

Rising Growth, Declining Investment:

The Puzzle of the Philippines

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Abstract

The economy of the Philippines is open to trade and capital inflows, and has grown rapidly since 2002. Over the last 10 years, however, domestic investment, while stagnant in real terms, has shrunk as a share of GDP. In an open and growing economy, why the decline? Three reasons explain the puzzle. First, the public sector cannot afford expanding its investment at GDP growth rates. Second, the capital-intensive private sector does not find it convenient to raise investment at the economy's pace. Third, fast-growing businesses in the service sector do not need to rapidly increase investment to enjoy rising profits. Yet, the economy keeps growing. On the demand-side, massive labor migration results in remittances that fuel consumption-led-growth. On the supply-side, free

from rent-capturing regulations, a few non-capital-intensive manufactures and services boost exports. The economic system is in equilibrium at a low level of capital stock, where all economic agents have no incentive to unilaterally increase investment and the first mover bears short-term costs. As a consequence, growth is slower and less inclusive than it could be. To make it speedier and more sustainable, and to reduce unemployment and poverty, the economy needs to move to a “high-capital-stock” equilibrium. This would be attainable through better-performing eco-zones, a competitive exchange rate, greater government revenues, and fewer *élite*-capturing regulations.

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Rising Growth, Declining Investment: *The Puzzle* of the Philippines

Breaking the “*Low-Capital-Stock*” Equilibrium

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The World Bank

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Introduction

In an open and growing economy, why does investment decline? This question - addressed in the context of the Philippines - is the focus of this paper. The Filipino economy is open to trade and capital inflows, and since 2002, growth has averaged 5.3 percent (Table 1), led by the service sector. Over the last 15 years, however, domestic investment has been stagnant in real terms and consistently declining as a share of GDP.

Three reasons explain this puzzle: in the Philippines, investment does not grow at the pace of GDP because the public sector *cannot* afford it, the capital-intensive private sector *does not want* to expand that fast, and the rest of the private sector *does not need* it.

- a. First, the public sector – constrained by serious fiscal pressures, due to decades of weak revenue performance, a weighty debt service and a high cost of inputs – *cannot* keep public investment growing at GDP growth rates;
- b. Second, the capital-intensive private sector *does not find it convenient* to expand investment at the economy’s fast pace, as it expects little returns. The marginal product of capital (MPK) is low, for two reasons: *i*) the public sector does not invest enough to provide incentives for private investment; and *ii*) inputs are expensive because of *élite*-capture in the traditional sectors of the economy (agriculture, sea and air transport, power, cement, mining, banking, etc). There, the politically-connected corporate conglomerates - protected by favorable rules and regulations - enjoy barriers to entry and oligopolistic market power, and sell at a high price the products (agricultural commodities, transport services, electricity, cement, etc.) that are critical inputs for both upstream and downstream sectors. Also, they pay higher wages - relative to other Asian countries - to the salaried insiders, thus securing “national labor peace” with their rents; and
- c. Third, the fast-growing businesses in the service sector - electronics assembly, voice-based business process outsourcing (BPO), and information and communication

technology (ICT) - *do not need* to increase their investment at GDP growth rates to enjoy fast-rising profits.

Yet, despite the resulting decline in investment, the economy keeps growing; and this is because its least protected sectors - the informal labor market and the non-capital-intensive activities - stimulate demand and drive supply. On the demand-side, work-seekers – denied entry into the formal labor market - migrate massively to industrialized economies, attracted by better remuneration; the resulting remittances and transfers (which, combined, account for over 13 percent of GDP) fuel consumption-led-growth - and lower the penalty for *élite*-capturing policies. On the supply-side, the service sector and a few non-capital-intensive manufactures, free from rent-capturing regulations, boost exports.

In equilibrium at a low-level of capital stock. In the status quo, the well-protected corporate conglomerates take advantage of the political system to enjoy oligopolistic privileges - and then use the resulting rents to stabilize the economy. The resulting self-interested political constituencies, in equilibrium, perpetuate the status quo. The economic agents have no incentives to unilaterally increase investment, because the first-mover will bear short-term costs: while the public sector faces macroeconomic fragility, the capital-intensive private sector is dealing with a low MPK. As a result, the economic system is in equilibrium at a “*low-level of capital stock*”. In the short-medium term, low levels of investments are rational, and the “*low-capital-stock*” *equilibrium* is delivering economic growth, which - although not creating jobs (the unemployment rate is at almost 8 percent) - seems sustainable.

For future competitiveness, it is essential to reverse the present under-investment. Indeed, it is difficult to see how, at present levels of investment, a sufficiently robust growth can be sustained in the longer term, which is essential to deal with the country’s longer term development challenges (i.e., generate more jobs and reduce poverty). The country’s growth potential is untapped because of today’s inadequate investment. To reach speedier and more inclusive growth and sustain it in the long term, the country needs to address its lack of competitiveness.

To sustain growth the economy needs a phased competitive diversification ... What is needed is a market-driven expansion of non-traditional products. Given the strength of rent-seeking interests, moving too abruptly would entail political risks; hence, the reform of oligopolistic practices in the traditional sectors of the economy can occur only gradually. To mitigate and postpone confrontation with rent-seekers, the Government should follow a three-pronged strategy: (i) start by getting the economic zones right² - while pursuing a competitive real effective exchange rate³ - in order to promote new exportables; (ii) increase revenues, to finance the needed boost in infrastructure and education spending; and (iii) implement gradual reforms to tackle the rent-seeking conglomerate economy.

... and concrete measures to open oligopolistic markets. Over time, as a result of this phased approach, the expanding competitive sectors should shrink the relative size of the rent-driven economy, and - in association with the businesses that are bearing the costs of rent-seeking - build a pro-reform political constituency, without creating conspicuous losers. At that point, the Government should move to reduce *élite*-capture. Greater competition in ports and shipping, civil air transport, wholesale electricity and cement production markets would substantially reduce costs, spur investments, and create jobs. Reducing protection for agricultural products, particularly rice, will benefit the food processing and livestock industries. Political reforms are needed to trigger and sustain these economic gains.

The economy needs to reach an equilibrium that is more conducive to sustainable growth. In conclusion, moving to a “*high-capital-stock*” equilibrium – attainable through fewer *élite*-capturing regulations, more public-private risk-sharing, and greater government revenues - is needed to sustain speedier and more inclusive growth, and to reduce unemployment and poverty more rapidly.

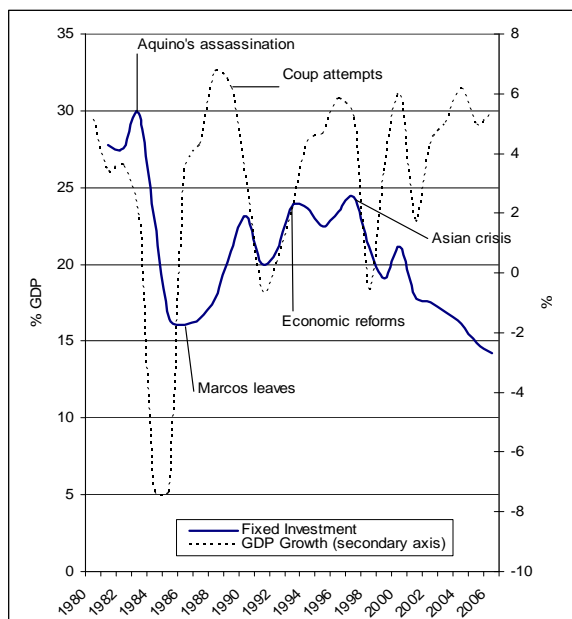
² See Box 1 page 37.

³ The average inflation-adjusted exchange rate against all trading partners.

1. *The puzzle: an open and growing economy, but investment is declining*

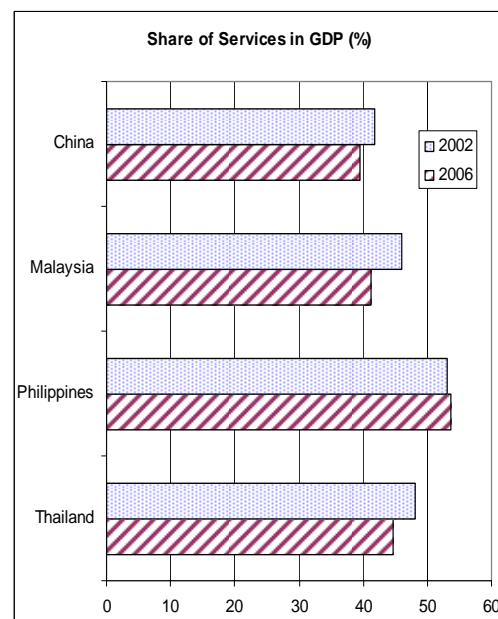
The Filipino economy is open to trade and capital inflows. After the political and debt crisis of the 1980s, the government implemented market-based economic reforms, resulting in a more outward-oriented economic system (Figure 1). The main policies included liberalizing trade, oil, telecommunications, and domestic shipping; opening up to foreign direct investment; privatizing government assets; and strengthening the central bank's independence. Services are rapidly becoming the dominant sector in the economy and account today for more than 50 percent of GDP (Figure 2).

Figure 1. Growth with declining investment ...



Source: National Statistical Coordination Board, 2007.

Figure 2. ... in a service economy



Source: Asian Development Outlook, 2007.

Since 2002, growth has been higher than in the past. Over the past 40 years, the country struggled to raise economic growth (from its historical trend of 3.8 percent) above population growth (Figure 1). In 2002-06, the economy - driven by services - grew at 5.3 percent, well above its past performance⁴ - but only average in its neighborhood (Table 1).

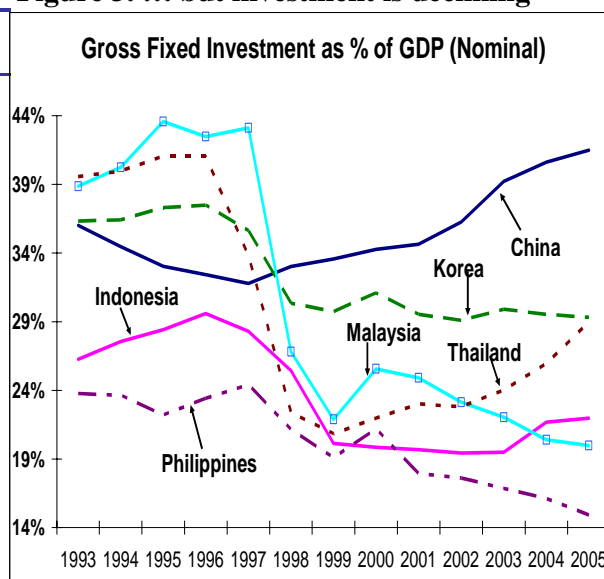
⁴ For the first time since the 1970s, growth performed at 5 or more percent for three consecutive years.

Table 1. The economy is growing ...

| | 2004 | 2005 | 2006 | 2002-06 |
|--------------------|------------|------------|------------|------------|
| Emerging East Asia | 8.0 | 7.5 | 7.8 | 7.4 |
| Develop. E. Asia | 9.1 | 9.0 | 9.2 | 8.8 |
| S.E. Asia | 6.0 | 5.1 | 5.2 | 5.3 |
| Indonesia | 5.1 | 5.6 | 5.5 | 5.2 |
| Malaysia | 7.2 | 5.2 | 5.5 | 5.5 |
| Philippines | 6.2 | 5.0 | 5.4 | 5.3 |
| Thailand | 6.2 | 4.5 | 4.5 | 5.3 |
| Transition Econ. | | | | |
| China | 10.1 | 10.2 | 10.4 | 9.9 |
| Vietnam | 7.8 | 8.4 | 8.0 | 7.7 |
| Small Economies | 6.6 | 7.6 | 6.0 | 5.7 |
| Newly Ind. Econ. | 6.0 | 4.7 | 5.1 | 4.8 |
| Chinese Taipei | 6.1 | 4.0 | 4.0 | 4.3 |
| Hong Kong, China | 8.6 | 7.3 | 5.9 | 4.7 |
| Korea | 4.7 | 4.0 | 5.1 | 4.7 |
| Singapore | 8.7 | 6.4 | 7.4 | 5.7 |

Source: World Bank East Asia Update, November 2006.

Figure 3. ... but investment is declining



Source: World Bank, 2006a.

As of the late 1990s, investment has been on a declining path. In almost all post-crisis economies of East Asia investment is far from pre-crisis levels⁵. However, since 1997, gross fixed investment in the Philippines has been stagnant in real terms and has declined as a share of GDP, thinning out to less than 15 percent (Figure 1 and Figure 3).

1a. What's falling is domestic investment

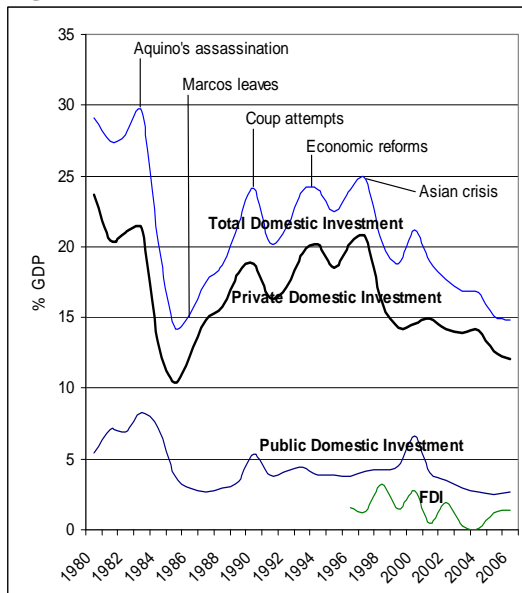
The financial crisis took a toll on both public and private balance sheets. After 1997, revenue collection weakened⁶, the fiscal deficit increased sharply, and the central government debt rose to over 65 percent of GDP. Limited by these fiscal constraints and by a poor investment environment, gross fixed capital formation declined as a share of GDP to the lowest level in 20 years. Public capital spending moved in a pro-cyclical rather than a counter-cyclical direction, falling to an estimated 2.3 percent of GDP in 2004-05 (Figure 4). The cuts in public investment led to under-investment in infrastructure and public education; the resulting deficiencies added to the ongoing decline in private investment.

⁵ Investment does not necessarily need to return to pre-crisis levels. In the early 1990s it may have been excessive, with resources allocated to lower return or unproductive projects, leading to a buildup of financial vulnerabilities.

⁶ The Government provided tax incentives and loosened tax administration.

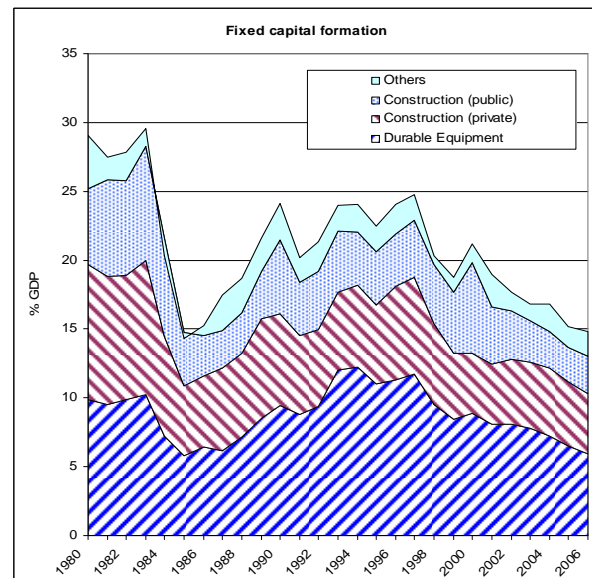
The investment decline is primarily due to lower domestic investment. Of the overall investment decline, domestic investment fell by 80 percent, while foreign investment decreased by 15 percent (Figure 4).⁷ Adding an element of rigidity to the downturn, 40 percent of the overall decline was due to lower construction (Figure 5).⁸

Figure 4. Domestic investment falls ...



Source: National Statistical Coordination Board

Figure 5. ... because of lower private outlays



Source: National Statistical Coordination Board, 2007

Private investment fell despite rising growth. The private sector found serious impediments to investing in the poor transportation network, the declining quality of education and the high cost of inputs, particularly electricity.⁹ Between 2000 and 2004, private investment - deterred by political instability and systemic uncertainties - did not respond to higher growth (Figure 4 and Figure 5), and private sector credit fell by 40 percent as a share of GDP.

⁷ In recent years, foreign investments have grown from a small base (from 2005 to 2006, net FDI inflows have reached \$2 billion, growing to 14 percent of the overall private investment), but are still too small to matter, and many investment approvals have not translated into actual flows.

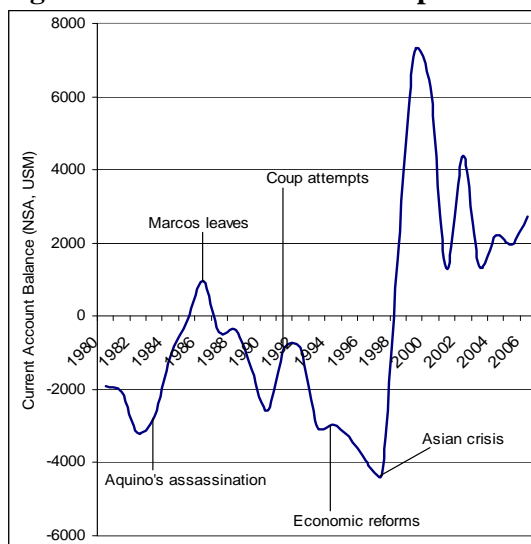
⁸ There is evidence that busts in the real estate tend to be longer-lived than in other asset markets, and tend to be associated with more severe downturns in overall economic activity. For example, in industrial countries, the evidence for housing market busts suggests they have an average duration of 4-5 years compared to 2-3 years for equity market busts (World Bank, 2006a).

⁹ Based on the competitiveness ranking of the World Economic Forum on basic infrastructure, the Philippines placed 89th out of 102 countries surveyed.

1b. Despite a more favorable environment, appetite is low

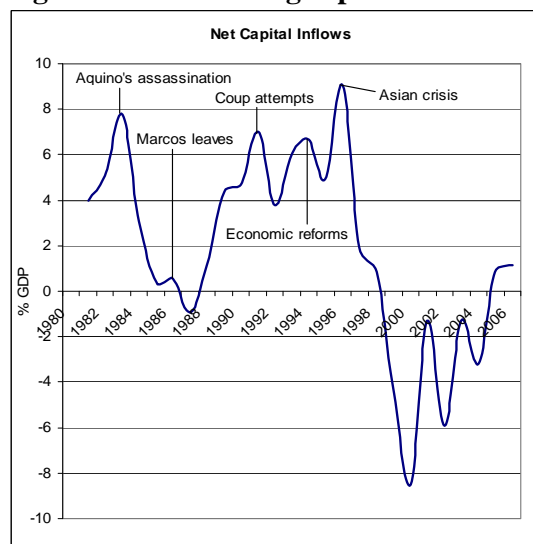
Since 2004, the investment environment has become more favorable ... In 2004, to address its fiscal challenge, the government launched a comprehensive reform program (including the adoption of the VAT), and during 2005-06 carried out a fiscal adjustment, accompanied by an enhanced tax effort. The improved outlook generated a more stable investment environment, potentially attractive for private capital inflows. Moreover, firms - in their fixed investment decisions - are today less influenced by the debt overhang, which constrained them during the late 1990s¹⁰. Also, the incremental capital output ratio (ICOR) shows that in the post-crisis period investment efficiency has improved.¹¹ Finally, surveys indicate a greater propensity to invest, as average capacity utilization rates - mainly in the manufacturing sector - have increased to over 80 percent.¹²

Figure 6. A current account surplus ...



Source: Central Bank of the Philippines, 2007.

Figure 7. ... and rising capital inflows



Source: Central Bank of the Philippines, 2007.

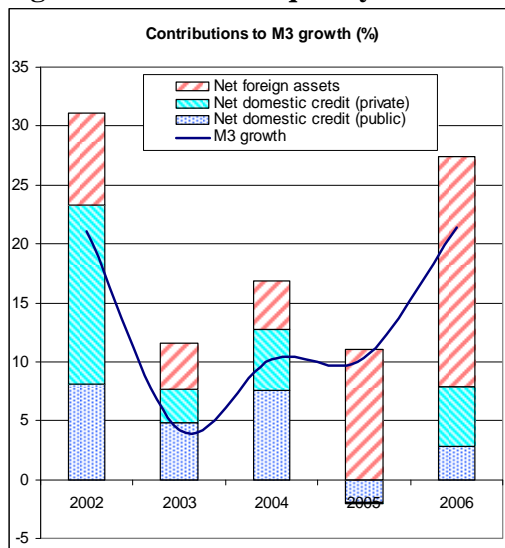
¹⁰ Firms with high debt-asset ratios face higher premiums and rarely finance new investments externally.

¹¹ The economy-wide ICOR is measured by the investment in a given period divided by the change in GDP in that period; it is also measured by the ratio of investment to GDP divided by the growth rate of GDP (World Bank, 2006a).

¹² This is suggesting private investment should pick up: with remittance-assisted personal consumption growing by more than 5 percent, firms would eventually need to increase investment to fulfill this demand. Moreover, consumer imports comprise less than 4 percent of GDP, whereas personal consumption accounts for 78 percent, indicating that the bulk of the increasing demand can be expected to be supplied by higher local production.

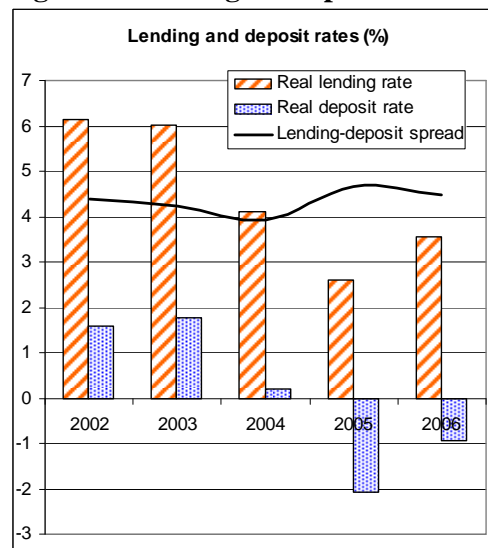
... and there is ample liquidity in the economy ... Favored by the government's fiscal efforts, gross domestic savings rose to 19.8 percent of GDP in 2006 (up from 17.1 in 2001). The current account (Figure 6)¹³ is in surplus, net capital inflows have been recently on the rise (Figure 7), and broad money (M3) growth has accelerated, driven by the accumulation of net foreign assets in the banking system (Figure 8). Bank balance sheets have strengthened and the lending-deposit spread is the highest recorded in recent years (Figure 9).

Figure 8. Increased liquidity



Source: Central Bank of the Philippines, 2007.

Figure 9. Lending looks profitable



Source: Asian Development Outlook, 2007

... but there is still little willingness to invest. Despite the more favorable environment, the savings-investment gap widened in recent years and the domestic appetite for investment remained stagnant (Table 2 and Figure 10). As a result of present growth and deficits, the “public debt-to-GDP ratio” is declining, but public investment has not picked up. The low and declining lending interest rate (Figure 9) suggests that, in spite of the ample liquidity, the demand for credit is not increasing. Also, despite the favorable lending-deposit spread, banks are cautious in their lending to the private sector (Figure 12), preferring to finance the government in local and foreign currency.¹⁴ In short, the private sector still invests little. Without a deeper reform of the investment climate, businesses are unlikely to lift spending on new plant and equipment (World Bank, 2005c).

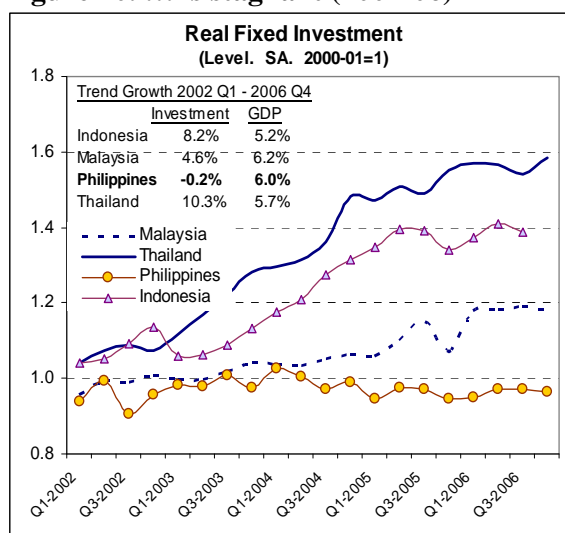
¹³ The surplus is largely remittances-driven, see Figure 22.

¹⁴ Government securities now comprise about a third of the banks' portfolio.

Table 2. Real Fixed Investment Growth ...

| | 1980 -89 | 1990 -96 | 1997 -01 | 2002 -05 |
|--------------------|-------------|-------------|-------------|-------------|
| China | 8.2 | 15.2 | 9.9 | 12.0 |
| South East Asia | | | | |
| Indonesia | 8.9 | 11.5 | -5.9 | 7.2 |
| Malaysia | 7.0 | 17.7 | -6.6 | 2.2 |
| Philippines | 0.4 | 5.3 | 0.2 | 1.1 |
| Thailand | 8.5 | 12.3 | -14.5 | 8.6 |
| NIEs | | | | |
| Chinese Taipei | 7.4 | 9.2 | 1.7 | 3.1 |
| Hong Kong, China | 5.3 | 9.3 | -0.2 | 0.7 |
| Korea | 8.6 | 11.5 | -1.8 | 2.9 |
| Singapore | 6.3 | 13.1 | 0.6 | -1.5 |

Source: World Bank, 2006a. Compound annual

Figure 10. ... is stagnant (2002-06)

Can the investment slowdown be structural? Potential causes of the investment slowdown are cyclical factors such as the pre-1997 investment boom, the impact of the financial crisis, and the 2001 global high tech recession. But policy makers are concerned that weak investment may reflect not only cyclical but also deep-seated factors, signaling more permanent or long term difficulties in achieving higher growth (Table 2 and Table 3).¹⁵ Indeed, the corporate *élite* - comfortably protected by political ties - finds convenient investing only a portion of its revenues in-country, and keeps sending considerable portions offshore.

Table 3. Fixed Investment (as % of GDP)- Pre and Post Crisis Periods

| | Indonesia | Korea | Malaysia | Philippines | Thailand |
|--------------------------------------|-----------|--------|----------|---------------|----------|
| Peak | 29.6 | 37.5 | 43.6 | 24.4 | 41.1 |
| | (1996) | (1996) | (1995) | (1997) | (1995) |
| Bottom | 19.4 | 28.0 | 20.0 | 14.6 | 20.8 |
| | (2002) | (2006) | (2005) | (2006) | (1999) |
| Latest in 2006* | 21.5 | 28.0 | 20.4 | 14.6 | 29.6 |
| Bottom – Peak (extent of decline) | -10.2 | -9.5 | -23.6 | -9.8 | -20.2 |
| Latest – Bottom (extent of recovery) | 2.0 | 0.0 | 0.4 | 0.0 | 8.7 |
| Latest – Peak | -8.2 | -9.5 | -23.2 | -9.8 | -11.5 |

Source: World Bank, 2006a. */ until the second or third quarter depending on data availability.

¹⁵ Indeed, in the 1980s (1980-89) investment spending grew at 0.4 percent. In the first part of the 1990s (1990-96) growth rose at 5.3 percent, but between 1997-2001, investment growth was again stagnant at 0.2 percent. In 2001-05, despite the economic recovery, fixed investment picked up modestly (investment growth averaged only around 1 percent).

In 2006, investment continued its decline as a share of GDP to below 15 percent. Public construction increased slightly, while private construction and acquisition of durable equipment contracted. Investment in durable equipment fell to 6 percent of GDP, its lowest share since 1985. Real fixed investment levels remain below the 1997 peak levels (Table 3).

2. Why the decline? Investment is not a driver of current growth

Three reasons explain the puzzle. Investment is declining in an open-and-growing economy because of the interaction of the following three factors.

- a. First, the public sector – constrained by serious fiscal pressures, due to decades of weak revenue performance, a weighty debt service and a high cost of inputs – *cannot* keep public investment growing at GDP growth rates;
- b. Second, the capital-intensive private sector expects low returns and *does not want* to expand investment at the economy’s fast pace. MPK is low, for two reasons: *i)* the public sector does not invest enough to provide incentives for private investment (as the return to private investment depends on both quantity and quality of public capital spending); and *ii)* inputs are expensive because of *élite*-capture in the traditional sectors of the economy (agriculture, sea and air transport, power, cement, mining, banking, etc). There, the politically-connected corporate conglomerates, protected by favorable rules and regulations, enjoy barriers to entry and market power, and hence sell at a high price their products (agricultural commodities, transport services, electricity, cement, etc.), which are critical inputs for both upstream and downstream sectors; and
- c. Third, the fast-growing businesses in the service sector (electronics assembly, voice-based BPO, and ICT), *do not need* to increase their investment at GDP growth rates to enjoy fast-rising profits.

2a. The public sector *cannot* invest

As the government struggles with severe fiscal pressures, public investment keeps falling. Decades of weak revenue performance, demanding debt service and fiscal constraints – along with a high cost of inputs, particularly for electricity, and an ineffective service delivery – led to expenditure compression; as a result, the government underinvested in infrastructure. Similar constraints have undermined the quality of education, historically a point of strength in the Philippines¹⁶, and health (Table 4).

Table 4. Sectoral Budget Allocations, 2004-2006

| | 2004 | 2005 | 2006 |
|-------------------------|-------|-------|-------|
| Economic Services | 19.4 | 17.2 | 18.7 |
| Agric. & Agr. Reform | 3.3 | 2.8 | 2.6 |
| Social Services | 28.9 | 27.7 | 27.9 |
| Education | 14.9 | 14.7 | 13.9 |
| Health | 1.7 | 1.4 | 1.3 |
| Defense | 4.9 | 4.8 | 5.0 |
| General Public Services | 16.1 | 15.4 | 15.3 |
| Net Lending | 0.7 | 0.8 | 0.8 |
| Debt Interest Payments | 30.1 | 34.1 | 32.3 |
| Total | 100.0 | 100.0 | 100.0 |

Source: Government and Ateneo Center for Economic Research and Development, 2007.

In 2002-05, deficit reduction was driven primarily by expenditure compression. In recent years, despite the large spending needs, infrastructure and social spending growth has been slow (Table 4). In these key sectors, spending levels declined both as a share of GDP, as a share of the total budget, and on a per capita basis. Roads maintenance, an item with high economic return, was consistently under-funded.

In 2006, policy credibility improved ... The bulk of the adjustment was due to the implementation of the VAT reforms¹⁷. The fiscal consolidation fostered macroeconomic

¹⁶ The lack of resources available for both basic and higher education is already resulting in poor mathematics and science scores in international comparisons, and a declining proficiency in English (World Bank, 2005c).

¹⁷ The 2006 VAT reforms raised tax revenue by 22 percent, increasing the tax/GDP ratio from 13 percent in 2005 to about 14.2 percent in 2006. This marked the first significant increase in tax effort since the post-Asian crisis collapse of tax revenue.

stability, and - by way of lower deficits - decreased risk *premia* and interest costs¹⁸, and is creating room for productive expenditure in the budget. Financial markets have reacted with optimism: stocks¹⁹, the peso and reserves have all risen significantly, as have foreign direct investment and capital inflows.²⁰

... but the fiscal adjustment might be too recent to convince investors. The increase in the 2006 tax effort reflected implementation of the VAT reforms, while the collection of (corporate and personal) income taxes and excise taxes was insufficient. The public-debt-to-GDP ratio remains high at about 77 percent, the fiscal position is still fragile and significant interest payments (Table 4) still expose the economy to swings in financial market sentiment. Hence, containing the risk premium with further tax efforts and steady progress on reforms is crucial. Concerns about the long history of macroeconomic volatility, the unsettled political climate, and (the unpredictability in the incidence of) corruption add to risks for investors (World Bank, 2005c).

2b. The capital-intensive private sector *does not want* to invest

The expectations on future profitability of investment are low. The capital-intensive private sector *does not want* to increase investment because it expects low returns (World Bank, 2005c). In the corporate sector, the MPK - calculated as market value/asset value, that is the Tobin's Q - has been falling since the early 1990s, and, since the Asian crisis, it has been lower than in neighboring countries (Figure 11).²¹ Despite the more favorable investment environment, the demand for domestic credit has been falling and the banks have been reluctant to lend (Figure 12). Indeed, a low MPK reduces the expectations about future profitability and thus the willingness to invest, and, over the years, has contributed to the decline of fixed investment.

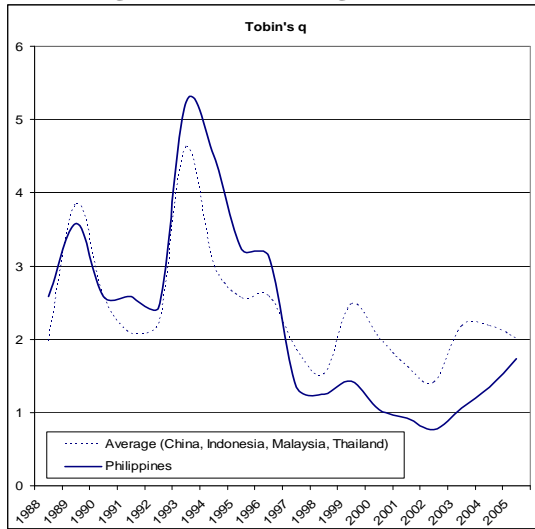
¹⁸ Spreads for government borrowing have fallen along with inflation.

¹⁹ Equity prices are approaching their pre-Asian crisis highs.

²⁰ The Philippine stock market was among the top East Asian performers, and in early 2007 continued to rise towards pre-Asian crisis highs.

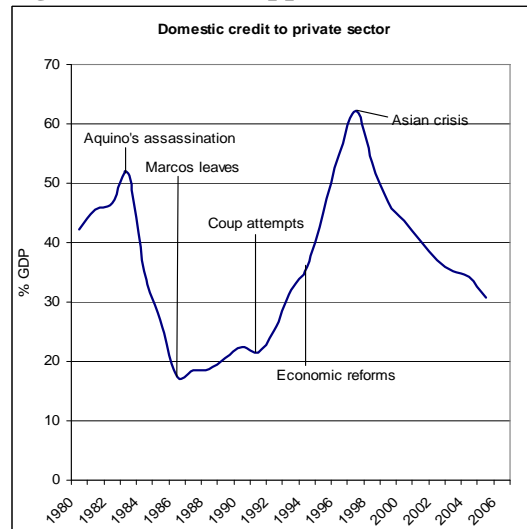
²¹ Aquino (2003) calculates the Tobin's Q of the Filipino corporate sector. While the firms with higher Tobin's Q can more easily and less expensively finance their investment with external financing, firms with low Tobin's Q are considered to have lower growth potential and the market might require higher external finance premiums in raising funds. This analysis, however, occurred when equity prices were considerably lower than current levels.

Figure 11. Declining MPK ...



Source: S&P/IFC EMDB - Price to Book Value Ratios

Figure 12. ... little appetite for investment



Source: Central Bank of the Philippines, 2007.

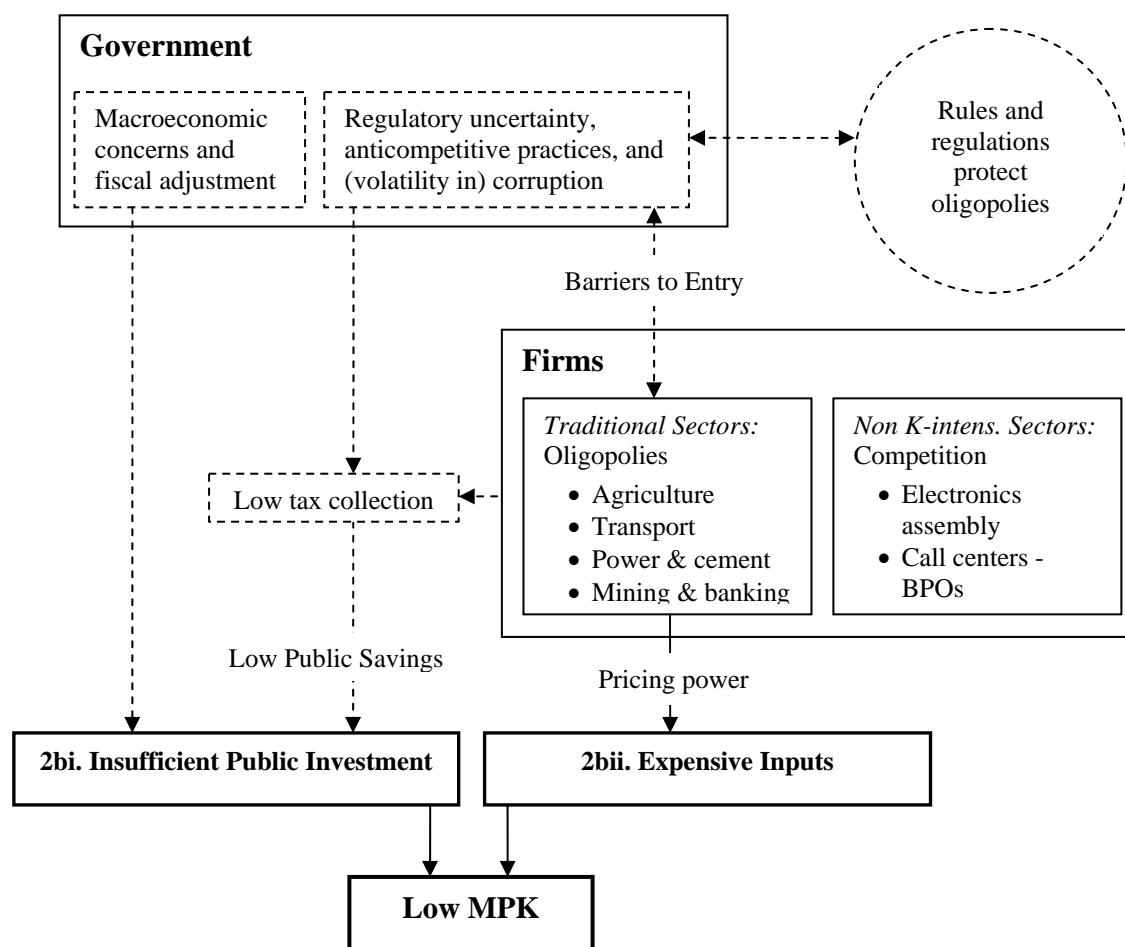
Why a low productivity of capital? In the traditional sectors of the economy, several rent-seeking corporate conglomerates, controlled by the local *élite*, use their political connections to: a) hinder tax collection, hence hampering public capital spending (which is a necessary condition for private investment: for example, the availability of public infrastructure is essential to stimulate the private sector's willingness to invest); and b) limit economic entry, drive potential investors out, discourage smaller firms to grow bigger, produce expensive inputs, and enjoy market power and oligopolistic rents. As a result, MPK is low because of: i) insufficient public investment; and ii) a high cost of inputs, due to *élite* capture (Figure 13).

Oligopolies further reduce the investment appetite. Operating as monopolies and oligopolies, the corporate conglomerates find convenient to restrict production – and investment - below the competitive level.²² Also, their willingness to invest is inhibited by their concentrated ownership structure, and their uncertainties about the stability and duration of government favoritism.²³

²² Monopolists produce where the marginal revenue equals its marginal cost, and not where the average revenue the marginal cost. Oligopolists are aware of the actions of the others and always take into account the likely responses of the other market participants.

²³ Under Marcos, conglomerate owners who had close ties to the government enjoyed lasting favoritism, which guaranteed a predictable business environment and a longer term investment horizon. This “organized corruption” was not replaced by a predictable system of rules, regulations, and contract enforcement. In other words, the country moved from “organized” to “disorganized corruption”.

Figure 13. The private sector expects low returns. MPK is low



Source: Author.

2bi. Insufficient public investment

Low public investment is a bottle-neck for private investment. Compared with its Asian neighbors, the country ranks low in transport comparisons (railroads, port, and air), and educational achievement. The declining quantity and quality of public investment, especially in infrastructure and education, provide little incentives for private investment and constitutes a bottle-neck to long-term economic growth. For example - according to the recent Investment Climate Assessment (ICA) - high transport costs have weakened the private sectors' willingness to invest in agriculture; and in manufacturing, inadequate infrastructure

services, especially power and transport, constrained firms' capital spending (World Bank, 2005c).

2bii. Expensive inputs

In traditional sectors, corporate conglomerates benefit from dominant positions. In the capital-intensive sectors of the economy, the key corporate conglomerates - profiting from a mode of production surviving from the country's historical past - use their political connections to create rents, by limiting economic entry and selling their products at a high price. Since all industries in the economy, to be able to produce and grow, require inputs from agriculture, maritime and air transport, power, cement, banking, etc., these sectors are strategic; indeed, they have multiple backward and forward linkages (Hirschman, 1958). For example, transport has both backward and forward linkages for manufacturing.

Expensive inputs limit domestic investment. As the cost of the strategic inputs is inflated by *élite* capture, investment remains low. In the agricultural sector, farmers do not invest because of the expensive inputs, the poor access to credit, and the incomplete land reform program. In manufacturing, investors are reluctant because of the costs of complying with regulations, especially related to customs, trade, and labor markets, corruption, and uncertainty in economic policies (World Bank, 2005c). Also the level of FDI (Figure 4) remains below the norm for Southeast Asia.

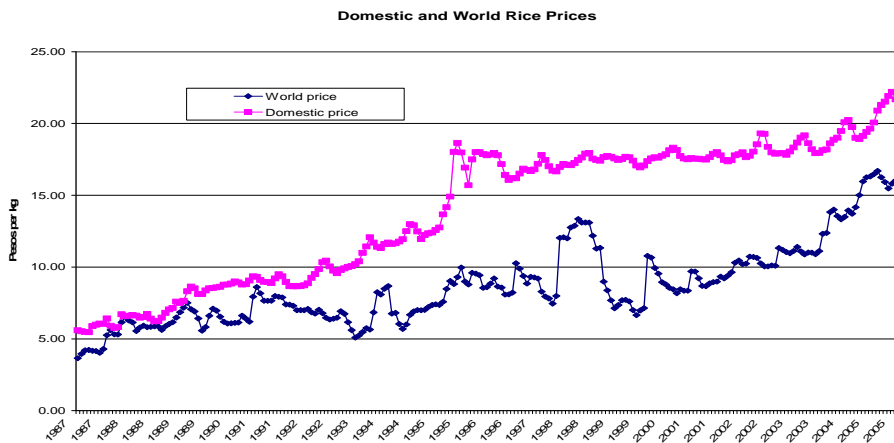
Agricultural commodities are protected ... Government support to agriculture, which accounts for 36 percent of employment, is the result of both a long-standing favoritism to large land-owners²⁴ and strong sentiments for the (still unrealized) goal of food self-sufficiency. Over the last two decades, domestic rice prices have consistently been kept above the world price (Figure 14).²⁵ Corn, sugar, poultry, and the livestock industry receive even higher levels of protection.

²⁴ The skewed land distribution stems from the colonial period.

²⁵ This has had several adverse repercussions: by reducing rice consumption, it has disproportionately impacted the poor; it has increased the income disparity between rich rice farm households and landless laborers, it has retarded crop diversification; it has lowered Philippine wage competitiveness; and it has been costly fiscally. Indeed, the National Food Authority (NFA) buys rice at market rates and sells at subsidized rates, piling up deficits in the process.

... and risk taking is not rewarded. The well-connected have easier and relatively unscrutinized access to credit, as banks – usually associated to the key conglomerates - do not thoroughly assess the expected returns on their investment; as a result of their inadequate knowledge to pick “winners”, average or mediocre projects get implemented. On the other hand, farmers under-invest in high-risk but high-return crops because they cannot afford insurance.

Figure 14. Rice: a domestic price above the world price produces rents



Source: World Bank, 2006 and World Bank, 2007b.

The maritime and aviation sectors, dominated by conglomerates, are not open to competition. The resulting high transportation costs undermine competitiveness, trading, tourism, and agriculture. For example, the price for exporting a 20-foot container from the Philippines is 60-300 percent higher than in other Asian countries (Table 5). By opening up its seas and skies - as long as competition is protected by rules and policies - the Philippines could become in the next few years a transport-and-logistics-hub in the Asia-Pacific region, and a competitive destination for tourism, medical services and retirement.

Table 5. Exporting a container can cost up to three times more...

| <i>20-footer container</i> | US Dollars²⁶ |
|----------------------------|--------------------------------|
| Philippines | 1,336 |
| Thailand | 848 |
| China | 335 |
| Singapore | 382 |

Source: World Bank, 2007 on Cross-Border Trading, 2006.

Port operations largely remain a monopoly. Philippines' ports are rated as the least competitive among those in eight major Asian countries (World Economic Forum, 2004). Until the reforms in the 1990s, port development and operation was a government monopoly; only a few private ports were allowed to operate commercially. Today, most ports are public, administered by the Philippine Ports Authority (PPA). The sector suffers from a lack of credibility in pursuing open and fair competition between ports and among port operators.

The airline sector is also highly concentrated and oligopolistic. Today, air transport carries about 70 percent of exports²⁷ and 98 percent of visitor arrivals. The country is endowed with a (mostly underutilized) network of airports, but the development of the sector is limited by a dominant conglomerate; indeed, the national flag carrier enjoys the government's protection and preferential allocation of state aid, subsidies, and airport slots. In the past, liberalizing entry of foreign carriers into the local market proved successful: the entry of three competitors²⁸ in 1995 and of two low-cost carriers²⁹ in 2005 lowered fares and increased choice.

Electricity and cement are oligopolistic markets. The electricity industry is dominated by three large companies, with around 70 percent of the total electricity generated by the largest supplier.³⁰ The cement market structure is highly concentrated³¹, and - reflecting lack of

²⁶ The cost does not include ocean freight and consists of several items/charges – documentation, inland transportation, customs clearance and technical control, ports and terminal handling.

²⁷ By value.

²⁸ Cebu Pacific, Asian Spirit and Air Philippines. The major beneficiary of this entry was the domestic passenger market, with a wider range of choices (e.g., airlines, flights, fares) and growth in traffic.

²⁹ Air Asia and Tiger Airways. Between 2004 and 2006, passenger traffic increased from less than 50,000 to more than 470,000. In 2006, the two low-cost carriers, accounted for 83 percent of the passenger traffic.

³⁰ By 2006, only 11 percent of power generation capacity had been privatized, compared to the original target of 70 percent, mandated by the Electric Power Industry Reform Act.

³¹ The top three firms - the multinationals Holcim, LaFarge and Cemex - account for nearly 90 percent of installed clinker capacity of 22mn tones, while four independent producers account for the rest. Between 2000 and 2005, when demand fell, cement producers increased prices by as much as 75 percent.

competition - local prices are amongst the highest (Table 6) and per-capita-consumption amongst the lowest in East Asia (Table 7).

Table 6. Cement prices are the highest ...

| <i>Cement</i> | Price (US\$ per tonne, Q4-06) |
|--------------------|--------------------------------------|
| Philippines | 72 |
| Indonesia | 69 |
| Vietnam | 65 |
| India | 52 |
| Thailand | 50 |
| Malaysia | 49 |
| China | 35 |

Source: World Bank, 2007 on JP Morgan and National Associations

Table 7. ... and consumption is the lowest

| <i>Cement</i> | Per Capita Consumption (kgs) |
|--------------------|-------------------------------------|
| China | - |
| India | - |
| Malaysia | 477 |
| Thailand | 450 |
| Vietnam | 316 |
| Indonesia | 144 |
| Philippines | 128 |

Source: World Bank, 2007 on Cement Manufacturers Associations

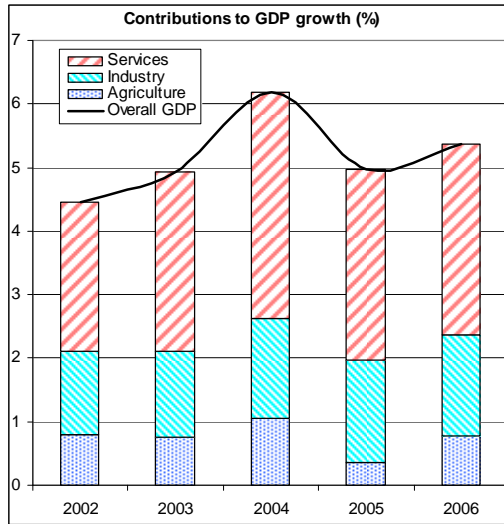
2c. The rest of the private sector *does not need to invest*

Economic growth is led by services. In average, in the past few years, agriculture kept growing slower than GDP, at almost 5 percent, and industry continued to grow on pace with GDP, at nearly 5.5 percent.³² In the same period, growth and profits came from the service sector. Boosted by private services (telecoms, electronics assembly, finance, voice-based BPO, and ICT-enabled services) and driven by a double-digit export growth (Figure 23), the sector is the economy's fastest growing (although not able to provide adequate employment opportunities), expanding at 6.3 percent and accounting for 3 percentage points of total GDP growth in 2006 (Figure 15).

The nature of growth is becoming less capital-intensive. While in recent years the investment in manufacturing has been consistently declining, the investment in services was stable, and – despite its relatively low level – able to support the sector's steady growth (Figure 16). As the service sector is less investment-intensive than industry, future economic growth is compatible with lower investment rates than implied by historical data. To enjoy rising profits, the service sector does not need to increase investment faster than GDP growth rates.

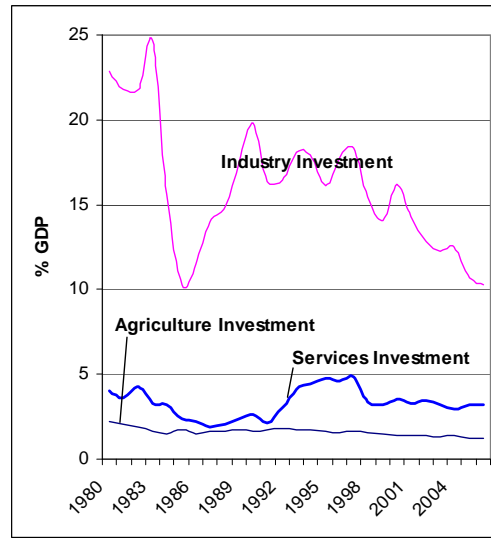
³² Mining - despite its untapped potential - witnessed a contraction.

Figure 15. Services are growing fast ...



Source: National Statistical Coordination Board, 2007.

Figure 16. ... and are less capital-intensive



Source: Author's elaboration on National Statistical Coordination Board, 2007.

FDI are also flowing to less capital-intensive activities. In 2006, net FDI - growing but still small - reached \$2.35 billion, compared with \$1.85 billion in 2005.³³ The inflows were sustained by the country's macroeconomic gains, including the fiscal and external position, and the declining inflation. Net FDI went mainly to non-capital-intensive niches in manufacturing and services. In manufacturing, the investments went to chemicals, electronics and air-conditioning system. In services, the inflows were in BPO, shipping crew training and medical research.

³³ However, 43 percent of the FDI was in the form of inter-company loans rather than new equity.

3. What keeps growth going? The least protected sectors of the economy

Despite the decline in investment, the economy keeps growing; this is because its least protected sectors - the informal labor market and the non-capital-intensive activities - stimulate demand and drive supply. Indirectly, they are also lowering the penalty for poor policies in both the oligopolic capital-intensive sectors and the formal labor market, thus perpetuating the status quo (Figure 25).

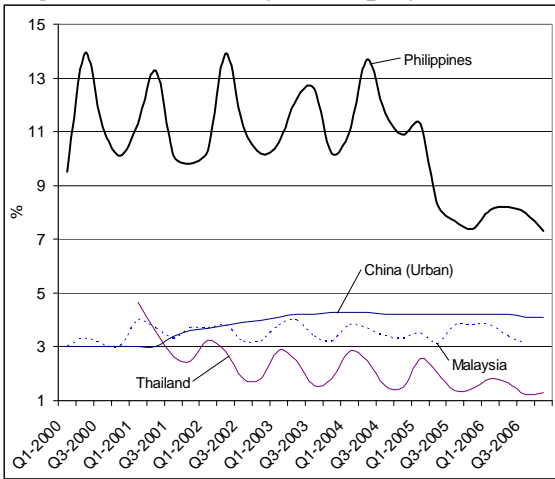
On the demand-side, massive labor migration results in remittances that fuel consumption-led-growth. A heavily-protected formal labor market and its comparatively high wages buy “national labor peace”, but its constrained growth spurs massive emigration flows in the growing working age population. The resulting remittances and transfers - which, combined, account for over 13 percent of GDP - keep the economy going, by fuelling consumption.

On the supply-side, a few non-capital-intensive manufactures and services boost exports. Free from rent-capturing regulations, non-capital-intensive exports drive the economy. Indeed, recent growth (in 2006, real GDP grew by 5.4 percent and real GNP by 6.2 percent) was driven by exports, with a strong performance in electronics.

3a. Unhappy work-seekers leave and send remittances, fuelling consumption

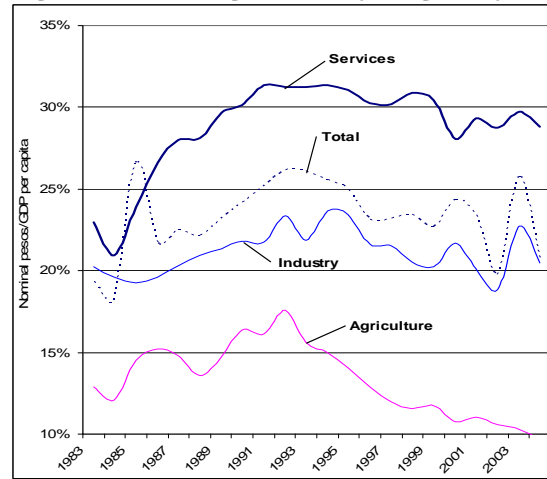
Workers cannot easily enter into the formal labor market. Heavy labor rules and protections - enforced by large enforcement agencies (which employ some 20,000 labor inspectors) - hamper job growth in the formal labor market (Figure 25 – A and Figure 28). In 2006, unemployment was higher than in neighboring countries, at almost 8 percent (Figure 17), and underemployment grew to 22.7 percent (from 17.6 percent in 2004).

Figure 17. Quarterly Unemployment Rate



Source: National Statistical Coordination Board, 2007.

Figure 18. Average monthly wages (by sector)



Source: Author's elaboration on Lanzona and National Statistical Coordination Board Annual Business Surveys, 2007.

Qualified workers are increasingly moving overseas (Table 8). Wage-setting does not reflect supply and demand. Despite the higher wages in the service sector (Figure 18), 32.3 percent of the unemployed were high-school graduates and 18.4 percent were college graduates.

Table 8. Overseas Workers by Occupation

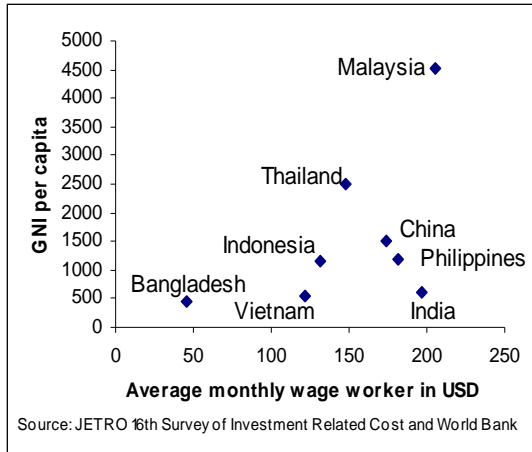
| <i>Based on work contracts only (in percent)</i> | 1993 | 2004 |
|--|-------------|-------------|
| Service workers | 34.9 | 40.2 |
| Professional and technical | 25.3 | 33.4 |
| Production | 36.4 | 22.6 |
| Clerical | 1.6 | 1.9 |
| Sales | 1.0 | 1.4 |
| Administrative and managerial | 0.1 | 0.2 |
| Agricultural | 0.7 | 0.2 |

Source: Philippine Overseas Employment Administration, 2007.

As oligopolistic rents secure “national labor peace”, the formal labor market is for well-paid insiders... Recent comparisons suggest that local wages tend to be high for the unskilled workers (Figure 19) and the skilled ones (Figure 20). By paying higher wages - relative to other Asian countries - to the salaried insiders, the politically-connected corporate conglomerates use the rents resulting from the government's preferential treatment³⁴ to stabilize the economic system, secure “national labor peace”, and perpetuate the status quo.

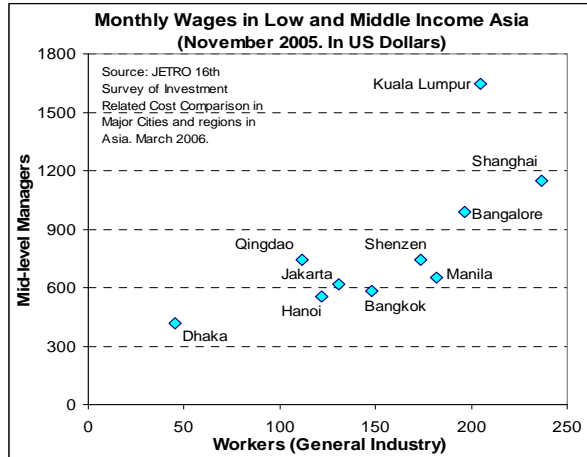
³⁴ For example, laws that prevent foreigners from owning land impede foreign banks to collateralize their loans and hence limit their lending ability. But also, as discussed, monopolistic or oligopolistic privileges: a dominant position and considerable pricing power.

Figure 19. Wages are high ...



Source: JETRO 16th Survey of Investment Related Cost and World Bank

Figure 20. ... even for skilled workers

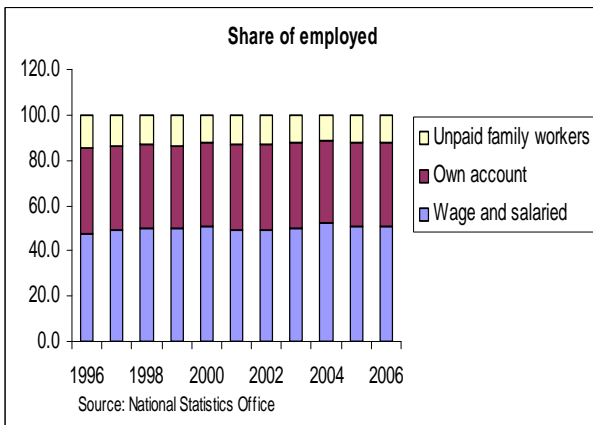


Source: JETRO, 2006 and World Bank, 2006a.

The informal sector prevails and a quarter of the domestic labor force works abroad.

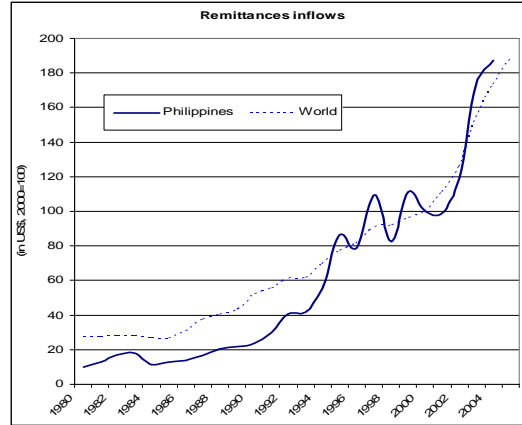
Informal activities and emigration are the major outlets for underutilized labor. The wage-and-salaried workers accounted for only about 50 percent of total employment, and the proportion of unpaid family workers, prevalent in agriculture and private households, is significant (Figure 21). In 2006, over a million work-seekers left the country for employment overseas, where some 8½ million Filipinos work, about a quarter of the domestic labor force and a tenth of the population (Figure 25 – F).³⁵

Figure 21. Fifty percent of unsalaried workers



Source: National Statistics Office

Figure 22. Rapid remittances growth



Source: World Development Indicators, 2007.

³⁵ During the first four months of 2007 the number of residents leaving the country to work abroad increased by 7.8 percent, to 343,4000 persons relative to the same period in 2006.

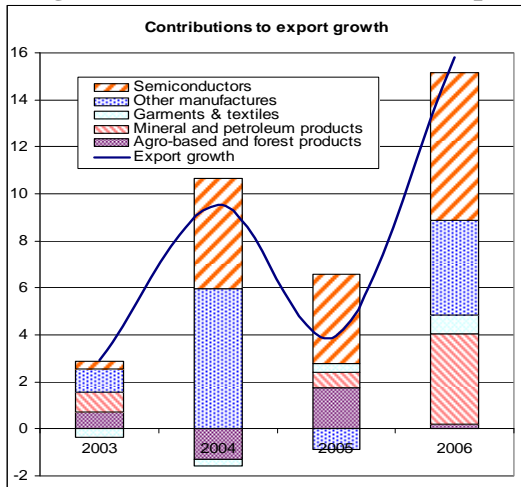
In 2006, remittances grew by 20 percent to \$12.8 billion, boosting domestic consumption. The flows of remittances and transfers from overseas workers have grown rapidly (Figure 22); at about 13 percent of GDP, they fuel - and reduce the volatility of - private consumption (Figure 25 - G), especially in the informal sector. For 2007 they are expected to reach \$14.7 billion, five percent higher than in 2006. Through these flows, large trade deficits have been transformed into current account surpluses (estimated at over 3 percent of GDP in 2006).

3b. The service sector boost exports, lifting growth

Dynamic growth has occurred in a few specific non capital-intensive sub-sectors. On the supply side, the service sector (Figure 25 - D) is on the rise, and already accounts for more than half of the GDP. Within services the major drivers of growth are consumer electronics, telecommunications, the financial sector, private services such as voice-based BPO, and tourism. In the future, knowledge process outsourcing (KPO), accounting, legal services, medical services and tourism (including medical tourism) are expected to grow considerably.

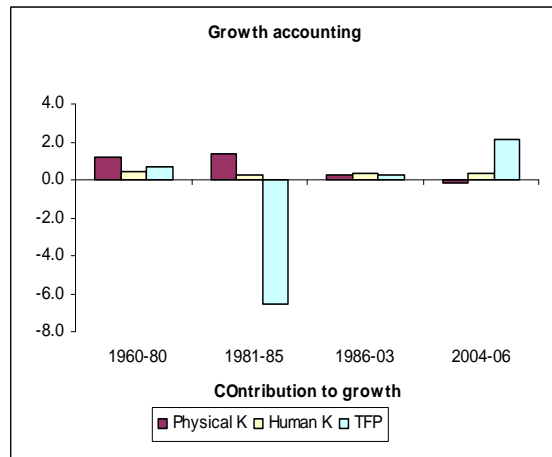
The country is riding on the high demand for electronics products and offshore IT services, by virtue of being in the world's most dynamic region. In the past few years, electronics exports drove growth, especially of semiconductors, and back office activities such as BPO or call centers (Figure 23). Despite the recent appreciation of the real effective peso exchange rate, the export performance of the electronics industry has steadily increased, representing today almost 70 percent of the export earnings; and semiconductors, mainly exported to Taiwan and China, account for 47 percent of total merchandise exports. While exports to China are growing very rapidly, back office activities are mainly exported to the US.

Figure 23. Semiconductors lead exports



Source: National Statistics Office, 2007.

Figure 24. TFP is leading the way



Source: World Bank, 2007a.

Total factor productivity (TFP) - rather than capital or labor - spurred recent growth.

Although TFP growth has been much lower than in the rest of East Asia (World Bank, 2005a), it picked up significantly during 2004-06. While two years might be too short of a time span for reaching robust conclusions, the recent spike might be capturing cyclical effects in capacity utilization and the lagged effect of past structural reforms (Figure 24).

4. What is the result? The economy is in a “*Low-Capital-Stock*” equilibrium

No economic agent with rational foresight has incentives to unilaterally raise investment. The public sector cannot jeopardize macroeconomic stability. The domestic private sector is profitable in the status quo. The international private sector is reluctant to settle in a highly-protected business environment. Competition is undermined by regulatory capture of major agencies, which increases unpredictability in regulatory policy, adding to investor uncertainty (World Bank, 2005c). When deciding to increase investment, the first-mover bears short-term costs, and faces strong disincentives.

In the medium term, the public sector does not have the resources to significantly step up investment. While public investment has been very low in recent years, today, if tax collection continues to improve, falling interest-payments-to-GDP would allow for rising public investment within a balanced budget framework. However, in the next few years the government is likely to keep its expenditures in check, continue its fiscal consolidation, and focus on reducing macroeconomic volatility.

The domestic private sector makes enough money within the status quo, and is reluctant to invest. In the domestic private sector, investment is low because of the combined effect of two factors. On the one hand, the capital-intensive sectors - dominated by well-protected monopolistic and oligopolistic insiders, and facing a low MPK - restrict production below the competitive level.³⁶ On the other hand, in the non-capital-intensive sectors businesses are very profitable - and fast-growing - with relatively little investment efforts (Figure 16).

Foreign investors “stay out” and non-*élite* businesses “stay small and informal”. What is described above results in barriers to the entry of potential investors into the economy. For foreign investors - discouraged by a net of privileges and protections (e.g., in the banking sector and in the formal labor market), by policy-driven competitiveness shortcomings (i.e., the effects of agricultural and industrial protection) and by the lack of resources for education

³⁶ Monopolists produce where marginal revenue equals marginal cost, and not where average revenue equals marginal cost.

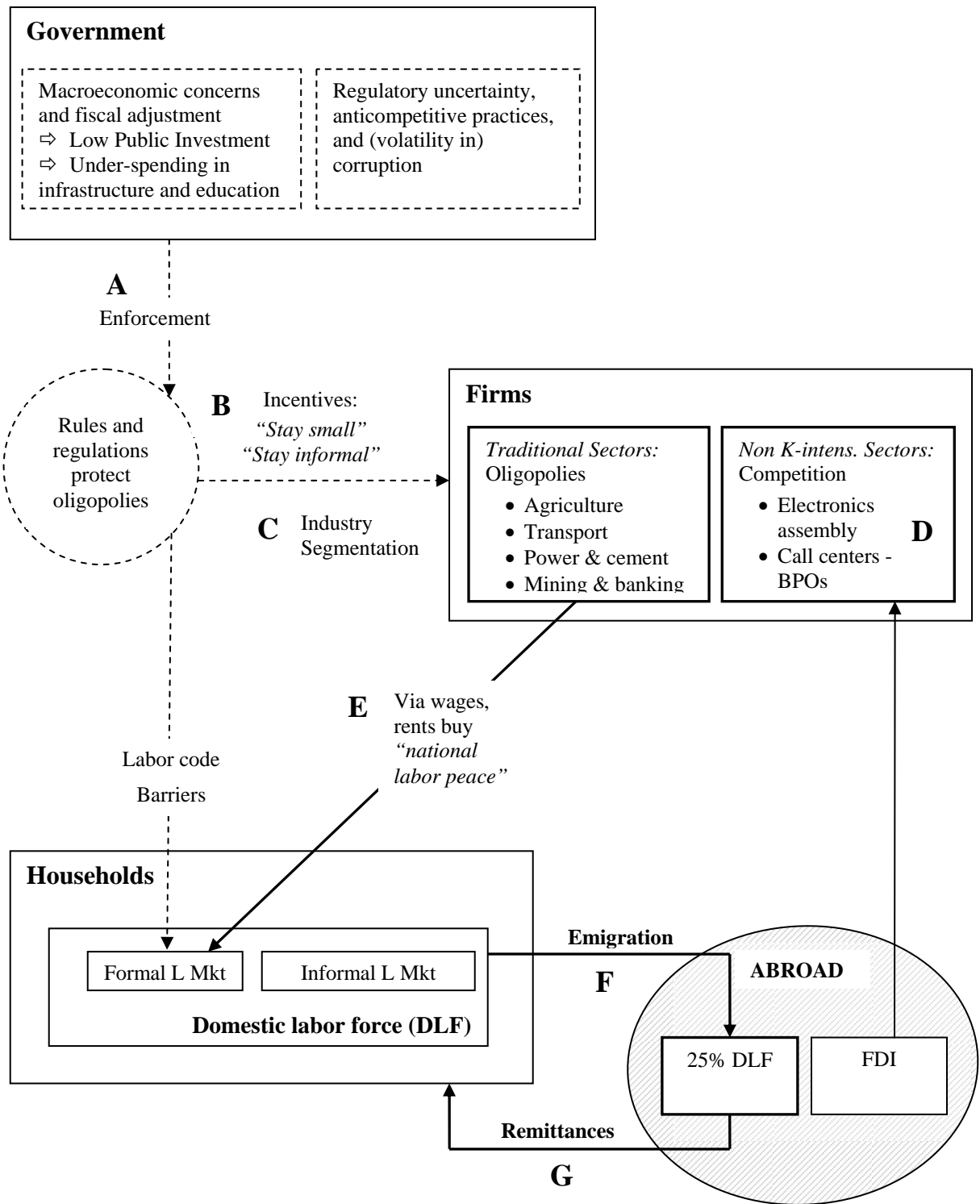
and training - the incentives are to stay out. For the small firms, not belonging to the corporate *élite*, the incentives are to stay small and *not* to become formal (Figure 25 - B).

The economic system is in equilibrium at a low-level of capital stock. The country is growing at a quick pace despite the low savings³⁷ and low investment. The status quo, far from being optimal, “works”, and will keep underlying the economic fundamentals in the short-medium term. Economic growth comes – and, will very likely keep coming - from “not-capital intensive” activities, mainly services, and from consumption, spurred by remittances. In the traditional sectors, the conglomerates enjoy the rents granted by limited economic entry, and through high wages rents keep buying “national labor peace” (Figure 25 - E). This, coupled with the heavy protections in the formal labor market (Figure 25 - A), stimulate additional emigration and further remittances (Figure 25 - G). The copious remittances reduce the workers’ incentives to abandon the informal sector. The resulting self-interested political constituencies, in equilibrium, perpetuate the status quo, where low levels of investments are rational, and the economy is in a “*low-capital-stock*” equilibrium.

The growth path is sustainable in the short-medium term. The drivers of growth are not expected to change significantly over the next few years. On the supply side, electronics assembly and back office activities will drive exports (Figure 25 - D). On the demand side, remittances - arriving mainly from the Gulf and the US - will foster consumption and spur growth via multiplier (Figure 25 - G). As a result, the growth pattern - although not creating jobs - seems sustainable in the short-medium term.

³⁷ Public savings are in short supply because of the low tax collection, household savings are minimal because of the combined effect of the low salaries in the informal sector and the incoming flow of remittances, and corporate savings suffer the low productivity of the capital and labor. Additionally, only a portion of the savings of the corporate *élite* is invested in-country, while considerable portions are invested offshore.

Figure 25. The status quo: a “low-capital-stock equilibrium”



Source: Author.

5. Why is this a concern? Growth could be faster and more inclusive

The economy needs to move from its “low-capital-stock” equilibrium to a *higher one*.

The “*low-capital-stock*” equilibrium is good for the well-protected conglomerates, but is it good for the country? Undeniably, the status quo is delivering economic growth, but it is difficult to see how - in the longer term - a sufficiently robust growth can be sustained at present levels of investment. In other words, today’s inadequate investment is curtailing a speedier and more inclusive economic growth, which is essential to deal with the country’s longer term development challenges (i.e., generate more jobs and reduce poverty). In order to achieve such growth, the Philippines need to reach a “high-capital-stock” steady state.

The country’s growth potential is untapped. Strategic growth opportunities are lost. If compared with the booming East Asian neighborhood, the Philippines has had, and - in the status quo - is projected to have, a more modest trajectory (World Bank, 2007). To reach its growth potential and sustain it in the long term, the economy needs to take better advantage of its geographical location and - by offering appealing opportunities within the regional context - attract more domestic and foreign investment to its core sectors. But to deliver faster growth, the country needs to address its lack of competitiveness.

The Philippines can hardly compete with its neighbors. For instance, the labor market is far from competitive. Relative to the other East Asian countries, due to a higher wage structure, unit labor costs are higher for broad ranges of manufacturing, and the country is finding it difficult to compete with lower wage economies particularly at the unskilled end of manufacturing. Additionally, the growth of output-per-worker is markedly lower (World Bank, 2007).³⁸

³⁸ At 1 percent per annum average growth in output per worker in the Philippines during 1961-2003 versus 4.4 percent in neighboring economies (World Bank, 2005a).

The presence of oligopolies in the traditional sectors of the economy hampers the country's competitiveness.³⁹ Agricultural protection creates rents, raises food prices and – by impacting wages - undermines labor competitiveness. Port and airline oligopolies make trade costly and tourism less attractive. Most banks, given their corporate ownership, lend within their conglomerate, limiting access to outsiders or unconnected companies,⁴⁰ which face a declining availability of credit. In the electricity and cement sectors, oligopolistic rents undermine cost competitiveness across a broad range of fixed investments, especially in infrastructure. As a result, international foreign asset holdings are below regional benchmarks (Figure 26), although at a level comparable with those of economies with similar GDP per capita (Figure 27).

Figure 26. International Foreign Asset Holdings, 2004

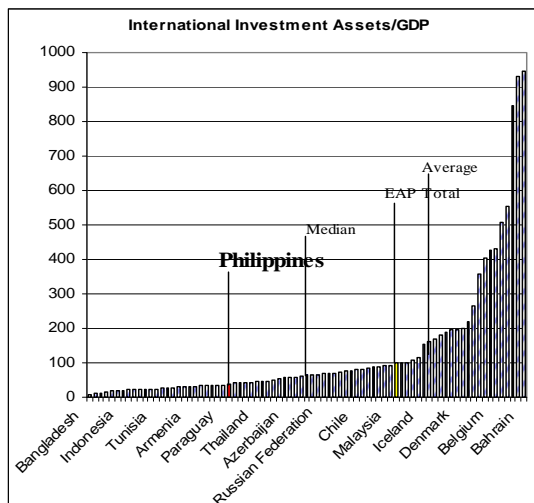
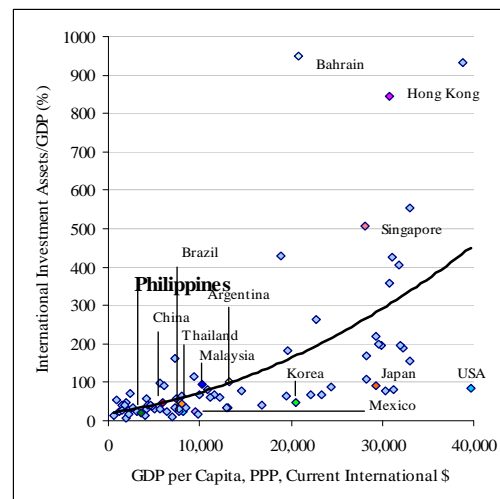


Figure 27. International Foreign Asset Holdings and GDP per Capita, 2004



Sources: IMF, Consolidated Portfolio Investment Survey, 2007. World Development Indicators, 2007.

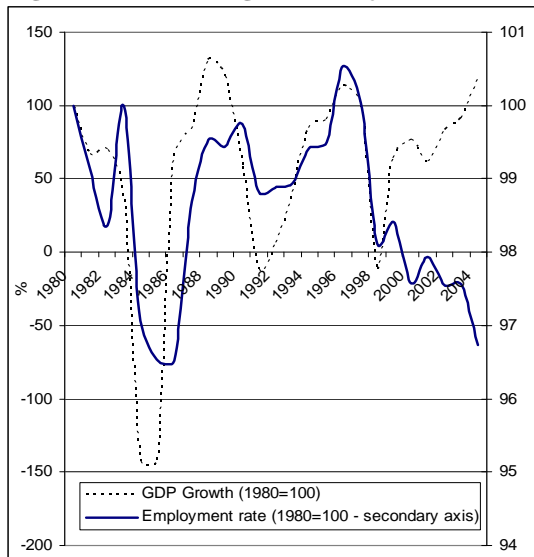
Growth is not inclusive. Over 2002-2006, higher growth did not translate into higher employment. The Philippines is characterized by jobless growth (Figure 28). Between 2004 and 2006, employment rose only by 2.5 percent on average each year. Services, primarily

³⁹ In 2006, the Philippines continued to receive low rankings international competitiveness surveys, including those of the World Competitiveness Yearbook (49th of 61), the World Bank (113th of 155), and World Economic Forum (77th of 120).

⁴⁰ In recent years, banking sector vulnerabilities were addressed but credit to the private sector has continued to decline in real terms. Asset quality is still below regional and world standards but banking sector vulnerabilities were reduced via the take out of non-performing loans and assets from commercial bank balance sheets.

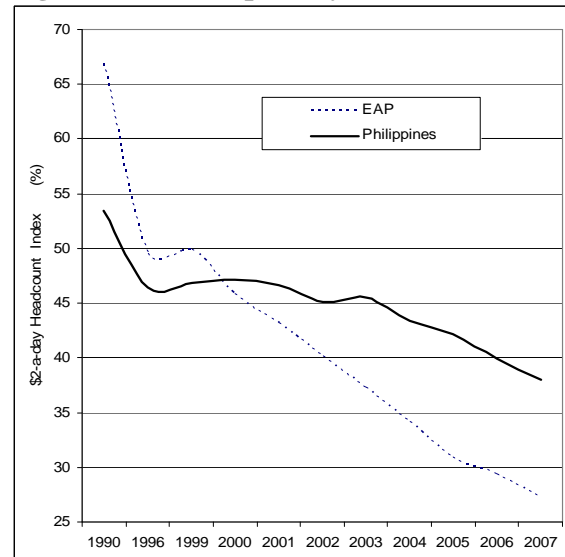
wholesale and retail trade, accounted for two thirds of the employment gain, and agriculture a quarter. In 2006, employment growth slowed to 2 percent, below the growth of the working age population.

Figure 28. Recent growth is jobless ...



Source: Author's elaboration on National Statistics Coordination Board, 2007 and Canlas, Aldaba, and Esguerra, 2006.

Figure 29. ...and poverty reduction is slower



Source: Author's elaboration on World Development Indicators, 2007.

For the past few years, poverty reduction has been slower than in the rest of East Asia (Figure 29), and rural poverty remains high. In the Philippines, 70 percent of the poor live in rural areas. However, the agricultural sector - traditionally more protected than the rest of the economy (David, Intal, Balisacan, 2007) - is not reducing poverty. In the past years, agricultural GDP grew at modest rates, productivity growth was low by regional standards⁴¹, and labor productivity and yield stagnated. The recent agrarian reform - while successful in transferring income and wealth from landlords to tenants - did not have a significant pro-poor impact (Balisacan and Fuwa, 2007), as the benefits bypassed landless agricultural laborers (Hayami, Quisumbing, and Adriano, 1990).⁴²

The sustainability of the growth model is exposed to longer term risks. In the long run, of the two engines of growth (export-led services and remittances-fuelled consumption), the

⁴¹ Between 1980 and 1998, total agricultural factor productivity has grown at 9 percent, compared to 27 percent in Thailand and 49 percent in Indonesia (World Bank, 2007b).

⁴² Indeed, to succeed, land reform needs to combine access to land, credit, and technology.

first might “cannibalize” the second. As the service sector grows and creates employment opportunities, the present labor outflows might get absorbed by the domestic economy. Also, when first-generation emigrants diminish in volume, remittances inevitably decline: in those countries where emigrants are allowed to settle - when the first generation comes to the end of its working life, and the ties between the following generations and the country of origin weaken - the second and third generation emigrants tend to remit a lower proportion of their income (Kleinschmidt, 2006).

6. What can be done? Diversify the economy and gradually push reforms

A three-pronged strategy for incremental reforms ... To sustain development in the long-term, the economy needs a competitive diversification: from the distortions induced by the oligopolistic conglomerates to a market-driven expansion of non-traditional products. To bypass the foreseeable resistance of the well-established rent-seekers, the government should follow a phased strategy:

- a. First, promote the production and export of non-traditional manufacturing and services, by getting the economic zones to perform better (Box 1), and pursuing a competitive real exchange rate;
- b. Second, increase revenues, to finance the needed boost in infrastructure and education spending; and
- c. Third, implement gradual reforms to tackle the rent-seeking conglomerate economy, to lower the cost of strategic inputs.

... to steadily build a pro-reform constituency. Given the strength of rent-seeking interests, the reform of oligopolistic practices in the traditional sectors of the economy can occur only gradually (Auty 2007, Auty and Pontara, 2008). Over time, as a result of the three-pronged approach, the expanding competitive sectors should shrink the relative importance of patronage networks, and build - in association with the businesses that are currently bearing the costs of rent-seeking - a pro-reform political constituency.

6a. Pursue better-performing economic zones and a competitive exchange rate

For speedier growth, policies should promote the manufacturing - and export - of new and more sophisticated products. Cross country comparisons show that growth accelerations are associated with the production and export of non-traditional manufacturing and services, in other words the products “in demand” in the industrialized nations

(Hausmann, Pritchett, and Rodrik, 2005; Jones and Olken, 2005; Rodrik, 2006). Hence, development policies should strategically promote a structural transformation toward these “more sophisticated” economic activities, by providing production incentives to new exportables (Rodrik, 2006).

A key starting point is improving the performance of the economic zones ... In the Philippines, the track record of the economic zones is mixed (Box 1): while they attract FDI and generate the majority of exports of non-traditional manufacturing (semiconductors - Figure 23) and voice-based services (BPO or call centers - Figure 15), they have been far less successful than in other countries in finding their niche, attracting investment and fostering economic development.

Box 1. Getting the “ecozones” right

Economic zones: not always good news. Over the last three decades, several developing countries – when a rapid nation-wide reform of their governance was neither possible nor credible - created “economic zones” to promote trade, spur exports and stimulate economic development. These industrial enclaves created new employment and increased export flows. Thirty years ago, 80 economic zones in 30 countries generated about 1 million direct jobs and US\$6 billion in exports; today, 3,000 economic zones operate in 120 countries, employ 50 million people and account for more than US\$ 600 billion in exports. However, in quite a few cases, these zones had adverse effects: higher-than-expected construction and maintenance costs, unstable employment (offered mainly to unskilled and low-wage female labor), weak links to local manufacturers, insufficient transfers of know-how (i.e., labor or managerial skills) and technology, and – thus - little domestic added value.

In the Philippines, the ecozones need to improve their performance. The Philippines was one of the first Asian countries in developing economic zones (“ecozones”). Today, the government-owned investment promotion agency (Philippine Economic Zone Authority – PEZA) supervises 41 private-owned and 4 government-owned ecozones. At first, these enclaves - conceived as a substitute for a good investment climate and designed to operate separately from the surrounding communities - offered “imported institutions” to new exporters (i.e., producers of non-traditional manufacturing, voice-based ICT services). However, their inadequate legal and regulatory framework resulted in a lack of fully competitive conditions, and large investors - not expecting sufficient returns to compensate their risks - have been reluctant to settle in. Additionally, the ecozones often offer distortionary incentives, which add to the government’s fiscal burden (i.e., a considerable amount of existing revenue is lost through tax avoidance).

What makes an economic zone successful? Only well-designed and effectively run economic zones can lead to additional infrastructure, FDI, employment, foreign exchange earnings, transfers of new technologies and skills, and - as a result - national revenues and economic growth. To be successful, a zone must lie in a geographically defined area, where domestic and foreign agents can find: (i) first-rate infrastructure and human capital; (ii) investment incentives and simplified procedures; (iii) domestic and international linkages; (iv) enabling institutions, such as - for instance - an equal treatment of domestic and foreign firms, and transparent dispute reconciliation mechanisms; and (v) coordination with a comprehensive country-wide reform, in the context of an overall growth strategy. Examples are the Export Processing Zones in Singapore and Malaysia in the 1970s, and the Special Economic Zones in China, in the 1980s and 1990s.

Source: Devereux and Chen, 1985; Rondinelli, 1987; Blomström and Kokko, 2003.

... while pursuing a stable and competitive real effective exchange rate⁴³. Despite the current incentives of the Central Bank (favorable to an appreciating exchange rate because of the large dollar-denominated external debt and its effects on income statements), a volatile and appreciated currency is not conducive to the expansion of new exportables, and negatively affects the production of tradables (Williamson, 2003; Prasad, Rajan, and Subramanian, 2007). Hence, to foster the diversification of the industrial base, to induce investment and entrepreneurship in tradables, and to promote the production and export of non-traditional manufacturing and services, it is necessary to pursue a stable and competitive real effective exchange rate (Dooley, Folkerts-Landau, and Garber 2003; Rodrik, 2006 and 2007a).⁴⁴

Box 2. Getting the exchange rate right

A competitive exchange rate helps achieving rapid and sustained growth. In the past decades, fast-growing developing countries have simultaneously exhibited not-overvalued real exchange rates, high domestic savings, and current account surpluses. China is the present-day example, but in recent years this was the case also in high-performing Asian economies such as Korea, Malaysia, and Thailand, as well as in Chile. The opposite (an appreciated real exchange rate, low domestic saving, current account deficits - and low growth) is also recognized in the international experience (e.g., Mexico in 1993, Russia and Brazil in 1998, and Argentina and Turkey in 2000).

The boost in aggregate demand accelerates investment and employment. Assuming no supply constraints (i.e., local growth is not constrained by a lack of supply capacity, but by a shortage of demand), a competitive exchange rate increases demand for exports and import substitutes, and motivates entrepreneurs to produce non-traditional export commodities, expanding investment, employment, and economic growth. Conversely, when capital inflows appreciate the real exchange rate, growth gets hurt by reduced investment incentives.

Source: Balassa 1984; Williamson, 2003; Prasad, Rajan, and Subramanian, 2007; Rodrik, 2006 and 2007a.

How to do it? To help identifying “*what the country is good at producing*” (Hausmann and Rodrik, 2003) and, consequently, foster investments and determine the pattern of specialization, PEZA should make convincing commitments to improving the performance of the economic zones. In particular, it should: (i) provide non-fiscal incentives to the construction *in loco* of first-rate infrastructure - e.g., via public-private-partnerships (PPP – see page 40); (ii) guarantee simplified business procedures; (iii) enhance in situ competition,

⁴³ See footnote 3 page 7.

⁴⁴ China and India have made a “stable and competitive real exchange rate” an explicit policy objective (Rodrik, 2006).

by ensuring - for example - that local institutions treat domestic and foreign firms equally and transparently (e.g., in dispute reconciliation); and (iv) coordinate this “ecozone strengthening process” within an overall growth strategy.⁴⁵ As a result, better-performing economic zones will create new wealth and bring about efficiency gains - without forcing an immediate redistribution of oligopolistic profits. Then, the investment in non-traditional activities will increase, and provide demonstration effects for prospective entrants. Over time, the enhanced dynamism of the export-oriented sector will diffuse beyond the original location, acting as a catalyst for reform of the economy as a whole (Rodrik, 2006). Finally, to support both the stability and the competitiveness of the real exchange-rate, the government should stimulate higher saving rates (Williamson, 2003, Rodrik, 2007a). This can be achieved by (i) tightening its fiscal policy (see page 40); and (ii) sterilizing capital inflows and remittances. Additional measures could entail compulsory saving schemes, real wage discipline (i.e., wages reflects supply and demand, to reduce the wage premia of formal sector jobs), and capital-account management (taxation of capital account inflows).

6b. Increase revenues, to finance spending in infrastructure and education

Additional revenues and more public-private risk sharing in infrastructure and education. Over the years, the lack of infrastructure and education is becoming an evident bottleneck to growth, as it hurts small and medium enterprises (SMEs), and discourages entry and investment of domestic start-ups and foreign investors. As the extra spending in infrastructure and skills upgrades needs public resources, more revenues are needed - via a stronger tax administration and additional tax policy reform - to maintain a sound fiscal policy; at the same time, public spending efficiency needs to improve. As private investment is constrained by a number of institutional factors that are difficult to address in the short run, to alleviate bottlenecks the government should both: (i) reduce the risk for; and (ii) increase the return on private investment, starting from the ecozones.

⁴⁵ Indeed, by generating not-appropriable learning, better-performing zones should also create knowledge spillovers, technological transfer and catch-up, train workers and managers, provide inputs (and demand) for new activities, and - last but not least - absorb surplus labor, hence reducing poverty (Rodrik, 2006).

How to do it? To finance additional public spending, the government should increase its revenues as a share of GDP by strengthening tax administration and adjusting excise taxes, continue lowering the debt-to-GDP ratio and interest payments, and restrain non-priority current expenditures. To increase tax collection, the taxpayer register should include the corporate conglomerates and tax arrears should be audited. Indexation would ensure that excise revenues do not decline in real terms: excises on fuel, alcohol, and tobacco are low by international standards and have not kept up with inflation since the tax reform of 1997 (IMF, 2006b). Finally, starting from the economic zones, it is necessary to stimulate risk-sharing among investors - for example, via PPP in infrastructure, by co-financing public works (transport and communications) and in education, by addressing under-provision of training in areas where skills are lacking.

6c. Gradually reduce *élite*-capture, to lower the cost of strategic inputs

In the traditional sectors, the rent-seekers are powerful and well established. In the Philippines, the status quo has historical roots: the colonial distribution of factor endowments determined the power and incentives of self-interested political constituencies, which, in equilibrium, profit from oligopolistic privileges and perpetuate them. Well-established in sectors that are strategic because of multiple backward and forward linkages, the conglomerates - by producing expensive inputs - skim rents from the economy and shrink the margins of the potentially most dynamic agents: the small and medium domestic private producers. They also control bank credit and dominate state procurement contracts through political connections.

Less *élite*-capture in agriculture, maritime and air transport, electricity, and cement. To attract investment in the capital-intensive sectors, the corporate conglomerates should be restrained in their use of political connections, and their rents should be trimmed down by reduced economic protection. For example, promoting competition in the agriculture sector would lower prices, improve competitiveness in the food processing and livestock industries,

increase disposable incomes for the poor and enhance labor market competitiveness.⁴⁶ There are also significant opportunities to stimulate the accumulation of domestic capital in the maritime and air transport industries, with the resolution of conflicts of interests and a comprehensive deregulation. Promoting competition in electricity generation and transmission would enhance operational efficiency, achieve financial viability, and augment long-term power supply capacity. To strengthen the investment climate and support market competition in the cement sector, it is necessary to reduce the cost of doing business through simplification of approval procedures. Also, in all mentioned sectors regulatory capacity and oversight needs to be enhanced.

How to do it? To accelerate economic growth, increase employment generation, and generate public resources for social programs, rent seeking by the *élites* that exercise political and economic power - or “*élite capture*” - must be addressed. First steps are improving the investment climate and competitiveness, and disseminating information on the distributional effects of government policies. But the key measure to attract raising investment and create more local jobs is opening and reforming the sectors dominated by rent-seeking corporate conglomerates.

As shown by the de-monopolization of telecommunications, it is possible The untapped potential for growth is illustrated by the deregulation of the telecom industry (Box 3).⁴⁷ Until the 1990s, the politically-connected Philippine Long Distance Telephone Company (PLDT) operated as a monopoly, and - in spite of the rising demand for phone lines - spent more resources in protecting its rents than in expanding its network. When the deregulation was announced, PLDT tried to block prospective entrants to safeguard its dominant market share, but was unsuccessful. By granting entry to domestic and foreign players, the reform spurred investment, created employment, and - over a decade - transformed first the industry and then the economy.

⁴⁶ Food, and rice in particular, comprises a large share of the consumption basket of low income workers. Allowing rice prices to adjust towards the border price would benefit the majority of the population and the majority of the poor.

⁴⁷ Another example has been, between 1995 and 2005, the liberalization of foreign-carriers-entry into the airline sector (paragraph 0 and footnote 28 and 29, page21).

Box 3. The telecommunications boom

In the 1990s, telecoms were opened to competition. In 1990, despite the estimated 800,000 applicants, the sole dominant provider (PLDT) took years to install a line, and tele-density was at 1 per 100 persons. The deregulation shook the industry, from the dominance of a single operator to increased market competition, dynamism and vastly improved access to telecommunication services. By 2006, there were 6.5 million fixed lines installed, tele-density had climbed to 7.7 and the waiting time for phone service was measured in days. Mobile penetration grew exponentially, from 3 million mobile phones in 1999 to over 35 million in 2006. New investors came steadily into the market, which now counts on 73 local exchange carriers, 11 international gateway facilities (IGFs), 7 mobile telephones, 14 inter-carriers, and 388 value-added service (VAS) providers.

Today one of the most dynamic industries, telecommunication employs more than 20,000 people. The Philippines is now an important location for new growth industries such as BPO, medical transcription and call centers, and other IT-enabled retail services, such as mobile-phone-based business solutions (e.g., through mobile phones, remittances charges are 1 percent of the average remittance value, while banks charge up to six times more). By 2006, the sector accounted for 5 percent of GDP, corporate profits had increased to \$3.3 billion, and an estimated 235,000 jobs are found in industries that have benefited from the telecoms reforms.

Source: Mirandilla 2006, World Bank, 2007, Bernardo and Tang, 2007.

... but leadership matters. To break monopolies and increase competition in protected sectors, a clear vision, political will, and a coherent implementation strategy are needed (Bernardo and Tang, 2007).⁴⁸ In agriculture, import protection for rice should be gradually reduced, and public investments should be geared towards reducing farmers' marketing and transaction costs. The NFA should devolve its rice trade functions to the private sector and focus on market regulation. In the transport sector, to promote full competition in foreign containerized cargo operations, ports and airlines licensing should be increased. The PPA's port development and operating functions should be separated from its regulatory function. The aviation sector should be liberalized further, as competition would reduce airfares and increase the number of tourists. Greater access to bank lending for unconnected companies (foreign corporations, domestic medium and small firms) should be promoted. The government should open the domestic market to cement imports, to contain price increases, and simplify the numerous regulatory, land, quarrying and environmental clearances required in setting up a cement plant, to encourage new domestic and foreign entrants. Finally, a reform of the labor market is overdue, by removing protections, streamlining enforcement agencies, and lowering wage pressures.

⁴⁸ According to Bernardo and Tang (2007), the electoral rules should attract qualified candidates and select contenders that think long-term.

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