Country Diagnostics Studies

ADB

Philippines: Critical Development Constraints

Asian Development Bank

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Economics and Research Department

Asian Development Bank

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Foreword

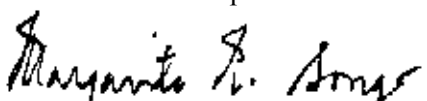
The Philippine Government envisions all Filipinos to emerge economically and socially secure in the 21st century. Today, as the economy continues to grow and gain strength, hopes are high that this vision will be realized within the foreseeable future. This is a formidable challenge that involves several tasks in many fronts.

In this context, the Government welcomes this report on the "critical development constraints" that the Philippines faces. The growth diagnostic framework used in the study is an attempt to establish priorities among many candidate policies and institutional reforms aimed at sustained and broad-based growth. The analyses and the informed recommendations geared to overcoming poverty, income inequality, and other unwanted economic and social outcomes are of immense value to policy makers in Government and observers of Philippine development.

The Philippines, as the report notes, has implemented a number of important policy reforms over the past three decades. Today, it is integrated with the rest of the world not only in trade in commodities but also in securities and foreign currencies. It has privatized many large Government corporations and deregulated key industries. It is actively involved in the Doha Round of the World Trade Organization. In the area of social development, it adopted the Millennium Development Goals. All these and more have helped usher in economic growth and improvements in living standards of Filipinos.

The Government, however, is aware that poverty, unemployment, and regional income disparities are all constant reminders of the difficulties that some of our countrymen are still experiencing. The report is, thus, very timely and will be a source of valuable inputs in updating the country's Medium-Term Philippine Development Plan.

Lastly, the report provides insights that can enrich development cooperation between the Philippine Government and the Asian Development Bank (ADB). The high priority given, for example, to fiscal strengthening, is bound to improve the conduct of official development assistance. The Government gratefully acknowledges ADB for the moral and financial support it extended to the report at hand.



MARGARITA R. SONGCO
Deputy Director-General
National Economic and Development Authority

Preface

Philippines: Critical Development Constraints is the first report in a series that is planned under the Asian Development Bank (ADB) regional technical assistance project, "Strengthening Country Diagnosis and Analysis of Binding Development Constraints in Selected Developing Member Countries." This report presents a diagnosis of the Philippine economy.

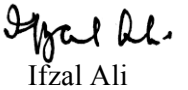
The Philippines' development performance during the past several decades has been less impressive than that of many of its East and Southeast Asian neighbors. In the 1950s and 1960s, the country had one of the highest per capita gross domestic products (GDPs) in the region—higher than the People's Republic of China, Indonesia, and Thailand. However, the Philippines has now fallen behind. Its growth has not only been slow but also erratic—with frequent booms and busts. As a result, household incomes have not risen significantly, poverty incidence has declined only slowly, and inequality remains high, which are constant reminders of the challenges that the Philippines faces in the new millennium.

In the past 5 years, growth has picked up and in 2007 the Philippine economy grew faster than at any point in the last several decades. However, domestic investment has remained low and its share in GDP has continued to decline. This raises the question of how the recent pace of growth can be sustained or even improved. Thus, the report attempts to identify the most critical constraints that are being faced by the country, which when removed can yield the highest welfare gains. It also attempts to answer how the constraints can be converted into opportunities for long-term growth, and how the benefits of economic growth can be translated into faster poverty reduction in the Philippines.

The study was led by Muhammad Ehsan Khan while Juzhong Zhuang, assistant chief economist, Economic Analysis and Operations Support Division, Economics and Research Department, provided the oversight and overall direction. The report, prepared by Dante B. Canlas, Muhammad Ehsan Khan, and Juzhong Zhuang with the assistance of Maria Rowena M. Cham, synthesized the findings of background papers commissioned under the study. The background papers were prepared by a team of experts comprising Gilberto M. Llanto, Emannuel S. de Dios, Joseph A. Lim, Hyun H. Son, Arsenio M. Balisacan, and Clarence Pascual. The preparation of the report was assisted by Lawrence N. Guevara, Amador Foronda, Mary Jane F. Carangal-San Jose, Damaris Yarcia, and Marife Lou L. Bacate. The report was edited by Jill Gale de Villa, while production was coordinated by Cherry Lynn T. Zafaralla with the assistance of Joe Mark Ganaban and Mercedita P. Cabaneros in graphic design and typesetting, and Juliet F. Vanta and Fatima Christine R. Blanco in proofreading. Rana Hasan, Herath Gunatilake, William E. James, Donghyun Park, and Dalisay Maligalig provided constructive comments and support in finalizing the report.

During the study, ADB adopted a consultative process where first the framework and approach and then the study findings were discussed with representatives from key agencies of the Government of Philippines, academic and research institutions, and private sector. Feedback received during these consultations greatly benefited us in preparing the report, which we believe will provide valuable inputs to the formulation of development policies and reform programs aimed at sustaining economic growth and poverty reduction in the Philippines. Tom Crouch, deputy director general, South East Asia Department; and Joven Balbosa, Philippine country team leader, helped in coordinating with the Government and other stakeholders in undertaking the consultations.

We are grateful for the support that was provided by the Government of Philippines. In particular, we would like to thank Deputy Director General Margarita R. Songco, National Economic and Development Authority, the Government focal point, for her keen interest in the study and guidance in completing this work. We are also grateful for the support and feedback from Undersecretary Gil S. Beltran, Department of Finance; Director General Rodolfo V. Vicerra, Congressional Planning and Budget Department of the House of Representatives; Assistant Director General Ruben S. Reinoso, National Economic and Development Authority; Director Gisela C. Lopez, Department of Budget and Management; and Alberto A. Lim, Makati Business Club. We look forward to a continued and productive dialogue with the Government in pursuing an agenda of sustained development in the Philippines.



Ifzal Ali
Chief Economist
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Abbreviations

ARMM	Autonomous Region of Muslim Mindanao
ASEAN	Association of Southeast Asian Nations
BIR	Bureau of Internal Revenue
BOT	build-operate-transfer
BSP	Bangko Sentral ng Pilipinas
DOF	Department of Finance
EPIRA	Electric Power Industry Restructuring Act
GDP	gross domestic product
GSIS	Government Service Insurance System
IMF	International Monetary Fund
LGUs	local government units
MTPDP	Medium-Term Philippine Development Plan
NCR	National Capital Region
NFA	National Food Authority
NIEs	newly industrializing economies
ODA	official development assistance
PPP	purchasing power parity
PRC	People's Republic of China
R&D	research and development
RA	Republic Act
RATES	Run After Tax Evaders
SMEs	small and medium enterprises
SSS	Social Security System
TFP	total factor productivity
VAT	value-added tax
WEF	World Economic Forum

Chapter 1
Introduction

A. Objectives

The Philippines' economic growth during the past five decades has not been impressive compared with that of many of its neighbors; in per capita terms, the growth was even less favorable. As a result, the pace of poverty reduction has been slow and income inequality remains high. In 2003, about one in four Philippine families and 30% of the population were deemed poor and, in 2006, the Gini coefficient of per capita income (a commonly used measure of income inequality) was slightly over 45%, among the highest in Southeast Asia.

The Philippine Government is committed to sustained growth, the rewards from which are within reach of every Filipino. The commitment is spelled out in the current Medium-Term Philippine Development Plan.

This report has two interrelated objectives. The first is to seek to identify some critical constraints to long-run economic growth and equitable development in the Philippines. The second is to spell out some policy adjustments that stand a good chance of overcoming the constraints identified to broad-based growth and to achieving the Government's development targets.

B. Methodology

The study uses a diagnostic approach, and broadly follows growth diagnostics developed by Hausmann, Rodrik, and Velasco (2005). The growth diagnostics approach provides a consistent framework for identifying the most critical or binding constraints to growth and for discerning the priorities and sequence of policies required to ignite and sustain growth. The growth diagnostics approach differs from the laundry list approach, as implied by the Washington consensus, and recognizes that the economic and political environment differs a great deal among developing countries; there is no "one-size-fits-all" solution to development problems and, therefore, the ordering of policy priorities contingent on country-specific circumstances is critically important. Further, countries at an early stage of development may not have adequate capacity to implement a wide array of policy reforms at the same time. With the diagnostic approach, reforms can start with easing a few critical areas that truly constrain growth. Therefore, the approach offers a practical tool for policy makers and development planners to use in formulating country-specific growth strategies. The application of growth diagnostics is one of the efforts in the search for new approaches to growth strategy after the Washington consensus was questioned in recent years.

The growth diagnostics approach starts with a set of proximate determinants of growth, investigates which of these post the greatest impediments or are the most critical constraints to higher growth, and figures out specific distortions behind the impediments. The point of departure of the inquiry is a standard endogenous growth model in which growth depends on the social return to accumulation, private appropriability of this social return, and the cost of financing (Box 1). Each of these three broad determinants of growth is in turn a function of many other factors, which can be presented in a problem tree (Figure 1.1).

The problem tree provides a framework for diagnosing critical constraints to growth. The diagnosis starts by asking what keeps the level of private investment and entrepreneurship low. Is it low social return to investment, inadequate private appropriability of the social return, or high cost of financing? If it is low social return, is that due to insufficient levels of complementary factors of production—in particular, human capital, technical know-how, and/or infrastructure? If the impediment is poor private appropriability, is it due to macro vulnerability, high taxation, poor property rights

Box 1
An Endogenous Growth Model

A standard endogenous growth model yields the result that, at the steady state, consumption and capital grow according to

$$\frac{\dot{c}_t}{c_t} = \frac{\dot{k}_t}{k_t} = \sigma\left[r(1-\tau)-\rho\right]$$

where a dot over a variable denotes the rate of change over time, and where other definitions are as follows:

c = per capita consumption,
k = per capita capital,
σ = elasticity of intertemporal substitution in consumption,
r = rate of (the expected) social return to investment,
1- τ = private appropriabilty of social return, and
ρ = cost of financing.

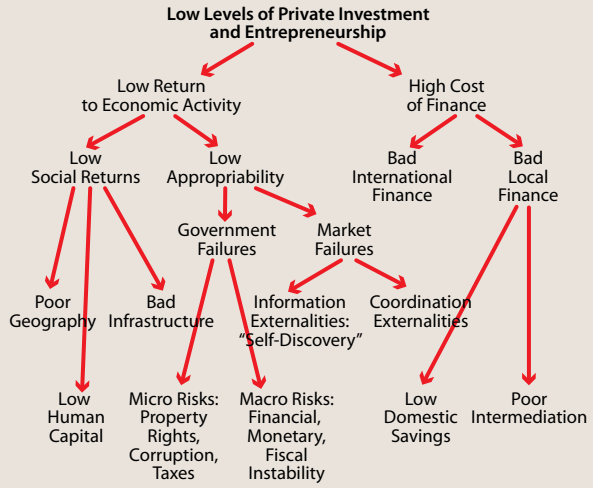
- The rate of (the expected) social return to investment (r) is a function of the availability of complementary factors of production such as infrastructure, technical know-how, and human capital. Lack of complementary factors reduces social return to investment and, with given private appropriability and cost of financing, leads to lower private return to investment and hence to lower private investment.

- The private appropriability of social return (1-τ) is a function of (i) micro risks such as high taxation, poor property rights and contract enforcement, and labor-capital conflicts; (ii) macro risks such as high inflation, currency crises, and financial meltdown; and (iii) market failures due to issues such as learning and information externalities, and coordination failures, with (i) and (ii) being interpreted as government failures. Higher micro and macro risks and larger market failures lower the private appropriability of social return and, with a given social return and cost of financing, lead to lower (expected) private return to investment and hence to lower private investment.

- The cost of financing (ρ) is a function of domestic savings rate, efficiency of domestic financial intermediation, extent of integration with external financial markets, and perceived country risks. Higher cost of financing, with given (expected) social return to investment and private appropriability, leads to lower private investment.

Source: Hausmann, Rodrik, and Velasco (2005).

Figure 1.1
Growth Diagnostics Framework



Source: Hausmann, Rodrik, and Velasco (2005).

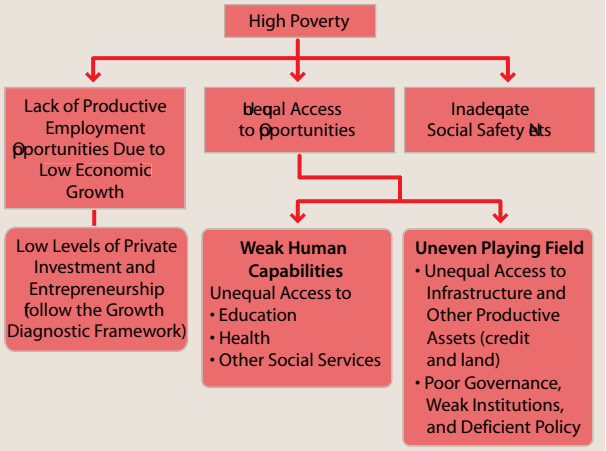
and contract enforcement, labor-capital conflicts, information and learning externalities, and/or coordination failures? If high cost of finance is the problem, is it due to low domestic savings, poor intermediation in the domestic financial markets, or poor integration with external financial markets?

At each node of the problem tree, the diagnosis looks for signals that would help answer the question. The two types of diagnostic signals that one can look for are price signals and nonprice signals. Examples of price signals are returns to education, interest rates, and cost of transport. For instance, if education is undersupplied, returns to skills/education would be high and unemployment for skilled people would be low. If investment is constrained by savings, interest rates would be high and growth would respond to changes in available savings (for example, inflows of foreign resources). If poor transport link is a serious constraint, bottlenecks and high private costs of transport would occur.

The use of nonprice signals is based on the idea that when a constraint binds, it results in activities designed to get around it. For example, high taxation could lead to "high informality" (e.g., under-reporting of income, resulting in lower tax revenues); poor legal institutions could result in high demand for informal mechanisms of conflict resolution and contract enforcement; and poor financial intermediation could lead to internalization of finance through business groups. Cross-country and cross-period benchmarking and results of business surveys are useful means to gauge whether particular diagnostic evidence signals a binding constraint for the country concerned.

Although the growth diagnostics approach was developed to identify the binding constraints to growth and associated policy priorities, the approach can also be applied to other areas of policy analysis, such as identifying critical constraints to poverty reduction (Figure 1.2). Slow pace of poverty reduction can be caused by the lack of economic opportunities due to poor growth, weak human capacities that prevent individuals from participating in the growth process, absence of effective and adequate social safety nets, and/or inequitable access to opportunities due to poor governance and weak institutions. Each of these could be due to many other factors. The growth diagnostics approach focuses on identifying the root causes of poverty and critical constraints to poverty reduction.

Figure 1.2
Diagnostic Framework for Poverty



C. Organization of the Study

The rest of the report is organized as follows. Chapter 2 provides an overview of the Philippine development performance and evolution of development policies during the last several decades. It describes the episodes of growth, discusses key growth drivers, and examines progress in poverty reduction. Chapter 3 elaborates on growth diagnostics, focusing on the three broad determinants of growth that could act as constraints: social return to investment, private appropriability, and cost of finance. Chapter 4 looks at the links between growth and poverty and at critical constraints to broadening the inclusiveness of growth. Chapter 5 summarizes the findings and discusses policy implications.

Chapter 2
Philippine Development: Performance and Policy

The growth and development experience of the Philippines after World War II relative to other countries in East and Southeast Asia has caught the attention of eminent economists studying growth and development. Lucas (1993), for example, has asked why the Philippines missed becoming an economic miracle in the context of the remarkable East Asian transformation featuring Hong Kong, China; Republic of Korea; Singapore; and Taipei,China. This section describes and tries to account for performance in growth and poverty reduction in the past several decades and the evolution of the Philippine Government's development policy.

A. Synopsis of Philippine Growth

Following the Philippines' political independence in 1946, in the 1950s the country embarked on an industrialization drive. Between 1950 and 2006, the Philippine gross domestic product (GDP), expressed in 1985 prices, expanded 11.2 times—an average growth of 4.4% each year. But the growth rate was never smooth. The economy, for instance, contracted in 1984–1985, 1990, and 1998.

Accounting for growth in population, which rose from about 19 million in 1950 to 87 million in 2006, for an average annual growth of about 2.75%, the Philippines in 1960 had a per capita GDP of about $612 expressed in 2000 United States dollars (Table 2.1).[1] By this measure, it was ahead of Indonesia, with a per capita income of $196 and Thailand, with $329. The Philippines trailed Malaysia; Hong Kong, China; Singapore; Republic of Korea; and Taipei,China. By 1984, Thailand's per capita GDP of $933 had overtaken the Philippines' $908. In 2006, per capita GDP of the Philippines stood at $1,175, compared with Thailand's $2,549.[2] During 2001–2006, the Philippines posted its highest average per capita GDP growth of the past 2.5 decades, at 2.7%; at that rate, per capita GDP would double in about 26 years.

Table 2.1
Per Capita GDP in 2000 $

Economy	1960	1983	1984	2006
Hong Kong, China	1,960	13,028	14,163	31,779
Indonesia	196	444	467	983
Korea, Republic of	1,110	3,884	4,147	13,865
Malaysia	784	2,059	2,161	4,623
Philippines	612	1,004	908	1,175
Singapore	2,251	10,386	11,042	27,685
Taipei,China[a]	1,468	2,846	3,169	15,482
Thailand	329	897	933	2,549

[a] Data for Taipei,China for 1960 are in constant 1996 United States dollars.
Sources: Data from *World Economic Outlook* (IMF, various years); and *World Development Indicators* (World Bank, various years); *Taipei,China Statistical Data Book* (CEPD, various years).

[1] All the data, unless otherwise stated, are taken from *World Economic Outlook* (IMF, various years) and *World Development Report* (World Bank, various years).

[2] Oshima (1987) describes how Thailand overtook Philippine per capita gross domestic product (GDP) in the 1980s, focusing on country differentials in labor productivity in the aggregate and in the three major sectors of agriculture, industry, and services.

As shown in Table 2.2, during 1981–1990, the average annual change of Philippine per capita GDP was a negative 0.6%; in contrast, Thailand grew 6.3%, overtaking the Philippines. The entire 1980s were a lost decade for Philippine growth: the Government declared a moratorium on foreign debt servicing in 1983 and, in consequence, in 1984–1985 the country had its first recession in the postwar era. The economy recovered in 1986 and this was sustained until 1989, when some political shocks slowed it down. The growth in the second half of the 1980s could not offset the dismal performance in the first half, resulting in a shrinking average annual per capita GDP during the decade.

Natural disasters intervened as the economy entered the 1990s. A major earthquake hit the central and northern Philippines hard in 1990, followed by the eruption of Mt. Pinatubo in 1991. The volcano's destruction was severe enough to cause a contraction that year. In 1992, presidential elections were held, but before the incoming administration could start working on its development agenda, it had to overcome a severe electric power crisis. The crisis was defused in 1994, allowing economic recovery to gain strength until 1997, when the Asian financial crisis broke. The Philippines caught the contagion from that crisis. Another recession materialized in 1998, which was also a presidential election year. The contraction proved short lived. In 1999, the economy recovered. The recovery continued until another political shock hit in late 2000, when the incumbent president stepped down and a new administration took over in January 2001.

A number of external shocks again hit the economy as it entered the new millennium. For example, in 2001, the information technology sector retreated on a global scale, causing the country's top manufactured exports (semiconductors) to decline. Then came September 11 and the "war against terrorism," and the risk and uncertainty it engendered in the Philippines, particularly in the Autonomous Region of Muslim Mindanao. In addition, public health shocks (the onset of the severe acute respiratory syndrome—SARS—and avian influenza) intervened. Though the diseases had minimal direct effects on the Philippines, negative externalities were caused by limited information about the geographic extent of these diseases. Nevertheless, the economy showed some resiliency as real per capita GDP managed to grow an average of 2.7% each year during 2000–2006.

At this growth rate, real per capita GDP would double every 26 years. In all likelihood, the Philippines will not be able to catch up with Thailand if its growth rate stays at a mere 2.7%. Doubling the 2006 level would bring real per capita GDP up to $2,350, still less than Thailand's in 2006.

Hong Kong, China; Republic of Korea; Singapore; and Taipei,China—often referred to as newly industrializing economies (NIEs)—have undergone remarkable economic transformation and modernization since the 1960s and now export manufactured products on a global scale. The four NIEs in East and Southeast Asia are regarded as models of successful industrialization and are often referred to as economic miracles. In contrast, the Philippines did not make a similar transformation.

Table 2.2
Annual Average Growth Rate of Real Per Capita GDP, 1950–2006 (%)

Period	Hong Kong, China	Indonesia	Korea, Rep. of	Malaysia	Philippines	Singapore	Taipei,China	Thailand
1951–1960	9.2	4.0	5.1	3.6	3.3	5.4	7.6	5.7
1961–1970	7.1	2.0	5.8	3.4	1.8	7.4	9.6	4.8
1971–1980	6.8	5.3	5.4	5.3	3.1	7.1	9.3	4.3
1981–1990	5.4	4.3	7.7	3.2	–0.6	5.0	8.2	6.3
1991–2000	3.0	2.9	5.2	4.6	0.9	4.7	5.5	2.4
2001–2006	4.0	3.3	4.2	2.7	2.7	3.2	3.4	4.0

GDP = gross domestic product.
Sources: Data from *World Economic Outlook* (IMF, various years); *World Development Indicators* (World Bank, various years); *Taipei,China Statistical Data Book* (CEPD, various years).

B. Accounting for Sources of Growth

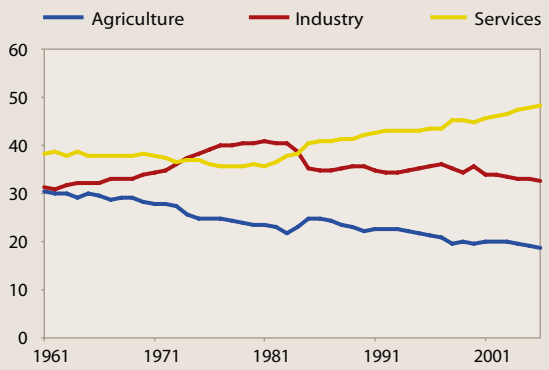
The Philippines' growth record during the past four decades leaves much to be desired when compared with the high growth performance of its East and Southeast Asian neighbors. What have been the key drivers of and reasons behind its slow and erratic growth?

On the supply side, the three major sectors (agriculture, industry, and services) grew steadily during the 1950s, 1960s, and 1970s (Table 2.3). But the economic crises in the mid-1980s, early 1990s, and late 1990s slowed growth considerably. During the recession in the early 1980s, industry was the hardest hit as the growth rate for the period slipped to 0.6% from a high 7.9% in the previous decade. Industry recovered in the 1990s and stabilized in the 2000s, but services proved to be the main contributor to growth starting in the 1980s. In the 1990s, agriculture contributed 12.9% to GDP growth; industry, 35.3%; and services, 51.9%. During 2001–2006, agriculture's average contribution to GDP growth increased to 15.9%; that of industry decreased to about 22.6%, while that of services increased to almost 61.5%.

Figure 2.1 depicts the output share of the major sectors. Agriculture, including fishery and forestry, was a major source of income and employment from the 1950s to 1980s. In 1986, agriculture's share of real GDP was about 25%. In 2006, this had declined to about 19%. The biggest subsector in agriculture is crops, and during 1986–2006, its share of real GDP fell from 23.0% to 18.6%. Forestry's share declined from 1.7% in 1986 to 0.1% in 2006, reflecting the rapid rate of deforestation that had taken place.

In the course of economic development, the share of agriculture to real GDP is expected to decline. Industry is normally expected to pick up the slack. This did not happen in the Philippines. The share of industry was highest in the 1960s and 1970s as import substitution policies, which were oriented mainly toward the domestic market, extended high rates of effective protection to local industries against imports. In the 1980s, industry's share began to decline. In 1986, industry's share to real GDP was 35%; in 2006, the share had dropped to 32.5%. The biggest subsector in industry is manufacturing. In 1986, manufacturing's share of real GDP was 24.7%; this fell to 24% in 2006. Food processing is the most important manufacturing subsector.

Figure 2.1
Sector Share in GDP (%)



GDP = gross domestic product.
Sources: Data from National Income Accounts (National Statistical Coordination Board, various years).

Table 2.3
Annual Average GDP Growth and Contribution of Major Production Sectors to GDP Growth (%)

Period	GDP Growth Rate	Agriculture		Industry		Services	
		Growth Rate	Contribution to GDP Growth	Growth Rate	Contribution to GDP Growth	Growth Rate	Contribution to GDP Growth
1951–1960	6.4	5.0	25.5	7.5	34.1	7.0	40.4
1961–1970	4.9	4.3	26.0	5.7	37.0	4.8	37.0
1971–1980	5.9	4.1	17.6	7.9	49.6	5.3	32.8
1981–1990	1.8	1.2	16.3	0.6	8.5	3.4	75.3
1991–2000	3.1	1.9	12.9	3.1	35.3	3.7	51.9
2001–2006	4.6	3.7	15.9	3.2	22.6	6.1	61.5

GDP = gross domestic product.
Source: Estimates by the National Economic and Development Authority based on National Income Accounts data of the National Statistical Coordination Board.

Philippine industry contributed only 33% to GDP during 2001–2006. This contrasts sharply with many of its Association of Southeast Asian Nations (ASEAN) neighbors. During the same period, industry contributed about 45–46% of GDP in Indonesia, Malaysia, and Thailand (Table 2.4)

Due to the services sector's high growth rates, its share in GDP increased and exceeded that of industry starting in the mid-1980s. In 1986, services' share was 40.6%; in 2006, this had risen to 48.7%. Trade, both retail and wholesale, was the biggest subsector in services. In 1986, trade's share in real GDP was 14.7%; this increased to 16.9% in 2006, helped in no small amount by the enactment of the Retail Trade Liberalization Law. Other than government services, all subsectors of services (such as transport, telecommunications, finance, and private services) were part of the economic expansion.

On the demand side, the share of private consumption in GDP in the Philippines averaged around 75% during the 1950s and 1960s, and declined to just below 70% in 1970s. Since then it has been on a rising trend, and reached 78% during 2001–2006 (Table 2.5). Consequently, private consumption has been the most important driver of GDP growth, averaging at 89% of GDP growth in the 1990s and slightly declining to 81.9% afterward (Table 2.6). Meanwhile, the contributions of investment to GDP growth have stayed below one third that of private consumption in most periods, and average contribution has fallen to –7.2% during 2001–2006. As for government spending, its share in GDP has continued to be below that of comparator countries—and has consistently been less than 10% of GDP. The dominant role of private consumption in driving GDP growth in the Philippines is also in sharp contrast with many of its ASEAN neighbors, where the role of private consumption is much less significant and the contributions of investment and net exports are more important (Table 2.7).

The Philippines has a high level of disparity in the regional pattern of growth (Table 2.8). The National Capital Region (NCR) is the largest contributor to GDP growth, followed by Region IV (Southern Tagalog) and Region III (Central Luzon). During 2001–2006, the Philippines' average annual GDP growth rate was 4.6%, of which 75% was contributed by 5 of the 17 regions. The NCR accounted for over 39% of GDP growth; Region IV, 14%; and Region III, 7%.

Table 2.4
Average Major Production Sector Shares in GDP, 2001–2006 (%)

Economy	Agriculture	Industry	Services
Indonesia	15.1	44.8	40.1
Malaysia	8.5	45.1	46.4
Philippines	19.6	33.3	47.1
Taipei,China	1.7	28.7	69.7
Thailand	9.3	46.0	44.7
Viet Nam	20.7	38.8	40.5

GDP = gross domestic product.
Sources: Estimates by the National Economic and Development Authority based on National Income Accounts data of the National Statistical Coordination Board for the Philippines; data from *World Development Indicators* (World Bank, various years) and *Key Indicators 2007* (ADB 2007d) for all other economies.

Table 2.5
Share of Expenditure Components in GDP (%)

	Consumption		Government		Investment		Net Exports
Period	Growth Rate	Share in GDP	Growth Rate	Share in GDP	Growth Rate	Share in GDP	Share in GDP
1951–1960	6.5	74.9	4.5	7.3	5.8	18.4	–5
1961–1970	4.7	74.2	5.5	7.1	6.3	20.7	–3
1971–1980	4.7	67.7	7.0	8.7	9.5	25.2	–4
1981–1990	3.0	70.1	1.5	7.6	3.0	21.3	–2
1991–2000	3.5	77.8	3.5	8.0	4.0	23.0	–9
2001–2006	4.9	78.4	0.4	6.8	–1.3	19.7	–7

GDP = gross domestic product.
Sources: Estimates by the National Economic and Development Authority based on National Income Accounts data of the National Statistical Coordination Board.

Table 2.9 decomposes real GDP growth into the growth of labor and capital, weighted by their shares in GDP, plus a residual that represents growth of total factor productivity (TFP), capturing factors such as technological progress, efficiency gains due to policy and institutional reforms, etc. The share of capital income (α) is estimated at 0.65 using a regression model. Under constant returns to scale, the share of labor income is 1-α, which is equal to 0.35. The results show that much of the growth in real GDP in the 1960s and until the 1990s was attributed to growth in capital and labor and came minimally from growth in TFP. In fact, TFP growth was negative in the 1970s and 1980s. But the tide seems to have turned in 2001–2006, with TFP growth at 2.41%.

TFP growth is a main source of long-run growth. Many studies have found that TFP growth in the Philippines was weak and volatile over time

Table 2.6
Contribution to GDP Growth by Expenditure Components (%)

	Consumption		Government		Investment		Net Exports
Period	Growth Rate	Contribution to GDP Growth	Growth Rate	Contribution to GDP Growth	Growth Rate	Contribution to GDP Growth	Contribution to GDP Growth
1951–1960	6.5	75.4	4.5	5.2	5.8	15.5	–2.2
1961–1970	4.7	71.3	5.5	7.9	6.3	24.7	–4.6
1971–1980	4.7	54.1	7.0	9.9	9.5	36.7	–1.7
1981–1990	2.9	118.0	1.5	6.1	3.0	11.9	–23.7
1991–2000	3.5	89.0	3.5	9.0	4.0	26.0	–1.3
2001–2006	4.9	81.9	0.4	0.2	–1.3	–7.2	–1.9

Note: Figures do not add up because of statistical discrepancy in the National Income Accounts data of the National Statistical Coordination Board.
Source: Estimates by the National Economic and Development Authority based on National Income Accounts data of the National Statistical Coordination Board.

Table 2.7
Average Shares of Expenditure Components in GDP, 2001–2006 (%)

Economy	Consumption	Government	Investment	Net Exports
Indonesia	61.0	7.4	22.9	8.8
Malaysia	48.3	14.4	27.8	9.6
Philippines	78.4	6.8	19.7	–7.4
Taipei,China	58.9	13.0	18.3	9.7
Thailand	54.6	3.4	23.2	13.5
Viet Nam	65.2	6.6	35.0	–6.8

GDP = gross domestic product.
Sources: Estimates by the National Economic and Development Authority based on National Income Accounts data of the National Statistical Coordination Board for the Philippines; *Taipei,China Statistical Data Book* (CERD, various years) for Taipei,China; data from *World Development Indicators* (World Bank, various years) for all other economies.

Table 2.8
Regional Contribution to GDP and GDP Growth (%)

Year	National Capital Region	Region IV Southern Tagalog	Region III Central Luzon	Region VI Western Visayas	Region VII Central Visayas	Other Regions
Gross Regional Domestic Product—Regional Shares						
1981–1990	29.6	14.8	9.3	7.4	6.4	32.5
1991–2000	30.3	15.7	9.5	7.2	6.7	30.7
2001–2006	31.2	15.4	8.8	7.2	7.1	30.3
Gross Regional Domestic Product—Contribution to Growth						
1981–1990	34.5	17.1	12.3	4.6	8.2	23.4
1991– 2000	31.4	16.3	7.9	7.4	9.0	28.1
2001–2006	39.0	14.4	6.7	7.8	7.2	25.0

GDP = gross domestic product.
Source: Data from National Income Accounts of the National Statistical Coordination Board.

(Cororaton 2002a). During some decades, such as the 1980s, average TFP growth was negative. Compared with other countries in Southeast Asia, the Philippines obviously performed weakly in TFP growth (Table 2.10), which could explain why Thailand overtook the Philippines' per capita GDP and growth rate in the 1980s.

C. Recent Trends in Poverty and Inequality

In view of the modest growth of the Philippine economy during the past 5.5 decades, real incomes of households have not risen significantly, poverty incidence has declined only slowly, and inequality remains high. Poverty and inequality amid growth is a constant reminder of the challenges that the Philippines faces in the new millennium.

(a) Poverty

In eradicating poverty, the Philippines has lagged far behind most of its East and Southeast Asian neighbors, particularly, the People's Republic of China (PRC), Indonesia, Thailand, and Viet Nam. In 2003, using the official poverty lines, 30% of Filipinos and 24% of Philippine families were classified as poor (Figure 2.2). At the $1-a-day poverty line, the poverty incidence was about 13.2%. In contrast, the PRC and Viet Nam started with higher levels of poverty than the Philippines during the early 1980s, but their absolute poverty rates soon dwindled and became lower than those of the Philippines in the early 2000s. Using the $1-a-day poverty line, the PRC's absolute poverty rate was about 10.8% and that of Viet Nam about 8.4%. Both Malaysia and Thailand have virtually eliminated absolute poverty (Figure 2.3).

As in most Asian developing countries, poverty in the Philippines is largely a rural phenomenon. Two of every three poor people in the country are in rural areas and depend predominantly on agricultural employment and incomes. Poverty incidence among agricultural households is about four times that of the rest of the population. Although the share of agriculture in the total labor force has gone down from about one half in the late 1980s to only a little more than one third by the mid-2000s, the sector continues to account for nearly two thirds of total poverty. Further, there were

Table 2.9
Annual Average GDP Growth and Contributions of Factors of Production (%)

Period	Contribution of Capital Stock Growth [$\alpha(\Delta K/K)$]	Contribution of Labor Growth [$(1-\alpha)(\Delta L/L)$]	Contribution of TFP Growth ($\Delta A/A$)
1961–1970	3.98	1.18	0.06
1971–1980	4.57	1.38	–0.64
1981–1990	2.05	1.37	–1.62
1991–2000	1.77	0.87	0.25
2001–2006	1.12	1.24	2.41

GDP = gross domestic product., TFP = total factor productivity.
Note: In the column heads, Y = GDP, K = capital stock, ΔK = change in capital stock, L = labor force, ΔL = change in labor force, A = total factor productivity, ΔA = change in total factor productivity, α = share of capital incomes, and $1-\alpha$ = share of labor incomes. Capital stock is derived by applying the perpetual inventory method to arrive at the initial capital stock and then applying the formula $K_t = K_{t-1}(1-\delta) + I_t$ where K_t is the capital stock, K_{t-1} is capital stock in the previous year, δ is the assumed depreciation rate, and I_t is the gross domestic capital formation.
Source: Estimations based on National Statistical Coordination Board data.

Table 2.10
Annual Average Growth of Total Factor Productivity in Selected Asian Countries (%)

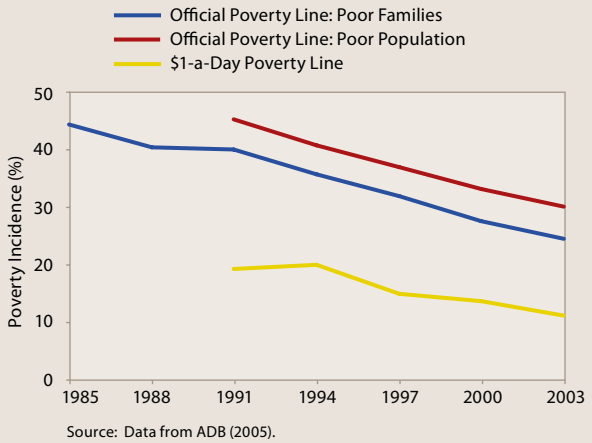
Period	Indonesia	Malaysia	Philippines	Thailand	Viet Nam
1980–1984	–0.32	0.74	–2.34	0.37	–
1985–1989	–0.47	0.20	0.49	3.66	2.02
1990–1994	0.82	3.36	–1.68	2.14	4.12
1995–1999	3.67	0.32	1.03	–2.16	3.22
1980–2000	–0.80	1.29	–0.37	1.00	3.27

Source: Asian Productivity Organization (2004).

large variations in poverty incidence across regions. In 2003, the poverty incidence was the highest in the Autonomous Region of Muslim Mindanao at 63.9%; Bicol, 45.7%; and Western Mindanao, 48.2%; and was lowest in the NCR (4.9%).[3] The highest concentration of the poor was in the Visayas and Mindanao, with 48.3% of the poor living in these regions in 2003.

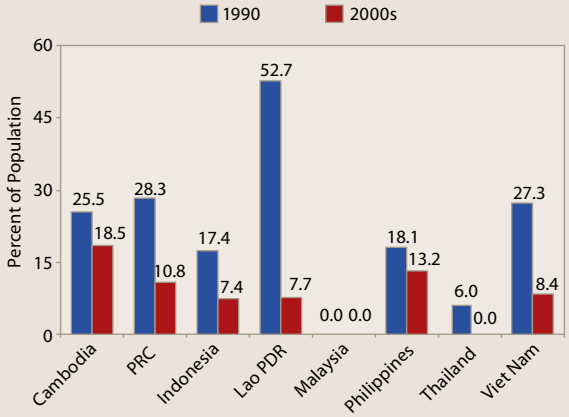
The large regional variation in poverty incidence has been attributed partly to a relatively large variation in access to infrastructure and social services across regions and island groups. A widely held view, for example, is that development efforts in the Philippines have favored Luzon and discriminated against the Visayas and (especially) Mindanao, leading to substantial regional differences in access to economic opportunities, rates of poverty reduction, and the incidence of armed conflicts. For instance, the *Philippine Human Development Report 2005* shows that measures of deprivation—such as disparities in access to reliable water supply, electricity, and (especially) education—predict well the occurrence of armed encounters (HDN 2005).

Figure 2.2
Poverty Incidence in the Philippines



Source: Data from ADB (2005).

Figure 2.3
Poverty Incidence Based on $1-a-Day in Selected Countries



Lao PDR = Lao People's Democratic Republic, PRC = People's Republic of China.
Note: Data for Cambodia are for 1993 and 2004; for PRC, for 1993 and 2004; for Indonesia, for 1993 and 2002; for Lao PDR, for 1992 and 2002; for Malaysia, for 1993 and 2004; for Philippines, for 1994 and 2003; for Thailand, for 1992 and 2002; and for Viet Nam, for 1993 and 2004.
Source: ADB (2007d).

Several studies have examined the causes of poverty in the Philippines. Balisacan (2007b) found that multidimensional deprivation in the Philippines—as manifested not only in low incomes but also in inadequate human capabilities such as poor health and educational achievements and in limited access to the means to achieving these capabilities—is closely linked to agriculture. Cluster analysis of provincial data indicates that the share of agriculture in employment increases with the level of provincial deprivation, being lowest (about 6%) in the least deprived provinces and highest (about 65%) in the extremely deprived provinces. Thus, moving rural populations out of the agriculture sector has the potential advantage of overcoming many dimensions of deprivation at the same time.

Balisacan (2007c) also looked at the statistical significance of the channels by which income growth, together with a host of other factors, influence poverty reduction. The study grouped all the factors into initial economic and institutional conditions, and time-varying policy variables. Among the initial conditions, the level of human capital stock was found to be statistically significant at conventional levels: an increase of 10% in the mortality rate relative to the mean for all provinces (84.7 in 1988) would reduce the rate of provincial income growth by 0.2% per year. All the time-varying policy variables were found to be significant and have the expected signs. Improvements in

[3] These figures were estimated using consistency-confirming poverty lines. As shown in Balisacan (2003), the official estimates are not an accurate guide to ascertaining changes in poverty over time or across the country's regions or provinces, or between rural and urban areas because the standard of living implied by the poverty lines varies for each region and over time. In contrast, consistency-confirming poverty lines are fixed for various subpopulation groups and periods in terms of the level of living they imply. Moreover, they use expenditure per capita as a proxy measure for individual welfare, while the official methodology uses income per capita as the relevant indicator.

literacy and access to infrastructure (electricity and roads) had a positive effect on income growth. Most interestingly, increments in land reform implementation (the Comprehensive Agrarian Reform Program) had a positive and significant effect on the mean income growth rate. A 25% increase in the pace of implementing land reform would raise the income growth rate by 0.6% per year. This is a significant result considering that land reform is often seen as a policy tool mainly for achieving noneconomic objectives. The result suggests that addressing access to productive assets would improve efficiency, thereby raising the economy's subsequent income growth rates.

(b) Inequality

The Philippines also has a relatively high level of inequality compared with most of its regional neighbors. In 2003, the richest 20% of the Philippine families received more than half of the national income, while the poorest 20% accounted for only one twentieth. The Gini coefficient of per capita income was 0.44 in the Philippines in 2003, compared with 0.34 in Indonesia, 0.40 in Malaysia, and 0.42 in Thailand (Figure 2.4). During 1994–2003, the Philippines' Gini coefficient rose by 7%, suggesting that income distribution had worsened during this period. The income distribution worsened during 1994–1997, then improved during 2000–2003; but in 2003 the Gini coefficient was still higher than the 1994 level. Thus, while average per capita income has increased, the benefits of growth have not been equally shared by all segments of the population.

Decomposing the country's total inequality into two components—between-region inequality and within-region inequality—shows that more than 90% of the inequality in 2003 was due to inequality among individuals within each region, while only less than 10% could be explained by differences in mean per capita income or expenditure across regions (Table 2.11). Decomposing the total inequality into within educational levels and between levels shows that about 65% of the inequality can be explained by differences in per capita income or expenditure of individuals with the same educational attainments. However, about 35% can be explained by differences in the educational subgroups (Table 2.12),[4] which indicates that improvements in human capital could help reduce inequalities and promote pro-poor growth.

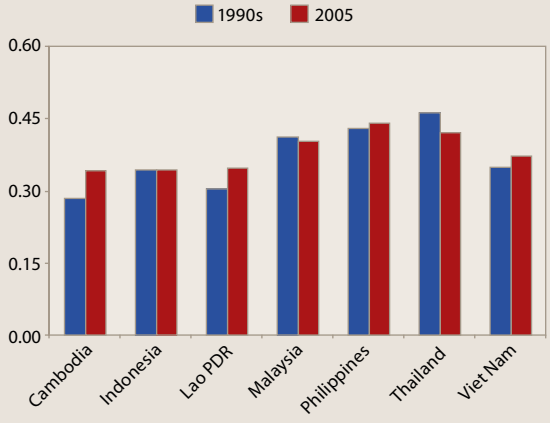
Table 2.11
Inequality Decomposition by Region

	1994	1997	2000	2003
Per Capita Welfare of Income				
Theil's index: total	0.316	0.390	0.386	0.367
Of which				
Within regions	0.278	0.340	0.339	0.340
(as a share of total)	(88.1%)	(87.1%)	(87.8%)	(92.8%)
Between regions	0.038	0.050	0.047	0.027
(as a share of total)	(11.9%)	(12.9%)	(12.2%)	(7.2%)
Per Capita Welfare of Expenditure				
Theil's index: total	0.260	0.305	0.306	0.283
Of which				
Within regions	0.225	0.257	0.261	0.257
(as a share of total)	(86.6%)	(84.3%)	(85.3%)	(90.8%)
Between regions	0.035	0.048	0.045	0.026
(as a share of total)	(13.4%)	(15.7%)	(14.7%)	(9.2%)

Source: Son (2007a).

[4] Educational levels of household heads were divided into seven groups: (i) no education, (ii) incomplete primary education, (iii) complete primary education, (iv) incomplete secondary education, (v) complete secondary education, (vi) incomplete college education, and (vii) complete college education and higher levels.

Figure 2.4
Gini Coefficient for Per Capita Income/Expenditure for Selected Countries



Lao PDR = Lao People's Democratic Republic.
Note: Data for Cambodia are for 1993 and 2005, Indonesia for 1993 and 2002, Lao PDR for 1992 and 2002, Malaysia for 1993 and 2004, Philippines for 1994 and 2003, Thailand for 1992 and 2002, and Viet Nam for 1993 and 2004.
Source: ADB (2007d).

D. Evolution of the Philippines' Development Policy

In the last 5.5 decades the Philippines experienced not only dramatic economic ups and downs, but also political upheavals. The country was under martial law rule for 13 years starting in 1972. In 1986, a "people power revolution" restored democracy. Since then, successive democratically elected administrations have initiated various policy and structural reforms aimed at accelerating the pace of economic growth and poverty reduction.

(a) Development Policy before 1986

In the 1950s, the country's development policy was centered around an industrialization strategy based on import substitution. The strategy was able to raise the level of capital per worker, allowing GDP to grow by about 6.4% annually during the decade. Import substitution, however, soon lost steam and, during 1960–1970, GDP growth slowed to an annual average of 4.9%. The Philippines adhered to import substitution well into the 1970s and the first half of the 1980s, long after the four Asian NIEs had shifted to export-led industrialization.

Import substitution rested on protectionist trade barriers, including high tariffs and quantitative restrictions against imports, and on foreign exchange controls. From the elaborate system of trade protection and foreign exchange controls emerged favored domestic industries, mostly heavy and upstream, that absorbed a good deal of official foreign reserves and contributed to persistent balance-of-payments difficulties. In addition, smuggling of imported goods, abetted by corrupt officials, became pervasive. The restrictive foreign trade regime benefited mostly the owners and employees of industries the Government chose to promote based on policies that were later consolidated under the Investment Incentives Act of 1967. The investment and industrial promotion policies, consisting mainly of tax and customs duties exemptions, did little to bring sustainable growth and poverty reduction.

Table 2.12
Inequality Decomposition by Education Level

	1994	1997	2000	2003
Per Capita Welfare of Income				
Theil's index: Total	0.316	0.390	0.386	0.367
Of which				
Within educational levels	0.222	0.252	0.246	0.241
(as a share of total)	(70.3%)	(64.7%)	(63.7%)	(65.8%)
Between educational levels	0.094	0.138	0.140	0.125
(as a share of total)	(29.7%)	(35.3%)	(36.3%)	(34.2%)
Per Capita Welfare of Expenditure				
Theil's index: Total	0.260	0.305	0.306	0.283
Of which				
Within educational levels	0.178	0.193	0.190	0.182
(as a share of total)	(68.6%)	(63.3%)	(62.1%)	(64.3%)
Between educational levels	0.081	0.112	0.116	0.101
(as a share of total)	(31.4%)	(36.7%)	(37.9%)	(35.7%)

Source: Son (2007a).

Associated with the import substitution strategy was a fixed or managed exchange rate regime, which periodically collapsed from the weight of countercyclical fiscal and monetary policies. Each of the peso collapses was generally accompanied by a balance-of-payments crisis, forcing the Government to seek liquidity support from the International Monetary Fund (IMF). The countercyclical policies had resulted in large and persistent deficits in the current account and in the national Government budget. To finance the twin deficits, the Government borrowed abroad, thereby enlarging its foreign debt. The fiscal deficits were automatically accommodated by the central bank. Because the central bank was not independent from the Government, its monetary management was inconsistent, inflation increased, and official foreign reserves were eroded. In the early 1980s, the Philippines was forced to declare a moratorium on foreign debt servicing, after the oil price shocks brought in high interest rates worldwide.

The dismal economic performance could also be traced to poor governance during the 1970s. A good deal of the foreign debt, it turned out later, consisted of loans that financed projects of political cronies of the then president. Most of the projects failed, and because the loans were coursed through Government financial institutions, they were eventually assumed by the Government.

(b) Development Policy from 1986

In 1986, the Philippine economy emerged from the martial law rule with serious imbalances. The consolidated public sector deficit reached about 6% and external debt was close to 100% of gross national product. Foreign reserves fell to a level equivalent to less than 1 month of imports. Inflation hit 50% in 1984 before falling to 23% in 1985. Real GDP recorded 2 consecutive years of negative growth, at –7% (in 1984 and 1985). The central bank was saddled with massive liabilities, and the finance sector was plagued by huge nonperforming loans of the two government financial institutions—the Development Bank of the Philippines and the Philippine National Bank. Social indicators were just as disappointing: unemployment was high and poverty was pervasive.

Key policies and reform agendas of the administrations since 1986 were mostly documented in the Medium-Term Philippine Development Plans (MTPDPs).[5] A review of the MTPDPs reveals that policies and reforms pursued since the restoration of democracy broadly fall into the following areas: monetary and fiscal reforms for restoring and maintaining macroeconomic stability; trade, industrial, and financial reforms for improving economic efficiency and competitiveness; governance reform and decentralization for improving the effectiveness of the national and local governments; and social policies and programs for fighting poverty, improving income distribution, and achieving the Millennium Development Goals (MDGs). These policies and reforms are embodied in a number of well-publicized initiatives or programs implemented since 1986, including trade liberalization, tariff reduction and accession to the World Trade Organization (WTO); fiscal consolidation and tax reform; creation of an independent central bank with inflation targeting as a key policy tool; privatization of several government-owned and -controlled corporations such as the Philippine National Bank and Petron (a petroleum refining and distribution company); power sector restructuring and reform; comprehensive agrarian reform; banking sector reform and capital market development; devolution of public services delivery to local government units; and declaration of poverty reduction as the overarching development goal and commitment to social programs for poverty alleviation and achieving MDGs.

The current MTPDP covers 2004–2010. The plan fleshes out the policies to support the Arroyo administration's 10-point agenda: (i) creation of 10 million jobs through support for entrepreneurship and agribusiness; (ii) strengthening of education through infrastructure support; (iii) balancing of the national budget through fiscal reforms; (iv) decentralization of progress and development through the development of transportation networks and digital infrastructure; (v) greater and better provision of

[5] The Medium-Term Philippine Development Plan (MTPDP) is the most important planning document of the Government of the Philippines. It spells out the strategic framework to guide the Government's policies, normally for the coming 6 years.

power and water supply; (vi) decongestion of Metro Manila by expanding new centers of government, business, and community outside Metro Manila; (vii) development of Clark and Subic as the logistics center in Asia; (viii) automation of the electoral process; (ix) peace agreements with rebel groups; and (x) closure of divisive issues caused by the "people power movements" of EDSA 1, 2, and 3.

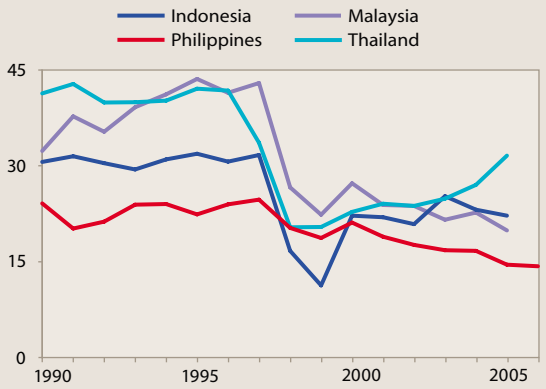
Policies and reforms initiated and implemented so far have had some visible impact on the Philippine economy, barring the reversal experienced during the 1997 Asian financial crisis. Especially in the past 5 years, growth has picked up and, during 2001–2006, the Philippines posted its highest annual GDP growth of the past 2.5 decades, reaching 4.6%. In the first three quarters of 2007, growth accelerated to about 7%, the fastest pace in the past several decades. At the same time, inflation is under control and is now at the lowest level in the past 20 years. The external payments position has also become more sustainable than in recent past decades.

However, the Philippines' policy and structural reform is by no means complete. The list of unfinished reform programs remains long and, arguably, more difficult reforms are yet to be implemented. The strongest evidence is the fact that the country's domestic investment remains sluggish and its share in GDP has continued to decline. This raises the question of whether the recent pace of growth can be sustained. Moreover, the reduction in poverty incidence has been slow and the Gini coefficient of per capita income remains very high, suggesting that the fruits of economic growth have not been widely shared among Filipinos. The next two chapters will examine the critical constraints to sustainable growth and poverty reduction in the Philippines now and in the next 5–8 years.

Chapter 3
Critical Constraints to Growth

Since the 1990s, the Philippines' overall investment rate has almost constantly lagged behind its neighbors' rates. Investment fell in many Southeast Asian countries following the 1997 financial crisis. However, while investment has recovered in most of the countries, in the Philippines the share of gross domestic investment in GDP has continued to fall and is presently at the lowest level since the crisis years of the early 1980s (Figure 3.1).

Figure 3.1
Comparison of Investment Rates (% of GDP)

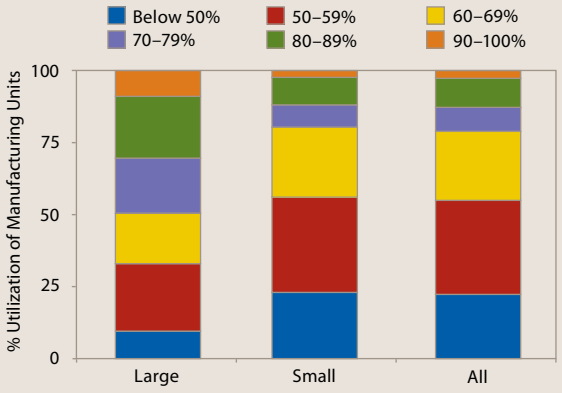


GDP = gross domestic product.
Investment = gross domestic capital formation.
Sources: Data from the National Statistical Coordination Board (2007) and World Bank (2007c).

Although investment has remained weak, GDP growth has picked up in recent years, in particular since 2005. The increase is driven by strong private consumption, which was in turn partly supported by rising remittance inflows. One possible explanation for the fall in the investment rate amid recovery of GDP growth is the growing share of the services sector in total output in the Philippines (ADB 2007d). A substantial part of the economic activities in services may require less investment to produce a unit of output than is true for industry. This implies that a larger share of services in GDP translates to a lower share of investment in GDP. However, data on credit use show that the biggest services subsectors—trade and transport, communications, and storage—are also the largest borrowers, after manufacturing. Such services subsectors (especially transport, communications, and storage) are no less investment-intensive than industry. Therefore, the large share of the services sector in total output is not likely to be a major contributing factor to the low investment rate.

Another possible explanation for the recent divergence in the GDP growth and investment rates could be that the Philippine economy has had excess capacities, which enabled it to register higher growth even with declining investment levels. This possibility is supported by the survey data on capacity utilization for the manufacturing sector. The 2003 Annual Survey of Philippine Business and Industry reported low capacity utilization levels across all size groups of manufacturing establishments (NSO 2004). Almost 50% of the large establishments reported operating at less than 70% of their installed capacity. Small establishments fared significantly better, but with still almost 20% of them reporting a capacity utilization level of less than 70% (Figure 3.2). The same survey in 2005 did not provide similar information, but the Monthly Integrated Survey of Selected Industries found that the average capacity utilization for the manufacturing sector rose from about 74% in 2003 to close to 81% in the second half of 2007 (NSO 2007), suggesting that the declining investment was at least partly compensated for by the increased capacity utilization.

Figure 3.2
Capacity Utilization of Small and Large Manufacturing Establishments, 2003



Source: Data from NSO (2004).

Therefore, the recent pace of growth may not be sustainable unless the declining trend in investment is reversed. While the public sector plays an important role in investing in infrastructure, the private sector should be the driving force of investment required for sustaining growth in the medium and long term. What are the constraints underlying the low level of private investment in the Philippines? Is it due to low social return to investment, low private appropriability, high cost of financing, or some combination of the three? We will now look at some empirical evidence.

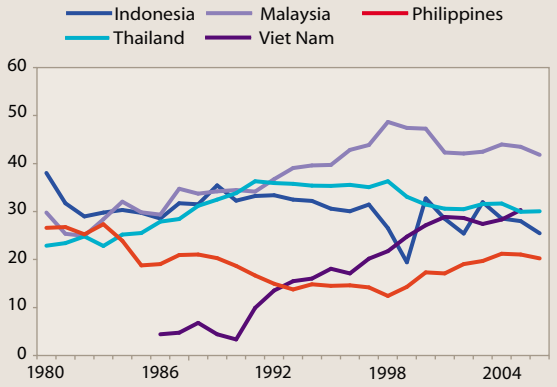
A. Cost of Finance

Low domestic savings could push the real interest rate up, inefficient financial intermediation could make access to finance difficult, and both could lead to a high cost of funds in domestic financial markets. For a small open economy such as the Philippines, access to the international capital market provides an alternative source of financing and, hence, cost of international borrowing is also an important determinant of cost of financing for investors. In addition, in the case of the Philippines, remittances from overseas workers provide another important source of finance.

Aggregate domestic savings rate is modest in the Philippines but may not be a critical constraint to growth at present.

The Philippines' gross domestic savings rate has always been modest. In 1998, the savings rate fell below 13% of GDP, the lowest in more than 50 years. Although the savings rate has been improving since and reached about 20% of GDP in 2006, it was still the lowest among ASEAN countries (Figure 3.3). One may argue that the savings rate should be a function of the level of income. When income is low, a country would need to spend more on basic consumption goods and its savings rate would therefore be lower than that of a country with a higher income level. However, a comparison with savings rates of selected East and Southeast Asian countries when their levels of per capita GDP in purchasing power parity (PPP) terms were similar to that of the Philippines shows that the Philippine domestic savings rate was low (Table 3.1). In fact, the domestic savings rate of the Philippines was similar to rates of Latin American countries that in the past faced periodic recessions and crises, which brought down the savings rate. Notably, by 2006, the Philippines' domestic savings rate had been overtaken by those of Argentina and Chile and was only slightly higher than those of Brazil and Mexico.

Figure 3.3
Comparison of Gross Domestic Savings, 1980–2006 (% of GDP)



GDP = gross domestic product.
Gross domestic savings for the Philippines is calculated as the difference between GDP and final consumption.
Sources: Data from National Statistical Coordination Board for the Philippines and from *World Development Indicators* (World Bank, various years) for other countries.

Table 3.1
Comparison of Gross Domestic Savings with Neighboring Countries at Comparable Per Capita GDP in PPP Terms

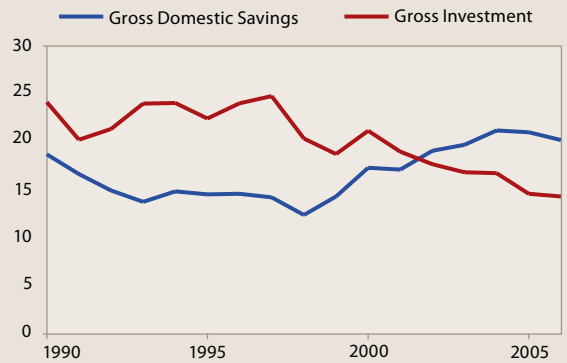
Country	Comparable Period	Per Capita GDP (in 2000 $)	Gross Domestic Savings (% of GDP)
PRC	2002–2003	4,805	40.4–43.4
Korea, Rep. of	1978–1981	4,847	23.9–29.3
Malaysia	1984–1987	4,584	29.4–34.7
Philippines	2005–2006	4,652	20.2–21.0
Thailand	1990–1991	4,758	33.8–36.3

GDP = gross domestic product, PPP = purchasing power parity, PRC = People's Republic of China.
Source: Data are from the *Philippine Statistical Yearbook* (National Statistical Coordination Board, various years) for the Philippines; *World Development Indicators* (World Bank, various years) for all other countries.

The Philippines' low domestic savings rate was likely one of the impediments to the country attaining the high and sustainable growth rates achieved by many of its neighbors in the past several decades. In the long term, the Philippines' growth prospects will benefit from a higher level of domestic savings. A comparison of the gross domestic savings rate with the gross domestic investment rate shows that prior to 2002 the savings levels lagged behind the investment levels, but the tide has since turned, with the ratio of domestic savings to GDP exceeding that of domestic investments to GDP by 1.4 percentage points in 2002, 2.9 percentage points in 2003, 4.5 percentage points in 2004, 6.4 percentage points in 2005, and 5.9 percentage points in 2006 (Figure 3.4).

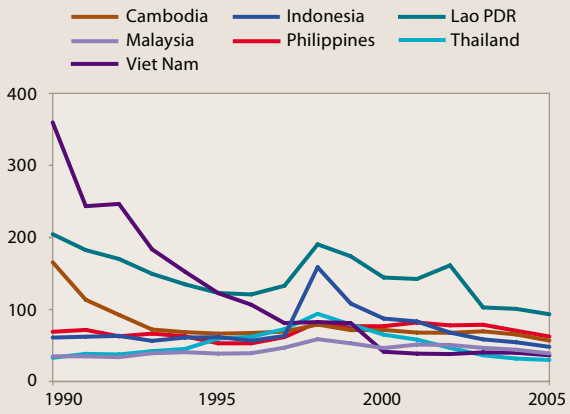
At the same time, the Philippines' current account has been in surplus for almost 5 consecutive years starting in 2003, the longest time span in the last 40 years. During 2003–2006, although the trade account was in deficit, the deficit was more than offset by the growing overseas workers' remittances, leading to positive net resource transfers and enabling the country to reduce its external indebtness (Figure 3.5). According to the central bank (Bangko Sentral ng Pilipinas—BSP), the overseas remittances grew by more than 19% annually during 2002–2006, reaching more than $12 billon in 2006 and equivalent to about 11% of GDP in the same year (BSP 2007). These developments suggest that the modest domestic savings rate does not constitute a critical constraint to investment and

Figure 3.4
Gross Domestic Savings and Investments (% of GDP)



GDP = gross domestic product.
Note: Gross investment refers to gross domestic capital formation; calculated as the difference between GDP and final consumption.
Source: Data from *Philippine Statistical Yearbook* (National Statistical Coordination Board, various years).

Figure 3.5
Comparison of External Indebtedness (% of GDP)



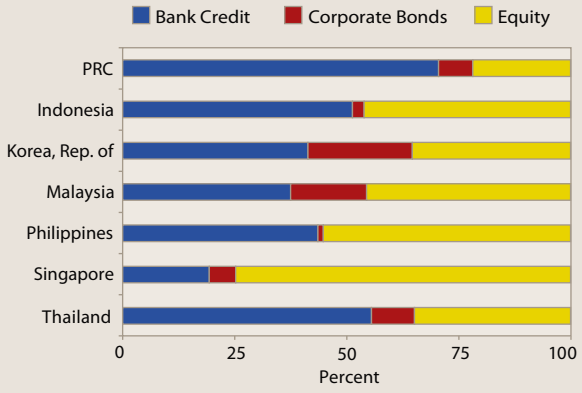
Source: *World Development Indicators* (World Bank, various years).

growth at present. However, if the declining trend in investment were to reverse, the modest domestic savings rate could start to curtail investment and growth.

Efficiency of domestic financial intermediation could be improved but may not constitute a critical constraint to growth.

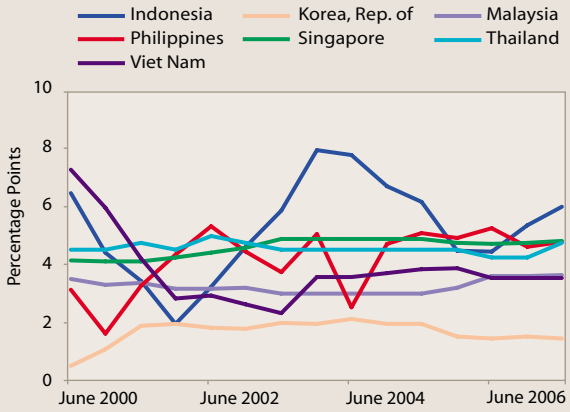
As in most of its regional neighbors, the Philippines' financial system is dominated by banks. In 2006, bank credit accounted for 44% of total corporate domestic financing, equity accounted for 55%, and corporate bonds accounted for 1% (Figure 3.6). Judging from lending-deposit interest rate spreads of the banking sector, the efficiency of domestic financial intermediation in the Philippines is comparable with that in some of its neighbors, such as Thailand (Figure 3.7). Therefore, poor domestic financial intermediation is unlikely to have constituted a critical constraint to growth. However, compared with some of the developed countries such as France, Italy, and the United Kingdom, the efficiency of Philippine financial intermediation has significant room for improvement. The declining returns on assets and on equity of the banking sector after the 1997 Asian financial crisis are also a reason for concern, which does not bode well for overall financial intermediation. According to Torreja (2003), returns on assets of the banking sector declined from 2.07% in 1995 to 0.45% in 2002, and returns on equity from 14.78% to 2.76% in the same period.

Figure 3.6
Sources of Corporate Domestic Financing, End-2006



PRC = People's Republic of China.
Note: Calculated on the basis of outstanding values of bank loans, corporate bonds, and equity marketization.
Source: Data from ADB (2008).

Figure 3.7
Comparison of Spreads between Lending and Deposit Rates



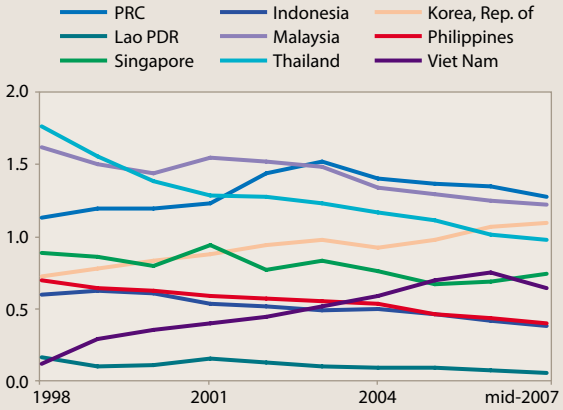
Note: Spread is the difference between the weighted average lending rate and the weighted average deposit rate.
Source: Data from IMF (2007).

Growth of real domestic credit has not recovered since the 1997 financial crisis, but this appears to be more a problem of weak borrowing appetite by the corporate sector than lack of liquidity in the banking system.

After the 1997 financial crisis, real domestic credit stagnated in most of the affected countries, and the Philippines is no exception (Figure 3.8). And like most of the countries (including Indonesia, Malaysia, and Thailand), the ratio of domestic credit to GDP has continued to decline over the last 10 years. The decline, however, is more likely to reflect weak borrowing appetite of the corporate sector than the lack of liquidity in the banking sector. The most telling evidence for this is commercial banks' soaring excess reserves (Figure 3.9). Until 1994, available reserves of the banking system were more or less close to the required level, dipping into negative territory in times of crises and uncertainty (1983–1985 and 1990–1992). Low excess reserves owing to high reserve requirements explain the credit crunch in 1983–1992. In contrast, the current credit slump has been accompanied by soaring excess reserves. The banks may be getting a smaller percentage of the total savings but even

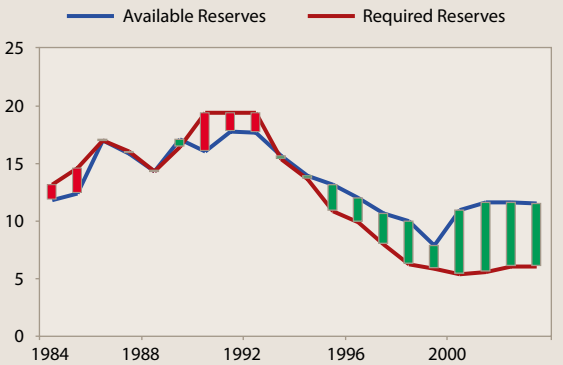
with that, they are not lending to the private sector, but, instead, are holding more Government bonds. The bulk of banks' excess reserves are accounted for by investments in treasury bills (2% of such investments qualify as reserves according to BSP rules). The share of loans to bank assets has fallen with the rise in bank holdings of Government securities. This is consistent with the findings from the 2005 Investment Climate Survey (ADB-WB 2005), which show that only 10% of business establishments surveyed indicated that access to financing was a major or severe constraint. This raises an important issue for regulators: the function of banks is to lend, not to the government but to the private sector.

Figure 3.8
Comparison of Ratios of Domestic Credit to GDP



GDP = gross domestic product; Lao PDR = Lao People's Democratic Republic; PRC = People's Republic of China.
Source: Data from Bank of Thailand for Thailand; IMF (2007) for all other countries.

Figure 3.9
Available and Required Reserves Assets of the Banking Sector (% of deposits)



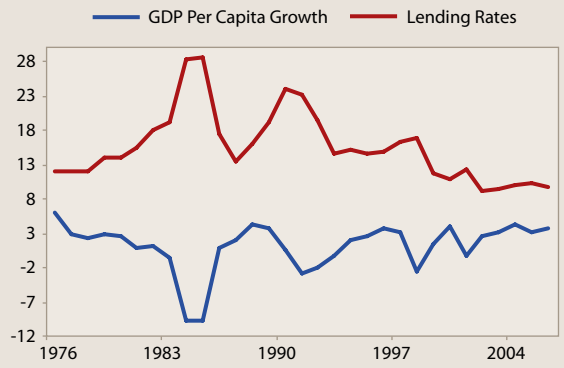
Note: Green bars indicate that available reserves are more than the required reserves; red bars indicate the reverse.
Source: Data from Bangko Sentral ng Pilipinas.

The borrowing cost is currently low by historical standards, and hence is unlikely to have constituted a critical constraint to investment and growth.

The Philippines has historically had very high lending rates, which have no doubt constrained economic growth. Figure 3.10 shows a negative correlation between the nominal average commercial lending rates and per capita GDP growth rates over time: high lending rates were associated with low per capita GDP growth rates. Since 2003, however, the nominal lending rate has declined significantly and is now close to the lowest level in 40 years, while the GDP growth rate is at the highest level. In real terms, the lending rate is currently also low by historical standards and is comparable with those in some of the Philippines' neighbors (Figure 3.11). Thus, the cost of borrowing from domestic banks is unlikely to have constituted a critical constraint to private investment and growth.

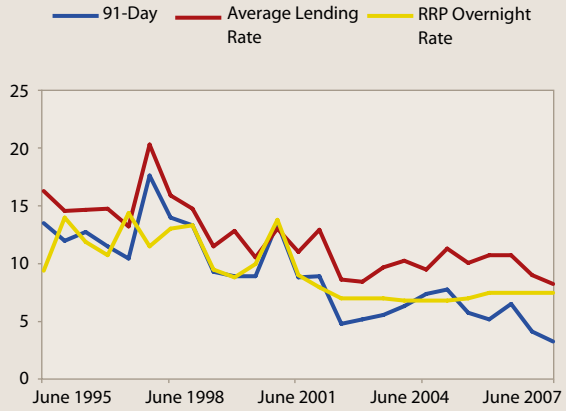
A key reason for the decline in the lending rates appears to be the corporate sector's weak demand for credit, which in turn reflects weak corporate investment. Weak corporate investment as a cause of weak credit growth is further evidenced by the fact that significant reductions in the lending rate after the Asian crisis did not spur investment spending. The decline in inflation to the low single digit has also helped bring down interest rates. But while lending rates have eased, they have not dropped as much as they should, certainly not as much as the decline in the treasury bill rates. What has kept lending rates from falling further is BSP's high overnight borrowing rate (Figure 3.12). Since the second half of 2001, the gap between the central bank's rate and the 91-day treasury bill rate has been growing. Thus, what currently matters is not just the treasury bill rate, but BSP's overnight borrowing rate, which has prevented further reductions in the rate at which banks lend to the private sector.

Figure 3.10
Comparison of Per Capita GDP Growth Rates with Lending Rates (%)



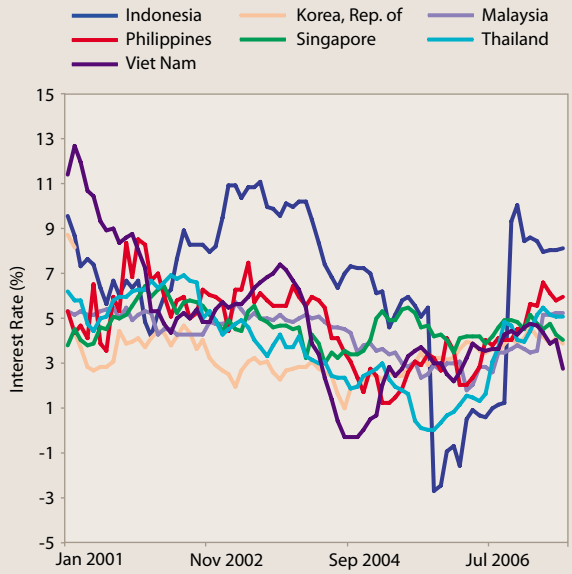
GDP = gross domestic product.
Note: Lending rate is the average nominal commercial lending rate.
Source: Data from IMF (2007).

Figure 3.12
Trends in Lending Rates (%)



Note: 91-Day is the rate for a 91-day treasury bill. Average lending rate is the weighted average interest rate charged by commercial banks on loans granted during a given period. RRP overnight rate is the interest rate at which the Banko Sentral ng Pilipinas borrows from banks with government securities as collateral.
Source: Data from Bangko Sentral ng Pilipinas. Available: http://www.bsp.gov.ph/dbank_reports/InterestRates_1_RPT.asp.

Figure 3.11
Comparison of Real Domestic Interest Rates (%)



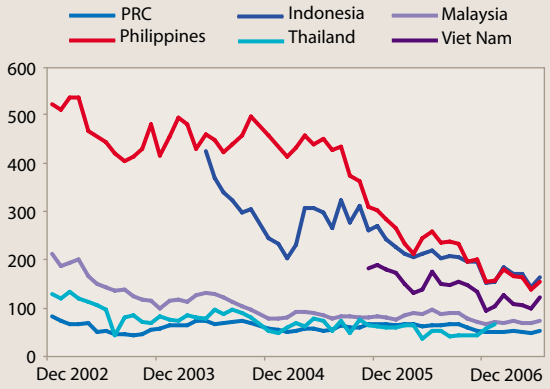
Note: Real domestic interest rate is the domestic interest rate net of inflation.
Source: Data from IMF (2007).

Access to international financial markets has been improving and may not be a critical constraint.

Investors in the Philippines enjoy access to foreign financing through financial markets that are at various stages of development and that continue to evolve using a variety of instruments from recent financial reforms. Financial markets consist of money markets (offshore and local), capital markets (debt and equity), foreign exchange markets (spot and forward), and derivatives (options, swaps, futures, and structured products). The latter are the most recent and least developed of these markets.

A measure of the ease of access to international financial markets may be the sovereign spreads. The comparison of sovereign spreads in Figure 3.13 shows that the Philippines had one of the highest levels of spreads among its regional neighbors until recently, but that the spreads have been declining recently and are now at par with those for Indonesia. This suggests that the access to international financial markets may have been poor in the past but has improved significantly recently.

Figure 3.13
Comparison of Sovereign Spreads
(basis points)



PRC = People's Republic of China.
Note: Sovereign spread is the difference between the yield of a US treasury bond and the treasury bond of the respective country.
Source: Data from JP Morgan Emerging Markets Bond Index.

Although access to and cost of finance do not currently constitute a critical constraint to private investment and economic growth overall in the Philippines, many small and medium enterprises find the access to financial services difficult.

According to the Annual Survey of Philippine Business and Industry of 2005, small and medium enterprises (SMEs) account for about 97% of the enterprises in the country and about 49% of the employment in the enterprises (NSO 2006); however, SMEs account for less than 17% of the revenues and only about 12% of the assets. SMEs represent a potential new growth area, but are unable to realize their potential partly because they lack access to credit. The 2005 Investment Climate Survey indicated that 25% of respondent firms claimed limited access to credit and that over 80% of SMEs had no access to overdraft or credit line facilities, which greatly hampered their ability to do business and grow (ADB-WB 2005). In addition, over 70% of the small and 47% of the medium firms reported that they had to produce collateral to borrow from banks. Feedback from the smaller firms suggested that, in addition to poor access to financial services, they also face higher costs of financing—interest rates offered to the smaller firms were 10–12% when funds were being made available to large firms at about 7%.

B. Social Returns to Investments

The returns to society of investments are diminished or enhanced depending on investments made in complementary factors of production, such as human capital and infrastructure. Investments in such complementary factors often have significant externalities. However, because they could be under-provided if left entirely to the market, such investments require public sector intervention. Human capital may augment labor (that is, raise the efficiency of individual workers). Human capital also contributes to knowledge, giving rise to innovations that raise the productivity of all factors of production and are an important source of long-run growth. Infrastructure or social overhead capital supports private production through connectivity of places and integration of markets, linking suppliers to producers and facilitating distribution of commodities, all helping to lower costs of doing business and increase returns to private investment.

(a) Human Capital

Human capital is not a critical constraint under the current industry structure.

The high level of unemployment among educated workers suggests that the lack of human capital is currently not a critical constraint to growth. Table 3.2 shows that in 2006, the unemployment rate was close to zero for workers with no schooling, 1.0% for workers with elementary schooling, 3.3% for workers with high school education, and 2.9% for workers with college education. The overall unemployment rate declined from 10.2% in 2002 to 7.3% in 2006, and the pace of decline was faster for workers with elementary schooling than for the workers with high school and college education. *Asian Development Outlook 2007* reports that the education levels among the workforce are rising and a large number of the college graduates are taking low productivity jobs: for example, the median years of schooling among taxi drivers in the Philippines is 10 while it is 9 for Indonesia and 6 for Thailand (ADB 2007b).

Declining returns to education across the education levels also suggest that the lack of human capital is currently not a critical constraint to growth. If skilled human capital were indeed a constraint to

Table 3.2
Unemployment Rates by Education Level in the Philippines (%)

Educational Level	Unemployment Rate		Contribution to Total Unemployment	
	2002	2006	2002	2006
No Grade Completed	**0.2**	**0.0**	**1.5**	**0.5**
Elementary	**2.1**	**1.0**	**20.8**	**14.0**
Not completed	1.0	0.4	9.6	6.0
Completed	1.1	0.6	11.2	8.1
High School	**4.3**	**3.3**	**42.7**	**45.5**
Not completed	1.4	0.9	14.2	12.1
Completed	2.9	2.4	28.5	33.4
College	**3.6**	**2.9**	**35.0**	**40.0**
Not completed	1.8	1.5	17.4	21.0
Completed	1.8	1.4	17.6	19.0
Total	10.2	7.3	100.0	100.0

Sources: Data from NSO (n.d.).

growth, the demand for skilled workers would be high and, as a result, the returns to skilled workers would be high. Empirical estimates of rates of return to education suggest otherwise: rates of return across the education levels are declining although the differences in the average rate of return to tertiary education (16.6%) and to primary and secondary education (2.2% and 5.2%, respectively) are large. However, a recent cross-country comparison suggests that the difference in levels of returns may not be as large across the education levels and are not excessive when compared to those in regional neighbors such as Indonesia and Thailand (ADB 2007b).

Other evidence also suggests that, overall, the lack of human capital is not a critical constraint to growth in the Philippines.

- The Commission on Higher Education reported that more than 447,000 students graduated from universities and colleges nationwide in April 2006, but many of the graduates would add to the 2.8 million unemployed and 6.9 million underemployed Filipinos as of January 2006 (de la Cruz 2007).

- The latest Labor Force Survey showed that while more than 400,000 students graduate from tertiary educational institutions each year, the number of employed professionals in the Philippines increased by only 31,000 to 1.414 million as of January 2006 from 1.383 million a year earlier, and the number of technicians and associate professionals increased by just 26,000 to 869,000 from 843,000 a year earlier. In comparison, the number of sales workers surged by 135,000, while the number of laborers and unskilled workers went up by 382,000 (de la Cruz 2007).

- Findings of the 2005 Investment Climate Survey (although limited to a few industries) also back the conclusions in the preceding paragraphs (ADB-WB 2005). The survey reported that only about 12% of the responding firms considered that availability of human capital was a constraint to doing business in the Philippines.

But human capital may be scarce in emerging industries.

Study findings based on the 2004 labor force statistics suggest that the earnings of the professional workers in emerging industries such as financial intermediation, information technology, call centers, and real estate were 3–4 times those of the unskilled workers in these industries (DOLE, various years). Conversely, for more established industries such as manufacturing, construction, and private education and health services, the professional workers' earnings were only 2.0–2.5 times those of unskilled workers. These patterns

suggest that human capital may be a constraint in some emerging industries. This argument is supported by the views of the European Chamber of Commerce, which has recently flagged the scarcity of skilled workers in industries such as information technology and business process outsourcing as a major constraint (Sto. Domingo and Rubio 2007).

Scarcity of skilled workers is also one reason for returns to education being much higher for the tertiary level than for the primary and secondary levels (Table 3.3). The emerging industries in information and communications technology and business process outsourcing generally employ college graduates at rates much higher than those in the traditional service trades. With rising skill intensity in the service sector, it is reasonable to expect a higher rate of return for education in services than in agriculture and industry. Table 3.3 shows that in services, the rate of return to education is 9.4%, compared with 0.9% in agriculture and 7.2% in industry.

Out migration of highly skilled workers may not be a critical constraint to growth.

Statistics reported by the Philippine Overseas Employment Administration suggest that the majority of migrant workers are employed in low technology occupations (POEA 2007). According to the 2006 data, over 80% of the 308,000 newly hired workers were employed in low paying and/or low-skill occupation groups (Table 3.4). Less than 4% of new hires were employed in engineering and related occupations. However, the statistics do not provide insights into how many of the workers may have higher skill levels but were forced to accept employment in the occupations requiring less skill because they were unable to find employment that better matched their skill level. The investor feedback gathered by the Global Competitiveness Report (IMD 2007) also suggests that less than 4% of the investors considered that brain drain may be a problem in the Philippines.

Table 3.3
Rates of Return by Education Level and Sector (%)

	1997	2000	2003
By Educational Level			
Primary	2.50	2.42	2.22
Secondary	6.75	5.57	5.16
Tertiary	19.80	17.62	16.57
By Sector			
Agriculture	0.84	0.96	0.89
Industry	7.57	7.01	7.23
Service	11.42	9.90	9.36

Source: Estimates based on data from the Family Income and Expenditure Surveys and Labor Force Surveys (NSO, various years).

Table 3.4
New Deployment of Overseas Workers by Occupational Group, 2006

Occupational Group	Newly Hired Workers	Percent of Total
Household Workers	91,451	29.7
Factory Workers	43,234	14.0
Construction Workers	43,040	14.0
Medical Workers	17,731	5.8
Hotel and Restaurant Workers	15,693	5.1
Caregivers and Caretakers	14,412	4.7
Building Caretakers	12,294	4.0
Engineers	11,169	3.6
Dressmakers and Tailors	7,831	2.5
Performing Artists	7,431	2.4
Total New Deployment	308,142	100.0

Source: Data from the Philippines Overseas Employment Administration.

(b) Infrastructure

Inadequacies in Infrastructure are a critical constraint to investment and growth.

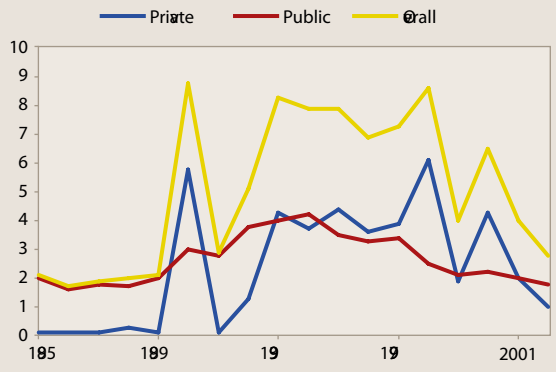
The Philippines' investment in infrastructure as a percentage of GDP has been low and erratic (Figure 3.14). Government expenditure on infrastructure investment, after peaking at 4% of GDP in 1994, has slipped back to around 2% of GDP. Trends in private investment in infrastructure have been even more erratic. Following the crisis in the mid-1980s, private investment in infrastructure remained below 0.5% of GDP until the early 1990s, when private sector investment in the power sector led to a sharp jump. Private sector investment has hovered near 2–4% of GDP since then, but dipped below 1% in 2002.

The Philippines has invested less in infrastructure than have most of its regional neighbors. In 2005, for example, the national Government capital expenditure as a share of GDP was 8.6% for Viet Nam, 5.3% for Malaysia, and 3.0% for the Republic of Korea, but was only 2.4% for the Philippines (Figure 3.15). Major development partners have been urging the Government to raise infrastructure investment levels to at least 5% of GDP. Current levels of investment are insufficient for keeping up with the growing needs of the economy and the population; the investments also fall short of the levels required for maintaining the existing infrastructure.

Due to the dearth of investment in infrastructure, the availability of key infrastructure in the Philippines compares unfavorably with that in many of its regional neighbors. While the country's road length per unit area is one of the highest in the region, the per capita and per vehicle road lengths are among the lowest in Southeast Asia (Figure 3.16). Further, only 22% of the road network in the Philippines is paved, compared with 99% in Thailand, 81% in Malaysia, and 58% in Indonesia. For paved roads, the Philippines' road length is among the lowest in Southeast Asia, whether in terms of per unit area, per capita, or per vehicle. Similarly, per capita power consumption levels in the Philippines are about one third those in Thailand and one fifth those in Malaysia (Figure 3.17). In telecommunications, the Philippines is also behind Malaysia and Thailand in terms of per capita availability of telephone lines, but the difference is not as large as in case of power consumption (Figure 3.18).

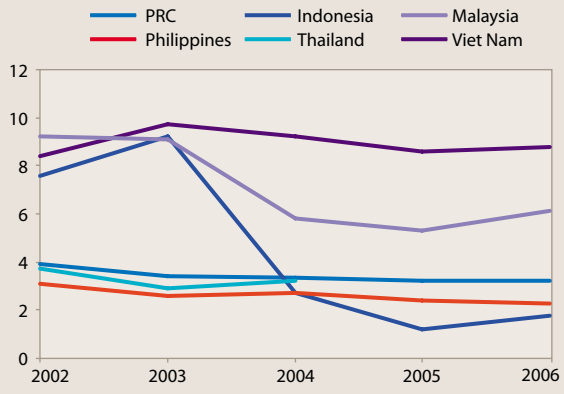
The low levels of investment in and poor conditions of infrastructure in the Philippines have increased the cost of doing business in the country (see discussions below) and had significant adverse impact on the perceived competitiveness and attractiveness of the Philippines as an investment destination.

Figure 3.14
Public and Private Sector Investments in Infrastructure (% of GDP)



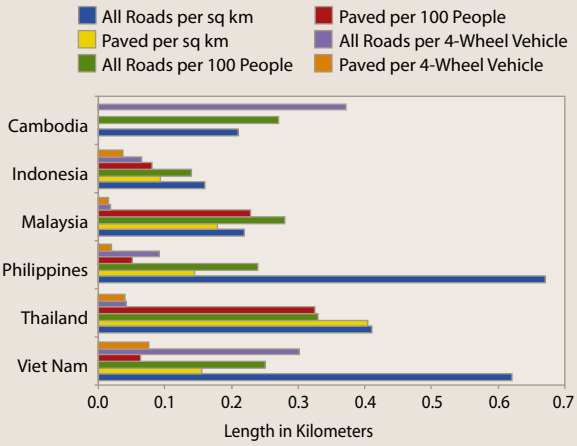
GDP = gross domestic product.
Source: World Bank (2005).

Figure 3.15
Government Development Expenditures (% of GDP)



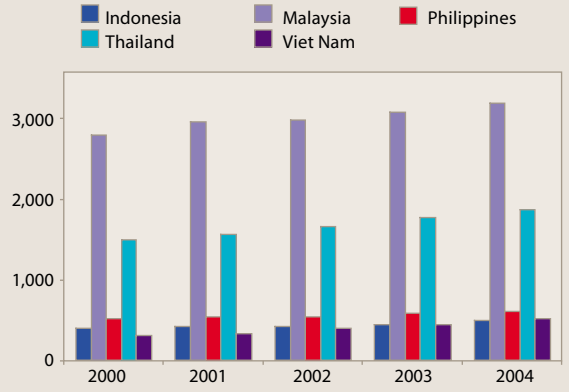
GDP = gross domestic product; PRC = People's Republic of China.
Sources: Data from China National Statistics Board (2007) for the PRC and ADB (2007d) for all other countries.

Figure 3.16
Comparison of Road Network Coverage, 2003–2004



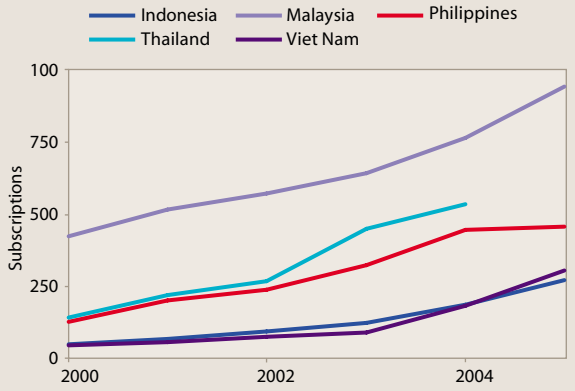
Note: Total length is for 2003–2004 for all countries. Paved length for Indonesia is for 2002, Viet Nam for 1998, and for all other countries for 2003. Paved length data for Cambodia are not available.
Sources: Data from World Bank (2005) and *World Development Indicators* (World Bank, various years).

Figure 3.17
Comparison of Per Capita Electricity Consumption, 2000–2004 (in kWh)



kWh = kilowatt-hour.
Source: Data from *World Development Indicators* (World Bank, various years).

Figure 3.18
Comparison of Fixed Line and Mobile Telephone Subscriptions, 2000–2005 (per 1,000 people)



Source: Data from *World Development Indicators* (World Bank, various years).

- A recent cross country study (World Bank and Turku School of Economics 2007) ranked the Philippines 86th among 150 countries in terms of adequacy of infrastructure and behind most of its regional neighbors except the Lao People's Democratic Republic (Figure 3.19).

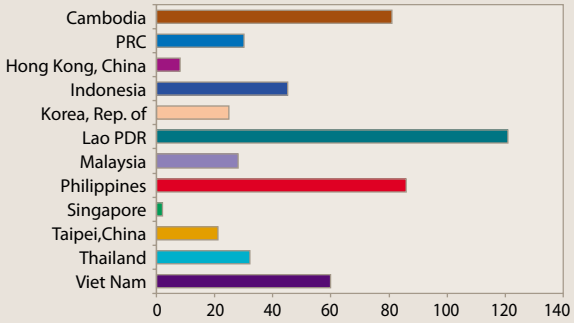
- The World Economic Forum in 2003–2004 ranked the Philippines 66th of 102 countries in its growth competitiveness index, partly because of the poor state of Philippine infrastructure (WEF 2004).

- In terms of overall infrastructure quality, the Philippines ranked 88th of 125 countries in the 2006 Global Competitiveness Index of the World Economic Forum, a slight improvement from its 89th rank in 2004 (WEF 2004).

- In terms of adequacy of infrastructure, the Philippines slid to 51st in 2007 of 61 countries from 49th in 2006 according to the 2007 World Competitiveness Yearbook (IMD 2007). Among its regional neighbors, the Philippines trails Thailand (46th, 2007), but is ahead of Indonesia (54th, 2007).

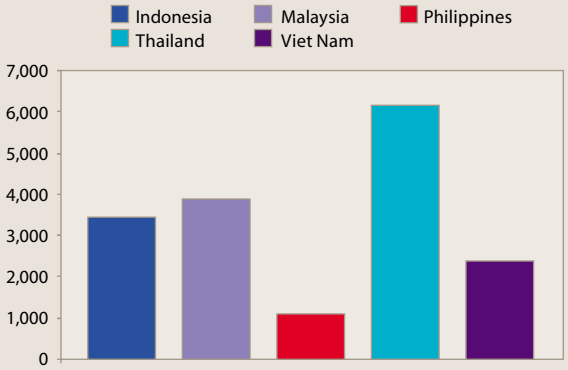
- Figure 3.20 shows that, since the 1997 Asian financial crisis, the Philippines ranked the lowest in FDI inflows among the major regional neighbors (ADB 2007d).

Figure 3.19
Infrastructure Quality Ranking, 2006–2007



Lao PDR = Lao People's Democratic Republic, PRC = People's Republic of China.
Note: Rankings of 150 economies; a higher ranking indicates poorer infrastructure quality.
Source: Data from World Bank and Tusku School of Economics (2007).

Figure 3.20
Annual Average Foreign Direct Investment, 2002–2006 ($ million)



Source: Data from ADB (2007b).

Increased cost of doing business and the inability to attract more foreign investment have constrained growth at both national and subnational levels. Empirical testing as part of this study finds a robust relationship between economic growth and infrastructure in the Philippines, and that the causality from infrastructure to economic growth is highly significant. The findings also confirm earlier studies (including Llanto 2004) that showed that poor infrastructure and lack of investment in infrastructure have constrained growth. The study's empirical testing also indicates that infrastructure has a positive and significant effect on growth in regional incomes, and the regions with better infrastructure have had higher growth rates. This is consistent with findings of Lamberte, Alburo, and Patalinghug (2003) and Basilio and Gundaya (1997) and others, which show that adequacy of infrastructure services and different levels of infrastructure development have led to differences in regional growth in the Philippines.

Within infrastructure, expensive and unreliable electric supply and inefficient transport network are the two most critical constraints to growth.

Of the firms surveyed by the 2005 Investment Climate Survey, 62% rate public infrastructure and services in the Philippines as "somewhat inefficient to very inefficient," in particular, due to poor shipping services in the country, which led to a 4.7% loss in production (ADB-WB 2005). Of the firms, 52% view Philippine public works as unsatisfactory. Recent studies by the Asian Development Bank, the World Bank, and other agencies indicate that expensive and unreliable electricity supply and inefficient transport network are the two most critical constraints in the infrastructure sector to growth in the Philippines. The Government had initiated a number of key reforms in power and transport, some of which are yet to be completed (Box 2).

- **For the transport network:**

(i) A recent World Bank study noted that more than half of the country's road network was in poor or bad condition, leading to vehicle operating and intercity freight costs that are more than 50% higher than in regional neighbors such as Indonesia and Thailand. The same study estimated that the high level of congestion on the main roads alone is costing the nation as much as ₱185 billion a year in 2006 prices (WB 2005).

(ii) The port of Manila ranked 31st among the top 50 ports worldwide in the 2005 World Port Rankings in terms of container traffic, with a total

Box 2
Unfinished Reform Agenda for the Power and Transport Sectors

Electric Power. The passage of the Electric Power Industry Restructuring Act (EPIRA) was instrumental in introducing important reforms in the power sector in the following areas:

- separating the competitive from the monopolistic components of the industry, such as generation versus transmission and distribution versus supply of electricity;
- unbundling the cost components of power rates to ensure transparency and to distinguish the efficient utilities from the inefficient ones; and
- promoting efficiency and providing reliable and competitively priced electricity, while giving customers a full range of choices.

Reform measures achieved under the EPIRA include (i) creating the National Transmission Corporation (TransCo), (ii) creating the Power Sector Assets and Liabilities Management Corporation (PSALM) to dispose of Government-owned generation assets, (iii) establishing a wholesale spot electricity market, (iv) unbundling power rates, and (iv) reviewing the independent power purchase contracts of the National Power Corporation (NPC).

The EPIRA provides for the establishment of a wholesale electricity spot market, which is a mechanism for determining the price of electricity not covered by bilateral contracts between sellers and purchasers of electricity. Because it is a spot market, electricity is traded in "real time." As a wholesale market, it is open to distributors directly connected customers, large users, and supply aggregators.

To enhance growth of gross domestic product, the Government has to address the following constraints: (i) financial viability of NPC and PSALM, (ii) the need for new investments in the power sector in view of the forecast of power shortage in the near future, (iii) improved management of the wholesale electricity spot market for credible competition, (iv) privatization of the rest of the generation assets, and (v) an efficient and credible regulatory framework and institution.

Transport. The Philippines' transport system relies heavily on the road network, which handles about 90% of the country's passenger movement and about 50% of freight. The road network provides the most common means of transporting passengers and economic goods within the islands as well as between them, using the recently inaugurated roll-on-roll-off shipping facilities. A light rail transport system is concentrated in the Metro Manila area, and a partly functioning heavy rail system operates to some destinations outside Metro Manila. A string of ports and airports connects the country's major economic centers.

Several issues must be addressed. While the Philippine road network is extensive, much of it is in poor condition. Only 70% of the national road network is paved. The national road network is a mere 12% of the total public road network. Village roads are mostly unpaved and in poor condition, and comprise more than half of the road network. Most of the road network has been devolved to local government units. The road network has deteriorated because of the central and local governments' neglect of basic road maintenance and underinvestment in new roads.

This is ironic because the problem does not fully rest with insufficient funds for road maintenance. Republic Act 8794 created the Road Fund, earmarked for maintaining national and local roads and controlling air pollution from motor vehicles. The Road Fund has accumulated a substantial amount

of money since May 2001, when the collection of a motor vehicle user charge from vehicle owners commenced—about ₱22.6 billion were collected from May 2001 to April 2005. The efficiency with which these funds are used could be improved.

The Philippine light rail system is administered by the Light Rail Transit Authority. Metro Manila has three light rail transit lines. The main issues are (i) the failure to link a 5 kilometer portion from North Avenue, Quezon City, to the major transport hub at Monumento, Caloocan City; (ii) insufficient capacity and number of coaches, especially during peak hours, causing stress to the many passengers; (iii) interruption of operations due to mechanical and or electrical failure, especially during adverse weather conditions—the light rail system does not have a dedicated power source; and (iv) the huge subsidy burden on the Government arising from failure to adjust the fare to cover costs.

Source: Llanto (2007).

of 2,665 twenty-foot equivalent units (World Container Port League 2005). The Philippines was way behind other ASEAN ports in the top 50 list, which includes Singapore (1st); Hong Kong, China (2nd); Busan, Republic of Korea (5th); Port Klang, Malaysia (14th); Tanjung Pelepas, Indonesia (19th); Laem Chabang, Thailand (20th); and Tanjung Priok, Indonesia (24th).

(iii) The Philippines has the highest cost in the ASEAN for exporting a container, partly because of inefficiencies in port handling. The World Bank's recent Doing Business Indicators noted that the cost of exporting a 20 foot container from the Philippines is 16–51% higher than from the PRC, Singapore, or Thailand (WB-IFC 2007).

(iv) About 18% of firms participating in the 2005 Investment Climate Survey reported that the inadequate transport network was a major constraint to investment (ADB-WB 2005).

(v) Firms experience delays 5.6% of the time when picking up goods for delivery to or delivering supplies from the domestic market. Firms in the NCR experience longer delays than those in nearby CALABARZON (comprising Cavite, Laguna, Batangas, Rizal, and Quezon provinces) and in Cebu and Davao areas, due to greater traffic congestion and inadequate transport network linking the NCR to other regional domestic markets. The proportion of paved roads to total roads indicates that undependable roads limit transport of goods and access to inputs and markets in a timely manner.

- **And for electricity:**

(i) A study of 10 Southeast Asian cities noted that the power tariffs for businesses in Manila were 20–80% higher than tariffs in the other nine cities (Leung et al. 2003). In addition, the reliability of electricity supply has been poor and the investment climate survey shows that SMEs have been losing up to 8% of their production due to frequent power disruptions.

(ii) As many as 33% of surveyed firms reported that dependable and affordable electricity supply was a major constraint for them (ADB-WB 2005).

(iii) Losses due to power failure amounted, on average, to 8% of production. Power outages hurt SMEs most, costing them about 8–11% of production, compared with 6% for large firms.

The findings are based on feedback from the firms operating in the Philippines and may not fully reflect the views of businesses that may have stayed away from investing in the Philippines. A survey by the Japan External Trade Organization in 2006 may be more useful in gauging views of such investors and similarly found that about 32% of the Japanese firms' international operations considered the underdeveloped infrastructure as a critical bottleneck (JETRO 2006).

C. Appropriability of Returns to Investments

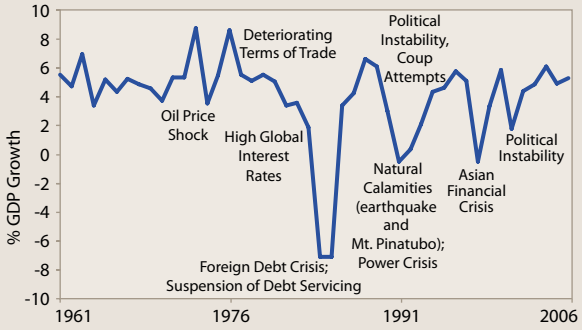
Private parties will invest only when they expect to capture adequate returns from their investments. Anything that weakens the capture discourages investment and, ultimately, slows growth. Risks to such appropriability can emanate from either government or market failures. Government failures increase either macro or micro risks. The macro risks may include fiscal and financial crises; the micro risks may be bad governance such as corruption, weak rule of law, overly burdensome taxation, and labor-capital conflicts. Market failures affecting the appropriability normally reflect information and learning externalities and coordination failures.

(a) Macroeconomic Risks

Historically the Philippines has had periodic macroeconomic instabilities.

The Philippines has frequently suffered from periodic macroeconomic instabilities (Figure 3.21). The instabilities often resulted from persistent fiscal and current account deficits, over-borrowing and over-lending activities in the banking sector, and excessive exposure to short-term external debt. These often depressed investor confidence and led to capital flight, sharp currency depreciation, and economic recessions. Sharp monetary contraction and high interest rates to stave off currency depreciation and inflationary pressures during these crisis periods aggravated the economic downturn. The 1984–1985 economic collapse cost the Philippines a decade of potential economic growth and development. Major recession or low growth episodes occurred in 1960, 1970, 1982–1985, 1991–1993, 1998, and 2001, and were associated with the macroeconomic instabilities in the last five decades. Indeed, these periodic and frequent downturns largely explain why the Philippines lagged behind many of its regional neighbors.

Figure 3.21
GDP Growth and External and Internal Shocks



GDP = gross domestic product.
Sources: Data from National Income Accounts, National Statistical Coordination Board, and Vos and Yap (1996).

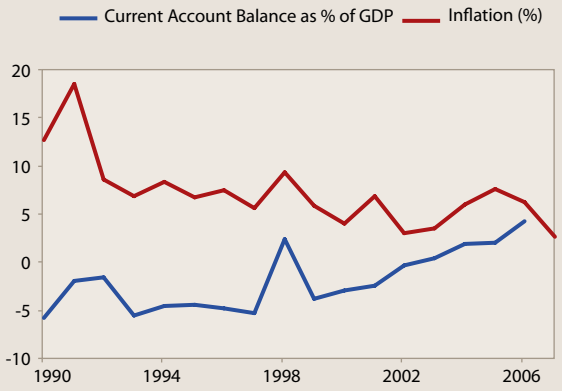
Despite some improvement in recent years, macroeconomic instability has remained a key investor concern.

The Philippines' macroeconomic situation has improved in recent years, with GDP growth picking up, inflation going down, and external positions improving (Figure 3.22), but investors remain wary of macroeconomic instabilities and resulting uncertainties in the economic policies. About 40% of firms responding to the 2005 Investment Climate Survey considered macroeconomic instability and 29% of them considered the economic policy uncertainty as major or severe constraints (ADB-WB 2005). Among respondents, the medium-sized establishments appeared to be most affected, with almost 52% ranking macroeconomic instability and about 43% ranking economic policy uncertainty as the major or most severe constraint.

Persistent fiscal deficits have been a key source of the macroeconomic instabilities and remained a critical constraint to growth.

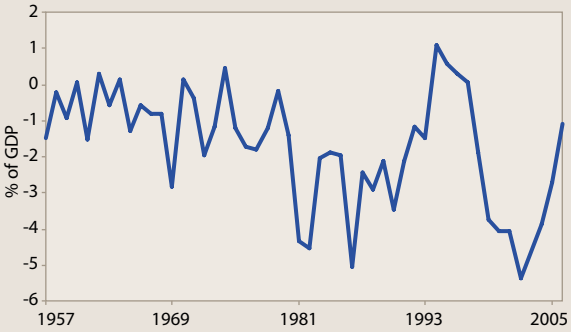
The Philippines recorded fiscal deficits for most of the last 2.5 decades (Figure 3.23). The

Figure 3.22
Inflation and Current Account Balance of the Philippines



GDP = gross domestic product.
Sources: Data from *Key Indicators* (ADB, various years) and *World Development Indicators* (World Bank, various years).

Figure 3.23
National Government Deficits of the Philippines (% of GDP)



GDP = gross domestic product.
Source: Data from *International Financial Statistics* (IMF, 2007).

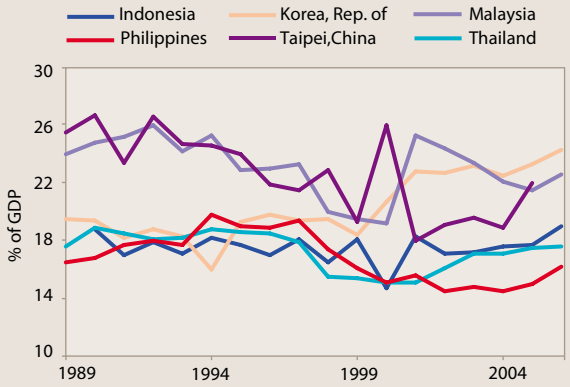
country went through additional serious fiscal and public debt distress during 2002–2005, resulting in sovereign credit downgrades and difficulties in accessing foreign capital. The most important cause of the deficits in recent years has been weak revenue generation, in particular, tax collection. Since 2001, Philippine Government revenue as a share of GDP has been the lowest in East and Southeast Asia (Figure 3.24).

A very disturbing trend was the decline in the tax effort in the post-Asian crisis years of 1999–2005 (Figure 3.25). Part of the reason for the decline in tax effort could be traced to lower profitability/losses of many businesses that were still feeling the impact of the Asian financial crisis. The excise tax system, which was based on specific tax rates without inflation indexation, and some provisions of the Comprehensive Tax Reform Law of 1997, which allowed significant exemptions to big corporations and high-income individuals, also contributed to the decline in the tax effort. Moreover, there were serious weaknesses in tax administration. The decline in the tax effort was arrested in 2003 and, except for 2004, tax collection has been improving. But it was still below pre-Asian crisis levels. During 2003–2006, the Government made significant progress in lowering the fiscal deficits, but at very high costs. The deficits were reduced mainly through deep cuts in social and economic services (including infrastructure) as interest payments went up, accounting for around 30% of the total budget in 2006 (Figure 3.26).

As budget deficits persist, the urge to tax intensifies. The passage of the reformed value-added tax (VAT) law and improved financial condition of the state-owned National Power Corporation (losses from which aggravated public deficits during 2002–2005) also helped reduce fiscal deficits in 2006. But tax collection appears to have faltered again in 2007 as fiscal targets in the first 9 months were missed and Government again spent less than planned to achieve the targets. Furthermore, to make up for the missed tax revenue targets, the Government is accelerating sale of Government-owned shares of stocks in private corporations. Amid these concerns, the Government announced that it is still committed to a balanced budget by 2008, 2 years ahead of the original target date.

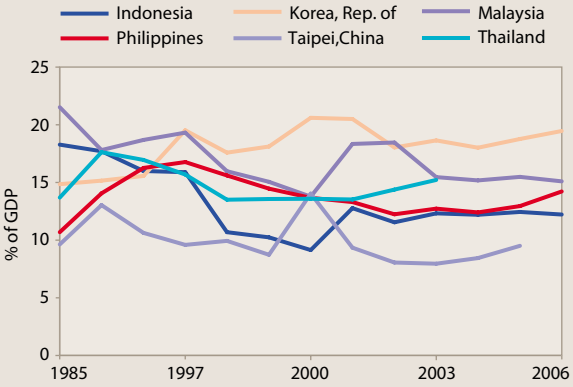
With the public debt at 64% of GDP in 2006, interest payment reached 5.5% of GDP and 31.1% of the budget in the same year. The Philippines, given its large public debt, is vulnerable to increases in interest rates, which may rise with high inflation (the rising oil price is the most immediate threat to inflation) or the need to stave off currency speculation during a sudden crisis. The risk of defaulting on foreign debt, which always dents appropriability of investment returns, may not be high at this time; but the Philippines is always vulnerable to currency risks, which may reverse the stable situation very quickly, as happened during the Asian crisis. The tight fiscal situation is also constraining the public sector's ability to finance key infrastructure and services.

Figure 3.24
Comparison of National Government Revenues
(% of GDP)



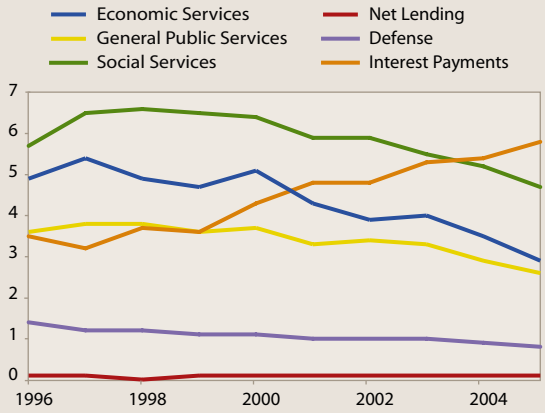
GDP = gross domestic product.
Source: Data from ADB (2007c).

Figure 3.25
Comparison of Tax Revenues
(% of GDP)



GDP = gross domestic product.
Source: *Key Indicators* (ADB, various years).

Figure 3.26
Government Expenditures by Type of Services
(% of GDP)



GDP = gross domestic product.
Source: Data from *Budget of Expenditures and Sources of Financing* (Department of Budget Management, various years).

Prudent monetary policy and continued structural reform can reduce the risk of financial crises.

The monetary and financial market reforms implemented since the Asian financial crisis have rendered the risk of new crises low at this time. The BSP's inflation targeting has succeeded in moving the inflation rate to very low levels. In 2007, the inflation rate may average only 2.7%, way below the BSP target of 4–5%. At the same time, efforts to broaden and deepen financial and capital markets will help to enhance investment and saving levels and rates. Recent mergers and acquisitions have allowed major commercial banks to raise their capitalization prodigiously. However, the recent appreciation of the peso against the United States dollar could become a threat to appropriability. The peso is appreciating more than other Asian currencies recently, partly driven by dollar inflows including the overseas worker remittances. As the peso appreciates, the dollar earnings of exporters of goods and services decline in peso terms. Because the exporters pay their wage bills, raw materials, and other operating costs in pesos, their profits decline. Foreign demand for Philippine goods will decline as they become more expensive compared with exports of other countries. The challenge to the BSP is how to sterilize the dollar inflows without triggering a rise in inflation.

(b) Microeconomic Risks

Poor governance is a credible threat to appropriability and a critical constraint to investment and growth.

Several studies have indicated that poor governance is a major concern for the Philippines, seriously affects appropriability for private investors, and is a critical constraint to investment and growth. Governance outcomes collected by Kaufmann, Kraay, and Mastruzzi (2006) indicate that, for most years the study covered, the Philippines scored respectably on the aspect of "voice and accountability" compared to other countries with similar per capita income levels. This largely reflects the formal guarantees of civil liberties, a free media, democratic processes, and checks and balances prescribed in the country's constitution and affirmed in public discourse. The Philippines also scored relatively well in terms of regulatory quality and about average in "government effectiveness," though more ambiguously for the "rule of law." In political stability and control of corruption, however, the Philippines fell consistently below the average (Table 3.5).

Using the same data from Kaufmann, Kray, and Mastruzzi (2006), Figures 3.27 and 3.28 show the percentile ranking of the Philippines on individual governance aspects—control of corruption and political stability. The shifting pattern across countries becomes apparent, particularly, in the last few years. For corruption, Thailand has remained several notches above the Philippines, but the Philippines' loss of momentum is apparent, and has allowed Viet Nam and fairly soon Indonesia to catch up with it. In terms of stability, Viet Nam rates the highest, consistently doing better than the 50th percentile. Again, the Philippines has slipped, particularly relative to 1998.

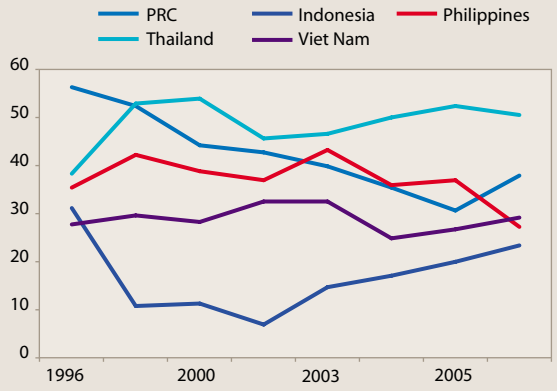
Findings of the study based on regression analysis were that corruption, political instability, and weak rule of law have had significant negative effects on investment. The findings also suggest that the 1980s turned into a "lost decade" of growth for the Philippines because of its failure to attract the massive wave of relocating direct foreign investments that followed the Plaza Accord. Instead, for most of the decade the country was mired in deep political turmoil, which placed it at a significant disadvantage relative to some of its neighbors as a foreign investment destination (Figures 3.29 and 3.30). Nor has the problem disappeared: instability was manifested in a number of political events (in 2000, 2005–2006, and 2007) that sorely tested normal constitutional processes. More generally, the perception of worsening corruption figures significantly in an explanation of the investment rate, which may partly explain the downturn in investment in recent years. This effect is mediated largely through lending rates, which reflect a premium for worsening corruption, political instability, and internal conflict. It thus becomes evident that poor governance weakens the appropriability of returns from investments and in the long run contributes to low-level real per capita GDP.

Table 3.5
Governance Indicators for the Philippines, Selected Years

Governance indicator	1996	1998	2002	2003	2004	2005	2006
Voice and Accountability		+	+	+	+	+	+
Political Stability	–	–	–	–	–	–	–
Government Effectiveness	+					+	+
Regulatory Quality	+	+	+	+		+	+
Rule of Law	+	+	–	–	–	–	–
Control of Corruption	–	–	–	–	–	–	–

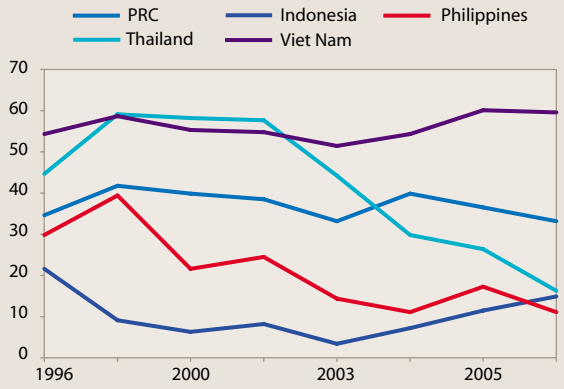
Note: + or – denotes a governance score for the Philippines that is significantly better (+) or worse (–) at the 5% significance level or less, compared to countries with similar gross domestic product per capita for the period.
Source: ADB staff computations using data from Kaufmann, Kraay, and Mastruzzi (2006).

Figure 3.27
Control of Corruption in Selected Countries, Percentile Rankings



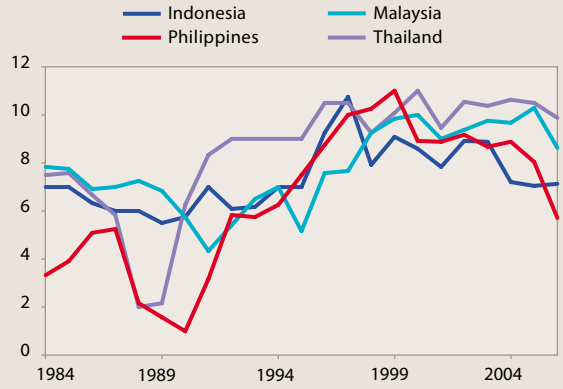
PRC = People's Republic of China.
Note: Higher scores indicate better control of corruption.
Source: Data from Kaufmann, Kraay, and Mastruzzi (2007) as generated from http://info.worldbank.org/governance/wgi2007.

Figure 3.28
Political Stability in Selected Countries, Percentile Rankings



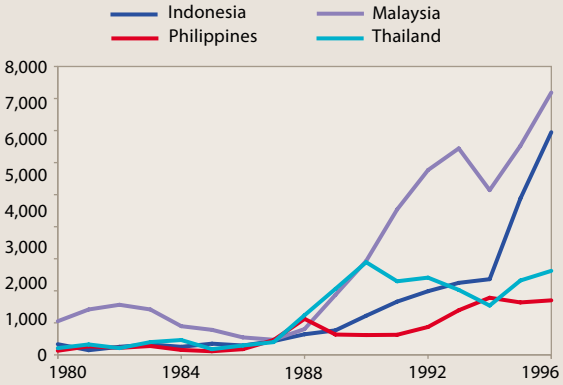
PRC = People's Republic of China.
Note: Higher scores indicate more stability.
Source: Data from Kaufmann, Kraay, and Mastruzzi (2007) as generated from http://info.worldbank.org/governance/wgi2007.

Figure 3.29
Government Stability Index for Selected Countries (1 = least stable to 12 = most stable; 1984-2006)



Source: Data from Political Risk Services (2007).

Figure 3.30
Foreign Direct Investment Flows for Selected Countries, 1980–1996 (in millions of current dollars)



Source: Data from United Nations Commission on Trade and Development. Available: http://www.unctad.org.

Governance issues are linked to other major constraints on growth. The thin fiscal buffer is due in no small degree to persistent corruption and patronage problems in revenue collection. Despite the Government efforts in improving tax administration, the leakage remains huge. Governance issues (both in terms of bureaucratic ineffectiveness and leakages due to corruption) have perennially plagued the Government's fiscal position, leading to low levels of spending on infrastructure and social services. A cause for concern is that beyond ad hoc changes in top agency personnel and short-lived integrity campaigns, definitive and systemic solutions to these problems appear to have eluded all past administrations.

High tax rate and poor tax administration are critical constraints.

Of firms responding to the 2005 Investment Climate Survey, 32% considered the high tax rate as a major or severe constraint to doing business in the Philippines (ADB-WB 2005). This is also apparent from a comparison of the corporate income tax rates in Table 3.6, which shows that the corporate income tax rate in the Philippines is the highest among comparable ASEAN neighbors. If the tax system is not transparent or the tax laws are difficult to interpret, taxation easily turns into a source for rent seeking. Survey respondents also raised inefficiencies and lack of transparency in the tax administration as a constraint to doing business, with about 26% of the firms considering these as major or severe constraints. Findings reported by the Global Competitiveness Report 2003–2004 ranked the Philippines 97th among 102 countries on the frequency of irregular payments in tax collection—the highest among the neighboring countries (WEF 2004).

Cumbersome business procedure and over regulation are constraints.

Cumbersome processes and rules tend to induce firms to engage in corrupt practices to avoid bureaucratic red tape. Surveys of the investors indicate that the red tape associated with starting and operating a business is considered a constraint. According to the Global Competitiveness Report 2003–2004, among the neighboring countries only Indonesia had more cumbersome processes for setting up a new business than the Philippines: in the Philippines, it took about 59 days to register a business compared with 8 days for Singapore; 11 for Hong Kong, China; 31 for Malaysia; and 42 for Thailand (WEF 2004).

The Global Competitiveness Report 2003–2004 also noted that the extent of regulatory burden was more severe in the Philippines than in its neighbors and other developing countries in Asia. The Philippines ranked 98th out of 102 countries where most comparable neighbors ranged from 20th to 40th.

Contract enforcement and property rights may or may not be constraints.

Evidence on whether contract enforcement and property rights are constraining growth has shown a changing trend. In 2004, the Global Competitiveness Report findings showed that in terms of contract enforcement, the Philippines fared better than its neighbors (WEF 2004). The number of days required to enforce a contract in Philippines averaged 164, which was lower than Thailand (575); Malaysia (270); Indonesia (225); the PRC (180); and Hong Kong, China (180). This also seems to be consistent with the findings of World Business Environment Survey 2000, which compared the confidence level of firms in the legal system upholding contract and property rights (IFC 2000). Survey findings suggested that the Philippines compared well with its regional neighbors with a confidence level at 80%, which was lower than the 90% for Malaysia but similar to the 82% for Thailand and much higher than the 42% for Indonesia.

Table 3.6
Corporate Income Tax and Value-Added Tax Rates in Selected Economies (%)

Economy	Corporate Income Tax	Value-Added Tax
PRC	30	5–17
Hong Kong, China	17.5	–
Indonesia	10–30	10
Malaysia	28	–
Philippines	35	12
Thailand	30	10
Viet Nam	28	0–20

PRC = People's Republic of China.
Sources: For Philippines http://www.bir.gov.ph; for Indonesia http://www.usasean.org/Indonesia/business_guide/taxation.asp; for Hong Kong, China http://www.gov.hk; for PRC http://www.abailaw.com/english/tax; for all other economies http://www.aseansec.org/6524.htm.

However, more updated data suggest that some of the investor confidence in the contracts and property rights being upheld may have eroded. A survey by the Makati Business Club in 2007 as an input to the World Economic Forum's Global Competitive Index revealed that the respondents considered contract enforcement as one of the top two constraints faced by the businesses (WEF 2007). This may partly be a result of gradual worsening of the business environment, but at least in part must have also been a result of a number of high profile cases, such as that involving Ninoy Aquino International Airport (NAIA) Terminal III.

Labor costs and labor market rigidities may or may not be a constraint.

Labor costs in the Philippines are higher than in most regional neighbors. As evident from Figure 3.31, the minimum wage in the Philippine was about 4–5 times higher than in Viet Nam and Indonesia while labor productivity was not higher by a similar proportion. Thailand had lower minimum wage rates and higher labor productivity levels and Malaysia had a higher minimum wage rate but much higher productivity levels.

In addition to high labor costs, market rigidities such as the difficulties in hiring and firing labor may deter investors. A comparison with its regional neighbors on labor-related regulations (Table 3.7) suggests that it is difficult to hire and fire employees in the Philippines, and the costs of firing an employee can be as high as 91 weeks of salary. Thus, investors, both existing and new, may view the Philippine labor market as very rigid and a constraint to investment.

However, results of the 2005 Investment Climate Survey suggested that the responding firms did not consider the mandated minimum wage rate to be a major or severe constraint, as less than 30% of the firms answered the question relating to the minimum wage rate (ADB-WB 2005). While 75% of respondents to the question considered the minimum wage rate to be a major concern, this is only 20% of all firms responding to the survey. Patterns in the feedback suggested that the food and food processing and garment industries may be more affected than other industries by the rigidities relating to the mandated minimum wage rates. Firms' apparent lack of concern for the high minimum wage rates may be because they are not effectively implemented. Feedback from the 2005 Investment Climate Survey suggested that the firms get around the labor regulations by hiring temporary workers during peak production periods—as many as 30% of the workforce may comprise temporary hires.

(c) Market Failures

A relatively small and narrow industrial base may be a critical constraint to growth.

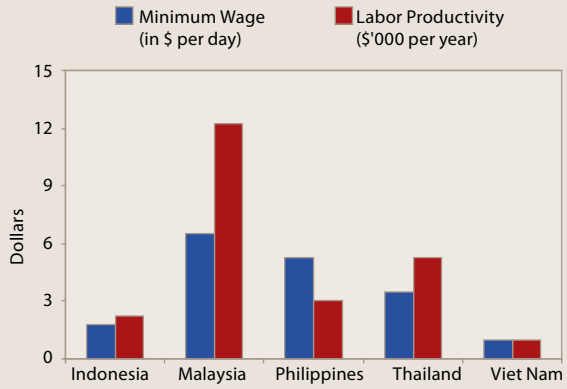
Compared with most Southeast Asian countries, the Philippines' manufacturing sector is small. In 2005, the share of manufacturing in GDP was 23.3% in the Philippines but was 27.5% in Indonesia, 30.6% in Malaysia, and 34.8% in Thailand (Figure 3.32). The level of manufacturing exports has also been low by regional standards. During 2000–2005, manufacturing exports (in

Table 3.7
Comparison of Labor-Related Regulations with Regional Countries, 2006

Country	Difficulty of Hiring Index (0–100)	Difficulty of Firing Index (0–100)	Rigidity of Employment Index (0–100)	Nonwage Labor Cost (% of salary)	Firing Cost (weeks of salary)
Indonesia	61	50	50	10	108
Malaysia	0	10	10	13	88
Philippines	56	20	39	9	91
Thailand	33	20	18	5	54
Viet Nam	0	40	37	17	87

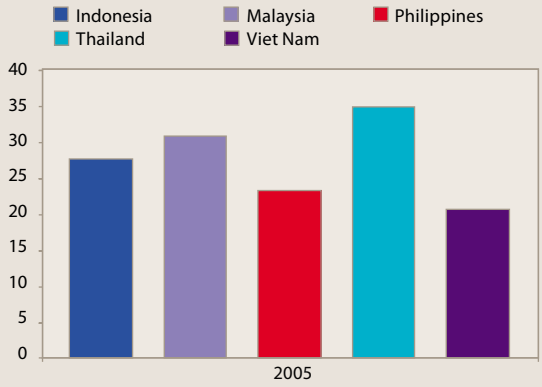
Note: High scores on individual indexes represent more rigidities and low scores represent more flexibility.
Source: Data from WB-IFC (2007).

Figure 3.31
Comparison of Minimum Wage Rates and Labor Productivity in Selected Countries, 2003



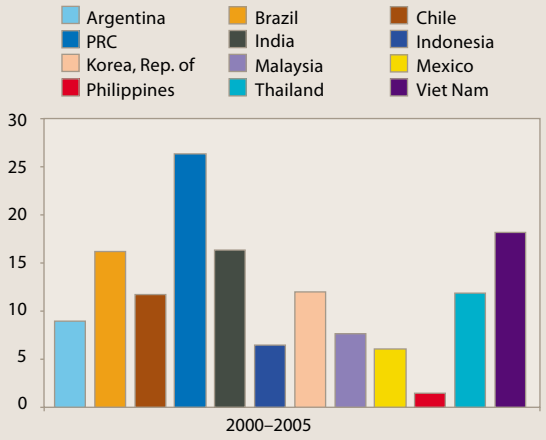
Source: Data from ADB-WB (2005).

Figure 3.32
Comparison of the Shares of Manufacturing in GDP, 2005 (%)



GDP = gross domestic product.
Source: Data from *World Development Indicators* (World Bank, various years).

Figure 3.33
Comparison of Growth Rates of Manufacturing Exports, 2000–2005 (%)



PRC = People's Republic of China.
Source: Data from *World Development Indicators* (World Bank, various years).

constant 2000 dollars) grew at about 1.4% per annum in the Philippines compared with 6.4% in Indonesia, 7.6% in Malaysia, and 11.8% in Thailand (Figure 3.33). No doubt, constraints identified previously (in particular inadequate infrastructure, macroeconomic instability, weak investor confidence due to concerns over poor governance, and political instability) have contributed to the poor performance of the Philippine manufacturing sector by lowering social returns to investment and/or private appropriability. Recent literature, however, points to another set of factors that could also lead to low private appropriability—market failures.

The market failures emphasized in this context are information and learning externalities, and coordination failures, and these have been proposed to explain the lack of export growth and diversification in some developing countries (Huasman and Rodrik 2006). An example of information externality is where the benefits of successfully introducing new products and production processes that are well established elsewhere but new to a country may spill over to third parties without giving due remuneration to the original proponent, but in cases of failure only the original proponent bears the cost. Presence of such information externality could lead to underinvestment in new products and production processes, yielding a low level of diversification and innovation. Similarly, an example of learning externality is when the benefits from investing in developing the capacity of workforce may spill over to third parties when the trained workers switch employers, acting as a disincentive to training

a workforce. Reference to coordination failures recognizes that a firm's productivity depends not only on its own efforts and the general economic conditions, but also on how the upstream and downstream firms link and perform, its access to infrastructure, regulations, and other public goods. Similar to information and learning externalities, coordination failures can deter investment. The presence of these market failures calls for nonmarket corrective actions.

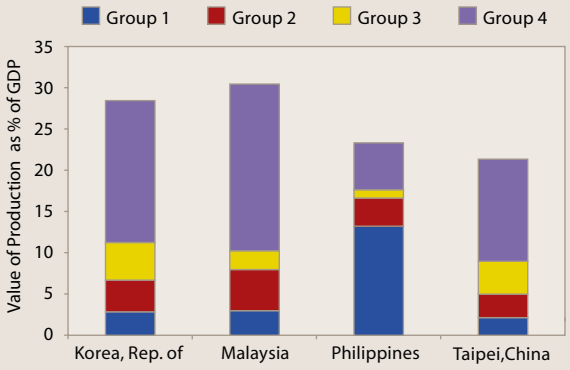
Though it is difficult to find direct evidence for such market failures in the Philippines, the following broad symptoms suggest that they exist.

- **Manufactured exports are slow to diversify and innovate and have low value added.** More than 60% of the country's merchandise exports come from two main categories: (i) electrical machinery and apparatus, and (ii) nonelectrical appliances and machinery. Both categories primarily involve assemblies of semiconductors and electronic equipment, with low value added. In 2005, the ratio of imports to exports of electrical and nonelectrical machinery was 90.3% for the Philippines, compared with 66.9% for the Republic of Korea and 83.1% for Malaysia. The lack of diversification in the Philippines is also evident from the fact that since 1997 only two export product groups crossed the $10 million threshold and only four that were above $10 million crossed the $100 million threshold.

- **Domestic manufacturing has low technological and scale quality and upgrading is slow.** Classifying all the manufactured goods into four groups according to the productivity level associated with each shows that the Philippine manufacturing sector focused most on goods in the group with low productivity—food, beverage, tobacco, textile, footwear, clothing, and wearing apparel (13.3% of GDP in 2005). The share of the goods in the group with high productivity—paper and pulp, printing and publishing, rubber manufactures, electrical machinery,nonelectricalmachinery,transport equipment, chemicals, and miscellaneous manufactures—is small (5.7%). The corresponding figures for Malaysia are 3% and 20.3% and for Taipei,China are 2.1% and 12.3%, respectively (Figure 3.34). These findings are consistent with the findings that growth of total factor productivity in the Philippines has been lower than in its regional neighbors (Chapter 2). Further, the composition of domestic manufacturing in the Philippines is very different from that of manufactured exports. This is unlike in the Republic of Korea and Malaysia, whose exports and domestic manufacturing are both concentrated in the high technology and scale products, indicating that their export sectors are strongly integrated with their domestic manufacturing.

- **The Philippines ranked very low in spending on research and development (R&D).** A survey of R&D expenditure in the most recent year (depending on data availability) showed that the Philippines

Figure 3.34
Comparison of Manufacturing Subsectors by Technology Level of Production Process, 2005 (% of GDP)



Note: Groupings are based on commodity specific index, PRODY, which is a weighted average of the per capita GDPs of countries exporting a given product (Hausmann, Hwang, and Rodrik 2006).
Group 1 commodities are with PRODY scores of below 6000 and include food, beverages, tobacco, textile, clothing, and footwear. Group 2 commodities are with PRODY scores of 6,000–9,000 and include wood, furniture and fixtures, nonmetal minerals. Group 3 commodities are with PRODY scores of 9,000–10,500 and include metals, metal manufactures, and leather made products. Group 4 commodities are with PRODY scores of greater than 10,500 and include paper and pulp, paper and publishing, rubber manufactures, electrical and nonelectrical machineries, transport equipment, and chemicals.
Source: Lim (2007b).

only spent 0.11% of GDP on R&D, one of the lowest in the world, and ranked 89th out of 103 countries (IMD 2007). In comparison, neighboring Malaysia spends 0.69% of its GDP on R&D, and Thailand spends 0.26%. The low R&D spending can partly explain the slowness of technological upgrade in the Philippines.

- **Linkages between the university system and R&D of industries and skill requirements of industries are weak.** The 2005 Investment Climate Survey states: "Given the Philippines' relatively well-developed university system, it is surprising that only one of 716 firms reported universities (and other public institutions) as the most important source of new technology. Moreover, only three firms rated universities as the second, and two firms as the third, most important source of new technology" (ADB-WB 2005, 35). Most firms in the survey claimed that technology improvements in the Philippines are mainly derived from technology embodied in new equipment and machinery or from trained and skilled personnel, not from any government, academic, or even the firms' R&D support. It appears that no universities are clearly linked to providing R&D or skilled engineers to high value-added electronic or semiconductor products produced within the country or highly skilled business process outsourcing such as software development, medical diagnostics, and computerized designs for fashion, cinema, and the like.

Incentives to pursue higher education in science and technology are low. As shown in Table 3.8, Commission on Higher Education statistics on Philippine public and private universities suggest that few students are seeking higher education and even fewer do so in the technology related disciplines (CHED 2007). Of about 295,000 students who earned baccalaureate degrees in 2002–2003, only just over 15,000 graduated with master's degrees and less than 1,800 obtained a doctorate. In the technology related disciplines, only about 300 graduated with a master's degree in engineering and technology and about 160 in mathematics and computer science. Only 6 students graduated with doctorates in engineering and technology and 13 in computer science. These statistics do not show whether the lack of interest in pursuing higher education in technology related disciplines is constraining investment in technology upgrades or if the lack of technology related jobs is keeping the students from pursuing higher education in these sectors.

The challenge for the Philippines is upgrading the technology for and scale of its domestic manufacturing. As it does so, growth will be enhanced to the extent new value continues to be added to both manufactured products for export and the domestic market. Old products with stagnant value added will be replaced by new products that

Table 3.8
Number of Graduates in Technology-Related Disciplines, 2002–2003

	Baccalaureate		Masters		Doctoral	
Discipline	Number	% of All Disciplines	Number	% of All Disciplines	Number	% of All Disciplines
Engineering and Technology	42,187	12.6	305	2.0	6	0.3
Information Technology	24,163	7.23	126	0.8	1	<0.1
All	334,307		15,215		1,748	

Source: Data from Commission on Higher Education (available: http://www.ched.gov.ph).

embody new knowledge. Furthermore, low focus on R&D reduces the country's chances of rapid growth because the Philippines is slow in moving toward high value addition and products with increasing returns to scale.

All these suggest some forms of information externalities and coordination failures that call for corrective action. Hausmann and Rodrik (2006) and Murphy, Schleifer, and Vishny (1989) asserted the need for the state to be proactive in solving coordination failures and setting up complementary inputs and legal and physical infrastructure of potentially dynamic sectors, especially those with positive externalities. The state must also actively give economic incentives to "first movers" willing to undertake risky innovation and entry into new activities and ventures that have high positive externalities and information spillovers. These so-called Schumpeterian activities encourage entry into technology and knowledge-intensive areas that exhibit increasing returns to scale that lead to higher growth.

Chapter 4
Critical Constraints to Poverty Reduction

The pace of poverty reduction in the Philippines has lagged behind that of its East and Southeast Asian neighbors. Low growth has been a major factor in the stagnant level of poverty in the Philippines. A number of studies have shown that the response of poverty incidence to economic growth in the Philippines is greatly muted compared to that in many of its Asian neighbors. For example, the growth elasticity of poverty reduction was 3.5 for Thailand and 3.0 for Indonesia, while it was only 1.3 for the Philippines (Balisacan 2003, Balisacan and Fuwa 2004). Part of the reason for the low growth elasticity of poverty reduction in the Philippines is the high level of inequality, which has continued to worsen. Thus, there is a great need for making growth more inclusive in the Philippines. This section looks at accesses to economic opportunities, human development, basic social services and productive assets, and social safety nets as potential critical constraints to broadening the inclusiveness of growth in the Philippines.

A. Access to Economic Opportunities

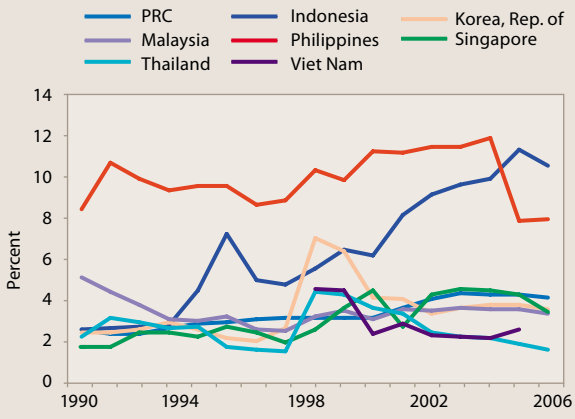
The lack and slow growth of productive employment opportunities are a critical constraint to poverty reduction and equitable development.

The Philippines has consistently underperformed most of its regional neighbors in providing productive employment opportunities to its growing labor force. Since the early 1990s, the unemployment rate in the Philippines has remained persistently high and has fluctuated between 8–12%, compared with 1.5–4.4% in Thailand and 2.5–5.0% in Malaysia (Figure 4.1). Even among the employed population, the level of underemployment was high at 22.7% in 2006, compared with 4.0% in 2000 in Thailand. Moreover, productivity of jobs in the Philippines is much lower than that in many of its neighbors. Figure 4.2 shows that the total labor productivity of the Philippines ranked very low in East and Southeast Asia and has stagnated for the last 30 years, while total labor productivity in countries such as Malaysia and Thailand improved steadily during the same period.

Access to productive employment opportunities is unequal between the rich and poor.

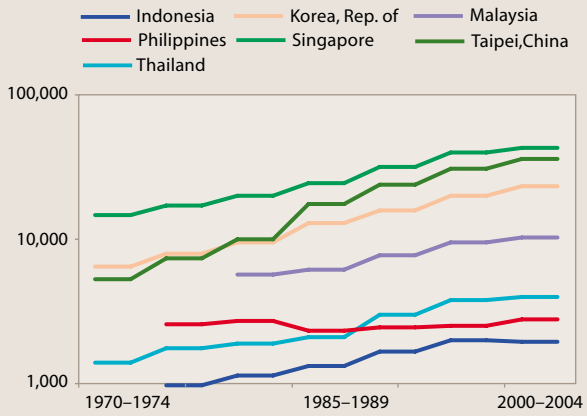
Even among the available employment opportunities, the poor are getting far less productive jobs than the rich. A recent study (ADB 2007d) showed that the average hourly wage earnings for workers from the bottom 20% of income distribution were 86% lower than those for workers from the top 20% (Figure 4.3). Son (2007b) found that in 2003, on average, the workers from poor households worked 15% less hours per week than those from an average household. This suggests that the higher employment rate in workers from poor households

Figure 4.1
Unemployment Levels in Selected Countries



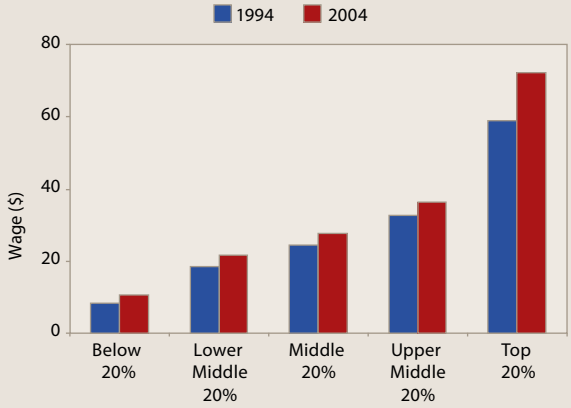
PRC = People's Republic of China.
Note: Philippine data have a break in 2005 due to the change in the definition of unemployment.
PRC data refer to unemployment rate of urban areas only.
Indonesia data had adjustments beginning 1997.
Source: Data from the Asian Development Bank Statistical Database System.

Figure 4.2
Total Labor Productivity
(constant 2000 $, logarithmic scale)



Labor productivity = per labor GDP in constant 2000 $.
Source: Data from ADB (2007c).

Figure 4.3
Inequality in Average Weekly Real Wages of Urban Full Time Employees (2002 $)



Source: Data from ADB (2007d).

may be misleading and may hide their unequal access to employment opportunities. The same study also found that poor households rely more on domestic remittances and much less on remittances from abroad than do average households. This suggests that the poor may not have equal opportunities to work overseas. While this discussion does not provide conclusive proof that poor households have unfavorable access to employment, it does provide indirect evidence for their having unfavorable access.

B. Human Development

Balisacan (2007c) found that inadequate human capabilities are often a key underlying cause of poverty and inequality in the Philippines. Improved human capacities can improve the poor's opportunity to benefit from growth, and lack of or weak human capacities hamper their chance to fully benefit from growth. Two key determinants of the human capacities are education and health attainments.

Access to primary education is near universal levels in the Philippines but access to secondary education is lower and not equitable.

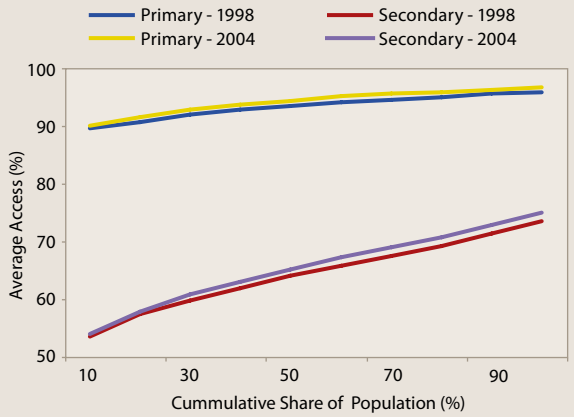
Although the Philippines has achieved near universal levels of primary education with enrollment rates over 96%, there is substantial room for improvement in the enrollment rates for secondary education, which currently average about 73%. School attendance varies significantly between regions, especially at the secondary level, and is below the national average in poorer regions—such as Bicol, parts of Mindanao (especially the Autonomous Region of Muslim Mindanao), and the Visayas.

Using the opportunity curve proposed by Ali and Son (2007) and Annual Poverty Indicator Survey data (NSO, various years), it is found that while access to primary education does not exhibit significant inequalities among income groups, significant inequality exists in the access to secondary education. The average access to secondary education (enrollment rate) for the bottom 10 percentile of the population was less than 55% but it was about 75% for the top 10 percentile (Figure 4.4). Further, access to secondary education increased between 1998 and 2004, but the increase was greater for households with higher income than for those with lower income, supporting earlier claims that education has become less affordable to the poor.

Access to health services is low and not equitable.

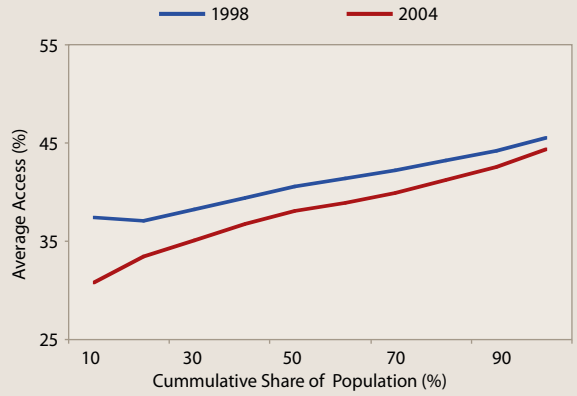
Using the same methodology shows that the access to overall health services is inequitable and that the services are largely used by those at the top end of the income distribution (Figure 4.5). In 2004,

Figure 4.4
Opportunity Curve of Access to Primary and Secondary Education, 1998 and 2004



Note: The opportunity curve as proposed by Ali and Son (2007) plots the distribution of access to opportunities for a particular service or asset. A downward-sloping curve suggests that opportunities available to the poor are more than those available to the nonpoor. An upward-sloping curve indicates that opportunities are distributed inequitably.
Source: Son (2007a).

Figure 4.5
Opportunity Curve of Access to Health Facilities, 1998 and 2004



Note: The opportunity curve as proposed by Ali and Son (2007) plots the distribution of access to opportunities for a particular service or asset. A downward-sloping curve suggests that opportunities available to the poor are more than those available to the nonpoor. An upward-sloping curve indicates that opportunities are distributed inequitably.
Source: Son (2007a).

the average access to health services (measured by the proportion of the sick who sought treatment in health facilities)[6] was a little over 30% for the bottom 20% of the population, while it was close to 45% for the top two. Further, access to health services declined during 1998–2004 and the decline was far greater at the bottom than at the top end of the income distribution. Thus, the provision of health services became less equitable between 1998 and 2004.

Another finding was that private health facilities, which were considered by clients as providing better quality of services, were more heavily used by patients from the higher income groups (about 15%) than from the lower ones (about 5%). People at the lower end of the income distribution used public health facilities such as rural health units (RHUs) and village health stations more than those at the upper end. Such facilities are generally perceived to provide low-quality health services: diagnosis is poor, resulting in repeat visits; medicines and supplies are inferior and rarely available; staff members are often absent, especially in rural areas, and are perceived to lack medical and people skills; and waiting time is long, schedules are inconvenient, and facilities are rundown (World Bank 2001).

Results from the National Statistics Office's 2004 Annual Poverty Indicators Survey also showed that use of health facilities varies across regions (NSO 2004). People living in the Mindanao region tend to underuse health services. Health status indicators vary widely across regions and provinces within the country. For instance, the NCR has an infant mortality rate of around 20, which is very close to the norm of developed countries, whereas some parts of Mindanao have mortality rates of about 100, similar to the least developed countries. The wide gap in health status calls for an effective system of health service delivery that will reach the disadvantaged areas and regions.

Disparity in health care between regions and income groups persists in the Philippines due to the fragmented administration of health services and the high costs of operating public hospitals. Administrative fragmentation occurs at different levels because of a lack of referral networking

[6] Including government hospitals, private hospitals, private clinics, rural health units, village health stations, or other health facilities.

among health care providers. In the past, the national Government controlled all public health facilities from the central office to the regional districts. However, health care has been decentralized and the regional health units are run by the municipalities, while the provincial and district hospitals are controlled by the provinces. This has proven disadvantageous because the less capable health centers have difficulty accessing the services of hospitals that have well-trained doctors and better facilities. In some cases, health units are linked because of informal personal contacts rather than institutionalized arrangements. Such personal networking would not be necessary if interrelationships among the health units could be formally established.

C. Access to Basic Social Services and Productive Assets

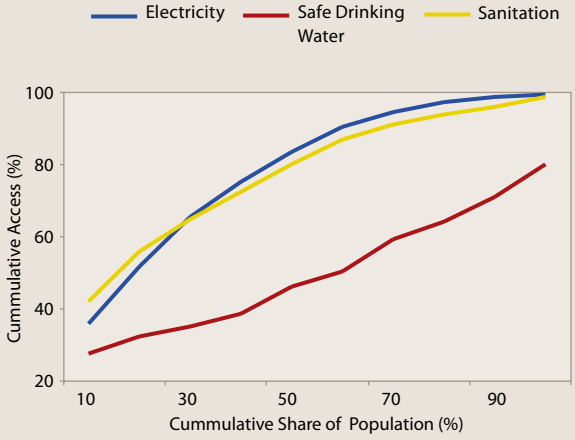
Balisacan (2007c) also found that limited access to basic social services and productive assets is often a key cause underlying poverty and inequality in the Philippines. This section discusses the access to basic social infrastructure and services.

Access to basic infrastructure and services is low and not equitable.

The 2004 Annual Poverty Indicators Survey shows that, on average, about 50% of the population does not have access to safe drinking water, and roughly 20% is without access to electricity (NSO, various years). But there were great variations across income groups. During 1998–2004, the access for the lowest 10 percentile of the population to electricity was about 35%, to safe drinking water was 25%, and to safe sanitation was a little over 40%, but the corresponding portions were 100%, 80%, and 100% for the top two 10 percentiles (Figure 4.6). Access across regions was also highly unequal (Figure 4.7), with the NCR far better served than the Autonomous Region of Muslim Mindanao.

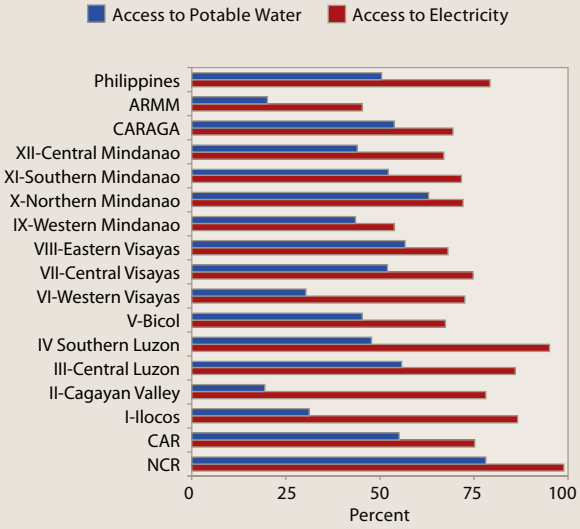
Figure 4.8 compares the per capita and per unit area of road infrastructure across the regions, and shows large disparities between rich and poor regions. Predictably, the NCR is far better served than the other regions, and poorer provinces have the shortest road network both in terms of length per population and land area.

Figure 4.6
Access to Key Infrastructure Services, 2004



Source: Son (2007a).

Figure 4.7
Access to Electricity and Potable Water, 2004



ARMM = Autonomous Region of Muslim Mindanao; CAR = Cordillera Autonomous Region; CARAGA is an administrative region in Mindanao (Region XIII) that includes the provinces of Agusan del Norte, Agusan del Sur, Surigao del Norte, and Surigao del Sur; NCR = National Capital Region.
Source: Son (2007a).

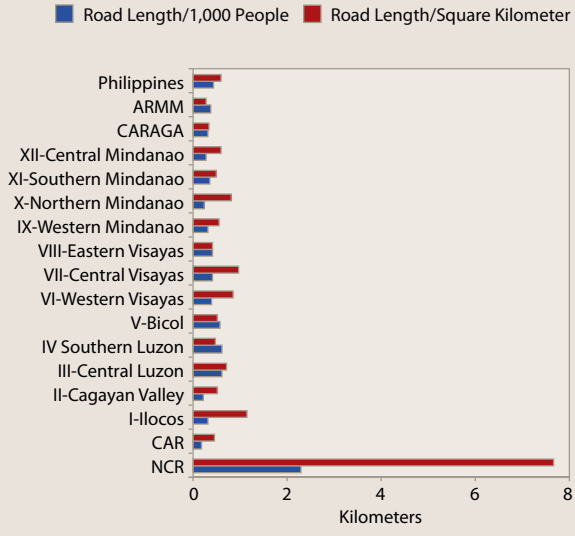
The poor have the limited access to finance.

For the poor, access to finance is key not only for smoothing consumption during adverse shocks but also for taking advantage of the opportunities arising from greater openness, new production technologies, and market diversification. The formal financial intermediary system tends to bypass the poor, especially in rural areas where agriculture is their main economic activity. Poor infrastructure combined with spatial dispersion and seasonality of agricultural production makes lending to small-scale farmers and fishers costly and risky. While microfinance has spread considerably in the past 10 years to help fill the unmet need for financial services, a majority of poor families in the poorer regions still do not have access to microfinance services (Figure 4.9). Moreover, providers of microfinance cater largely to nonfarm enterprises and poor agricultural households generally do not have access to microfinance services. The key challenge is to develop mechanisms enabling microfinance to reach agriculture and grow at a substantially accelerated pace in order to achieve national outreach and necessary sustainability.

The poor have the limited access to land.

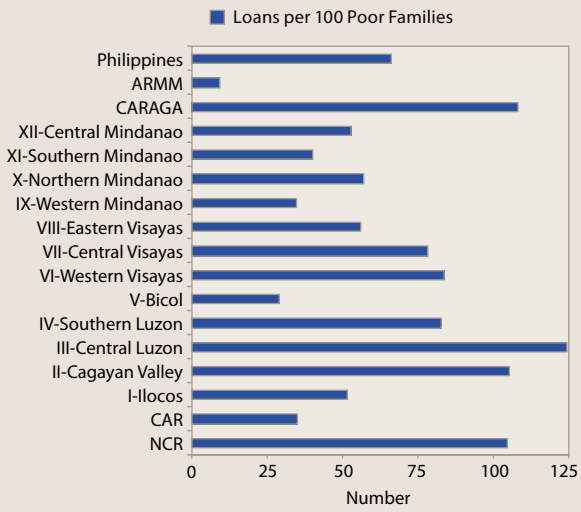
Evidence from a number of studies, including Balisacan and Pernia (2002), Quisumbing et al. (2004), and Balisacan (2007a), suggests that the access to land is one of the key determinants of welfare in the rural areas of the Philippines. However, access to land is highly inequitable and is gradually worsening. The Gini coefficient of land distribution has increased from about 0.53 in 1960 to about 0.57 in 2002 (Table 4.1), which compares unfavorably with a decline in the coefficient for East Asia and Pacific, from 0.47 to 0.41, over the same period. Other indicators of access to land also paint a dismal picture with both the average farm size and land-labor ratio fast declining as the land is passed on from one generation to the next. Between 1960 and 2002, the average farm size shrunk by about 44% and the land-labor ratio by over 48%. The studies on the land distribution also suggest that the lack of access to land not only limits the ability of the poor to engage in agriculture, but also curtails their ability to invest in human capital and productivity enhancements, and to access financial services.

Figure 4.8
Regional Coverage of Roads, 2004



ARMM = Autonomous Region of Muslim Mindanao; CAR = Cordillera Autonomous Region; CARAGA is an administrative region in Mindanao (Region XIII) that includes the provinces of Agusan del Norte, Agusan del Sur, Surigao del Norte, and Surigao del Sur; NCR = National Capital Region.
Source: Data from National Statistical Coordination Board and Department of Public Works and Highways.

Figure 4.9
Regional Distribution of Active Microfinance Loans, 2007



Note: Magnitude of poor families is based on 2000 Family Income and Expenditure Survey data.
Sources: Data based on Family Income and Expenditures Surveys (NSO, various years). Active client data is based on preliminary 2007 People's Credit and Finance Corporation data provided by the Department of Finance.

Table 4.1
Average Farm Size and Landholding Distribution

Year	Average Farm Size (ha)	Land–Labor Ratio (ha/labor)	Percent of Farms		Percent of Area		Gini Coefficient
			Above 10 ha	Above 25 ha	Above 10 ha	Above 25 ha	
1960	3.6	1.34	5.5	0.5	38.3	15.4	0.53
1971	3.5	1.16	4.8	0.6	33.8	17.1	0.54
1980	2.8	1.08	3.5	NA	26.0	NA	0.54
1991	2.2	0.88	2.3	0.3	23.5	10.6	0.57
2002	2.0	0.69	1.8	0.2	19.4	8.1	0.57

NA = not available.
Source: Balisacan (2007a).

Increasing inequalities in access to land tends to offset the progress that has been made on land reform through the Comprenensive Agrarian Reform Program, and the fact that the land distribution could have been much more inequitable in its absence. As of end-December 2006, about 84% of the target of 8.06 million hectares had been distributed (Balisacan 2007a), largely comprising nonprivate agricultural, publicly alienable and disposable, and public forest lands. In contrast, only 18% of lands identified for compulsory acquisition had been acquired and distributed. Most beneficiaries of the program have not received land titles, support services, and key infrastructure that were to accompany the land reforms as part of the program. A key challenge for the country remains implementation of the unfinished land reform agenda, which will help check rising inequalities in land distribution.

D. Social Safety Nets

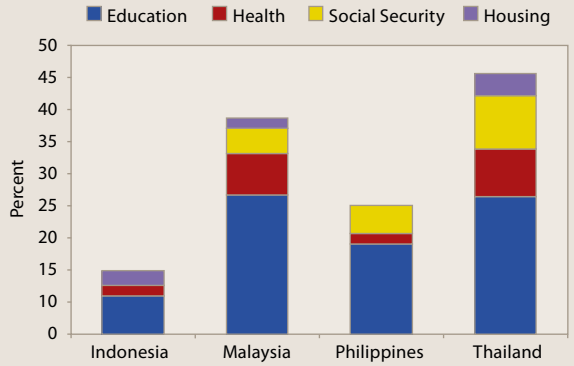
The Philippines has a wide range of programs for social protection but the coverage is low and the level of benefits is inadequate.

Compared with other Asian countries, the Philippines is often seen to have a wide scope of programs for social protection to (Sta. Ana III 2002, Ortiz 2001). However, the 1997 Asian financial crisis exposed the weaknesses of the country's social protection system, as evident in low coverage (in terms of beneficiaries and level of benefits), absence of and/or weaknesses in targeting methodologies and techniques, and operational constraints due to the lack of coordination among the programs' implementers (Torregosa 2005). These issues cut across the social protection programs in the areas of social assistance, health, education, housing, livelihood creation, and disaster relief.

- The social protection system has low coverage, partly due to the lack of funding. Over the years, persistent budget deficits have led the Government to substantially reduce spending on social services (Cook et al. 2003, Torregosa 2005). During 2001–2005, the share of central Government spending on the social sector was 22% in the Philippines, compared with 45% in Thailand, 37% in Malaysia, and 11% in Indonesia (Figure 4.10). Further, due to the limited financing from the Government budget, continued reliance on foreign grants and funding threatens program sustainability.

- The problem of insufficient funding is exacerbated by poor targeting, leading to significant leakages and wastage of resources on the nonpoor and the near-poor. Poor targeting is partly a result of the lack of reliable poverty measures, especially at the local level, and partly due to poor governance. National surveys, often conducted at long intervals, generate poverty statistics only at the province level, making it difficult to identify and validate the poorest families being targeted (Torregosa 2005, Reyes 2002). Worse, many programs lack built-in monitoring and evaluation components, which make impact assessment difficult.

Figure 4.10
Annual Average Social Expenditures as a Percentage of Total Government Expenditures for Selected Countries, 2001–2005



Source: Data from ADB (2007d).

- Social protection programs in the Philippines are not well coordinated and are often implemented piecemeal due to their individual mandates. This causes waste because of overlaps and redundancies in sectoral or geographical beneficiaries. A consolidation of the programs would help to harmonize implementation.

The Philippines is prone to disasters for which relief is inadequate.

Disasters, both natural and manmade, have been a major source of poverty and vulnerability in the Philippines. An average of 20 typhoons, accompanied by strong winds, intense rainfall, and flooding, buffet the country every year, and in recent years hydrologic events have become more intense and more frequent (presumably due to global climate change). The most vulnerable areas of the country are the Eastern Visayas and Southern, Central, and Northern Luzon, the first two being among the country's poorest regions. Agriculture, the sector on which two thirds of the poor depend for income and sustenance, is most vulnerable to vagaries of climate and weather and to the incidence of pests and diseases. In 2004–2006, disasters, particularly typhoons and associated hydrologic events, adversely affected an annual average of about 8 million people, mostly in rural areas. This was an increase of over 50% from the number recorded in 1994–2006 (Table 4.2). Only about one half of the affected people received assistance from government and private relief institutions. Of those assisted, the value of the assistance was a miniscule amount, not even representing 1% of the average income during "normal" times of the poorest 30% of the population. This is a serious concern considering that disasters often inflict severe damage and loss to property and destroy the only means of livelihood for the poor. Failing to receive assistance, they risk falling to perpetual poverty traps.

Table 4.2
Disasters and Related Assistance to Affected Persons

Type of Disaster	Number of Persons Affected (annual average)		Number of Persons Assisted (annual average)		Assistance per Affected Person (pesos)		As Percent of Income of Poor Person	
	1994–2096	2004–2006	1994–1996	2004–2006	1994–1996	2004–2006	1994–1996	2004–2006
Typhoon	4,092,023	5,928,979	2,221,036	2,992,873	7	16	0.14	0.18
Flooding	829,560	1,864,245	326,826	1,039,266	6	20	0.12	0.22
Strong Wind/Monsoon Waves	2,877	14,381	1,936	10,304	21	83	0.41	0.92
Sea Tragedy	515	906	271	411	2,083	170	39.56	1.88
Tremors/Landslides	6,761	7,778	289	7,109	11	977	0.21	10.78
Volcanic Activity	35,872	15,811	28,210	15,811	117	630	2.23	6.95
Others	71,386	1,332	14,748	1,182	0	260	0.00	2.87
Total	5,038,994	7,833,432	2,593,316	4,066,955	8	19	0.15	0.21

Note: The average income of a poor person is the average of the poorest 30% of the population.
Sources: Data from Department of Social Welfare and Development; Family Income and Expenditure Surveys (NSO, various years).

Some of the major antipoverty reduction programs have not lived up to expectations.

Since 1986, various Philippine presidents have stressed direct antipoverty programs as the core objective of the administration. Antipoverty action is embodied in the Government's Medium-Term Philippine Development Program that is drawn up every 6 years. The agenda has evolved from one of alleviating poverty to a more holistic approach to eradicating it. Each president has had flagship poverty reduction projects. Despite the plethora of measures, various evaluations suggest that the Government's antipoverty efforts may not have lived up to the expectations. A budgeting issue revolves around whether to allocate a separate budget line for poverty related projects or to give agencies the responsibility to request for budgetary funds. In addition, shortcomings have been identified in programming and institutional issues (ADB 2005, Balisacan and Edillon 2005).

- **Programming-related issues**. The antipoverty programs have been weak because they are often short-lived, poorly targeted, lacking in accountability, not well coordinated, and wanting in key components. Framing the poverty plans has been cumbersome and lengthy, and problematic because every administration tends to introduce new poverty programs while discontinuing ones that are associated with the previous government, even if they have been making good progress. This shortens the lifespan of the programs, making it difficult to realize the full impact of poverty initiatives.
- **Institutional issues**. Institutions that carry out antipoverty programs have been weakened by high staff turnover, politicization, and redundancy. Every change in administration since 1988 resulted in appointing new agency heads and recruiting new staff down to the director level. Rapid staff turnover negates continuity and slows the pace of antipoverty efforts. Poverty programs are often pursued to meet short-term political goals. The operations of the National Anti-Poverty Commission since 1988 have been highly politicized (ADB 2005). Political influence is rife throughout the process—from appointing agency heads, to choosing "basic sector" representatives and target beneficiaries, and to distributing the budget and goods for poverty alleviation.

Chapter 5
Summary, Conclusions, and Policy Implications

The Philippines, under a succession of administrations since 1986, has been committed to sustained growth of income and employment, stable prices, poverty eradication, and improved distribution of income and wealth in an open-economy setting. In pursuit of these development goals, the national and local governments have ushered in wide-ranging economic and social policy reform programs.

Under these reform programs, real GDP doubled between 1986 and 2006—a growth rate of about 3.5% each year. However, this pace of growth leaves much to be desired when compared with that of many of the Philippines' East and Southeast Asian neighbors. In recent years, growth has picked up and in the first three quarters of 2007 real GDP grew at about 7%. But there is no room for complacency. Private investment remains weak, raising the question of whether the current pace of growth is sustainable. In 2003, about 25% of families and 30% of the population still lived in poverty, a reminder of the difficulties that many individuals are still going through. And inequality in the distribution of household incomes remains high by regional standards.

Moving forward, the challenge for the Philippines is to sustain the current pace of growth or even accelerate it, while making every Filipino a winner in the growth process. To meet this challenge, a key step is to identify the most critical factors that constrain growth and poverty reduction. The diagnostic approach this study adopted to identify the critical constraints is informed by basic insights from recent literature that seeks to account for international differences in the levels and growth rates of per capita income. Once the most critical constraints have been identified and prioritized, targeted efforts at relaxing them may unleash profound spurts of growth and poverty reduction that can be sustained well into the future.

A. Critical Constraints to Growth and Poverty Reduction

Many factors are at work in the growth and development process, but in the long run, a country's prosperity and the welfare of its people are determined by the accumulation of physical and human capital, their efficient utilization, and equitable access to the opportunities that the growth and development process generates. What factors have been hindering these in the Philippines? Using a variety of evidence—macroeconomic, financial, and social indicators; findings from investment and business surveys; regression analysis; insights from in-depth case studies; and benchmarking with other similarly situated countries—the study determined that the following are critical constraints to growth and poverty reduction in the Philippines during the next 5–8 years:

- Critical constraints to growth are

(i) tight fiscal situation;

(ii) inadequate infrastructure, particularly in electricity and transport;

(iii) weak investor confidence due to governance concerns, in particular, corruption and political instability; and

(iv) inability to address market failures leading to a small and narrow industrial base.

- Critical constraints to poverty reduction are

(i) lack and slow growth of productive employment opportunities;

(ii) inequitable access to development opportunities, especially education, health, infrastructure, and productive assets; and

(iii) inadequate social protection and social safety nets.

Many of these critical constraints are interlinked. Only when the fiscal situation sufficiently improves will the Government be in a position to allocate more resources to infrastructure investment. However, improved infrastructure alone is not enough to lower the cost of doing business and to stimulate private investment. Better infrastructure needs to be accompanied by significant improvements in investor confidence, which can be done through the Government adequately addressing governance concerns by implementing initiatives aimed at reducing corruption and improving political stability. Removing these three constraints (e.g., tight fiscal space, inadequate infrastructure, and weak investor confidence) will result in increased private investments from domestic and foreign sources. But, to ensure that growth can be sustained at a high level similar to that achieved by many Southeast and East Asian economies in recent decades, the Government will also need to address the market failures (such as information and coordination externalities) in order to encourage investments in diversifying and expanding the manufacturing sector and exports, and in upgrading the level of technology.

Sustained and high growth, resulting from removing its critical constraints, will create more productive employment opportunities. This is essential because insufficient employment is the most critical constraint to poverty reduction in the Philippines. However, the expansion in employment opportunities may not lead to significant poverty reduction unless inequalities in access to development opportunities are reduced and removed by instituting good governance and better policies. Removal of constraints due to unequal access will greatly help accelerate the pace of poverty reduction, but they may not suffice to reduce poverty sufficiently unless the inadequacies in the social safety nets are addressed so as to keep the most vulnerable groups, such as the old-aged and destitute, from extreme deprivation. Similarly, people who graduate from poverty may still be vulnerable to natural disasters or economic shocks unless the inadequacies in the social protection are addressed.

Governance concerns not only weaken investor confidence, they underlie most other critical constraints just listed. For instance, corruption undermines tax collection, political instability hinders investment and growth and reduces the tax base, and both contribute to the "tightness of the fiscal space." Poor conditions of infrastructure are a result of insufficient development spending and of poor governance, which causes leakages and improper appropriation of public funds. Similarly, poor governance hinders the pace of poverty reduction, as it reduces growth of incomes and productive employment opportunities. It is also a major contributing factor to inequalities in access to education, health, infrastructure, and other productive assets, as well as to weaknesses of many poverty reduction programs. Therefore, addressing governance concerns will go a long way toward relaxing the critical constraints to growth and poverty reduction and should be made a top development priority in the Philippines.

The study looked at other possible constraints (such as the level of domestic savings, the efficiency of domestic financial intermediation, the cost of international borrowing, and the stock of human capital) and found them to be less critical than the ones just listed. However, in the longer term, as the Philippine economy reaches a higher growth trajectory, some constraints that are currently less critical could become more so. They include the needs for a higher level of domestic savings and for a higher skill and knowledge base to support the development of new and emerging industries.

B. Overcoming the Constraints to Growth and Poverty Reduction

Some of the constraints identified are well recognized and have been the focus of the Government's policy and reform agenda in recent years. Thus, this study confirms their continued relevance and points to the need for more concerted efforts to overcome them. Other critical constraints identified have been less well recognized and discussed and, therefore, the study offers some new thinking on and new insights into the development problems the Philippines faces. The following policy priorities are proposed to address the constraints and are for the Government's consideration.

(a) Expanding the Fiscal Space

Despite significant Government efforts in fiscal consolidation and tax reform since 1986 (Box 3), the fiscal situation remains very tight. Expanding the fiscal space requires further action on at least two fronts—taxation and government spending. Many measures could be taken on both fronts, but the following are the top priorities.

- **Institute efficient tax collection machinery.** Making the tax collection machinery efficient should be the top priority for improving revenue generation. While the Government has devoted significant efforts to this in recent years, more needs to be done. An important step is an evaluation of what the Lateral Attrition Law, a performance-based incentive scheme, has accomplished. Fundamental to this is the adoption of the implementing rules, the draft of which was for review of the Bureau of Internal Revenue (BIR) as of October 2007.

  Equally important is regular monitoring of the status and outcomes of programs for improving tax collection that have been started, such as the RATES or "Run after Tax Evaders" effort. The program was launched by the Department of Finance (DOF) and the BIR, ostensibly to go after the "big fish" among alleged tax evaders, but progress has been limited so far. Under the RATES, the Department of Justice filed 87 tax evasion and estafa cases. To establish the credibility of the program, these cases must be monitored and their outcomes fully disclosed. In addition, the proposal to corporatize the BIR and implement an appropriate compensation and incentive structure for the agency should be revived.

- **Streamline the tax incentive program.** The Government recognizes the importance of rationalizing the special fiscal and investment incentives program in order to reduce huge tax revenues forgone, but the implementation has been held up pending the enactment of a new law to this effect. Thus, coming up with a consensus bill and its expedient enactment should be a top priority.

- **Rationalize the rate structure of the tax system.** The country's corporate income tax rate is one of the highest in the region. This should be reviewed because the rate is seen as disadvantageous by potential investors. In addition, the personal income tax system could be evaluated to determine whether the rates need to be streamlined. But any reduction in corporate and individual income tax rates must be matched with new tax enhancement measures, including removal of many deductibles. Furthermore, there may be scope for enhancing excise taxes. For instance, the questionable excise tax law on cigarettes enacted in 2005 could be reassessed and amended so that it can deliver the expected increase in tax revenues. The DOF, for example, notes that some cigarette brands continue to be classified based on their net retail price in 1996, which keeps the actual excise tax collection from them below potential while resulting in inequitable tax treatment between old and new brands. All this renders rationalization of the tax structure an immediate concern.

- **Cut losses of and subsidies to Government corporations.** On the expenditure side, there is still significant room for cutting Government spending on net lending or subsidies to some large and loss-making Government corporations, such as the National Food Authority (NFA). Fees and charges for front-end services from these corporations must be regularly reviewed and adjusted, and they must be made to mimic private corporations in the efficiency and quality of their service delivery. The Government may also look into some aspects of their operating activities to find out which of them could be privatized. Savings derived from reducing or removing subsidies to loss-making Government corporations could be reallocated to finance infrastructure and social safety nets that are working effectively. Many evaluations of the NFA, for instance, indicate that much of the benefits expected from the subsidies going to the agency is captured by even high-income individuals and groups. Hence, the NFA should stay out of money-losing grain trading and limit its role to achieving grain security by managing buffer stocks.

- **Strengthen expenditure management.** Efforts to strengthen the links between planning and budgeting and to improve expenditure management should be continued. Most importantly, such efforts help to minimize the possibility of budgetary appropriations for high-priority public investments being underprovided. Meeting past unmet budgetary needs for education, health, and infrastructure, for example, is indicated. In addition, the Organizational Performance Indicator Framework that is being rolled out by the Department of Budget and Management clarifies what the Government and its instrumentalities ought to be doing, minimizes duplication of functions among agencies, and holds agencies accountable by adopting performance indicators; this is helpful and must flourish fully.

Furthermore, current government procurement reforms should be monitored constantly to determine if they actually deliver a transparent and efficient system of bids and awards. The recent explosion,

Box 3
Major Tax-Related Reforms and Initiatives Since 1985

The following lists reforms and initiatives from 1986 through 2007.

A. Tax System

- Tax Reform Package, 1986—Introduced the luxury tax, increased withholding tax rates, rationalized income taxes and excise tax, and abolished the export tax.
- Executive Order (EO) No. 273, 1987—Introduced the value-added tax (VAT) at 10% of gross value of the goods sold and discontinued various sales taxes, compensating tax, and excise tax on some specific products.
- Republic Act (RA) No. 7496, 1992—Introduced the Simplified Net Income Taxation (SNIT) for the self-employed and professionals, including reducing the rate structure to seven brackets.
- RA No. 7716, 1994—Restructured the VAT system to widen the tax base and enhance the tax administration through the expanded VAT (EVAT) law.
- RA No. 7844, 1994—Introduced various tax credits for exporters.
- RA No. 7916, 1995—Introduced preferential tax treatment for special economic zones.
- RA No. 8184, 1996—Simplified the excise tax on petroleum products by adopting product-specific rates.
- RA No. 8240, 1996—Increased the tax on beer and cigarettes by introducing specific tax rates.

- RA No. 8241, 1996—Amended the EVAT to exempt six specific items and provide presumptive tax credits to agro-processors and government contractors.
- RA No. 8424, 1997—Rationalized income tax through the Tax Reform Act of 1997 or Comprehensive Tax Reform Program (CTRP), which reduced the tax rates; broadened the tax base, included measures to better capture "hard-to-tax incomes"; abolished the SNIT; introduced minimum corporate income tax; and exempted taxable income of fixed income earners.
- Corporate income tax rate reduced from 34% to 33% in 1999 and to 32% in 2000.
- RA No. 9334, 2004—Reformed the Excise Tax on Alcohol and Tobacco Products, popularly known as the "sin tax."
- RA No. 9337, 2005—Imposed a 10% VAT on oil and electricity, increased the corporate income tax rate from 32% to 35% until 2008, and reduced it from 35% to 30% in 2009, through the RVAT Law.
- 2006—Increased the VAT rate from 10% to 12% of gross value of the goods sold after the economic conditions prescribed by the RVAT Law or RA No. 9337 were achieved.

B. Tax Administration

- 1994—Tax computerization program initiated to establish an integrated tax system designed to provide a standard processing framework for the functions of the Bureau of Internal Revenue (BIR) related to tax collection and administration.
- 2001—The Large Tax-Payers Unit established in the BIR.
- EO No. 259, 2003—The Revenue Integrity Protection Service (RIPS) created to detect, investigate, and prevent corruption in the revenue generating agencies of Government under the Department of Finance.
- RA No. 9335, 2005—The Lateral Attrition Law (which includes provision of a system of rewards and sanctions, a rewards and incentive fund, and a revenue performance evaluation board) created to improve the collection performance of the BIR and Bureau of Customs.
- 2005—Run After the Smugglers (RATS) program created to detect and prosecute smugglers and other types of trade law violators that are not detected and acted upon during initial and secondary reviews and screenings by other components within the Bureau of Customs.
- EO No. 625a, 2007—Initiated the Run After Tax Evaders (RATES) Program, which files tax cases against high profile personalities.

Sources: Aldaba (2006), Bureau of Internal Revenue (2007), and Diokno (2005).

for instance, of controversies about procurement in some projects funded by official development assistance (ODA) clearly highlights the need for looking into and possibly correcting current procedures.

(b) Accelerating Infrastructure Development

This study has highlighted the high cost of electricity and inadequacy of the road and transport system as critical constraints to growth. The Government recognizes this, as evidenced by the priorities every MTPDP since 1986 has given to infrastructure development and, more recently, the introduction of the Comprehensive Integrated Infrastructure Program (CIIP) 2006–2010, under which the Government has committed to increasing infrastructure spending to 5% of GDP (ADB 2007a). To accelerate infrastructure development and successful implementation of the program, four problem areas urgently need the Government's attention—regulation, competition and incentives, capacity development for the lead agencies, and finance.

- **Catching up with the Electric Power Industry Restructuring Act (EPIRA).** With the electric power industry now being privatized, finance will largely be the concern of the private companies. But to assure creditors that their loans will be serviced, the Government must ensure that loan covenants are observed, rate regulation is enlightened and market-friendly, and the sanctity of contracts is not compromised. All this helps assure continued flow of finance to the electricity and power sector. In other words, creditors' concerns must be adequately addressed.

  The Government body in charge of energy regulation must institute a market-friendly regulatory framework with clear implementing rules and regulations. In reviewing petitions for rate increases, the Government must ensure continuous delivery of quality service from the utilities in the sector. Ensuring viability of the firms must be a high priority consideration. At the same time, given that the electricity and power industry is bound to be a natural monopoly or oligopoly, effective competition policy is critical to help ensure that quality services are uninterrupted and forthcoming at competitive prices.

  Capacity development is indispensable for the Government agencies in charge of planning and ensuring reliable electricity and power supply, in particular the Department of Energy. The energy sector is facing new challenges from rising oil prices and the need to diversify energy sources in consideration of climate change. Ensuring energy security over the long term is essential for sustained growth. The technical, legal, economic, and financial expertise of Government agencies in charge of energy infrastructure development must thus be raised to a high level.

  The EPIRA is one of the most ambitious public policy reforms undertaken by the Philippine Government. Commensurate to its importance, the reforms in the EPIRA are accorded high priority in the MTPDP for 2004–2010. The sale of power generating assets has quickened as a result, which is clearly a move in the right direction. It will bring the electric power industry closer to the "open-access" provision of the law and help raise the credibility of price competition in the wholesale spot market, both of which are crucial in achieving the ultimate goal of the EPIRA to make electricity prices affordable and competitive in the region. Once this final goal is reached, the country will have more attractive investment and growth opportunities than it has now.

- **Upgrading and maintaining roads and transport systems.** Reliable sources of finance are critical to road and transport development. Reliable financing can be provided in at least two ways: (i) by increasing government budgetary outlays, and (ii) by increasing reliance on public-private partnership under the build-transfer-operate (BOT) law and its variants. The guarantee and incentive provisions of the BOT law must be unambiguous; they should not be sources of additional uncertainty. Likewise, to ensure the flow of credit to BOT projects, creditors' concerns must be taken care of.

- In terms of maintenance, the Motor Vehicle Users' Charge, or Road Fund, shows great promise. The fund, however, must be properly administered to achieve its intended results, especially in light of the finding that only about 50% of roads are well maintained. Consistent with this, the DOF plans to introduce a scheme funding phase 2 of the National Road Improvement Project by providing financing from the Motor Vehicle Users' Charge. The scheme intends to minimize distortions that may arise from political interference in the allocation of the Road Fund. The plan is laudable and deserves to be tried.

  The Government body in charge of regulating the road and transport system, particularly toll ways, must gear its review of petitions for toll rate increases to allow smooth flow of services from the road facilities while also assuring that users are not deterred by unaffordable toll rates, which would impair the viability of the road facilities. With regard to pricing policy, agreed-upon parametric pricing under the loan covenant must be honored. This enables private operators to maintain the facilities, service their loans, and guarantee the delivery of high quality service.

  The Government agencies in charge of planning infrastructure development must ensure they have sufficient technical, legal, and financial expertise and capacity to support planning and implementation. The agencies must exercise ownership over the projects they are implementing, whether solely through the national Government budget or through public-private partnership.

  As articulated in the latest MTPDP, the Government is conscious of the imperatives of raising not only the quantity but also the quality of the country's transport system, primarily to decongest Metro Manila, while spreading and propagating growth in the lagging regions. The Government envisions physical integration of the three major islands through the construction of a "nautical highway." In line with this, the Development Bank of the Philippines has opened a loan window supportive of roll-on-roll-off projects of the private sector. This and other budgetary initiatives of the Government are an impetus to public-private partnership in infrastructure development, a strategy that holds a great deal of appeal, and must be made to prosper.

- **Expanding regional and local infrastructure.** The Local Government Code specifies the division of responsibilities in infrastructure development between the national Government and the local government units (LGUs). For example, the national Government is in charge of the national arterial road network, which is about 12–15% of the total road network, while the LGUs take care of local, secondary, and farm-to-market roads. The partnership between national and local governments needs to be enhanced in adequately developing and improving infrastructure all over the country.

  The importance of coordination cannot be overlooked. The worst infrastructure is in poor municipalities and rural and remote areas. Infrastructure development in these areas suffers from coordination failures. Infrastructure projects need to be synchronized among national and local governments and across provincial governments to link their infrastructure productively so that markets can be integrated and economies of scale achieved.

  Financing of infrastructure programs at the local level is crucial. In this connection, LGUs must be actively enlisted in infrastructure development programs of the national Government and made conscious of their roles therein. Under the Local Government Code, at least 20% of each LGU's internal revenue allotment is intended for development and infrastructure projects. LGUs favor infrastructure development. While it is appropriate for LGUs to share the cost of developing their infrastructure, low income municipalities may still need to be provided meaningful subsidies from the national Government for building infrastructure and raising their capacities for project formulation and implementation.

For additional financing of local infrastructure development, appropriate incentives could be developed for better LGU performance by tapping ODA funds and linking access to such funds to LGU performance in relation to their MDG targets. It may also help to channel grants to LGUs from the national Government in addition to the general grants under the Internal Revenue Allotment scheme to help enhance the capacity for developing and implementing projects.

Institutional strengthening for the Municipal Development Fund Office may assist it to realize the efficiency and equity objectives of infrastructure development at the regional and local levels. Specifically, the need remains urgent for an effective mechanism to raise LGUs' ability to avail of ODA funds that support their infrastructure development programs.

(c) Instituting Good Governance

Governance concerns not only weaken investor confidence, but also underlie many other critical constraints identified in this study. Instituting good governance should therefore be made a top development priority in the Philippines. Two issues stand out—fighting corruption and addressing political instability.

- **Fighting corruption.** Eliminating corruption rests largely on the existence of well-defined and implementable rules and procedures in transacting with Government; a credible legal and judicial system that efficiently resolves corruption cases brought to it; a professional and nonpolitical career civil service; and a system of sanctions against erring agents, whether public or private. In this regard, the reform of Government procurement procedures through Republic Act (RA) No. 9184 (the Government Procurement Reform Act), along with recent efforts to harmonize these procedures with international standards, is a good start. The creation of the Presidential Anti-Graft Commission also deserves commendation.

  Compensation and incentive structures in government could be reviewed for better performance. The threat of government servants being dismissed when caught engaging in corrupt practices should be credible, and foregone earnings as a result should be of significant value. Furthermore, insulation against political intervention and a deliberate reduction in the scope of political appointments are important for strengthening the career civil service and giving it the leeway to perform professionally.

- **Addressing political instability.** Strong evidence shows that political instability holds back growth in the Philippines. Reforms to restore the credibility of the electoral process are a vital first step to restoring stability. The law mandating the computerization of election returns has been enacted and its implementation should not be delayed. The Government has affirmed its commitment to this reform, and fast-tracking the implementation of election computerization would contribute to political stability.

(d) Supporting Expansion and Diversification of the Industrial Base

The Philippine Government has long held industrialization to be a major development goal. As agricultural productivity increases and many of the sector's workers are rendered redundant, industry and services must grow fast enough to reach full employment and raise living standards. The economy must learn to "walk on two legs": industry and services (ADB 2007b). The Philippines needs more efforts to diversify its product range and enhance the value addition of its industry, whether designed for the export or domestic markets.

Growth comes from the emergence of new goods, not only from the increased production of the same ones. In addition, process innovations are important to raise the technological contents of products and achieve sufficient economies of scale. While industrial restructuring, diversification, innovations, and technological upgrades are essentially activities of the private sector and should be driven by market forces, the Government has the responsibility to provide an enabling environment and has a strategic and coordinating role to play. The responsibility involves not only putting in place

physical, institutional, and social infrastructure conducive to business and private investment, but also addressing distortions arising from market failures such as information and learning externalities and coordination failures. These failures could lead to underinvestment in knowledge and innovations, discourage entrepreneurship, and constrain diversification. Thus, some alternative thinking about industrial policies, departing from the traditional approach of picking winners, is useful—see, for example, Rodrik (2004).

During the 1970s and early 1980s, the Philippines tried to implant strong industrial policy but failed because the policy did not target high value-added export sectors and was badly implemented. Performance criteria were not used to make the economic incentives effective and the policy, instead, favored sectors owned by close allies of political figures. More recently, to attract foreign direct investment, the Government has put in place some investment promotion schemes and relied mainly on setting up industrial and export processing zones. To export businesses locating in the zones, the Government provides special fiscal incentives such as tax holidays and exemptions from customs duties for imports of capital equipment, raw materials, and intermediate products, provided the final products are re-exported. Much of the value added of such schemes is only in employment generation. Links of the big firms in the special zones to local firms and technological spillovers are weak, if not absent. In addition, the Government continues to issue a yearly investment priorities plan along the lines of traditional industrial policy.

Recent literature on industrial policy has shed some light on why the traditional approach to industrial policy often fails, and highlighted the importance of policy design and implementation. Rodrik (2004) listed some general design and implementation principles for the so-called "new industrial policies" that may have high pay-offs:

- Public support and incentives should be provided only for activities and not sectors; moreover, the activities in question should be new ones, including products that are new to the local economy or new technologies for existing products.

- The activities supported should also have the potential to crowd in other complementary investments, generate informational or technological spillover, encourage R&D, and facilitate industrial restructuring and productivity enhancement.

- Clear benchmarks for success and failures must be adopted to ensure that public support is not abused or wasted. Public support should not be indefinite. Sunset clauses could be used to phase out support. The Government also needs to take some mid-course corrections.

- Agencies that implement industrial policy must be competent, have sound institutional and governance structure in place to prevent "being captured," have good communication with the private sector, be supported by the highest level of leadership possible, and be effectively monitored by all stakeholders.

Such an approach need not be restricted to industry or manufacturing, whether large corporations or SMEs—the approach also applies to the development of nontraditional activities in agriculture and services. If carefully designed and properly implemented, this new approach has great potential to help the Philippines seize many of the opportunities arising from the new trading, investment, and production arrangements, including "off-shoring" and outsourcing of business processes, which have emerged in the region and globally. At the same time, new policy measures must comply with WTO rules. The Philippines clearly could learn lessons from the industrial policies of some of the economies in East and Southeast Asia that are regarded as models of successful industrialization—see, for example, Kuchiki (2007), Hernandez (2004), and Rodrik (2004).

Improving access to credit by SMEs by addressing market failures such as information asymmetry will also help to diversify the industrial base. Finally, diversification of the industrial base and promotion of nontraditional manufacturing exports require maintaining a competitive real exchange rate (Lim 2007a).

(e) Making Access to Opportunities More Equitable

For growth to make a significant dent in poverty, the Government must ensure not only that the growth process generates sufficient productive employment opportunities, but also that they are

within reach of every segment of society, including low income strata. The list of things the Government has to accomplish before this challenging goal could be achieved is long, and attention to the following three policy priorities will help advance the development agenda in the Philippines in a visible way: (i) increasing investment in expanding human capacities, especially of the disadvantaged; (ii) improving the effectiveness and funding of development programs at local levels; and (iii) improving the effectiveness and targeting of social safety nets and disaster relief.

- **Expanded and more equitable access to education, training, and health services.** Spending for education and health targeted at the poor must be sufficiently large to get visible impacts. Alternative financing modalities, including national Government-LGU counterpart schemes, need to be more aggressively developed to raise the spending levels on basic social services, especially in low income LGUs. The aim should be to raise spending levels close to those of the country's more economically dynamic neighbors.

  Innovative approaches in education that have been tried and are known to be working, including vouchers, alternative education systems, and conditional cash transfers, should be scaled up. For example, education vouchers have been used successfully in other countries to increase parent participation in children's schooling and the quality of education services.

  The implementation of the Basic Education Sector Reform Agenda, which covers universal access to basic education and effective school-based management, has to be expedited and monitored. The reform must go beyond providing quantity of education inputs to include, even more importantly, quality of education services, especially in rural areas and regions of Mindanao and the Visayas where the chances of achieving the MDG targets for basic education and health are poor.

  In health, the Government has developed critical interventions through its FOURmula One for Health (F1) program. The implementation of this program, which aims to achieve better health outcomes, more responsive health systems, and more equitable health financing, has likewise to be hastened. The program has to enhance the Philippine Health Insurance Corporation (PhilHealth) coverage of indigent families (by increasing enrollment numbers and expanding coverage of services), while at the same time ensuring sufficiency of benefits (providing payments for medicines and treatments). The program should include fostering a more competitive drugs industry to reduce the cost of drugs and medicines.

  Government should consider bundling specific health and education interventions to enhance their natural complementarities (for example, breakfast feeding programs in schools are needed because cognition is enhanced with proper nutrition and immunization programs in schools will reduce absenteeism). In this regard, the effectiveness of the Early Childhood Development Program should be evaluated.

- **More effective and better funded development programs at local levels.** Effective and adequate programs to address the development needs at the local level can help the poor benefit from opportunities. In this regard, the Government may consider the following:

(i) The national Government may refine its choice of government unit (province, city, municipality, or village) to target for grant and loan support. Proper ranking of the chosen LGUs by development status is critical to designing incentive structures intended to extract proper governance practices from LGUs and to minimizing any leakage from the financial support provided to them.

(ii) Rural infrastructure development must be launched with a big push, preferably under the auspices of LGUs. The national Government could come in with some form of cost-sharing arrangement or counterpart grant mechanisms.

(iii) Much progress has been made in microfinance but further expansion is needed, given the large regional income disparities in the Philippines and weak access to credit by SMEs, especially in the lagging regions. SMEs continue to be deprived of credit, as the fixed cost of accessing credit from established commercial banks and other formal financial intermediaries is prohibitive for them. Moreover, microfinance helps households that are victims of temporary economic shocks to smoothen fluctuations in their consumption patterns. Institutionally, the appropriate national Government agency could consider dedicating a desk or bureau to monitoring micro and small businesses, to find out whether they have the capacity to graduate into medium-sized enterprises. Information about factors contributing to growth of SMEs is helpful.

(iv) Despite the achievements under the Comprehensive Agrarian Reform Program in the last 20 years, more needs to be done. The Government needs to extend the Comprehensive Agrarian Reform Law to allow the acquisition of remaining lands identified for redistribution, their distribution, and provision of support services to the beneficiaries.

(v) The development of growth areas could be promoted, linking them to depressed areas as this addresses the problem of coordinating industrialization across provinces and regions.

- **More effective and better targeted social safety nets and disaster relief.** Reliable social protection and safety nets promote growth with equity. But they are not very helpful if they are poorly designed and not well-targeted; intended beneficiaries who need the assistance most are missed as a result. The weaknesses of the existing social safety nets include poor targeting; lack of awareness of various programs; and low coverage level in terms of area, depth of support, and number of beneficiaries.

  In addition, victims of disasters must be given opportunities to recover. Poor households tend to locate in hazardous areas. When disaster strikes, they are driven deeper into poverty, and even those who have managed to escape poverty may find their improved situations to be fragile and temporary. The social protection schemes must have as components timely and reliable relief and rehabilitation efforts. Disaster prevention is, likewise, crucial. In this connection, partnerships with LGUs, civil society, business, and external funding agencies are essential.

  The wide range of pro-poor programs that the Government has instituted is proof of its commitment to equitable development (Box 4). To invigorate the commitment across time and place, impact monitoring and evaluation are crucial, as they help ensure cost-effectiveness and sustainability of safety net programs. The National Anti-Poverty Commission, together with the National Economic Development Authority, must put in place a systematic impact monitoring and evaluation system as part of the Government's good governance program. Such an evaluation system may start with the conditional cash transfer program launched by the Department of Social Work and Development. For instance, the program provides for cash transfers of up to ₱15,000 per family over a period of 5 years if parents keep their school-age children in school and bring them to primary health clinics for full immunization.

Box 4
Salient Poverty Reduction Programs, 1986–2007

Since 1986, the overarching objective of the Medium-Term Philippine Development Plans (MTPDPs) has been poverty reduction. In addition to broader initiatives aimed at poverty reduction as the end result, each of the MTPDPs has had focused programs on tackling absolute poverty. The salient programs include the following.

Tulong sa Tao (MTPDP 1986–1991). The program was aimed at reducing poverty by creating employment opportunities in low income municipalities. It focused on creating and strengthening self-help groups, raising group savings, and establishing group enterprises.

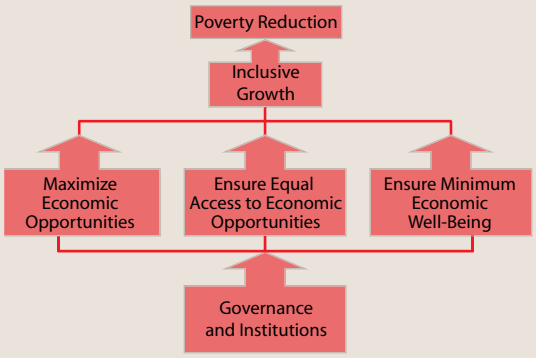
Social Reform Agenda (MTPDP 1992–1997). The agenda emphasized two key areas—poverty reduction and countryside development—and included a package of Government interventions organized around flagship programs of the MTPDP for the country's 20 poorest provinces. Within priority provinces, preference was given to the poorer municipalities and within these, to poorer villages. Within the selected geographic regions, the focus was on disadvantaged economic and social groups. The philosophy was to organize Government thrusts toward securing minimum basic needs before attending to other demands. A flagship initiative under the agenda was the Comprehensive and Integrated Delivery of Social Services (CIDSS), which relied on empowerment to fight poverty. The CIDSS employed an elaborate targeting mechanism based on a set of 33 indicators to monitor basic needs for survival, security, and an enabling environment.

Lingap Para sa Mahihirap or Lingap (MTPDP 1999–2004). The program identified the 100 poorest families in every municipality and focused on improving their welfare by providing subsidized food, social services and housing, and livelihood development. The program was financed through the Lingap Para sa Mahihirap (Poverty Alleviation) Fund.

Kapit-Bisig Laban sa Kahirapan or KALAHI (MTPDP 2001–2004 and 2004–2010). The initiative encompasses a wide range of activities including asset reforms, provision of human development services, creation of employment and livelihood opportunities, social protection and security against violence, and participation of basic sectors in governance. The interventions are grouped into four programs: (i) the CIDSS, which seeks to empower poor communities through enhanced participation in community governance and involvement in the design, implementation, and management of antipoverty initiatives; (ii) the Agrarian Reform Zone, which focuses on acquiring lands for qualified farmers, improving tenancy, and providing agricultural support services; (iii) KALAYAAN, which aims to address the needs of poor communities in conflict areas; and (iv) Poverty Free Zones, which provides livelihood opportunities for people in targeted areas.

Source: ADB (2005).

Figure 5.1
Three Pillars of Inclusive Growth



C. Toward Inclusive Growth

The Philippine Government has long been committed to creating prosperity that every citizen can access. Achieving this vision requires a strategy for inclusive growth (Ali and Zhuang 2007, Ali and Son 2007). The strategy rests on maximizing economic opportunities through high and sustainable growth, ensuring equal access to economic opportunities, and guaranteeing a minimum economic well-being for all (Figure 5.1).

Expanding investments in human, physical, and technological capital, together with promoting market access and exports, raises productivity and creates economic opportunities. Such outcomes permit families to increase their investments in education, training, and health. Enhanced human capacities enable all members of the society, especially those from disadvantaged groups, to participate in and benefit from the growth process and to take responsibility for their own well-being. Nonetheless, some disadvantaged individuals will find it difficult to seize opportunities, and their welfare hinges greatly on social protection and safety nets that government provides. All these require an enlightened and active government and good governance.

To sum up, easing the critical constraints identified in this report can trigger a growth process conducive to eradicating poverty and reducing inequality in the Philippines. Improved fiscal space will enable the Government to invest more in infrastructure, human capital, and social programs. Concurrent governance reforms will help to improve investor confidence, promote economic and social justice and level playing fields, and raise the quality of public services and goods delivery. Upgrading the technology and increasing the scale and diversity of manufactured products will help to generate new growth drivers, improve their sustainability, and create more decent and productive jobs. All these will lead to more private investment and entrepreneurship and to high economic growth. Finally, more equitable access to development opportunities will help to ensure that the benefits of growth and development will be widely shared by all members of Philippine society, bringing about a virtuous cycle of inclusive growth.

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About the Country Diagnostics Study—Philippines: Critical Development Constraints

The Philippines' pace of growth and poverty reduction has lagged behind that of many of its regional neighbors. While growth has picked up in recent years, domestic investment has remained weak and its share in gross domestic product continued to decline. This raises the question of whether the recent pace of growth is sustainable and whether it can be improved further. This report asks what the critical constraints to growth and poverty reduction are for the Philippines in the medium term, and discusses policy options to help address these constraints.

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