growth in the last 15 years.

39. **Before its deregulation, the telecommunications industry was virtually a monopoly with 1 player controlling more than 90 percent of the market and owning the country’s only transmission line.** Telephone lines were hard to obtain. Waiting time for a phone line took up to 10 years and service quality was low. This changed in 1993 when the Ramos Administration liberalized the telecommunications industry, initially by issuing executive orders that challenged the monopoly head-on, which was owned by one of the country’s most powerful oligarchs.



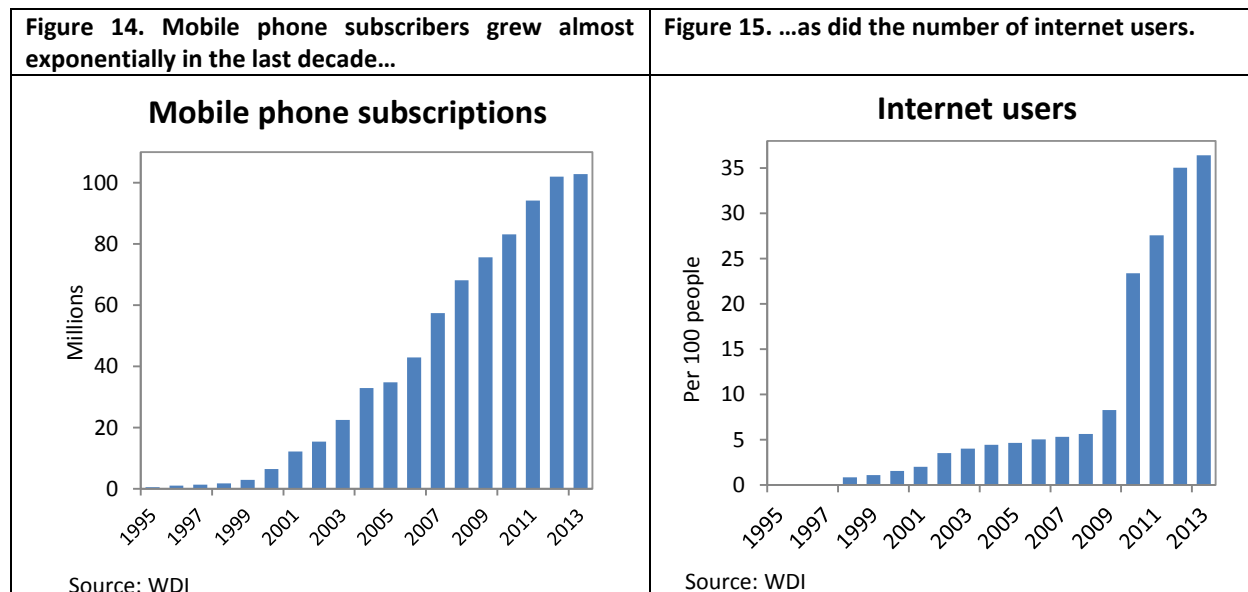
40. **As a result of this reform, several players, including international investors, entered the industry.** By 2001, the industry had 7 players. Revenues grew eleven-fold from PHP 20 billion in 1993 to PHP 230 billion in 2008,⁴¹ or a compounded annual growth rate of 18 percent (Figure 12). The industry’s contribution to value-added increased at a similar pace (Figure 13). Ironically, the original monopoly that was initially affected by liberalization, the Philippine Long

⁴⁰ This section draws partly from Bernardo and Tang (2008). The report team is grateful to them for sharing their data which the team updated.

⁴¹ This is the latest available comparable data.

Distance Telephone Company (PLDT), emerged as the biggest beneficiary of the reform, earning much higher revenues arising from a much bigger market. Net job creation was also recorded in the telecommunications industry and much more in the industries that depended on it, such as BPOs.

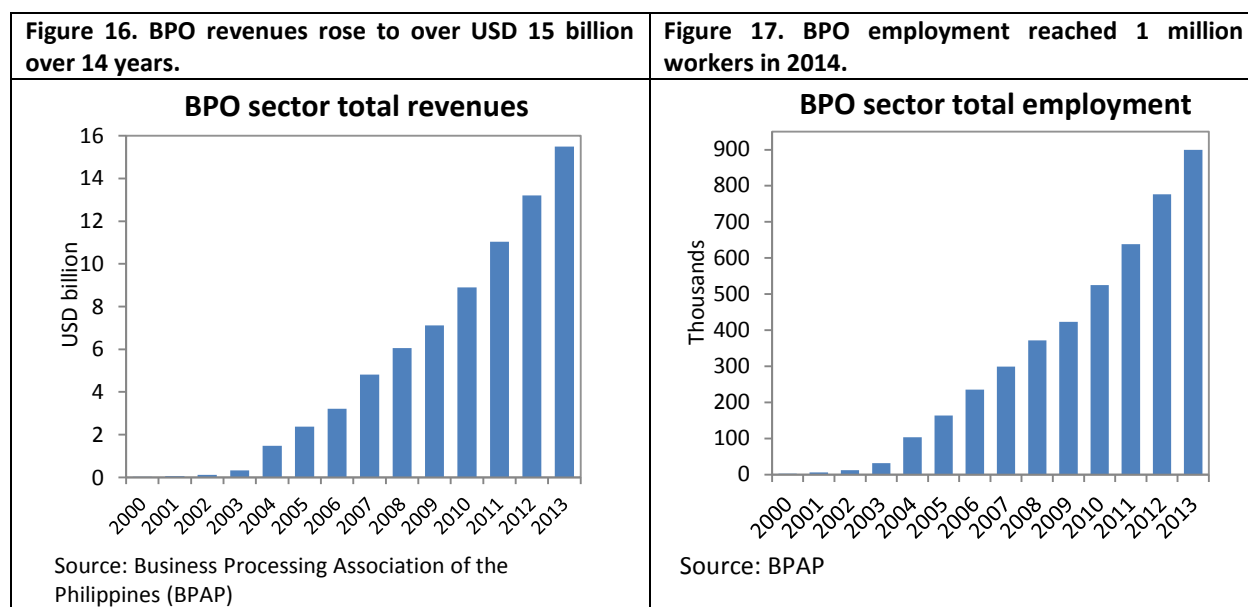
41. **With stronger competition alongside technological advances, consumer prices fell substantially while access to information increased significantly, allowing more people to have a voice in national issues.** Telecommunications costs have gone down substantially. For example, international direct dialing from the Philippines to the US cost around USD 0.32 per minute in 2007 from about USD 0.50 per minute in 2000 (Alampay 2008). By 2011, promo rates have further brought the cost down by as much as 60 percent.⁴² With much lower prices, demand increased significantly. By 2013, there were over 100 million mobile phone subscribers and over 36 million internet users, compared to virtually zero before the reform in 1994 (Figures 14 and 15). Better access to knowledge and information via the internet, for example via social networking websites such as Twitter and Facebook, has helped build stronger demand for good governance, evident in recent public debates (e.g., on tobacco and alcohol taxes), and has helped improve disaster risk management, as citizens share information about flooding.



⁴² The decline in prices is more pronounced in domestic mobile calls, with marginal cost down to zero in the case of unlimited call packages. Internet connection costs have also gone down by a significant amount, from a monthly rate of around PHP 1,800 for an hour of access per day to less than PHP 800 for unlimited access at higher speeds (based on the monthly payment for a broadband internet service with a speed of up to 512 kilobytes per second).

BPO sector as key beneficiary

42. **The BPO industry is a prime example of a dynamic industry that has benefited tremendously from the liberalization of telecommunications.** In the last decade, the BPO industry grew at impressive rates averaging 24 percent annually, with revenues reaching USD 15.5 billion in 2013 (Figure 16) and direct employment reaching 1 million people in 2014 from virtually zero in 1999 (Figure 17). The industry expects to reach 1.3 million employees by 2016.⁴³ It has also generated significant positive spillovers to other sectors of the economy. As mentioned earlier, the BPO industry has been driving the rapid growth of the real estate, transportation, communication, construction, retail trade, and private services sub-sectors. In 2012, call centers accounted for 60 percent of total BPO revenues and 60 percent of total employment. However, in recent years, BPO growth has begun to shift from contact centers to more knowledge-based businesses such as back office systems development, accounting, medical transcription, and animation. Revenue growth in these non-voice BPOs ranged from 40 to over 100 percent. Even during the recent global economic slowdown, the BPO industry maintained high positive growth.⁴⁴



⁴³ Values in Figures 16 and 17 cover only call centers in between 2000 and 2003. Values for 2004 onward cover call centers, back-offices, knowledge process outsourcing, information technology outsourcing, engineering services outsourcing, animation, healthcare information management outsourcing, and medical transcription. Values from 2007 onward include game development along with all the mentioned IT-BPO subsectors.

⁴⁴ The growth of the BPO industry remained outstanding despite the recent global slowdown and is projected to grow even faster, given the global economic rebalancing. The sector is still poised to achieve high double-digit growth, especially in the back-office segment. However, recent supply bottlenecks (e.g., availability of qualified BPO workers) are slowing down growth in the industry. Nevertheless, provided that the overall investment climate improves, investments in information technology infrastructure are sustained, input costs such as communications and labor costs remain competitive, and an abundant supply of qualified workers is available, the industry is expected to grow further and contribute significantly to the economy over the medium term.

43. **The success of the BPO industry highlights the large dividends that can be gained from liberalization.** Going forward, non-traditional and non-captured industries with very large growth potential, such as tourism and outsourcing of higher-value manufacturing, such as design of electronics (Special Focus 3) could become key growth and employment drivers if supported by a freer market, as well as the requisite investment in physical and human capital.

Air transport reform⁴⁵

44. **Air transport reform also had a significant impact on the economy in terms of reducing prices and creating jobs in the trade and tourism sectors.** Like the telecommunications industry, the airline industry was a virtual monopoly before 1993, when it was dominated by Philippine Airlines (PAL). Flights were limited and largely flew out from Manila and, to a lesser extent, from Cebu. Service was characterized by frequent flight delays, cancellations, and high passenger ticket prices and freight costs. PAL earned the nickname “Plane always late.”

45. **In 1995, the government deregulated the air transport industry and opened the market to more competition.** This reform was part of a broader civil aviation reform to address 3 main issues: i) airport congestion in Manila, ii) poor performance of international tourism, and iii) inefficiencies in the domestic aviation market. On domestic aviation, in which the reform was the most successful, the government allowed new domestic airlines to operate freely and to complement or establish new routes. This led to a three-fold increase in the number of domestic airline routes. Moreover, up to 6 airlines entered the market between 1995 and 2010. The degree of competition reached a high point in 2011, when the new players’ combined market share reached almost 60 percent.

46. **The air transport reform’s impact on the economy has also been astonishing.** Several indicators are worth mentioning. First, the cost of travel has significantly gone down. For example, the ticket price for the Manila-Cebu route fell by around 50 percent in real terms between 1997 and 2014.⁴⁶ On most routes, air travel has become much cheaper than sea or land travel.⁴⁷ Second, much lower prices have significantly increased the number of domestic airline passengers, from less than 5 million before the reform to around 30 million in 2014, allowing tens of millions of Filipinos to travel by air for the first time. Partial deregulation of the international sector also increased the number of international passenger arrivals from 9 million to around 25 million between 2004 and 2014 (of which around one-fourth are tourists) (Figures 18 and 19). Third, the surge in airline passengers has raised industry revenues four-fold over a 15-year period and, to a lesser extent, industry value-added (Figures 20 and 21). As in the telecommunications industry, the original monopoly, PAL, also benefited from the

⁴⁵ This section draws in part from Salazar-Rodolfo (2011).

⁴⁶ Data for 1997 are from Philippine Airlines as cited by Austria (2001) and data for 2014 are from Philippine Airline’s website (<https://onlinebooking.philippineairlines.com>).

⁴⁷ For example, the cost of an air ticket for the Manila-Laoag route is only slightly higher than the bus fare and is even lower during the lean season.

expanded market. Furthermore, more competition in the airline industry led to better protection of passenger rights, with the passage of the Air Passenger Bill of Rights in 2012.

Figure 18. Air passenger traffic increased ten-fold between 1970 and 2010, largely due to reforms in the last 2 decades.

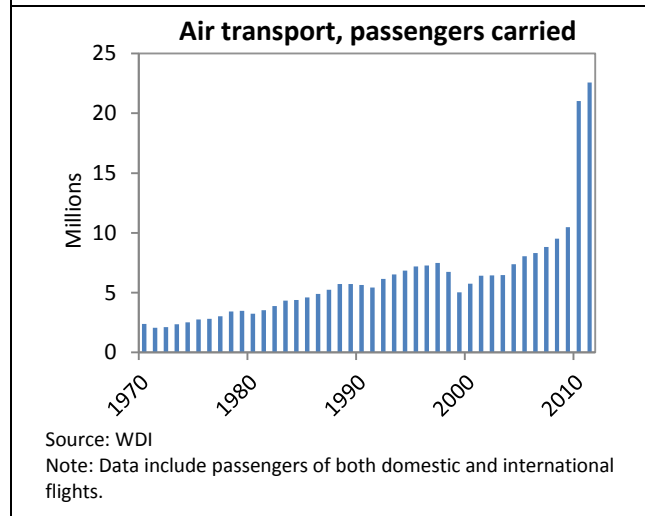


Figure 19. Air passenger traffic more than doubled in the last 8 years.

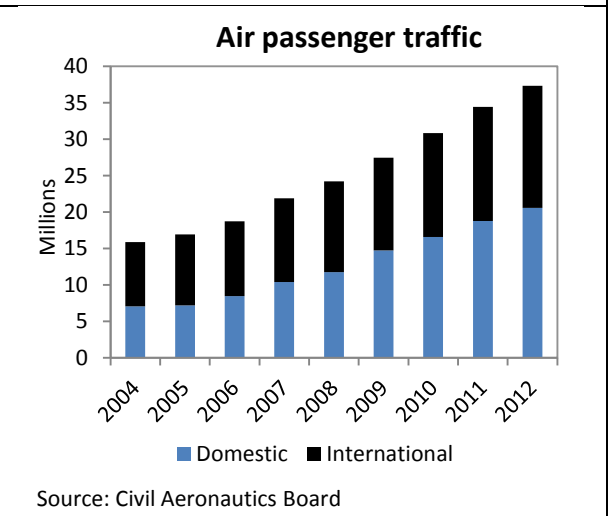


Figure 20. Air transport revenues grew four-fold between 1994 and 2008.

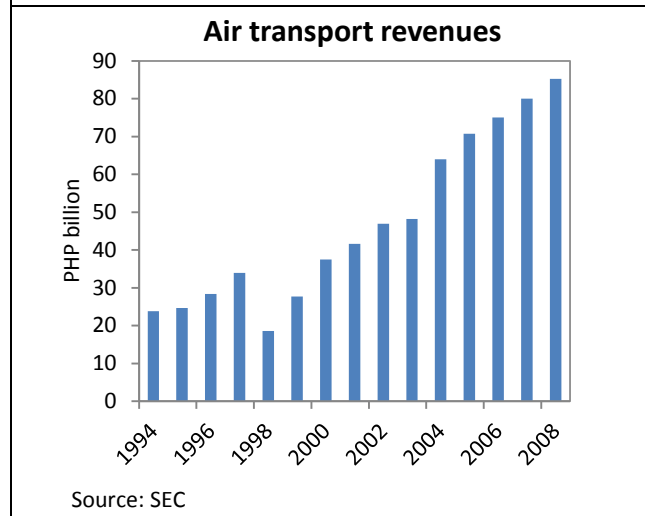
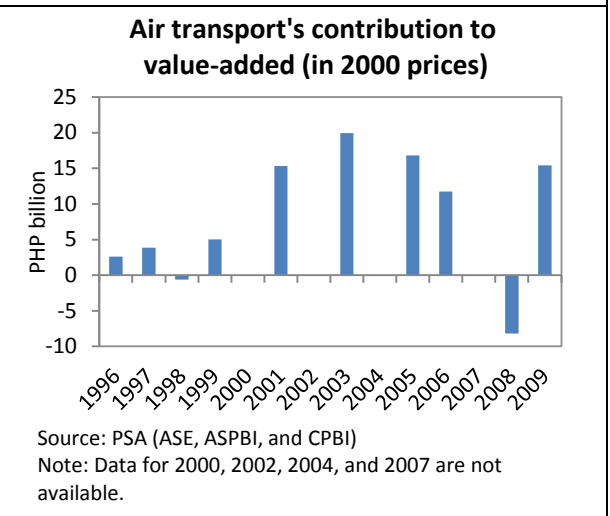


Figure 21. Value-added also increased albeit to a lesser extent.



Further reforms to enhance competition

47. **Increasing competition in the economy, coupled by more investments in infrastructure, could reinvigorate the agriculture and manufacturing sectors, and create more and better jobs.** This requires reforms to i) strengthen competition policy, ii) enhance competition in key sectors with strong potential to reduce poverty such as ports, shipping, water utility, airlines, oil, cement, chemicals, and agriculture, iii) open the economy further to

foreign competition, and iv) strengthening regulatory capacity. Having more contestable markets can spur investments from both domestic and foreign sources, bring down the cost of manufacturing inputs and logistics, provide workers in agriculture and informal services with better jobs in manufacturing and high skill services, and increase real household income by reducing consumer prices.

Strengthening overarching competition policy to level the playing field and lower prices

48. **An explicit competition policy is needed to combat ongoing and potential anti-competitive practices that are not sanctioned under the existing legal framework.** The principle of fair competition needs to be at the heart of this policy. This can be achieved in 2 steps. In the short term, the principles and key provisions for a fair competition policy can be established through an executive order (EO). In the medium-term, an explicit anti-trust and fair trade law could be enacted. To enforce this policy, a strong and independent competition authority is needed. This office should have i) statutory independence, ii) be adequately funded and fiscally autonomous, and iii) be led by senior executives who are appointed for fixed terms. Without an institutional structure in place to implement and coordinate the reform process, there is a danger that any reform momentum to enhance competition might quickly dissipate. The government's resolve to enhance competition by creating the Office for Competition in the Department of Justice to investigate monopolistic behavior is a step in the right direction. Strengthening this office through legislation should be pursued. In December 2014, the Senate passed a "fair competition" bill. The House version is currently being debated.

49. **To sustain the reform, there is a need to build public support and consensus around the principles of fair competition.** Three elements would help achieve this. First, an independent advisory body to advance the economic reform agenda could be set up to provide impartial advice on the scope and strategy of the reform. This body could include leading economists and senior private sector executives.⁴⁸ If warranted, it could be institutionalized and transformed into a permanent Council of Economic Advisers to advise the President and the Director-General of the National Economic and Development Authority on important issues facing the economy. Second and equally important, a structured dialogue could be conducted with the private sector and other stakeholder groups as partners in supporting the principles of fair competition and contestable markets across all sectors and industries, as well as in actively assisting the government in creating a level playing field. Third, public education is needed to generate ownership and "buy-in" of proposed reforms in order to create a constituency with a deeper appreciation for the importance of inclusiveness, openness, competition, and economic gains from contestable markets.

⁴⁸ To ensure impartiality, private sector representatives need to abstain from any proceedings that involve their own industries.

Enhance competition policy in key industries of the economy by reducing monopoly or oligopoly control

50. **In the past, increasing competition in industries controlled by non-natural monopolies and oligopolies, such as telecommunications and air transport, had a large positive impact on economic development and benefited workers, businesses, and the government.** For workers, it meant more and better jobs and higher real income as new and more productive firms joined the market and as monopoly profits were reduced and shared with workers in the form of higher wages and lower prices. For businesses, a more level playing field enabled many new firms to enter the market, some of which are now driving economic growth. For the government, it meant higher tax revenues and hence higher investment spending. However, there are segments of the population that have not benefited much from these reforms. The poor and informal workers, in particular, have benefited the least as evidenced by the slow pace of poverty reduction in the decades following liberalization. To uplift their welfare, a number of key industries with more direct impacts in terms of job creation for the poor or lowering prices of basic commodities need to be opened up for more competition.

51. **Enhancing competition in ports, shipping, water utility, and air transport has huge potential in reducing poverty and creating jobs for millions of poor and vulnerable people.** Enhancing competition in ports and shipping is essential in helping reduce food and input prices, improve producers' access to markets and raise farmers' income in less developed regions, such as Mindanao. In addition, enhancing competition in the water utility sector can help improve access to clean and affordable water, improve health outcomes, and raise worker productivity especially in rural areas.⁴⁹ Finally, enhancing competition in the air transport sectors can help spur the growth of tourism and enhance regional integration and development.

52. **Competition can also be enhanced in industries that provide vital inputs to manufacturing, such as agribusinesses (e.g., sugar, corn, and soybean) and the oil, chemical, and cement industries.** Enhancing competition in these industries can spur manufacturing by lowering input costs. In all these industries, the key policy recommendation is to gradually reduce import tariffs and other trade barriers in order to cut input costs and improve product quality through more competition. Liberalizing the sugar, corn, and soybean sectors can help lower processed food prices and consequently increase the real income of most Filipinos. Liberalizing the cement industry has the potential of bringing down infrastructure cost, while liberalizing chemical and oil manufacturing can improve vertical linkages of Philippine manufactured products (e.g., plastic casing for electronic products; see Special Focus 3).

⁴⁹ Around 40 percent of Filipinos have poor access to clean and affordable water. This translates to lower productivity and hence lower real income, as workers spend a significant amount of their time sourcing water (an average of 1 hour or more a day) and/or recuperating from sickness caused by dirty water (from a few days to several weeks). Addressing issues in the water utility sector, while not directly creating jobs, can increase worker productivity and hence the real income of the poor.

Review the foreign investment negative list and consider reducing restrictions

53. **In addition to enhancing domestic competition, allowing more foreign participation would facilitate the entry of technology and innovation that can help the country become more competitive.** While the Philippines' ownership rules are not excessively restrictive relative to those of other countries in the region, its slower growth record over the past decades indicates that it needs to position itself ahead of the regional norm. Opening up the economy to more foreign participation is one way of speeding up growth, given the benefits that come with more FDI.

54. **Two key recommendations are proposed to enhance FDI inflows.** The first is to amend the economic provisions of the 1987 Constitution by removing the explicit rigidity imposed on natural resources, public utilities, mass media, educational institutions, and the practice of professions. The prerogative to impose such restrictions could be given to congress, as is the case in the other sectors and in most countries. This would align the Philippines with other countries in the region. The second is to further open priority sectors to international players. This requires their removal from the foreign investment negative list. These sectors are likely to have the largest gains in terms of competition, capital, technology, and improved governance. They are also likely to generate jobs and increase real income. These sectors are:

- a. **Telecommunications:** Although the Philippines is known for its vibrant and fast-growing BPO industry, the telecommunication infrastructure still has considerable shortcomings relative to potential (e.g., dropped calls, lag in text messaging, weak internet signal, and network overload). It also has the most expensive prices in the region as of 2013. Opening the telecommunications sector to foreign capital and know-how can raise productivity and spur overall business activity, as most modern, especially technologically-sophisticated, companies in a globalized age depend on effective telecommunications systems. The BPO industry and other industries that depend on it stand to benefit significantly from this reform.
- b. **Shipping:** Inter-island shipping is open to domestic players only but many domestic shipping companies are inefficient, have poor safety standards as evidenced by the number of maritime accidents, and historically behaved like a cartel. Allowing more foreign participation (and often the threat of competition is enough) can serve as a disciplining force to reduce shipping costs, improve service quality by a wide margin, and save lives. This would directly benefit tens of millions of Filipinos in terms of lower food prices and millions of farmers, say in Mindanao, who would be able to sell their produce in Luzon's fast growing market.
- c. **Media:** The mass media sector is completely barred from foreign ownership. Opening it to foreign investors could help increase its independence (as several media firms are part of local conglomerates) and thus its ability to raise accountability and demand for good governance, help eradicate corruption, and consequently improve overall economic performance.

- d. **Practice of licensed professions:** The practice of licensed professions, such as engineering and medical service, is almost exclusive to Filipinos, even though current laws governing professions allow for reciprocity.⁵⁰ While this restriction has ensured employment for many Filipino professionals, it also limits access to new knowledge and technology, especially in engineering and science. Relaxing restrictions in some lagging fields, especially in light of the Association of Southeast Asian Nations (ASEAN) Economic Community 2015 and other trade agreements which the Philippines can benefit from (e.g., Trans-Pacific Partnerships), could improve knowledge and skills accumulation of Filipino professionals, as foreign professionals bring in new knowledge and expertise.⁵¹
- e. **Construction:** Locally-funded public construction works are largely limited to domestic companies, although some exceptions apply. Foreign competition can raise productivity and reduce costs in construction considerably. Opening the sector further to foreign ownership can increase the value for money to society and provide incentives for domestic companies to become more competitive. Foreign participation can be encouraged by ensuring that project sizes are increased to entice more foreign firms to bid.
- f. **Mining:** This sector is particularly intensive in its use of capital and technology and would benefit from foreign investment and know-how. In addition, reforming mining taxation can help ensure that the benefits from increased mining activity will accrue to the Philippine economy, benefit affected communities more, and help ensure environmental protection.
- g. **Land:** There is a need to ensure an efficient way of securing long-term property rights for land, whether in the form of ownership, lease, patents, or other usufruct rights while guarding against land speculation and land grabbing. Strengthening long-term land lease rights, as alternative to outright ownership, may be enough to significantly increase FDI. In addition, allowing foreign long-term leases can facilitate credit and lead to greater access to finance, which is at present constrained by the inability of foreign banks to accept land as collateral.

⁵⁰ According to the Joint Foreign Chambers of the Philippines (2012), there are 46 individual laws that provide for the regulation of as many professions. All laws allow for reciprocity. When a foreign national applies to practice in the Philippines, the Professional Regulatory Commission decides whether there will be pertinent reciprocity.

⁵¹ For instance, more competition in the education sector (e.g., less restriction in hiring foreign professors to complement local talents) can potentially raise the global ranking of Philippine universities. As a case in point, US universities have kept their prestige by leveraging on global talents.

Strengthening regulatory capacity

55. **In tandem with liberalization, regulatory capacity needs to be strengthened.** The independence and competence of important regulatory bodies and the justice system need to be ensured. Moreover, political and judicial interference in regulatory decisions, such as occasional reversal of decisions, need to be limited. These can be achieved by i) clearly defining the role of regulatory bodies, including provisions to limit conflict of interest, ii) ensuring some degree of fiscal autonomy and adequate expertise to avoid politicization of decisions and to allow regulatory bodies to execute their mandates freely, iii) reducing discretionary powers of regulators by establishing clear and rule-based procedures and policies, iv) improving transparency of decision making, and v) conducting regular regulatory assessments. A stronger regulatory body can also help the country better address concerns brought about by a more open economy, such as national security and environmental hazard.

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SPECIAL FOCUS 1

Congestion in Metro Manila and its impact on the economy⁵²

1. **In the last decade, Metropolitan Manila experienced high and sustained economic growth as well as a population boom, but infrastructure deficits led to worsening road congestion.** Since 2000, Metro Manila's economy grew by almost 10 percent annually compared to around 5 percent for the whole Philippine economy. Day time population in Metro Manila increased from 13 million in 2000 to 16 million in 2010, as more people residing in adjacent provinces came to work in the metropolis. However, this growth was not accompanied by commensurate investments in infrastructure. Infrastructure spending was minimal (less than 1 percent of GDP annually), new road projects numbered less than 10,⁵³ and the last completed major mass rail transport project was in 2004. As a result, the main road network is now heavily saturated. Average speed went down from 30 kph in 2006 to 20 kph today (JICA 2014). On major roads such as EDSA and C5, rush hour traffic slows down even further to just 5 kph.

2. **Worsening congestion results in significant productivity losses for the economy.** While congestion do not translate into very high commuting costs (less than 8 percent of household income⁵⁴) in part due to subsidies given to mass rail transport, it nevertheless manifests itself in a very long commute time and significant productivity losses. For instance, workers living in northern Metro Manila and working in the Makati business district (a distance of around 20 km) spend up to 4 hours commuting per day. In recent years, train congestion has also worsened significantly. For the same distance, time spent commuting by train more than doubled due to long queues and slower trains (the result of under-maintenance). The same JICA study estimates that road congestion costs the economy some PHP 876 billion annually (around 8

⁵² This special focus was prepared by Beatrice Tanjangco (Research Assistant), Roberto Galang (Operations Officer), and Karl Kendrick Chua (Senior Country Economist) with inputs from Victor Dato (Senior Infrastructure Specialist). This special focus draws in part from interviews with the Philippine Ports Authority Communications Office and Royal Cargo, and the December 12, 2014 press statement of the private sector part of the Port Congestion Multi-sectoral Working Group.

⁵³ Completed projects are the i) elevated portion of SLEX, ii) Libis-Katipunan flyover, iii) Quezon Avenue-Araneta Avenue underpass, iv) C5 extension, v) Mindanao NLEX connector, vi) LRT line 2, vii) LRT line 1 extension, viii) Diosdado Macapagal Highway, and ix) the C5-NAIA ramp. Ongoing projects are the i) NLEX-SLEX connector, ii) NAIA expressway, iii) Daang Hari highway, and iv) rehabilitation of the PNR commuter railway.

⁵⁴ Manila's share of commuting cost to total expenditure (8 percent on average, 4 percent for lowest decile, and 9 percent for top decile) is comparable with that of cities in other developing countries. In Mumbai, India people spend on average 9.6 percent of income on fare and fuel. In Buenos Aires, Argentina, the bottom quintile spends up to 32 percent of income to commute, while the highest quintile spends about 9 percent. In Sao Paulo, Brazil, the lowest income group (less than 5 times the minimum wage) spends 30 percent of income on transportation while the highest income group (more than 30 times the minimum wage) spends 7 percent. For more information, please see http://siteresources.worldbank.org/INTTRANSPORT/214578-1099319223335/20460038/TP-3_affordability_final.pdf.

percent of GDP) or PHP 2.4 billion per day. This translates into a “productivity tax” of 10 to 30 percent per person.

3. **To address worsening congestion, the government implemented several measures to manage travel demand by limiting the number of vehicles on the road, sometimes with inadvertent and occasionally severe consequences.** Private vehicles are barred from the road during rush hour once a week depending on their plate number. Public utility vehicles (PUV) are subjected to stricter franchising regulation and enforcement to eliminate illegal PUVs. Trucks are subjected to various degrees of truck bans. However, these demand-side measures are not sufficient if the lack of transport infrastructure is severe, as is the case in Metro Manila. As movement of people and goods compete for limited space on the road, significant costs are incurred by commuters and businesses in terms of reduced productivity, loss of opportunity, poor quality of life, and increased safety risks, or in terms of delayed deliveries, slower trade and even economic growth.

4. **In 2014, a more restrictive truck ban by the City of Manila caused substantial disruptions in business that it affected trade and economic growth.** Truck bans have been implemented since 1978.⁵⁵ In 2012, the Metro Manila uniform ban on trucks weighing more than 4,500 kg was expanded by reducing the daytime window for trucks from 8 to 7 hours.⁵⁶ This affected truck productivity only marginally, as trucks were still able to do 2 to 3 trips per day. However, in February 2014, the City of Manila implemented its own truck ban on top of the modified Metro Manila truck ban. Truck operators, as well as the wider business community, vehemently opposed it, as it would massively disrupt the movement of goods to and from the Port of Manila, which is located within the city. The Manila daytime truck ban originally prohibited trucks from traversing the city’s streets from 5 AM to 9 PM.⁵⁷ After negotiations, laden trucks were given a window from 10 AM to 3 PM and extended to 5 PM after further negotiations. However, trucks carrying empty containers were totally banned from 5 AM to 9 PM. This led to major disruptions in trade and production, contributing to slower trade and economic growth in succeeding quarters. It also exposed the weaknesses of the port system.

5. **As a result, trucking productivity diminished significantly, resulting in higher prices, worse road congestion, and more frequent accidents.** With the movement of containers constrained during the day, the productivity of trucks fell significantly to 1 to 2 trips per day.⁵⁸ To offset this loss in productivity, the trucking confederation increased its rates by as high as

⁵⁵ See MMDA (2014), MMDA Resolution 1 Series of 2012, Manila City Ordinance 8336, Manila City Resolution 2-2014, and Basilio (2014) for more information on truck bans.

⁵⁶ Prior to 2012, the truck ban was imposed from 6 to 9 AM and 5 to 9 PM. In 2012, it was adjusted to 6 to 10 AM and 5 to 10 PM. They were also completely banned from EDSA, the main road. However, trucks loaded with perishables and agricultural products were exempted.

⁵⁷ As in the metro-wide truck ban, trucks carrying perishables and fast moving goods were exempted.

⁵⁸ See Philippine Inter-island Shipping Association (2014) for more discussion.

300 percent.⁵⁹ In many occasions, the truck ban inadvertently worsened congestion as trucks used less efficient routes. At the same time, a number of highly visible accidents involving trucks were reported in major roads, raising questions about the link between the new truck ban and road safety.⁶⁰

6. Meanwhile, a growing trade imbalance, because the Philippines imports much more than it exports, led to the accumulation of empty containers inside the Port of Manila, and worsened significantly during the truck ban. Prior to the Manila truck ban, empty containers were parked in in-land container yards as they waited for an exporter to use them. However, the Manila truck ban severely limited the movement of empty containers. Given the lower cost of leaving empty containers in the port as compared to moving them to in-land container yards, empty containers accumulated in the port, thereby disrupting port operations. According to the Philippine Ports Authority (PPA), container yard utilization in the Port of Manila jumped from 47 to 110 percent between February and May.⁶¹ An estimated 17,000 twenty-foot equivalent units (TEUs) of empty containers, from an average of 8,000, clogged the Port of Manila.⁶²

7. In the following months, trade and production were severely affected, leading to a contraction in imports, exports, and slower manufacturing growth. The piling up of empty containers led to congestion in the port, affecting shipments in and out of the Port of Manila. The increasing number of empty containers inside the port prevented other ships from unloading their cargo. As many as 37,000 TEUs bound for Manila accumulated in regional hubs such as Hong Kong, Singapore, and Kaohsiung. As a result, import and export container traffic⁶³ in Manila and Luzon contracted. In TEUs, import container traffic fell by 11 percent and export container traffic fell by 19 percent in the second quarter of 2014. In the third quarter, import container traffic deteriorated further by 17 percent while the contraction in export container was broadly maintained at 18 percent. Also, in the third quarter, manufacturing growth slowed to around 7 percent from 12 percent in the previous quarter given delays in the shipment of

⁵⁹ A number of news articles report that truck rates increased between 100 and 300 percent. See for example: <http://business.inquirer.net/182512/port-congestion-problem-sends-exporters-reeling> and <http://www.sunstar.com.ph/cebu/business/2014/11/24/port-congestion-drags-exporters-378343>.

⁶⁰ The rush to deliver appeared to have resulted in more road accidents. Night-time accidents likewise increased as truck drivers maneuvering at night lacked sleep. This resulted in traffic nightmares even between 12 and 6 AM. Trucks not cleared from the road by morning contributed to massive traffic jams during rush hour. Several articles report truck accidents happening in the early hours of the morning, reducing the number of open lanes for drivers. See for example <http://newsinfo.inquirer.net/630930/truck-accident-causes-traffic-gridlock-on-roxas-bvd-in-pasay-city#ixzz3KkGZW3UV>, <http://newsinfo.inquirer.net/651161/truck-rams-16-posts-along-east-service-road-in-taguig-city#ixzz3KkHCCD6s>, <http://motioncars.inquirer.net/30795/truck-crash-on-c5-causes-death-injury-and-massive-traffic> and <http://www.gmanetwork.com/news/story/369535/news/metromanila/1-killed-in-motorcycle-truck-accident-in-pasay>.

⁶¹ See the July 28 PPA Press Release: <http://www.ppa.com.ph/ppa%20web/news/ppa07092014-6.htm> for more details.

⁶² See the July 9 PPA Press Release: <http://www.ppa.com.ph/ppa%20web/news/ppa07092014-2.htm> for more details.

⁶³ This is measured in twenty-foot equivalent units (TEUs). See <http://www.ppa.com.ph/ppa%20web/portstat.htm> for actual numbers.

raw materials. Several exporters interviewed for this study complained that they missed deadlines given delays in production.

8. As congestion on the roads and in the port began to take a toll on people's lives and the economy, the government, working with the private sector, undertook several measures to decongest Metro Manila. The initial response of the PPA was to move overstaying problematic containers (i.e., more than 90 days) to Subic.⁶⁴ On the other hand, overstaying customs-cleared containers (i.e., more than 5 days) were also relocated.⁶⁵ The PPA offered credit incentives to importers who would withdraw their cargo on weekends. Higher fines for overstaying containers inside the port (from PHP 500 to PHP 5,000 a day) were imposed in October. Later, remaining overstaying empty containers were forcefully transferred to nearby Batangas and Subic Ports (around 110 and 120 km from the Port of Manila, respectively). To facilitate shipping lines, the President issued Executive Order 172 declaring Batangas and Subic Ports as extensions of the Port of Manila in times of congestion and emergency. Private port operators also took steps to ease port congestion. The operator of the Manila International Container Terminal within the Port of Manila provided an inland container yard in nearby Laguna Province, while the operator of the South Harbor, also within the Port of Manila, provided a web-based application to systematically track empty containers. A 24-hour "last mile truck lane" permitted trucks with designated tags to use arterial roads during the truck ban hours. Moreover, traffic management was intensified. Finally, giving way to clamor from the business sector, the City of Manila lifted the daytime truck ban on empty containers in September 2014.

9. These measures helped lower port congestion. By October, port congestion started to ease. Container yard utilization in the Port of Manila gradually improved and reached the target of 80 percent by end-November. The number of ships queuing to berth fell from 25 in November to 12 in December. Imports and export schedules began to normalize. Road congestion also started to move towards "normal" congestion levels.

10. However, several key issues remain unresolved and recent moves to limit truck movement could worsen the situation yet again. In December 2014, the Metro Manila Development Authority imposed a six-month long truck ban along Roxas Boulevard to ease holiday traffic and to prepare for the 2015 Asia-Pacific Economic Cooperation (APEC) meetings, among other reasons. As a third of trucks use this thoroughfare to reach the port, the flow of goods will again be severely compromised. There is also growing concern about the government's directive to phase out trucks older than 15 years, which constitute around 70 percent of total trucks. As many of these trucks are still road-worthy, this move could paralyze the logistics sector. The complexity of securing import clearance certificates is also a major

⁶⁴ Problematic containers are containers that have difficulty clearing customs due to under-declaration, mis-declaration, abandonment, or smuggling issues. They are given 90 days to clear customs after which they are declared to be overstaying.

⁶⁵ The PPA offers 5 free days of storage to containers that have been cleared by customs. A container that remains within the port after this 5-day allowance is considered by the PPA as overstaying.

concern. While processes in the Bureau of Customs have been streamlined, processes in the Bureau of Internal Revenue (BIR) have seen little improvement. For instance, 7 redundant or cumbersome steps have been identified in a process review conducted by both the private sector and the BIR, but no action has been taken to address this finding.⁶⁶

11. The private sector part of the Port Congestion Multi-sectoral Working Group⁶⁷ has proposed the following short-term recommendations to facilitate the efficient flow of goods:

i) keep Roxas Boulevard open to trucks during the holiday season when trade is the heaviest, ii) move empty containers from the port to container yards, with shipping lines taking responsibility for their containers, and having flexible operating hours for container yards so that trucks can deliver or pick up containers any time, iii) streamline the BIR accreditation process for importers by eliminating the 7 redundant steps identified in the process review, and iv) impose a moratorium on the 15-year limit for trucks while conducting more public consultation to arrive at a better solution.

12. In the long-term, solving congestion requires more investment in infrastructure. In roads, there is an urgent need to expand and modernize the country's mass transport system, including bus rapid transit systems. Moreover, road connectivity between major business districts and residential areas needs to improve by investing in elevated expressways, as Bangkok and Jakarta have done. Current work to connect the north and south expressways is a step in the right direction, but more is needed, such as connecting the Port of Manila directly with the north-south expressway via a dedicated elevated expressway. In ports, there is a need to decongest the Port of Manila by developing the nearby Ports of Batangas and Subic. Integrating the domestic and international berths will also help decongest the Port of Manila by avoiding inefficient transfers of goods between domestic and international ships and harbors. Finally, complementary reforms to improve competition in domestic shipping, as well as cabotage liberalization, are needed.

⁶⁶ These are i) no unresolved issues in tax declaration, ii) certified true copy of BIR certificate of registration, iii) authenticated copy of income tax return, iv) details of registration address, v) for individuals, personal profile with ID picture, vi) for corporations, standard registration requirements from SEC, and vii) for cooperatives, standard registration requirements from the Cooperative Development Authority.

⁶⁷ The Port Congestion Multi-sectoral Working Group is a private-sector led task force. It works with the cabinet cluster on port congestion. The cabinet cluster on port congestion was established in June 2014 in response to the port congestion problem.

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SPECIAL FOCUS 2

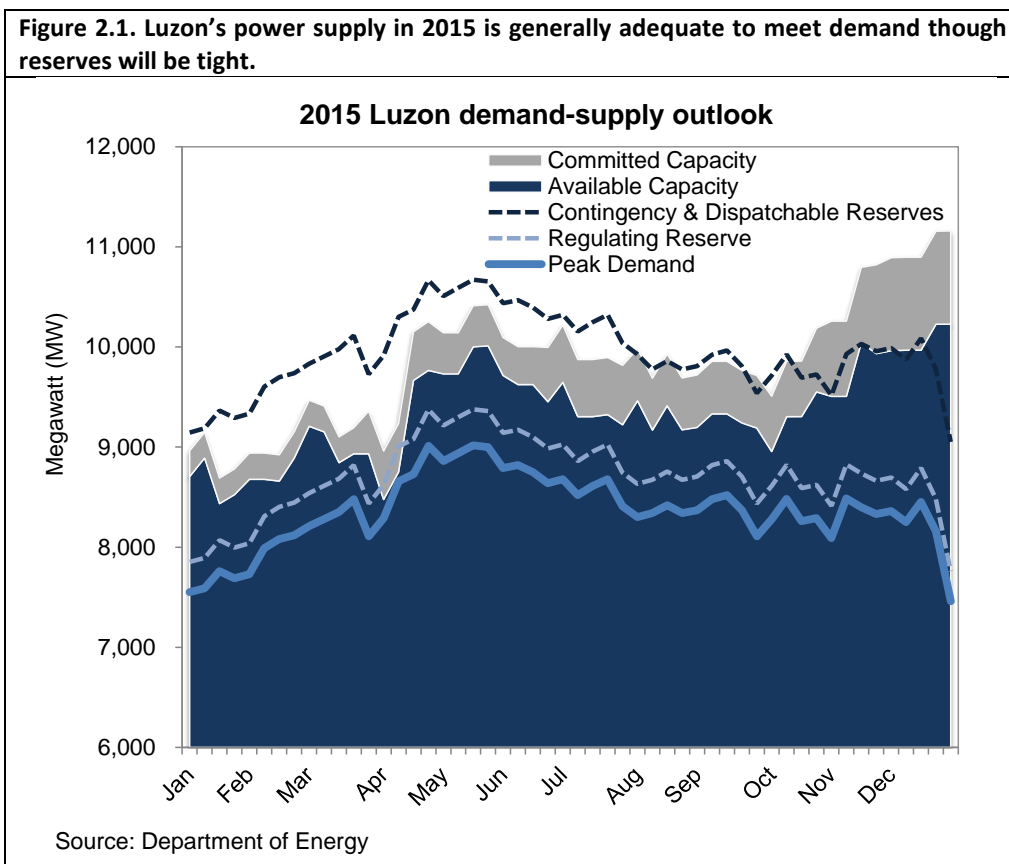
Potential power shortages in Luzon and the way forward⁶⁸

1. **Concerns about power shortages in Luzon this year dominated headlines in the last 12 months.** Luzon accounts for about 70 percent of total generation. It includes Metro Manila and its 2 adjacent regions, which account for over 60 percent of the national economy. Key growth drivers, notably manufacturing, tourism, and business process outsourcing (BPO), are located in this area and are highly dependent on reliable electricity. Therefore, possible systemic power outages can drag down growth, as the power crisis in the 1990s showed. More importantly, they could reverse the country's hard-earned gains in improving its investment climate.
2. **The problem is not unique to Luzon as Visayas and Mindanao also have their share of power sector woes.** While Meralco, the country's largest distributor serving Metro Manila and surrounding areas, has provided generally reliable power albeit at higher prices,⁶⁹ electric cooperatives (ECs) in the rest of Luzon and in the Visayas offer slightly lower prices but at uneven reliability. Some ECs in the Visayas were badly affected by Typhoon Yolanda and have not completely recovered. Meanwhile, Mindanao has suffered from chronic generation shortages for over 5 years. Households and businesses that are not connected to the main grid in Luzon, Visayas, and Mindanao are very costly to serve. Finally, many households in small islands still lack a modern electricity connection.
3. **Back in Manila, congressional and public debates on the possible power shortage have helped improve policymakers' and the public's understanding about the nature of the problem, its underlying causes, and the range of possible solutions:**
 - **Luzon's power generation capacity problem has multiple dimensions.** First, existing generation units are aging and exhibit reliability issues, as seen in their high outage rates. Second, the inadequacy of contingency and operating reserve capacities are becoming more apparent. Third, additional generation capacity is expected to come online later rather than sooner, and start-up risks can further delay operations. Finally, the international natural gas market is currently inaccessible, because of the lack of liquefied natural gas import terminals. This means that investments in gas-fired generation, which is the cheapest option in terms of capacity cost per installed megawatt, are more difficult.

⁶⁸ This special focus was prepared by Alan Townsend (Senior Energy Specialist) with inputs from Victor Dato (Senior Infrastructure Specialist). The team is grateful to Romeo Bernardo (Managing Director of Lazaro, Bernardo, Tiu, and Associates) for providing useful comments.

⁶⁹ Relative to its neighbors, Philippine power costs are generally higher due to the lack of subsidies and its archipelagic geography, among other reasons.

- **However, it is by no means certain that Luzon will suffer power shortages in 2015.** The period of concern is between April and May 2015, when the hotter and drier summer weather combined with the planned maintenance shutdown of the Malampaya field, could cause a crunch.⁷⁰ The combination of available and committed capacities seem sufficient to meet demand for most of 2015, but reserves are tight and, at times, inadequate (Figure 2.1). In this period, any unexpected generation plant outages would not be compensated for lack of available reserves.



- **The government is not stepping in to build or contract new generation.** This reflects the emerging consensus, as discussed above, that supply risks are mainly limited to peak periods during the Philippine summer, with a particularly worrying stretch in April when the Malampaya field is shut down for maintenance. The problem arises only if there is a combination of unexpected high demand and generation outages.
- **Having dropped the option of contracting new, albeit interim supply, the government's focus has shifted to the Interruptible Load Program (ILP).** This industry initiative was implemented in the Visayas in the wake of Typhoon Yolanda, and in

⁷⁰ Maintenance shutdowns cause temporary outages of 600 MW and, for a time, 1,200 MW.

Mindanao, following its power crisis. Under the ILP, large industrial and commercial customers will “interrupt” their power use during periods of high demand and instead use their own generation sets. In turn, the government will reimburse fuel expenses and “reasonable recovery for their use.”⁷¹ It is also proposed that the reimbursement be exempted from value-added tax. As long as there is sufficient participation in the ILP program, alongside demand conservation, the probability of involuntary curtailments will be reduced significantly. According to the Department of Energy, a total of 149 companies have signed up as of 19 December 2014, offering 614 MW in total capacity.

- **Shortages are unlikely in 2016.** New generation that will come online between 2016 and 2018 will keep Luzon comfortably supplied (assuming no delays), with the next possible supply crunch not showing up until 2019. If liquefied natural gas import terminals become operational within the decade, the probability of shortages will likewise diminish substantially.

4. **With good planning, fewer unplanned outages, power conservation, and favorable weather, Luzon is likely to avoid a catastrophic power crisis in 2015.** However, that will still leave the country with many issues around high power cost and supply constraints.

5. **To ensure adequate and affordable power supply, a number of areas need action.** These include: i) increasing generation capacity, in particular investments in a mix of energy sources to enhance energy security while keeping prices more affordable, ii) enhancing competition in the power retail sector by more focused implementation and by lowering the threshold for open access so that the market can become more contestable, iii) reducing transmission constraints in Luzon by improving coordination between grid capacity and new generation projects so that the transmission company can make more timely investments, iv) implementing a market for reserves, which is crucial for signaling when new power supply is needed, v) crafting a sensible natural gas policy given its affordability, and vi) continuing the reform agenda for electric cooperatives to enhance their financial viability (e.g., through credit guarantees and fiscal rules), technical capacity, and governance (e.g., delinking politics with EC management).

6. **With modest policy actions but sharper focus, the government can chart a path to supply adequacy and power rates that are fair for customers, reliable for operators, and efficient for the economy.** These include:

- **A shift, by the Energy Regulatory Commission, to generation benchmarking:** Currently, ERC approves all generation contracts (numbering by the hundreds) that distributors enter into with generators. Approval processes are not efficient and outcomes are unsatisfactory as prices vary widely from contract to contract and there is little evidence

⁷¹ It is important that compensation be based on actual cost to avoid overcompensating firms especially in light of falling oil prices.

of efficient contracting. Whatever is approved can be passed on to customers, so incentives for efficient contracting are weak. Under a benchmarking approach, electricity distributors would recover only a pre-determined generation rate that reflects the optimal portfolio of purchases that an efficient distributor would make, given the available choices. The distributor would not be allowed to recover costs beyond that benchmark rate. This approach would incentivize distributors to effectively manage their portfolio of contracts and their exposure to the spot market. Had generation benchmarking been in place prior to November 2013, spot market issues during that period would have had no impact on the bills of consumers.

- **Give the market a chance to work:** Following price spikes in November 2013, the regulator intervened in the Wholesale Electricity Spot Market (WESM) by lowering the market price cap even though WESM itself is not the cause the problems at that time (as verified by 2 independent reviews). Wholesale markets are established in part to send strong price signals when new capacity investment is needed. Lowering the WESM price cap and taking other measures to prevent the market from functioning as designed are not desirable. A truly market-driven WESM, combined with generation benchmarking, will facilitate generation investment and protect consumers.
- **Strengthening regulatory capacity of ERC:** The ERC regulates hundreds of electricity producers and service providers, so it needs to be adequately supported to do its job. This includes access to independent advisory support in conducting highly technical reviews of utility rates and in improving cost management.
- **Facilitating project execution and delivery:** Setting up new generation plants and other power infrastructure faces significant transaction costs, including securing over a hundred permits, and lack of coordination among government agencies and between the national and local government. To reduce transaction costs, the government can rationalize the issuances of permits, provide “one-stop shop” services, and use its convening power to ensure that consultations are more inclusive and effective, thereby reducing delays in project delivery. “Not-in-my-backyard” opponents have valid concerns and these should be addressed. The externality they face could be compensated with reduced rates.

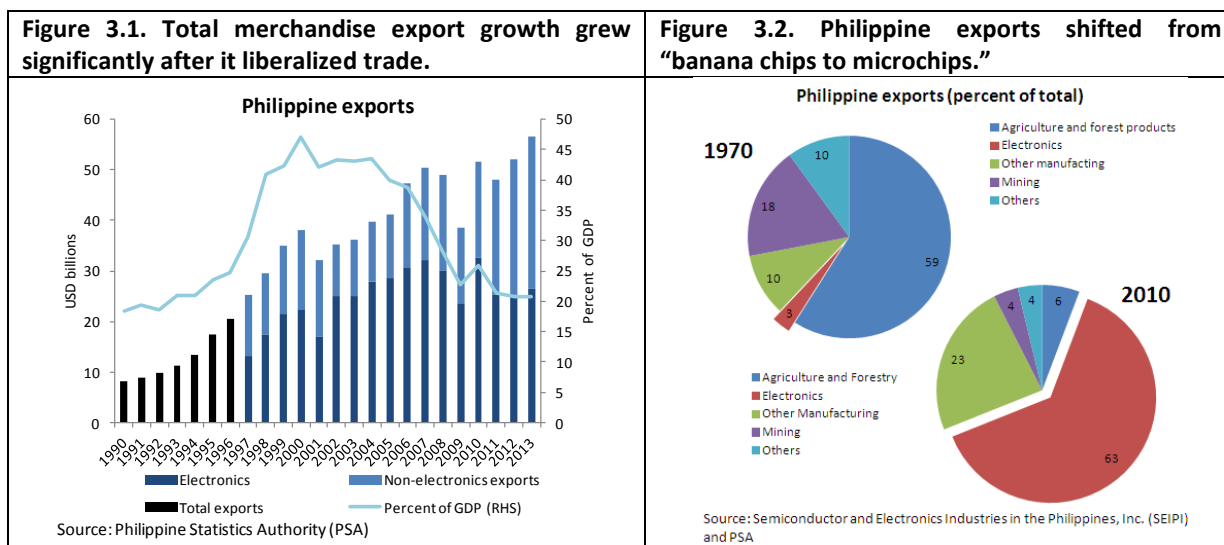
SPECIAL FOCUS 3

Reviving Philippine electronics exports⁷²

Introduction

1. **Total Philippine merchandise exports grew significantly since the country liberalized trade in the 1980s.** Prior to trade liberalization, exports were equivalent to 15 percent of GDP. In the late 1980s, the Philippines began to gradually open up its manufacturing sector. Since joining the 1993 Association of Southeast Asian Nations (ASEAN) free trade agreement, total exports increased to a peak of 47 percent of GDP in 2000 before declining gradually to 21 percent of GDP in 2013 (Figure 3.1).

2. **As the country became more integrated into the global supply chain, the Philippines' export basket became more diversified.** Among the most notable transformation in Philippine exports is the shift from exporting agricultural products in the 1970s to exporting electronic components in the 1990s. As one export association puts it, Philippine exports have moved “from banana chips to microchips” (Figure 3.2).⁷³ Exports of electronics grew exponentially between 1970 and 2000. In 1970, the share of electronics exports to total Philippine exports was around 3 percent (SEIPI 2009). In 2002, this number grew to 71 percent before gradually falling.



⁷² This special focus was prepared by Justin Chan (Research Assistant) and Karl Kendrick Chua (Senior Country Economist). The authors are grateful to the Semiconductor and Electronics Industries in the Philippines, Inc. (SEIPI) for information about the industry.

⁷³ Source: Semiconductor and Electronics Industries in the Philippines, Inc. (SEIPI). For more information, see <http://www.seipi.org.ph/our-industry/about-the-philippines>. In 1970, Philippines exports of fruit and nuts, prepared or preserved, ranked 7th, while bananas including plantains, ranked 19th.

3. However, since the 2009 global slowdown, electronics exports have not fully recovered. Prior to the slowdown, electronics exports reached a peak of USD 32 billion. Understandably, the global slowdown led to a decline in electronics exports. At that time, most industry observers believed exports would recover soon. However, 5 years after the slowdown, electronics exports have yet to match its pre-slowdown performance. In 2008 and 2009, electronics exports fell by 7 and 21 percent, respectively (Figure 3.3). Nascent recovery of the global economy led to a jump in electronics exports by 38 percent in 2010. However, this rate of growth was not sustained in succeeding years as exports contracted yet again by 23 and 0.3 percent in 2011 and 2012, respectively. The industry started to grow again in 2014 but this pace of growth was not enough to bring the industry back to its pre-slowdown momentum.

Figure 3.3. Electronics export growth slowed down in recent years, driven by contraction in semiconductors.

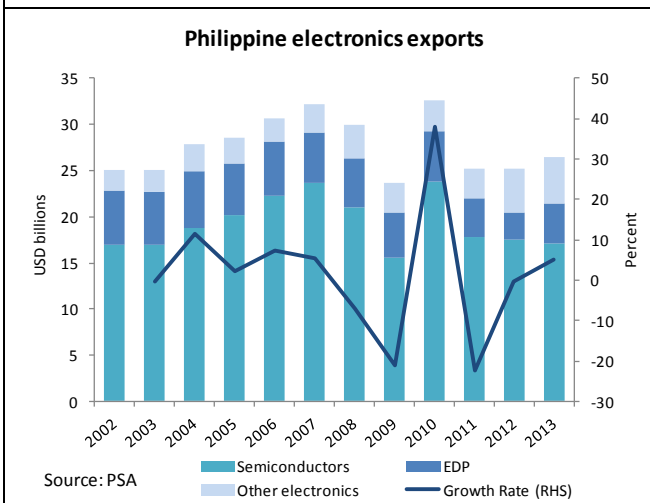
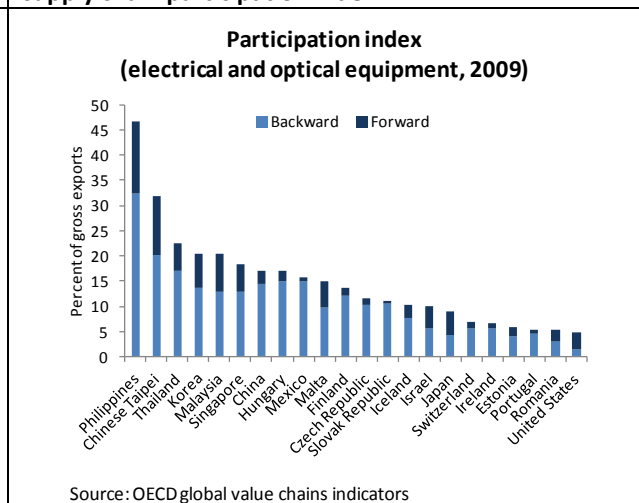


Figure 3.4. The Philippines is highly integrated in the global supply chain as measured by OECD's global supply chain participation index.



4. This special focus analyzes the trend in electronics exports, the likely reason for lackluster growth in recent years, and discusses how the industry can overcome these challenges going forward. It begins by giving an overview of the electronics industry followed by a discussion of its performance in the last decade. It then analyzes the likely reasons for the industry's underperformance. Finally, it presents some recommendations on how the Philippines can regain its edge as one of the leading electronics exporters.

Overview of the Philippine electronics industry

5. The Philippines is an integral part of the global electronics supply chain.⁷⁴ Among a group of comparator countries, the Philippines ranks highest in the OECD's participation index

⁷⁴ The global electronics industry is characterized by fragmented production stages across different countries (Backer & Miroudot 2013). Most of Philippine electronics exports are composed of imported raw materials and are processed, assembled, or manufactured domestically before being exported to the next stage of the supply chain.

for the electrical and optical equipment industry (Figure 3.4).⁷⁵ In 2013, the top markets for Philippine electronics exports were Hong Kong, China, Japan, Singapore, and the US. In the same period, exports to each of these countries comprised at least 10 percent of total electronics exports. As China is an assembly hub, the country's ultimate markets are advanced and middle income countries around the world. In 2013, the Philippines ranked as the 10th largest exporter of semiconductors with a market share of 2.2 percent (Figure 3.5).

6. **The Philippine electronics industry is grouped into 2 broad categories, electronics manufacturing services (EMS)⁷⁶ and semiconductor manufacturing services (SMS).** The EMS segment produces finished products such as laptops, hard disk drives, printers, photocopiers, fiber optic cables, cellular phones, car stereos, anti-skid brake systems (ABS), televisions, and solar panels (BOI 2011). On the other hand, the SMS segment produces intermediate goods used in the production of other electronics products such as integrated circuits, transistors, diodes, resistors, capacitors, printed circuit boards, and other components (BOI 2011). Prior to the 2009 slowdown, the average shares of SMS and EMS to total electronics exports were around 70 and 30 percent, respectively.

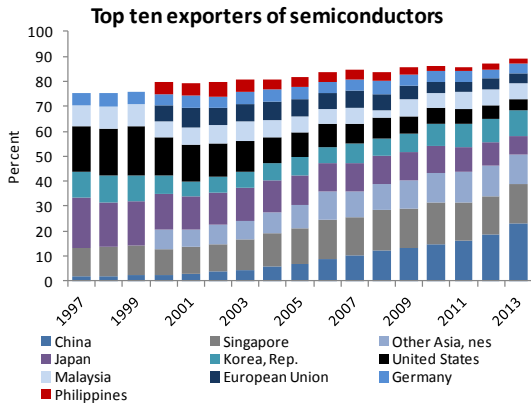
7. **The Philippine electronics industry is primarily involved in the assembly, packaging, and testing (APT) of semiconductors** (Agarwalla 2005). In this stage of production, raw materials are imported into the country and are processed to produce SMS products. These are then tested before being exported to another country for the succeeding stage in the production process. In the electronics value chain, APT is a relatively low-skill and labor-intensive segment (relative to say, design) that generates the lowest value-added (Austria 2010). Argawalla (2005) estimates that Philippine participation in the electronics industry value-chain, in the form of local parts and labor, is less than 15 percent.

8. **As of 2011, the electronics industry consisted of 936 major players. The 20 largest companies are estimated to have total revenue of around USD 10 billion.** These include 674 foreign companies as well as 262 homegrown companies such as IMI, Ionics, Fastech, and First Philec (Figure 3.6) (TESDA 2011). The well-known international brands include Texas Instruments, Toshiba, Continental Temic, and Lexmark (Figure 3.7). Most of these firms are located in Metro Manila (42 percent) and the adjacent region of Calabarzon (48 percent) while a few are located in Cebu (7 percent) and in Northern and Central Luzon (3 percent) (SEIPI 2009). Together, they provide 536,000 direct jobs (SEIPI 2012). Villegas (2004) estimates that for every direct job, 7 indirect jobs are created, bringing total job creation to around 4 million.

⁷⁵ The participation index is expressed as a share of gross exports. It can be decomposed into backward and forward participation. Backward participation is the percentage of imported goods in exports. Forward participation is the percentage of exported goods used by other countries as imported inputs to their exported goods.

⁷⁶ According to the Board of Investments (BOI 2011), EMS is composed of the following categories: electronic data processing (EDP) equipment, office equipment, telecommunications equipment, communications and radar, control and instrumentation, medical and industrial, automotive electronics, consumer electronics, and solar/photovoltaics.

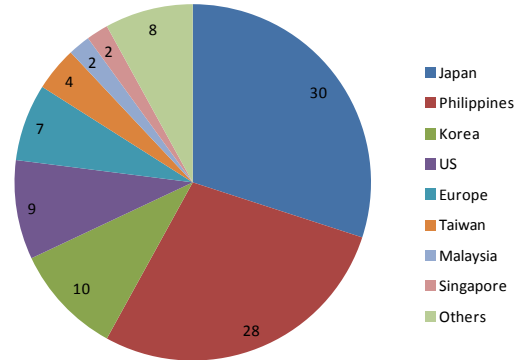
Figure 3.5. Philippines' share to total semiconductor exports declined significantly after the 2008 global financial crisis.



Source: World Integrated Trade Solution (WITS)

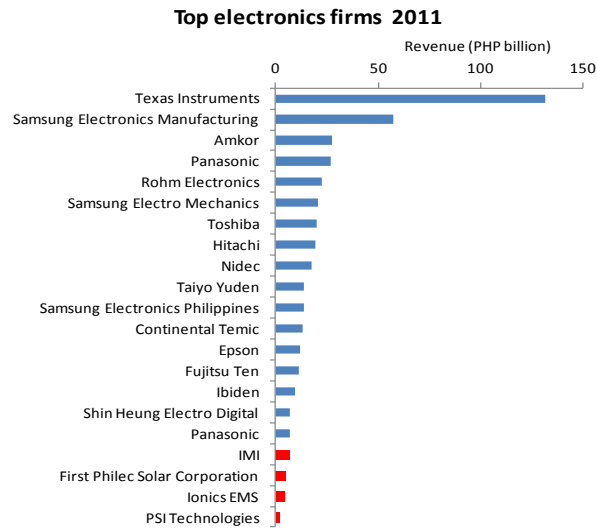
Figure 3.6. Majority of foreign electronics firms in the Philippines are from Japan, followed by Korea and the US.

Companies in the electronics industry by country of origin (percent of total)



Source: Technical Education and Skills Development Authority (TESDA)

Figure 3.7. The electronics industry in the Philippines includes some of the world's largest brands such as Texas Instruments.



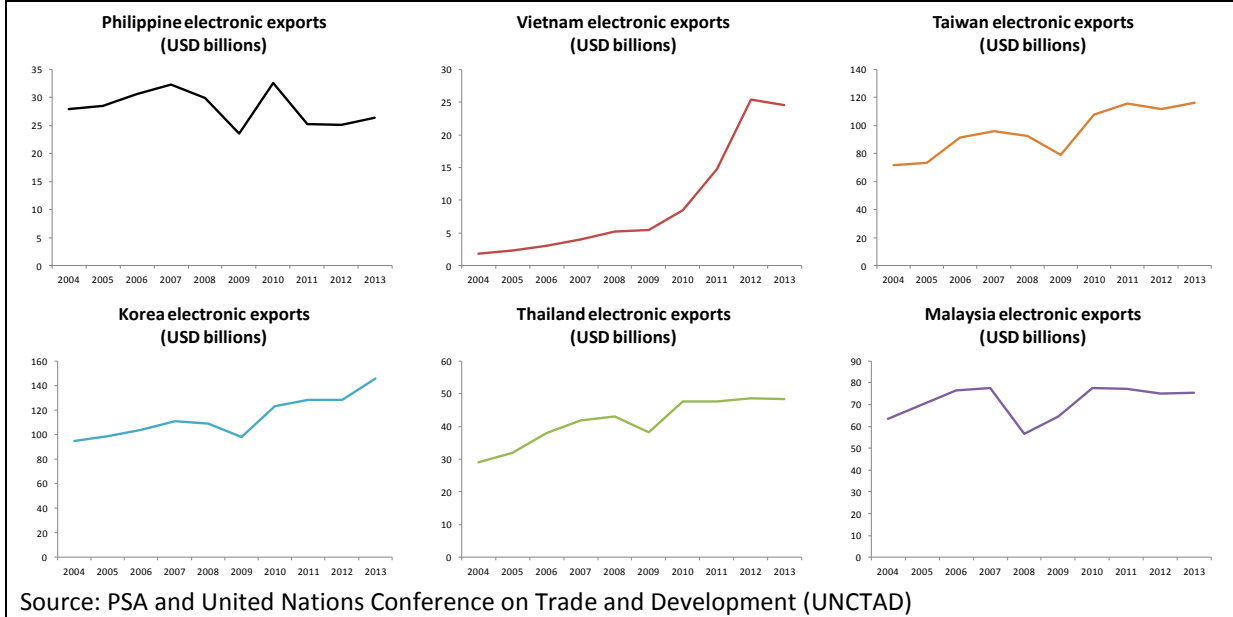
Source: Securities and Exchange Commission (SEC)

Trends in Philippine electronics exports

9. In recent years, the Philippine electronics industry was unable to regain its pre-slowdown growth performance. The recovery of electronics exports in 2010 was not sustained in the following years. In 2012 and 2013, the average growth rate of electronics exports was less than half of its pre-slowdown growth. As a share of GDP, electronics exports declined from 22 percent in 2007 to 10 percent in 2013. Its share to total Philippine exports also fell to 47 percent in 2013 from a high of 71 percent in 2002.

10. **In contrast, other countries in the region have recovered.** Korea, Taiwan, Thailand, and Vietnam have all surpassed their pre-2008 export performance while Malaysia is close to recovering its losses (Figure 3.8). Most impressive is the rapid growth of Vietnam’s electronics exports in the years following the 2009 global slowdown after it secured a total of USD 4.5 billion investments from Samsung to manufacture its highly popular tablets and smartphones (Samsung 2014).

Figure 3.8. Compared to other electronics exporters in the region, the Philippines is the only country that is far from recovering its export loss since 2009.



11. **Between EMS and SMS, SMS has been driving the decline in electronics export performance** (Figure 3.9). SMS accounts for the bulk of Philippine electronics exports. As a result, the electronics industry is heavily reliant on this segment’s performance. Between 2007 and 2013, SMS exports contracted from USD 24 billion to USD 17 billion. Its share to total electronics exports dropped from 73 percent in 2007 to 65 percent in 2013.

12. **However, the contraction in SMS has been partly offset by the growth in EMS.** While SMS was declining, the office equipment, consumer electronics, telecommunications, control and instrumentation, and medical and industrial instruments subcategories of EMS have partially picked up the slack given their strong performance. However, the expansion of these segments was not enough to offset the losses from SMS. Combined with the underperformance of the SMS segment, this resulted in the increase of EMS’ share to total electronics exports from 27 percent in 2007 to 35 percent in 2013.

Figure 3.9. In place of SMS, EMS drove growth of electronics exports in the last 3 years.

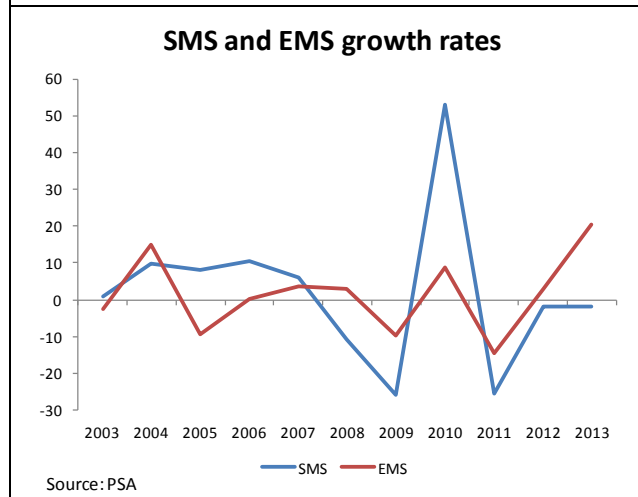
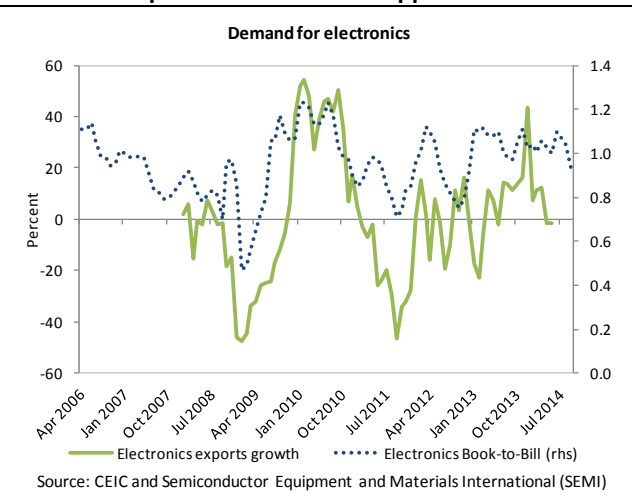


Figure 3.10. Philippine electronics exports and worldwide semiconductor demand have begun to decouple in recent months, suggesting falling relative demand for parts made in the Philippines.



Reasons for the decline

13. **The decline in electronics exports in the last 5 years is attributed to 3 factors:** i) initially, from the declining demand brought about by the 2009 global slowdown, ii) the relative decline in the country’s competitiveness, and iii) the slow progress made in diversifying its export basket.

14. **The immediate cause of the decline is the slump in global demand for electronic products following the 2009 global slowdown.** Electronics was one of the sectors significantly affected by the global slowdown as both businesses and consumers postponed their purchase of non-essential electronic products. This significant decline in demand led to a decline in production. The slowdown in demand is evident in the North American book-to-bill ratio.⁷⁷ With an average of 0.95 prior to the global slowdown, the ratio dropped to a low of 0.47 in January 2009 (Figure 3.10). In the Philippines, falling demand led to temporary job cuts and closure of some firms. For instance, in 2008, the industry laid off 25,000 jobs (5 percent of the total) (SEIPI 2012) and forced many workers to go on unpaid leaves. A few companies permanently closed business.

15. **However, recent global recovery has yet to translate into a commensurate recovery of the industry, suggesting that the country’s competitiveness has fallen.** As the previous section explains, the Philippines is the only major electronics exporting country in the region that has

⁷⁷ The book-to-bill ratio of the Semiconductor Equipment and Materials International (SEMI) tracks worldwide billings (shipments) and bookings (orders) of North American-headquartered manufacturers of equipment used to manufacture semiconductor devices.

not fully recovered despite the recovery of global demand. This strongly suggests that the problem lies in the country's competitiveness. Based on interviews with industry players and using enterprise survey results, the following factors were identified as binding constraints: i) high costs and reliability of power supply, ii) insufficient infrastructure, and iii) cumbersome trade regulations.

- Power cost is the single most important domestic cost accounting for up to 30 percent of production costs (Lachica 2014). More importantly, though power is generally reliable, the industry requires 100 percent reliability as it uses highly sensitive machines whose performance can be disrupted by even a millisecond fluctuation of electricity. Any minute fluctuation can significantly slow down production and delivery schedules.⁷⁸
- Insufficient infrastructure results in high logistics costs. The typical electronics firm needs to abide by strict delivery schedules and thus is highly dependent on an efficient logistics service.
- Finally, given the Philippines' integration into the global supply chain, cumbersome trade regulations, particularly non-tariff barriers such as i) lack of automation, ii) complex and often redundant procedures, iii) inefficient port system, and iv) lack of information, have slowed down the movement of parts and assembled components across borders, thereby increasing costs.

To offset these costs, the Philippines offers generous tax incentives to encourage electronics firms to stay in the country. It also provided discounts on power rates. Other relevant factors affecting competitiveness include: i) the limited pool of managerial knowledge and skills in production, ii) the weak link between the industry and the academe, and iii) the lack of policy consistency at the local government level (Padojinog 2010). Together, these factors can discourage investors from expanding or coming into the Philippines, or worse, leave the country as Intel had done in 2009.⁷⁹

16. Finally, slow progress in diversifying the country's export basket has further slowed down the industry. Currently, the industry is focused on the assembly and testing of legacy semiconductor products such as components for laptops and hard disk drives.⁸⁰ These products are considered sunset products with little room to grow (Wan 2013). As their relative demand falls compared to tablets and smartphones, their prices fall as well, therefore cutting revenues. In other words, Philippine electronics exports will continue to decline unless the industry diversifies into the production of newer and higher demand technologies. As mentioned earlier,

⁷⁸ For a more detailed discussion of the power issue, see Austria (2010).

⁷⁹ Craig Barret, Intel chairman, cited political stability as a major factor in its investment decisions (Calimag 2008).

⁸⁰ In electronics industry terms, legacy products refer to old or outdated products such as laptops and their components, as opposed to newer products such as tablets and smartphones, and their components.

Vietnam was able to see rapid growth in electronics exports by convincing Samsung to set up 2 major factories that produce smartphones and tablets.

Challenges and the way forward

17. **Despite the challenges that the industry faces today, there is potential for the industry to regain its prominence in the global electronics industry.** At the industry level, this requires faster progress in product diversification. At the country level, this requires addressing long-standing issues to reduce the cost of doing business. Both are needed since they are interdependent.

18. **At the industry level, product diversification is key to increasing exports.** For SMS products, potential areas include expanding into research and design or adopting more advanced methods of semiconductor packaging.⁸¹ Meanwhile, the industry can also focus on segments of EMS that have strong growth potential such as next generation smart phones, tablets, phablets (i.e., phone-tablet combination), wearables, vision systems, and sensors. This will help make the industry's performance less dependent on SMS exports and balance growth. The challenge of identifying products and the required technology can be aided by a product and technology roadmap that is shared by the industry, the academe, and the government. SEIPI has begun the groundwork for PATHS (i.e., Product And Technology Holistic Strategy). This roadmap can serve as a platform for the 3 parties to coordinate their efforts and develop a clear strategy that will identify possible niches where the Philippines can be competitive. With rapidly changing consumer preferences for high-tech electronics, such a roadmap can help attract foreign investors, especially those from global frontrunners that have a large influence over future market demand.

19. **To increase domestic value-added, the participation of small and medium enterprises (SMEs) is crucial.** SMEs can contribute to the industry by supplying or manufacturing local materials such as plastic casings, moulding compounds, bond wires, and other chemical inputs. Currently, exporters resort to importing materials which account for around 60 percent of production costs (Lachica 2014). To incorporate SMEs to the supply chain, the Philippines needs to further develop its local suppliers in terms of technology and production capacity to be able to meet the demands and quality standards of bigger international companies. Following the examples of Korea, Singapore and Taiwan, the government can support i) monitoring and diffusing of new technologies, ii) training and technical assistance, iii) cost-sharing schemes for technological upgrades, and iv) provision of technological services that SMEs could not provide themselves (Aldaba 2009). Moreover, as the startup capital for SMEs is expected to be large, government policies to reduce the cost of credit is needed.

⁸¹ Packaging is the process of enclosing a semiconductor die called the "package" to protect the delicate circuitry from physical contact and damage. See: <http://strategysanity.com/glossary.html#package> for more information.

20. **At the country level, this requires addressing long-standing issues, such as high power costs and unreliable quality, poor infrastructure, and costly trade regulations.** Of particular importance is addressing the cost and quality of power supply as these are essential in attracting investment in wafer production, which can raise export revenues significantly.⁸² Over the long term, power costs can be more competitive and its supply more reliable by embarking on key power sector reforms as discussed in Special Focus 2. Poor infrastructure can be addressed by strong government commitment to double infrastructure spending to 5 percent of GDP by 2016 and sustaining it thereafter. Timely implementation of public-private partnership programs is also essential. Furthermore, costly trade regulations can be addressed by bringing down non-tariff barriers. Key reforms include automating processes, reducing paperwork, simplifying procedures, and modernizing the ports system. Finally, sustained development of human capital for the industry requires investment in science and technology education, in particular, supporting advanced degrees in engineering that can spearhead expansion into research and design. This requires strong partnerships among the industry, the academe, and the government.

21. **Successful implementation of these recommendations can help the country seize the window of opportunity brought about by China's economic rebalancing.** Given China's rising labor costs, which has grown over six-fold from 2000 to 2012, several electronics firms currently in China will be looking for alternative production facilities in the coming years. The Philippines will be in a good position to attract these investment outflows if it can decisively address the binding constraints that the sector faces. Moreover, this would allow the Philippines to move up the value chain by shifting from APT processes to final goods assembly, and in the process create more and better jobs for the economy, both direct and indirect.

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⁸² A wafer is a thin disk of semiconductor material. Wafer fabrication is the process of processing these wafers into integrated circuits. See <http://www.maximintegrated.com/en/glossary/definitions.mvp/terms/W> for more details.

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SPECIAL FOCUS 4

Liberalizing rice policy in the Philippines⁸³

Performance of agriculture

1. **The country's agriculture sector has been underperforming for over 30 years, characterized by low growth and productivity, and high food prices.** On average, growth and productivity of Philippine agriculture have been lower than those of manufacturing and services. Compared to other countries in the region, Philippine agricultural growth and productivity have also been lower (Table 4.1). Moreover, in contrast to its neighbors and high income countries, growth of agricultural output in the Philippines has mostly been driven by more intensive use of inputs rather than more efficient use of inputs or adoption of new technologies.⁸⁴ Today, employment in agriculture, and more broadly in the rural sector, is still characterized by low productivity and returns, large-scale informality, and high incidence of poverty. Three out of every 4 poor Filipinos live in rural areas and are mainly dependent on agriculture.

2. **Diversification towards more profitable crops has been limited largely due to policies that keep prices of key food items, particularly rice, artificially high.** The sector's structure remains broadly the same as in 1970. Rice is still the dominant crop, accounting for around 50 percent of arable crop area and close to 20 percent of total agriculture gross value-added. Except for bananas and pineapples, agricultural exports continue to encounter difficulty in competing in the world market given quality and price issues. This structure is largely the result of policies, such as high import protection, that keep prices of key food items, particularly rice, artificially high. This gives incentives to farmers to continue planting rice, which has limited potential to move up the value chain, and precludes them from diversifying into higher value crops and earning higher income. Moreover, high rice prices over the years have not resulted in adequate supply because high output prices tend to trigger higher cost of production and marketing, and not better production efficiency. As a result, agricultural modernization and structural transformation into manufacturing and high skill services have been very slow.

⁸³ This special focus is a summary of the technical report "Philippines: Recent agricultural developments and revisited reform agenda" (World Bank 2014) and the agriculture sections of the PDR "Creating more and better jobs" (World Bank 2013). The former mainly updates the 2007 agriculture public expenditure review. The summary was prepared by Miro Capili (Junior Research Assistant), Paul Mariano (Research Analyst), and Karl Kendrick Chua (Senior Country Economist).

⁸⁴ From 1961 to 2010, agricultural output in the Philippines grew by 324 percent. This is lower than China's 721 percent, Malaysia's 643 percent, and Thailand's 353 percent. These countries achieved higher agricultural growth by using fewer inputs more efficiently and adopting new technologies.

Issues in the agricultural sector

3. **Low agricultural productivity and high food prices reflect the incomplete agrarian reform effort, lack of public investment, and misguided policies through the years.** Genuine land reform continues to be hampered by weak assignment of property rights (e.g., lack of individual security under collective titles), restrictions on the transfer of awarded land, and imperfect targeting of the poor. These have resulted in minimal farm investment, thereby lowering productivity. Moreover, up until 2010, public investment in agriculture was very low and directed to a few crops, instead of supporting farmers through the provision of public goods such as resilient irrigation systems and farm-to-market roads. Finally, several misguided policies have contributed to the sector's underperformance. These include i) industrial policies that were biased against agriculture, ii) poor quality of logistics, iii) limited research and development, and extension services, and iv) the emphasis on rice self-sufficiency through high import protection.

Table 4.1. Agricultural value-added in the Association of Southeast Asian Nations (ASEAN) region

	Agriculture real value-added			Agriculture real value-added per worker			Agriculture real value-added per hectare		
	1980-2000	2000-2010	2011-2012	1980-2000	2000-2010	2011-2012	1980-2000	2000-2010	2011
Indonesia	3.0	3.3	3.7	1.1	3.1	3.7	1.9	1.9	3.2
Malaysia	2.0	3.2	3.4	2.8	4.5	5.2	-0.1	3.2	5.8
Philippines	1.6	2.9	2.7	0.3	2.3	2.2	1.0	3.6	1.7
Thailand	2.8	2.6	4	2.0	2.9	5.1	2.6	4.3	4.1
Vietnam	3.7	3.7	3.4	1.9	2.5	2.4	1.5	2.1	n/a

Sources: Statistics Division of Food and Agriculture Organization (FAOSTAT) and World Development Indicators (WDI)

Note: No available land data for 2012.

4. **In the rice sector, a number of misguided policies have hindered the diversification of agriculture away from rice and have raised food prices to the detriment of the majority of Filipinos.** First, the focus on rice self-sufficiency since the 1960s has shifted budget allocation towards rice production. Historically, a disproportionate share of public expenditures (about 65 percent of the total budget of the Department of Agriculture (DA) and related government-owned and/or controlled corporations) had been allocated to rice. These expenditures included i) lowland irrigation, ii) input subsidies such as seeds and fertilizers, and iii) production support such as farm machinery and postharvest equipment. Often, investments were provided at low quality and with little support mechanisms. For example, irrigation investments were not accompanied by sustainable management arrangements, resulting in the repeated restoration

and rehabilitation of many irrigation systems.⁸⁵ Second, high import tariffs and quantitative restrictions (QR) on rice,⁸⁶ alongside the National Food Authority's (NFA) near-monopoly on rice trade, have resulted in inadequate rice supply and have kept domestic prices artificially high relative to world prices (by 50 to 100 percent) (Figure 4.1). Third, the NFA's policy of protecting farmers by buying palay at higher prices remains poorly targeted and does not benefit most farmers. This is because NFA's palay procurement covers a small share of domestic production, amounting to only 2 percent of the 18.4 million metric tons of palay produced in 2013.

5. Moreover, high logistics and marketing costs have also contributed to higher rice prices. Logistics and marketing have been hampered by insufficient investments in roads and post-harvest facilities (although increasing in recent years), policy distortions, and lack of competition. The supply chain for agriculture is still characterized by high transportation, storage, and marketing costs. The main problems contributing to high transportation costs are the low quality of roads, especially farm-to-market roads connecting smallholders' farms to urban markets, and lack of competition in the local shipping and trucking industries.⁸⁷ Moreover, uncertainty over the timing and levels of imports and domestic sales by the NFA, high energy costs, and the high cost of capital⁸⁸ have resulted in underinvestment in milling,⁸⁹ drying, and storage.⁹⁰ Moreover, marketing costs in the Philippines remain high due to disjointed marketing agents, among other reasons (Figure 4.2). To illustrate, it takes about 18 marketing agents (e.g., assemblers, traders, and millers) in the Philippines to process 90,000 tons of dry palay a year, a job managed by just 1 Thai miller. Moreover, rice markups (i.e., the difference between farm gate and retail price) remains very high, in fact increasing from 88 percent in 1990 to an average of 105 percent from 1991 to 2012 (Figure 4.3).

⁸⁵ When an irrigation system is poorly maintained, rehabilitation is needed every 10 years on average and full restoration is needed every 20 years so that water can be used efficiently to achieve positive impact on farm yields.

⁸⁶ Current agricultural protection is based on Republic Act (RA) 8178 "An act replacing quantitative restrictions on agricultural products, except rice, with tariffs, creating the Agricultural Competitiveness Enhancement Fund and for other purposes," which was enacted in 1996. Under the law, the Philippines can import 350,000 tons of rice annually under the Minimum Access Volume (MAV). Imports under the MAV are levied a duty of 40 percent, while imports above the quota are levied a duty of 50 percent. The Philippines filed for an extension of the special treatment on rice until 2012 when the 10-year rice quota under Annex 5 of the WTO Agreement on Agriculture expired in June 2005. In 2006, the tariff exemption was extended for another 7 years and in July 2014, it was extended for another 3 years.

⁸⁷ Some segments of the trucking industry, notably those that serve the country's main port, set prescribed standard rates. See for instance <http://www.scribd.com/doc/212541808/CTAP-rates-effective-March-15-2014>. This may be an indication of a cartel. Moreover, since trucking requires a franchise, this could effectively limit competition. For a discussion on anti-competitive behavior in the domestic shipping industry, see Special Focus 5.

⁸⁸ High cost of capital raises the effective cost of trucks, buildings, sacks, and milling equipment.

⁸⁹ Keefer and Zoratto (2012) estimate that underinvestment in rice milling could have resulted in a 15 percent reduction in domestic supply. Currently, only 5 percent of rice millers use large and efficient milling machines, which process 10 tons per hour with a 68 percent yield (i.e., breaking only 32 percent of the grains).

⁹⁰ Storage costs in the Philippines are high because of inefficiencies in the management of public storage facilities.

Impact on the economy and on people

6. **High rice prices reduce real income of households, make poverty reduction harder, and increase malnutrition in the case of food-poor households.** For the average Filipino, rice is the largest item in the food basket. Among the poorest 30 percent of households, rice constitutes more than 20 percent of their total consumption. This means that, as rice prices increase, real income of poor Filipinos falls significantly. With high rice prices, households would have less disposable income for other necessities, including human capital investments that could enhance future employment prospects. For instance, in February 2014, 1 kg of rice cost PHP 34 in a Philippine supermarket while it cost PHP 16 in Vietnam. This means that Filipinos spent double for rice and have to cut spending on other expenditures such as education and healthcare. High rice prices also make poverty reduction stubbornly difficult. For instance, between 2000 and 2012, poverty incidence hardly declined while rice inflation exceeded overall inflation. Given higher rice consumption levels of poor households, changes in rice policies would have significant implications on mitigating poverty. For poor Filipinos who cannot afford to buy more rice, malnutrition sets in. Being underweight and underheight are characteristics of poor Filipino children. In fact, for children 0 to 5 years old, the incidence of being underheight increased from 27 percentage points (ppt) in 2005 to 29 ppt in 2008. Meanwhile, the incidence of being underweight for children 6 to 10 years old has been increasing since 2005, reaching 32 percent in 2011 from 26 percent in 2008. Moreover, in 2011, the Philippines, compared to a group of countries that reported malnutrition statistics, had one of the highest prevalence of stunting (Figure 4.4).

Figure 4.1. Filipinos pay far more for rice than consumers in other countries.

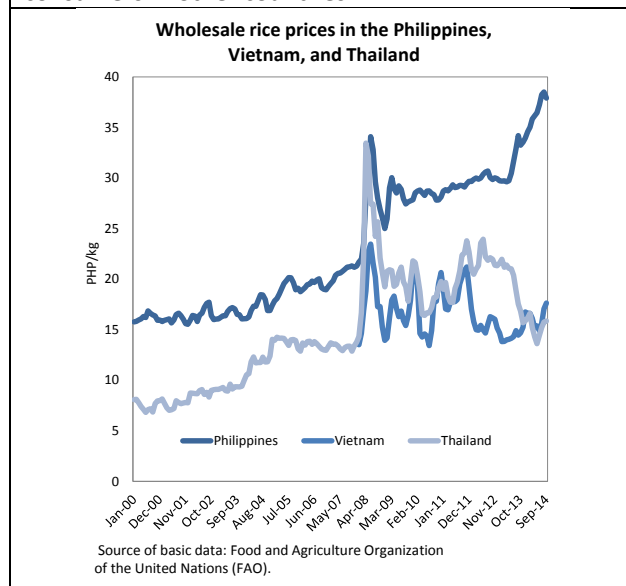
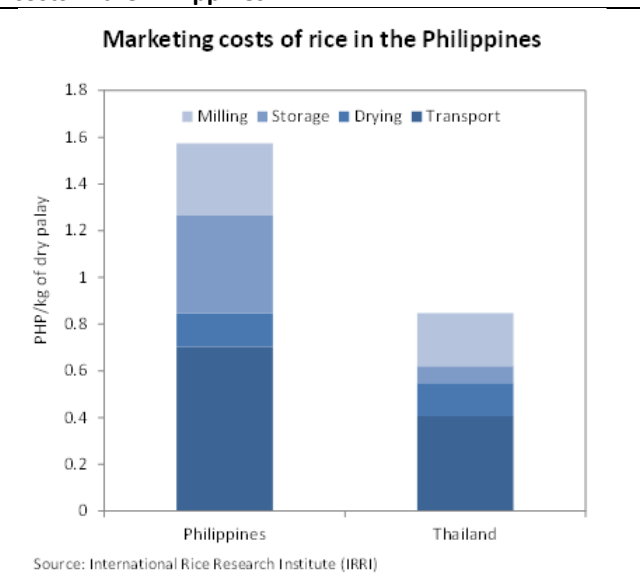


Figure 4.2. There is a large scope in reducing marketing costs in the Philippines.



7. **However, most Filipino farmers do not benefit from high rice prices paid by consumers, as evidenced by their high incidence of poverty.** As discussed earlier, rice markups increased from 88 percent in 1990 to an average of 105 percent between 1991 and 2012,

implying that rice farmers do not benefit much from higher prices. Moreover, most farmers, including many small rice farmers, are net food buyers rather than net food sellers. This means that the majority of farmers are negatively affected by high rice prices. One indicator for this is higher poverty incidence among farmers. Even among rice farmers, poverty is as high as non-farmers (Table 4.2)

Figure 4.3. Retail rice prices have been increasing faster than farm gate prices due to inefficient logistics and marketing.

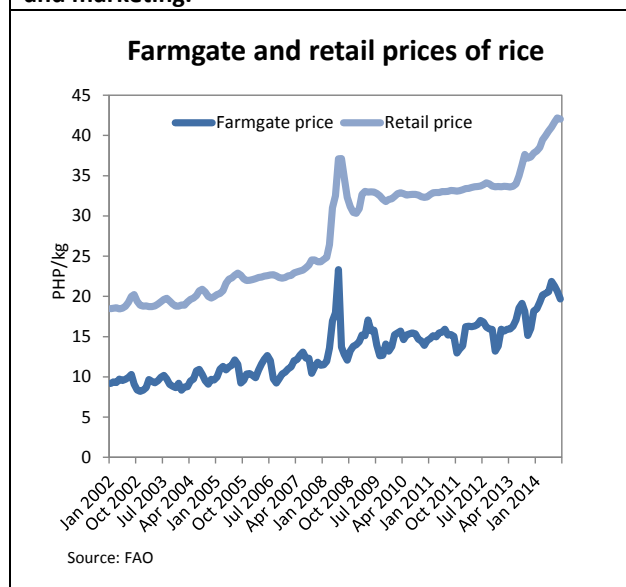


Figure 4.4. The Philippines has among the highest prevalence of malnutrition.

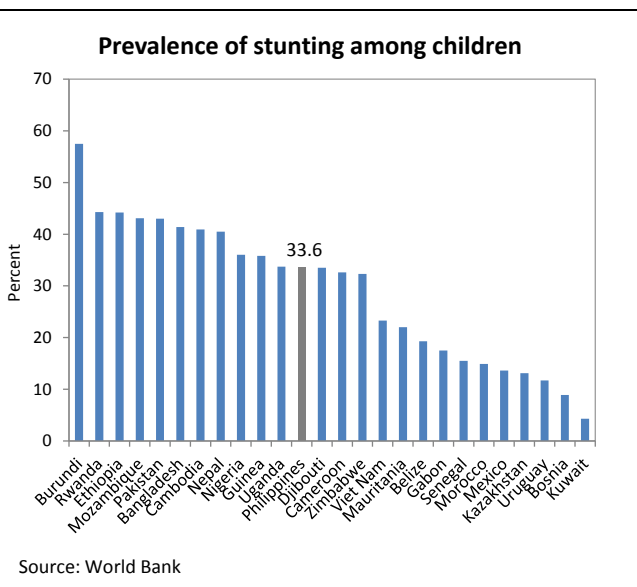


Table 4.2. Poverty incidence among farmers in 2012

Farmer group	Poverty incidence (in percent)
Rice farmers	28
Corn farmers	58
Coconut farmers	38
Other crop farmers	40
Landless laborers	50
Non-farm rural	27
Non-farm urban	9

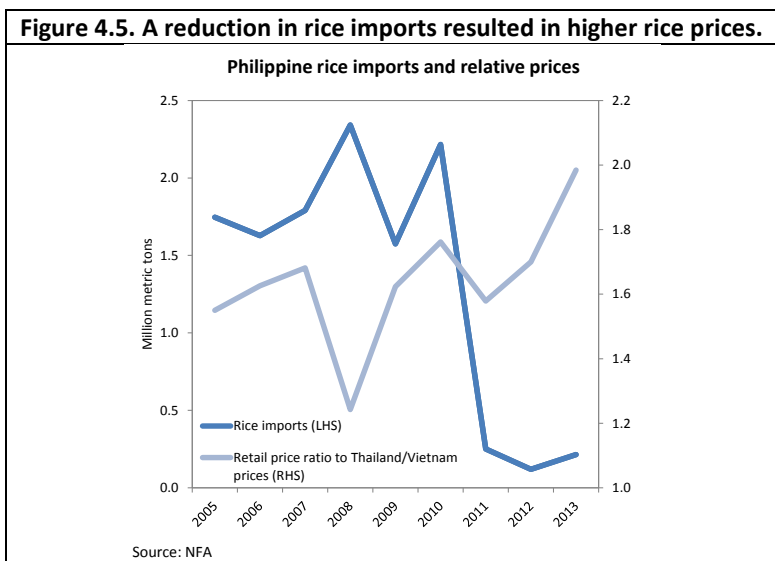
Source: World Bank staff calculations using the 2012 Family Income and Expenditure Survey (FIES).

8. Finally, high food prices exert pressure on the minimum wage and thus lower the competitiveness of downstream industries such as manufacturing. This prevents successful structural transformation of the Philippine economy. Given the large share of rice in the consumption basket, high rice prices can trigger an increase in the statutory minimum wages. This, in turn, can make labor-intensive manufacturing and services less competitive, resulting in

unemployment and large-scale informality. For instance, Lasco (2005) estimates that a 1 percent increase in rice prices is associated with a 0.35 percent increase in wages in the short-term and above 1 percent in the long-term. In turn, the Philippine development report “Creating more and better jobs” estimates that between 1996 and 2008, a 10 percent increase in the real minimum wage rate is associated with a 3 percent reduction in manufacturing employment. Moreover, higher prices of corn and sugar, for example, have raised processed food prices and those of other finished goods. More generally, higher food prices have also raised the cost of living and have hampered the country’s poverty reduction efforts.

Recent developments in rice policy

9. **Since 2010, the Aquino Administration has begun to address some of the problems in the rice sector.** First, importation of rice has been opened to the private sector beginning 2011. From 2011 to 2012, private firms imported 660,000 out of 770,000 tons of total import. Second, the government has moved away from providing input subsidies, in particular to rice production, to investing more in public goods and targeted support.⁹¹ Third, to protect poor farmers from the effect of high food prices, the government introduced a targeted conditional cash transfer (CCT) program, which is gradually replacing the inefficient NFA universal subsidy.⁹²



⁹¹ From 2012 to 2013, the budget allotment to the Department of Agriculture Office of the Secretary (DA-OSEC) for rehabilitating and expanding irrigation systems increased from 41 to 46 percent. The allotment for farm-to-market roads also increased from 14 to 16 percent. Moreover, large-scale seed and fertilizer subsidies for rice and corn farmers in place in the early 2000s were replaced with targeted and smaller support to local seed producers.

⁹² See Department of Social Welfare and Development (DSWD) (2014) for more discussion on the CCT program.

10. **However, a number of areas still require attention.** First, despite some improvements in NFA management, its financial situation remains dire due to high debt servicing.⁹³ Second, producing more rice domestically has not improved food security in the country. In fact, the pursuit of rice self-sufficiency has been associated with increasing hunger incidence and high malnutrition rates (as discussed earlier). Third, recent declines in rice importation have driven up retail prices as domestic production struggled to keep up with consumption. For instance, the NFA reduced the volume of imports significantly from 2.2 million metric tons in 2010 to 0.3 million metric tons in 2013, resulting in a 9.7 percent increase in the price of rice (Figure 4.5). Finally, the country filed for a WTO extension of its tariff exemption in 2012, which was granted for a three-year period beginning July 2014. While this may buy some time for the rice sector, it only delays the much-needed reform to raise food security and help the agricultural sector diversify.

Policy recommendations

11. **To achieve more inclusive growth, food prices need to be reduced by liberalizing food policy.** This does not necessarily mean lower farm profit as farmers can be assisted to diversify into higher value crops. Moreover, reducing marketing costs would bring down retail prices of rice without farm gate prices falling.

12. **Reforms should start with rice, where the impact would reach most Filipino consumers.** A number of reforms could be pursued. First, the import quota for rice can be replaced with an import tariff initially set at 30 percent.⁹⁴ This could be followed by a plan to gradually reduce import tariff to around 15 percent.⁹⁵ Second, the government could consider redefining the NFA's role in formulating and implementing rice policies. The first best scenario would be to fully and permanently transfer rice importation to the private sector as it has proven to be capable of efficiently filling the gap between consumption and production in recent years. For its part, NFA could focus on emergency buffer stocking and disaster mitigation programs to reduce risks on agricultural production brought about by natural calamities. Redefining the role of the NFA can improve the allocation of DA's budget towards more public goods and support to other crops with high potential. To signal a new beginning, the NFA's current debts can be restructured as the current level of capital deficiency at 1.3 percent of GDP is too high. After rice, attention is needed in reducing the prices of corn and sugar by

⁹³ Total debt incurred by the NFA from 2007 to 2011 amounted to PHP 9.9 billion in 2013. Its total capital deficiency by the end of 2013 was estimated at PHP 148 billion from PHP 43 billion in 2006.

⁹⁴ This corresponds to the current effective import tariff estimated as the difference between wholesale price in the Philippines and landed import price from Vietnam, adjusted for transport costs. At this rate, there would be no significant immediate impact on domestic prices.

⁹⁵ This rate would be high enough to continue providing incentives to rice farmers but adequate to discourage illegal importation of rice, currently a widespread phenomenon in the Philippines, and to promote diversification of agricultural production.

gradually lowering import tariffs. To protect vulnerable farmers, the CCT program can be expanded to cover affected farmers.

13. **Simulations show that moving away from quantitative restrictions and reducing tariffs result in lower rice prices and significant poverty reduction** (Cororaton, Clarete, and Sharma 2013). For instance, eliminating import quota would lift 424,000 people out of poverty. Converting the quota into a lower tariff of around 25 percent would lift 647,000 people out of poverty. On the other hand, a more restrictive quota would raise rice prices by 10 percent and push 393,000 people into poverty.

14. **Measures to reduce food prices should also be accompanied by policies to lower production and marketing costs to better support farmers.** These include: i) completing the Comprehensive Agrarian Reform Program's distribution targets and increasing security of property rights for all farmers, for instance, by subdividing collective Certificate of Land Ownership Awards, ii) improving resource allocation in the budget for agriculture by increasing public investment in resilient irrigation systems, farm-to-market roads, agricultural research, extension, and food safety, while reducing public spending in private goods such as inputs, mechanization, and post-harvest equipment, iii) setting up wholesale markets for palay, similar to Thailand, as a means to consolidate marketing agents and reduce marketing margins, and iv) shifting from a production approach to an area-based value-chain approach while targeting smallholder associations and small and medium rural enterprises to improve the effectiveness of farm support.⁹⁶

⁹⁶ This calls for the Department of Agriculture (DA) to improve linkages with other government agencies, the private sector, farmer groups, and local government units to identify areas for interventions at all stages of value chains and provide public goods that would encourage more private investments.

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SPECIAL FOCUS 5

Enhancing competition in the domestic shipping industry⁹⁷

Overview of the maritime sector

1. **Being an archipelago, the Philippines requires an efficient water transport system. However, this is presently not the case. The domestic maritime industry is characterized by high costs, low quality of service, and a poor safety record** (Table 5.1). The cost of logistics accounts for 24 to 53 percent of wholesale price, while shipping and port handling costs represent around 8 percent (to as high as 30 percent) of wholesale price depending on the goods and routes, and 5 percent of retail price.⁹⁸ Philippine domestic shipping is generally more expensive compared to Malaysia and Indonesia—2 other archipelagos. In the East Asia region, the Philippines trails behind its neighbors in various logistics performance and connectivity indices. For instance, in liner shipping connectivity, the Philippines ranked 66th out of 157 countries in 2013 and performed the worst among a group of East Asian comparators.⁹⁹ The Philippines ranked 116th out of 148 in the quality of ports index, whereas the average rank in East Asia was 47. In the East Asia region, the Philippines has the highest absolute casualty rate, which is 40 percent higher than the second-ranked country, Indonesia.¹⁰⁰ On average, there are 228 ships involved in accidents and 303 casualties per year in the Philippines.

2. **Among the probable causes of the weak state of the domestic maritime industry are policies that hinder more open competition, including competition from more efficient foreign shipping companies.** More competition can serve as a disciplining force or an incentive to be more efficient. However, the country's laws make it difficult for new shipping companies to enter the market. They also raise costs artificially by mandating that certain services (e.g., dry docking and repair) be done within the country when cheaper options are available elsewhere. Finally, Philippine laws restrict foreign shipping companies from serving domestic routes even if these can provide better services. This restriction is called cabotage. Removing competition

⁹⁷ This special focus summarizes findings from the recent study by the World Bank Group's Trade and Competitiveness Global Practice "Enhancing competition conditions and competitiveness of Philippine domestic shipping services" (2014). The summary was prepared by Roberto Galang (Operations Officer).

⁹⁸ These prices are averages based on a sample of goods and are based on data from Japan Bank for International Cooperation (JBIC) (2002) and University of Asia and the Pacific Industry Monitor (2002) as cited in Japan International Cooperation Agency and Maritime Industry Authority (2005). JBIC (2002) was cited by Hussein S. Lidasan and Jun T. Castro in their PowerPoint presentation titled "Philippine Intermodal Logistics System and Policies," delivered in a logistics conference held in Dusit Hotel, Makati, Metro Manila, on February 5, 2009.

³ The liner shipping connectivity index captures how well countries are connected to global shipping networks. It is computed by the United Nations Conference on Trade and Development (UNCTAD) based on 5 components of the maritime transport sector, namely, number of ships, their container-carrying capacity, maximum vessel size, number of services, and number of companies that deploy container ships in a country's ports.

¹⁰⁰ The Philippines also has the highest relative casualty rate, surpassing Myanmar. This is measured by the ratio of total casualties to total fleet size.

constraints and enhancing the competitiveness of shipping companies can help reduce shipping costs, and improve the services and safety standards in the industry.

3. **Cognizant of these issues, the president has given priority to the reform of the country’s maritime industry.** In his July 2013 state of the nation address, President Aquino identified cabotage liberalization as a priority reform and asked congress to amend the cabotage provisions “in order to foster greater competition and to lower the cost of transportation for agricultural sector and other industries.” The government is also looking to improve competition in the domestic shipping industry and the quality of ports. This special focus looks specifically at reforms to enhance competition in the domestic shipping industry.

Table 5.1. Characteristics of the Philippine maritime sector

Sector features	Indicator	Philippines	EAP
Weak competition	Share of primary routes served by a single operator (%)	40	NA
High shipping costs	Share of logistics costs to wholesale price (%)	24-53	20
High shipping costs	Share of shipping and port handling costs to wholesale price (%)	8.4	NA
High shipping costs	Share of shipping and port handling costs to retail price (%)	4.9	NA
Small domestic trading volumes	Domestic market throughput (millions of metric tons)	74	782
Low quality of services	Rank in liner shipping connectivity (out of 157)	66	17
Poor port infrastructure	Rank in quality of port index (out of 148)	116	47
Low profitability	Average return on equity (%)	1	NA
Old vessel age	Average age of ships (years)	30	22
Poor safety standards	Average number of yearly accidents	228	32
Poor safety standards	Average number of yearly casualties	303	60

Sources: World Bank (2013), World Economic Forum (2013), JBIC (2002), Securities and Exchange Commission, MARINA, National Statistical Coordination Board, World Development Indicators, and Board of Maritime Inquiry, UNCTAD (2011), and various country statistical offices.

Note: For age of ships, global average was used due to absence of regional data.

Selected East Asia and the Pacific countries are Singapore, Hong Kong, China, Malaysia, Thailand, Vietnam, and Indonesia.

Issues in the domestic shipping industry

4. **The recent World Bank Group study “Enhancing competition conditions and competitiveness of Philippine domestic shipping services” identifies a number of regulatory constraints that hinder more open markets in the Philippine domestic shipping industry.** These regulatory issues can constitute barriers to entry, as they can make it more costly for new firms to enter the market or impede the ability of firms to deploy ships to their best use. These are:

- a. **Licensing restrictions:** Until recently, any firm wishing to operate a commercial domestic shipping service in the Philippines must first obtain a Certificate of Public Convenience (CPC). Currently, CPC applications can be challenged by incumbent operators. The regulation requires giving incumbents advance notice on the entry of new firms in their market and an invitation to a public hearing where they can contest the feasibility of the new applicant. Often, incumbents argue that the market is too small to accommodate an additional player or that new entry would not be financially

viable. At the very least, the regulation creates an avenue for incumbents to use the CPC process to delay the entry of a new competitor and add to its start-up cost. In the extreme case, the CPC issuance process can be used by incumbents to block entry altogether.

- b. **Prohibition on foreign dry docking:** Current regulations¹⁰¹ require domestic vessels to dry dock and undergo repair in domestic shipyards, unless it applies for an exemption. This policy not only reduces the level of competition among shipyards, it also increases the costs faced by domestic shipping operators. Dry docking outside the country can be up to 70 percent cheaper for large vessels. In fact, even if transportation costs are factored in, it would still be cheaper to dry dock a vessel outside the country.
- c. **Prohibitive taxes:** In 2012, the government clarified that firms chartering vessels need to pay VAT and tariff on the value of the vessel when the previous practice was to exempt the chartering of vessels from these taxes. This makes vessel chartering for short periods very costly. Vessel charters allow domestic firms to lease a ship for a specific period to test the feasibility of new routes or use new vessel types without the need to shoulder the full cost of importing the vessel outright. The current tax regime on vessel chartering limits the willingness of firms to charter vessels as firms are highly unlikely to recover the additional taxes during the short charter period. By limiting access to the global charter market, domestic shipping companies cannot quickly adjust to changes in market demand and bring in more efficient ships.
- d. **Conflict of interest in port fee structure:** The Philippine Ports Authority (PPA) is the regulator of port charges but it also earns 10 percent of domestic cargo handling rates and 20 percent of foreign cargo handling rates that private port operators collect. This creates a potential conflict of interest.
- e. **Lack of maritime data:** Information on vessel operations, such as route traffic, cargo flows and passenger services, is difficult to obtain. The lack of market information often functions as a barrier to entry since incumbents have more information on market opportunities.

5. **In contrast, natural barriers to entry in the shipping sector are relatively low.** Although significant capital investment is required, the overwhelming majority of this investment is in the ships themselves. These assets are very mobile and can be readily redeployed to another market if entry is unsuccessful. Also, for the most part, the technology used in the shipping industry is generic and readily available for potential new entrants.

¹⁰¹ Presidential Decree 1221 requires locally flagged ships, even those engaged in international trade, to dry dock in the Philippines, unless they get a permit.

6. **Removing competition constraints and enhancing competitiveness of shipping companies can lead to greater efficiency, increased capacity, better quality of ships, lower operating costs, and lower freight rates.** In the absence of regulatory barriers, the threat of entry is very real. It can be an effective means to discipline the market as the stakes for incumbent operators are very high.

Reforms in the domestic shipping industry

7. **In the last 2 decades, several reforms were enacted to promote more competition, culminating in the passage of the Domestic Shipping Development Act of 2004 (RA 9295).** Historically, freight and passenger rates, as well as market entry, in the domestic shipping industry were highly regulated, as had been the case in many countries. In 1989, the government started to deregulate the industry by gradually removing restrictions on rate setting. This culminated with the enactment of RA 9295, which fully allows domestic shipping operators to establish their own rates. However, entry of new shipping routes remains regulated to this day.

8. **The reforms appear to have been effective in fostering more competition in the market.** Shipping rates are now generally determined by market forces. And although shipping rates today are relatively high, there appears to be no hard evidence that the industry colludes to set shipping rates.

9. **However, current regulations still limit the entry of new players. RA 9295 gives the Maritime Industry Authority (MARINA) the power and discretion to issue CPCs to qualified domestic ship operators and often incumbents play a role in the process.** As such, further reforms are needed to improve clarity of regulations and to facilitate market entry.

10. **To improve the quality of shipping services, the Department of Transportation and Communication (DOTC), MARINA, and the PPA are implementing a five-prong reform program to foster greater competition and competitiveness in the sector.** The proposed regulatory reforms primarily require executive actions, mostly within the ambit of the DOTC. The following reforms are underway:

- a. Remove the opportunity for incumbents to object to the granting of a CPC.
- b. Remove the requirement to dry dock and repair domestic ships exclusively in the Philippines.
- c. Facilitate chartering of foreign vessels to operate in domestic routes by clarifying their tax liability.
- d. Replace PPA share of cargo handling fees with a fixed rate to reduce conflict of interest.
- e. Provide more information on cargo flows and passenger services to the public to better inform potential entrants.

11. **The first reform on removing CPC restrictions has already been completed.** In March 2014, MARINA enacted new regulations that streamlined the procedural requirements for the application for CPCs and limited the ability of incumbent firms to delay their issuance by eliminating the requirement to inform incumbents of new market entry. This has led to an average reduction in processing time for CPC issuances from 40 to 20 days, as most applications are no longer contested. At the same time, a “special processing window/express lane” program was created to further shorten the processing time for CPC issuances to within 9 days for particular types of vessel importations. By halving processing time, vessels can be deployed quicker, resulting in up to USD 300,000 in additional revenues.

12. **However, domestic shipping reforms only address part of the weaknesses of the domestic maritime sector.** Complementary reforms to liberalize cabotage and improve port efficiency are also needed. While the domestic reform program may help lower shipping costs for certain cargo types or routes, inter-island shipping costs will likely remain high overall due to existing constraints in port infrastructure and cabotage restrictions that prevent more efficient foreign ships from servicing domestic routes. These reforms are discussed in 2 upcoming reports of the World Bank Group.

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DATA APPENDIX

Table A.1. Key economic indicators (2011 to 2016)

	2011	2012	2013	2014 ^{4/}	2015	2016
	Actual			Projection		
Growth and inflation	(in percent of GDP, unless otherwise indicated)					
Gross domestic product (percent change)	3.6	6.8	7.2	6.0	6.5	6.5
Inflation (period average)	4.8	3.2	3.0	4.1	3.0	3.5
Savings and investment						
Gross national savings	23.1	22.3	23.5	23.3	25.2	26.4
Gross domestic investment	20.5	18.1	19.7	20.3	22.5	24.0
Public sector						
National government balance (GFS basis) ^{1/}	-2.1	-2.4	-1.5	-0.2	-2.1	-2.1
National government balance (Govt Definition)	-2.0	-2.3	-1.4	-0.1	-2.0	-2.0
Total revenue (Govt Definition)	14.0	14.5	14.9	15.4	15.6	16.0
Tax revenue	12.3	12.9	13.3	13.8	14.0	14.3
Total spending (Govt Definition)	16.1	16.8	16.3	15.5	17.6	18.0
National government debt	51.0	51.5	49.2	46.1	44.3	42.4
Balance of payments						
Merchandise exports (percent change)	4.1	21.2	-3.6	10.0	8.0	11.0
Merchandise imports (percent change)	9.5	11.3	-3.1	7.0	9.0	11.0
Remittances (percent change of US\$ remittance)	7.2	6.3	7.4	6.5	6.0	5.5
Current account balance	2.5	2.8	3.8	3.0	2.7	2.4
Foreign direct investment (billions of dollars)	2.0	3.2	3.9	5.0	5.0	4.0
Portfolio Investment (billions of dollars)	3.1	4.2	0.4	0.3	1.0	2.0
International reserves						
Gross official reserves ^{2/} (billions of dollars)	75.3	83.8	83.2	79.8	82.3	84.7
Gross official reserves (months of imports)	11.6	11.9	11.5	10.2	9.8	9.0
External debt ^{3/}	30.1	28.1	28.0	27.5	26.8	26.0

Sources: Government of the Philippines for historical and World Bank for projections.

1/ Excludes privatization receipts and includes CB-BOL restructuring revenues and expenditures (in accordance with GFSM)

2/ Includes gold

3/ World Bank definition. The difference with central bank data is that it includes the following: i) gross due to head office/ branches abroad of branches and offshore banking units of foreign banks operating in the Philippines, which are treated as quasi-equity in view of nil and/or token accounts of permanently assigned capital required of these banks; ii) long-term loans of non-banks obtained without BSP approval, which cannot be serviced using the foreign exchange resources of the Philippine banking, and iii) long-term obligations under capital lease agreements.

4/ Data on inflation and international reserves are actual data. The rest are World Bank projections.

Table A.2. National government cash accounts (GFS basis) (2010 to 2014)

	2010	2011	2012	2013	2014
	WB proj.				
	(in percent of GDP, unless otherwise stated)				
Revenue and grant	13.4	14.0	14.5	14.9	15.4
Tax revenue	12.1	12.3	12.9	13.3	13.8
Net income and profits	5.4	5.9	6.1	6.2	6.3
Excise tax	0.7	0.7	0.7	1.0	1.1
Sales taxes and licenses	2.4	2.4	2.7	2.7	2.8
Others	0.7	0.7	0.7	0.7	0.7
Collection from Customs	2.9	2.7	2.7	2.6	2.9
Nontax revenue ^{1/}	1.3	1.6	1.6	1.6	1.6
Grant	0.0	0.0	0.0	0.0	0.0
Total expenditure	17.0	16.1	16.9	16.4	15.5
Current expenditures	13.8	13.3	13.6	13.3	12.8
Personnel services	5.2	5.1	5.1	5.0	5.2
MOOE	2.0	2.1	2.4	2.5	2.1
Allotment to LGUs ^{2/}	2.4	2.4	1.9	2.1	2.0
Subsidies	0.2	0.5	0.5	0.6	0.5
Tax expenditures	0.5	0.3	0.5	0.2	0.2
Interest payment	3.4	3.0	3.1	2.9	2.8
Capital outlays	3.1	2.6	3.2	3.0	2.5
Net lending	0.1	0.2	0.3	0.1	0.2
Balance (GFS definition)	-3.6	-2.1	-2.4	-1.5	-0.2
Balance (GOP definition)	-3.5	-2.0	-2.3	-1.4	-0.1
Primary Balance (GFS)	-0.2	0.8	0.7	1.4	2.7
<i>Memorandum items</i>					
Privatization receipts (PHP billions)	0.9	0.9	0.0	0.2	0.0
Nominal GDP (PHP trillion)	9.0	9.7	10.6	11.5	12.7

Sources: Department of Finance, Bureau of Treasury, and Department of Budget and Management, and World Bank staff calculations

1/ Excludes privatization receipts (these are treated as financing items in accordance with GFSM).

2/ Allocation to local government units (LGUs) excludes capital transfers, which are included in capital outlays.