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## The Role of the Private Sector in Regional Economic Integration: a View from the Philippines

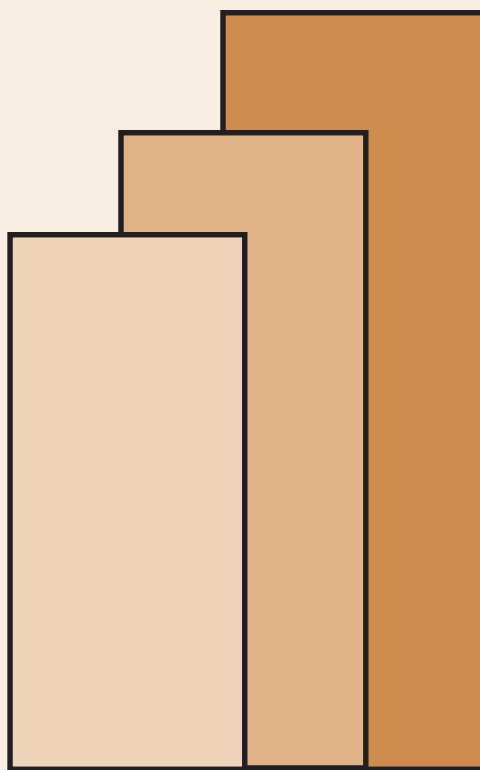
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# **The Role of the Private Sector in Regional Economic Integration: A View from the Philippines**

*Maureen Ane D. Rosellon and Josef T. Yap\**

## **Abstract**

The private sector is the driver of growth in most ASEAN economies. It is therefore expected to play a significant role in the process of economic integration in ASEAN. In the Philippines, the private sector has dominated the economy, contributing about 95 percent of GDP, but it has not lived up to its potential. Unlike other economies in East Asia, the Philippines did not experience the anticipated private sector participation and economic transformation that accompany the openness model of development. The ASEAN Economic Community is an extension of this paradigm. Philippine-based firms are found to have low utilization of arrangements in the ASEAN free trade agreement and private sector investment as a percentage of GDP is observed to be relatively low and to have consistently declined since 2000. This paper seeks to explain the reasons for the Philippines' relatively weak private sector response to the opportunities provided by greater openness and deepening regional economic integration. The paper cites some factors which include structural supply-side constraints and institutional weaknesses. Some of these factors are extraneous to the private sector but some emanate from the behavior of the private sector. These factors are expected to mitigate the impact of policies related to establishment of the AEC. However, there are pockets of success as a result of move towards the AEC such as the launch of the National Single Window.

## **I. Overview of the Philippine Situation**

Sustainable economic development continues to be elusive for the Philippines. A wide spectrum of economic policies has been implemented during the past five decades. Yet the boom-bust cycle has remained a constant feature of the economy along with relatively high poverty incidence. The overview underscores one of the dilemmas that currently face policymakers in the Philippines: a dominant private sector in the Philippines but one that has not lived up to its potential.

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Compared with other economies in East Asia, the Philippines' economic growth record has been disappointing. While the region's middle and high income economies experienced at least two per cent average growth of real per capital Gross Domestic Product (GDP) during the past 50 years, the Philippines recorded only a 1.9 per cent average (Table 1). As a result, the Philippines was not even described as a "high-performing economy" by the World Bank in its 1993 study of the East Asian Miracle while Thailand, Malaysia and Indonesia were included in this select group.

<b>Table 1: Annual Average Growth Rate of Real Per Capita GDP, 1950-2006 (in %)</b>								
Period	Hongkong, China	Indonesia	Korea	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	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
Average growth rate for 56 years	5.9	3.6	5.6	3.8	1.9	5.5	7.3	4.6
Source: Asian Development Bank (2007)								

Mainstream economists attribute this situation largely to economic protectionism and the import-substitution policy that were followed after World War II up to the 1970s. Protection of selected sectors led to the misallocation of the country's resources, i.e. sectors in which the Philippines did not have a comparative advantage benefited from this policy stance. Moreover, the lack of competition removed the incentive of protected firms to become innovative and adopt modern technology. This resulted in monopolistic firms producing poor quality goods and services at relatively high cost, the burden of which was passed on to the Filipino consumer.

In response to this analysis, the Philippines—like many other developing countries—adopted the "openness model". This reform package began modestly in the early 1970s and was interrupted by the debt crisis in 1983-85. The reform program, however, was accelerated in the late 1980s and has been the government mantra since. The general thrust of the reforms was closer global economic integration underpinned by liberalization, deregulation and privatization. At the same time—similar again to other developing countries—the Philippines adopted measures to strengthen the supply capacity of its economy with a view to building competitive industries

which would be the main beneficiaries of increased access to world markets. More attention was given to macroeconomic stability and exchange rate movements; appropriate sequencing of liberalization of the trade, financial and capital-account regimes, supported by prudential regulation and financial sector reform; strengthening domestic institutional capacity; and attracting foreign direct investment (UNCTAD 2004).

The ASEAN Economic Community is a direct offshoot of the “openness model”. The AEC is a realization of economic integration which aims to establish ASEAN as a single market and production base by 2015, and make it a region of high competitiveness, equitable economic development, fully integrated into the global economy (ASEAN 2008). These elements are incorporated in a Blueprint—signed at the 13th ASEAN Summit in 2007—that ensures consistency and coherence of actions, and implementation and proper coordination among stakeholders.

Unfortunately, the “openness model” did not generate the desired results and the Philippines has continued to lag behind its neighbors. As seen from Table 1, per capita GDP growth in 2001-2006 was still below the peak reached in 1951-1960 and was also lower than that of other East Asian economies. Moreover, the “openness model” did not generate the structural transformation that it was supposed to. Data in Table 2 shows that the GDP share of valued added from the manufacturing sector declined between 1980 and 2008. This stands in contrast to the experience of Thailand, Malaysia and Indonesia.

The Philippines is therefore in a relatively unique position wherein a whole range of policies were implemented without much success. A critical factor is the nature of the private sector in the Philippines which is characterized as an oligarchy (De Dios and Hutchcroft 2003). Hence, even if wide-ranging reforms have been implemented, the response from the private sector has been mixed. This is reflected primarily in an investment-GDP ratio that is lower than that of other countries in the region and has fallen consistently from 2000 to the 2009 (Table 3). More recent analysis points to the role of the oligarchy in compromising institutions (De Dios 2008;

Philippine Human Development Network 2009). Weak institutions have also constrained economic growth (De Dios 2008).

**Table 2: Share of Manufacturing in GDP (%)**

	1980	1985	1990	1995	2000	2006	2007	2008
China	43.9	37.0	35.5	40.6	40.7	43.1	43.0	42.8
Indonesia	13.5	18.1	23.0	26.6	27.7	27.5	27.0	27.3
Malaysia	21.6	19.3	22.8	24.7	29.9	29.0	27.4	25.8
Philippines	25.7	25.2	24.8	23.0	22.2	22.9	22.0	22.6
Thailand	21.5	21.9	24.9	28.7	33.6	35.1	35.6	37.6
Viet Nam	16.1	16.4	12.3	15.0	18.6	21.2	21.3	21.1

Source: UN Statistics Division. [<http://unstats.un.org/unsd/snaama/dnltransfer.asp?fID=16> ; accessed, 23 Nov 2009]

<b>Table 3: Gross Domestic Investment (% of GDP)</b>					
	Indonesia	Korea	Malaysia	Philippines	Thailand
1994	31.1	37.0	41.2	24.1	40.3
1995	31.9	37.7	43.6	22.5	42.1
1996	30.7	38.9	41.5	24.0	41.8
1997	31.8	36.0	43.0	24.8	33.7
1998	16.8	25.0	26.7	20.3	20.4
1999	11.4	29.1	22.4	18.8	20.5
2000	22.2	31.0	26.9	21.2	22.8
2001	22.0	29.3	24.4	19.0	24.1
2002	21.4	29.1	24.8	17.7	23.8
2003	25.6	30.0	22.8	16.8	24.9
2004	24.1	30.4	23.0	16.7	26.8
2005	25.1	29.7	20.0	14.6	31.4
2006	25.4	29.9	20.5	14.5	28.3
2007	24.9	29.4	21.7	15.4	26.4
2008	27.8	31.2	19.1	15.2	28.9
2009	31.0	25.9	14.0	14.0	21.9
Source: ADB, Asian Development Outlook					

This paper seeks to explain the reasons for the relatively weak private sector response to the opportunities provided by greater openness. Some factors are structural, pertaining largely to supply-side constraints like poor infrastructure. Some of these factors, as mentioned earlier, are

historical; and some are related to information availability and to technical capacity. A critical issue is whether the AEC will be able to help address some of the problems that have constrained private-sector response to the opportunities provided by greater openness.

### **Private Sector Involvement in the ASEAN Economic Community**

The private sector is the driver of economic growth in most ASEAN member countries. The ASEAN business community, primarily through its investments, promotes economic growth thereby supplying revenue to the economy, creating jobs, and bringing in technology and innovation. Government's main role is to provide a conducive business environment to encourage investment.

The same roles are played out in the process of global and regional economic integration. The member states implement measures to provide a good investment climate, which includes elimination of behind-the-border, at-the-border, and across-the-border constraints to business; and to ensure a more liberalized regional market. The progress of the integration process initially comes from the cooperation between governments and to a lesser extent the private sector. Later on, the business community provides recommendations and direction for policy making. Collaboration with the government also involves helping develop infrastructure, where private sector support is much needed. This would indicate an increasingly significant role for the private sector in the process of economic integration. For ASEAN economic integration to progress, public and private sector consultations should continue and the operation of businesses should incorporate the private sector's commitment to support economic integration in the ASEAN region.

### *Commitments Under the AEC*

One of the areas of cooperation is enhancing private sector involvement for the building of the AEC. In the AEC Blueprint, participation of the private sector is identified in certain elements of the AEC:

- Under Free flow of goods: Harmonization of standards, technical regulations and conformity assessment procedures will be implemented through the ASEAN Policy Guideline on Standards and Conformance, where the ASEAN calls for active participation (in terms of feedback) from the private sector.
- Under Free flow of investment: The ASEAN Comprehensive Investment Agreement is a buildup of the Framework Agreement on the ASEAN Investment Area (AIA), which implemented investment cooperation; and the ASEAN Investment Guarantee Agreement (IGA) which implemented investment promotion and protection. In one of its pillars—facilitation and cooperation—one of the actions is consultation with ASEAN private sectors to facilitate investment.
- Under the Priority integration sectors: The priority sectors are expected to be the catalyst for ASEAN economic integration and where resources will be initially focused. The task involves identification of sector-specific projects or initiatives, which would result from regular dialogue or consultation with stakeholders, the private sector in particular.
- Under Food, agriculture and forestry: To enhance intra- and extra-ASEAN trade and long term competitiveness in these products, ASEAN encourages cooperation, joint approaches, collaborative research and technology transfer among ASEAN member countries, organizations and the private sector. Specifically, the recommendation is to use strategic alliances and joint approaches with the private sector to promote food safety, investment and joint-ventures, as well as promote agricultural products and market access.
- Under Infrastructure development: The private sector is one resource to tap in energy and in mining cooperation. One plan of action is to increasingly involve the private sector in the ASEAN Power Grid (APG) and the Trans-ASEAN Gas Pipeline (TAGP) projects which aim at optimizing and securing the region's energy source. The private sector will find investment opportunities in these projects in terms of financing and technology

transfer. Likewise in mining, the private sector is encouraged to participate in mineral development. As greater investment is needed in developing regional infrastructure, ASEAN encourages the private sector, as well as international organizations, to increase involvement in financing regional infrastructure projects such as the APG, TAGP and ASEAN Highway Network.

- On Implementation: Successful implementation of the programs and measures in the integration process include partnership arrangements with the private sector, i.e. business community and industry associations, at both national and regional levels, and effectively, the participation of all stakeholders.

#### *Organized Private Sector Support in ASEAN*

Economic leaders have acknowledged the important role of the business sector in formulating policies and actions in the process of integration. They get the views and recommendations of the private sector through the business advisory councils. The ASEAN business community is a part of two business advisory councils: the APEC Business Advisory Council (ABAC) and the ASEAN Business Advisory Council (ASEAN-BAC).

ABAC is the private sector arm of the APEC, wherein ASEAN is a member. It is composed of top business and industry leaders convened by the APEC leaders. ABAC advises APEC leaders, through its reports and dialogue with both government and private sector, on ways to improve the business and investment environment and to make sure that the whole region reaps the benefits of globalization.

ABAC reports contain sentiments and proposals of the business community with respect to measures to liberalize trade and eliminate investment barriers. From discussions with the business community, ABAC has put together in its reports, recommendations to APEC leaders in different areas such as: investment promotion; facilitation of the movement of goods, labor and investment; deepening and strengthening capital markets; facilitation of trade agreements



through harmonization of standards; security in energy; protection of intellectual property rights; development of Information Communication Technology; fight for corruption; post-crisis recovery measures; impact of climate change; promotion of corporate social responsibility (ABAC 2007; 2008; 2009).

Evident is ABAC's support for liberalization in international markets as it has been constantly supporting WTO negotiations. But with the business community's frustration with the stalled Doha Development Agenda negotiations, ABAC initiated the examination of the possibility of an FTAAP as a regional alternative.

ABAC has also acknowledged the significant contribution of the small and medium enterprises (SMEs), especially in job creation. For that reason, ABAC has been continuously in full support and advocacy for enhancing SME and micro-enterprise development in the APEC.

Furthermore, in this year's APEC annual meeting, ABAC recommended a new vision for economic integration in APEC (ABAC 2010b). That is, the flow of goods, services, investment, technology and people will be liberalized consistently with the evolving nature of regional supply chains and value chains in the Asia Pacific region. In this new vision, ABAC highlighted that the business community be closely involved and the links between ABAC and APEC Senior Officials be more defined and integrated. The business community's expertise can help policy makers in devising prudent initiatives and feasible solutions. A step toward this is the recent launching of a web-based gateway to information on tariff and rules of origin, after a consultation with the business community found a lack of customs transparency in APEC (ABAC 2010a). With such readily available information, businesses can then take full advantage of special arrangements in the various free trade agreements.

In 2003, ASEAN Heads of State and Government (HOSGs) established an assembly of top business and industry leaders – the ASEAN-BAC, whose primary mission is to promote public-private partnership in the process of integration and in the steps toward an ASEAN Economic Community (AEC). Main objectives of the ASEAN-BAC are (i) to provide private sector

feedback and guidance to boost ASEAN's efforts towards economic integration and (ii) to identify priority areas for consideration by the ASEAN leaders. Accordingly, its activities are to: (i) review/identify issues to facilitate and promote economic cooperation and integration; (ii) submit annual recommendations for the consideration of the ASEAN HOSGs; and (iii) organize the annual ASEAN Business and Investment Summit (ASEAN-BIS) to coincide with the annual ASEAN Summits.

ASEAN-BIS is held annually to gather the government and the private sector organization and industry representatives in an interactive venue to come up with initiatives and action plans to boost productivity and competitiveness and enhance cooperation and integration in the region. This shows that the business community is a significant partner of the ASEAN in meeting its objectives. The ASEAN-BIS has been host to dialogues and discussions on the ASEAN business climate, growth areas and integration efforts; opportunities in ASEAN regional partnerships; industry-specific integration in ASEAN; developing ASEAN's global competitive advantage; and enhancing cooperation with the international community. In 2009, the ASEAN-BIS focused on the first year implementation of the AEC Blueprint, as well as tackled concerns and responses of the private sector with regard to the global financial and economic crisis. In the ASEAN-BIS dialogues, emphasis is likewise given to encouraging the international business community to appreciate ASEAN business and investment opportunities, and to develop joint-ventures and bring investments into the region.

One major achievement of the ASEAN-BAC is its contribution to the realization of an AEC Blueprint, which has benefited from the recommendations of the Task Force on Economic Integration, one of the various committees set up by the business council in fulfilling its mandate.

The cooperation between officials and business advisory councils (ABAC and ASEAN-BAC) has produced initiatives and actions toward deeper regional integration. Therefore, continuous close interaction between governments and the business community is important in strengthening regional economic integration. In essence, the private sector and the government are involved in

a symbiotic relationship. The business community (represented by business advisory councils, sectoral and working groups) provides guidance and direction to the government (represented by the country leaders, ministers, senior officials, committee on trade and investment and others); and conversely, the government acts on the recommendations and implements them for a better environment and more liberalized market for business. With improved conditions for business, the private sector can be expected to invest, compete, and innovate; and thereby contribute to efficiency and, subsequently, growth in the community.

### **The European Union experience<sup>1</sup>**

The European Union (EU) is one example of economic integration that demonstrates a Single Market that has established a borderless community with goods, services, people and capital being able to move freely and has brought marked increases in intra-trade in goods and services. The EU progressed from a common market to a single market to a monetary union. EU has 27 member states, 16 of them using the euro as currency.

EU's move toward a single market was warmly welcomed and strongly supported by the business community. This is considered as one factor that induced both economic and political integration in the EU. Jorgensen (1999) explained some rationale following this support from the European business community:

*“Firstly, it was in the interest of the businessmen of the member states to move toward a common market first, a single market later and finally to an economic and monetary union. Secondly, it is part of the entrepreneur’s ideals (let’s say of the Schumpeterian entrepreneur) to avoid economic sclerosis and always move forward, towards new and more advanced equilibria, not only in the economic and technological field, but also in the institutional field.”*

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<sup>1</sup>Largely based on Jorgensen (1999).

Critics suspected that the EU's move toward a single market would build a Fortress Europe. In principle, this was possible. The European business community can appeal for protection from competition, and trade unions may opt to guard insiders at the expense of outsiders. Such state of affairs could have encouraged strategic capitalism and national champions in the EU.

On the contrary, the European business community did not seek protection from the state (union). The European market is big in itself, but eventually a closed and protected system for Europe would have resulted in missed opportunities in a bigger and dynamic global market. Moreover, a Fortress Europe would have meant lower growth and higher unemployment in the long run.

It was not without consequence to business when the integration of the European market proceeded. For instance, when the national standards and classification system that previously protected the inefficient industries were harmonized, the inefficient firms were wiped out by competition from foreign firms. But with an enlarged market of opportunities, the firms that survived and new firms that entered overshadowed the losses from the structural reforms.

The private sector bore the brunt of restructuring, but it recognized the necessity and has in fact become a part of the decision-making process. There were close consultations between the European Institutions and the business community that brought in the initiatives and innovations in the process of European integration. In the discussions, each party is given autonomy and 'no bargaining' or conditional agreements take place (e.g. approve more liberalized markets in exchange for a relaxed competition policy). The roles are quite clear: the business sector places its efforts and participation in the decision making process into focusing on how to increase market liberalization; while, the European Commission takes in ideas from the business community and uses them in formulating action plans. Several consultative committees have been set up to tackle various issues, as well as to ensure that information flows smoothly and stakeholders decide on issues with much deliberation.

In dialogues, the business or industry associations play an intermediary role between individual businesses and the government. On the one hand, business associations represent the interest of their members through which businesses can collectively influence the government. On the other hand, they can also be agents through which the government can influence business, for instance, in terms of disseminating information or building partnerships pertinent to business. With European integration, business associations and government information exchange developed at the national level and carried on up to the European level (Bennett 1997).

After 40 years of European integration, a new and growing role for the European business community has developed. The European institutions are increasingly dependent on the private sector initiatives with regard to market liberalization and safeguarding stakeholders (e.g. consumers). Businesses and trade unions are given more participation in social legislation, and NGOs are also increasingly involved in decisions related to development projects in developing/less developed countries. For its part, the European and national institutions are playing a supervisory role, making sure that the decisions are carried out while keeping the concerned sectors and entities functioning in order and in vision of integration, and not to the detriment of outsiders.

### **Private Sector in ASEAN and the Philippines**

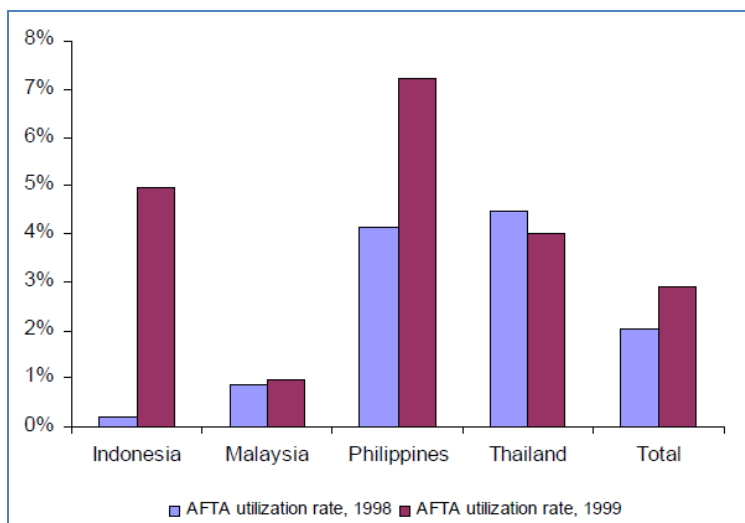
The role of the private sector in ASEAN economic integration is clear-cut. The EU experience provides a useful template. Some existing processes—ABAC and ASEAN-BAC—emulate the EU example. This section discusses the extent to which private sector has lived up to its role. Usage of FTAs gives a snapshot from the ASEAN perspective. A comprehensive study conducted by the Asian Development Bank assesses the capacity of the private sector in the Philippines. Another ADB study looks into the critical development constraints that limit private investment and entrepreneurship. The next section attempts to explain these outcomes.

### *Private sector usage of FTAs*

Free trade agreements (FTAs) appear as a fundamental step toward regional integration. Arrangements in free trade agreements (FTAs) such as the elimination of tariff and other barriers are intended for the benefit of business to trade within the region with more ease and less risks and costs. By using these arrangements, the private sector demonstrates its involvement and commitment to the process of economic integration.

Data show relatively low usage of AFTA preferences in 1998-1999 (Figure 1). Overall, less than 3 percent of intra-ASEAN trade used the AFTA preferential rates. It was found that most traders were inclined to paying the MFN applied rate, which meant avoiding the administrative cost and delay in availing CEPT rates, or taking advantage of duty drawback or duty-free programs in export processing zones and other investment incentive schemes.

**Figure 1: AFTA Utilization Rates** (percent of Intra-ASEAN imports)



Source: Baldwin (2007)

Using a different measure, a JETRO (2004) report claimed that the share of Common Effective Preferential Tariff (CEPT) exports to total ASEAN exports more than doubled from 10.8 percent in 2002 to 22.5 percent in 2003. This indicated an increase in utilization of CEPT rates in the early 2000s.

Specifically for the Philippines, usage of AFTA ranges from 15-17 percent depending on the measure that is applied. Avila and Manzano (2007, as cited by Wignaraja et. al. 2010), using computations based on the amount indicated in certificates of origin over value of trade, reported an overall utilization rate of 15 percent for Philippine exporters, with users mostly in the transport sector. Meanwhile, based on certificates of origin issued and used by Philippine exporters, data in 2007 revealed 17 percent usage of the certificate of origin for CEPT out of the total certificates of origin (Table 4).

In a survey of Japanese-affiliated firms operating in the ASEAN, Hiratsuka et. al. (2009) found that the level of usage of FTA in the Philippines, measured as the percentage of firms in the country using FTAs, is relatively low (Table 4). In terms of exporting firms, usage remained at around 15 percent in 2006-2007, and declined to 11.8 percent in 2008 but was hypothesized to be part of the business cycle (Medalla and Balboa 2009). The table shows that, together with Viet Nam, the Philippines posted low utilization rates compared to the rest of the ASEAN, in terms of both export and import operations.

**Table 4: Use of Certificates of Origin in port of Manila, 2007**

Certificates of Origin	Entries	% of Total
GSP Form A	21,443	28.4
CEPT Form D	12,828	17.0
General CO (White)	40,659	53.9
ACFTA	507	0.7
Total	75,437	100.0

Source: Table 6, Medalla and Balboa (2009), based on data from Export Division, Port of Manila, Bureau of Customs

Overall AFTA utilization rate for ASEAN's export operations in 2006-2008 are 19.7 percent, 19.3 percent, 23.0 percent, respectively (Table 5); but this is considered low compared to that in NAFTA, considering that the rules of origin criterion in ASEAN is less restrictive than in NAFTA. These findings suggested that the administrative costs to using AFTA are high as a

result of complex and inefficient administrative procedures, which could particularly explain the low AFTA utilization rate in the Philippines.

**Table 5: Utilization of FTA\* by Japanese-Affiliated Companies**

	<u>Exporting companies</u>			<u>Importing companies</u>		
	2006	2007	2008	2006	2007	2008
ASEAN (total)	19.7	19.3	23.0	16.0	16.7	19.7
Indonesia	18.5	14.7	35.9	20.8	17.7	28.7
Singapore	32.5	27.3	43.2	...	...	...
Thailand	18.2	18.8	22.5	17.7	14.9	25.3
Philippines	15.2	15.7	11.8	10.8	11.4	8.0
Vietnam	6.6	14.3	9.4	9.5	24.0	12.5
Malaysia	26.8	23.0	23.8	15.7	19.3	20.0

\*ASEAN as FTA partner; ... results not presented

Source: Hiratsuka et al (2009)

A more recent study by Wignaraja et. al. (2010) assessed the impact of FTA on Philippine business by looking at the usage of AFTA by firms in the Philippine transport, electronics and food sectors. A survey of 155 firms from the three sectors indicated that 20 percent of these firms used AFTA, and 41 percent plan to use FTAs. The survey also revealed that Philippine firms view FTAs as a means of increasing market access; hence, have shown interest in ASEAN's FTAs with China (especially for the food sector), Japan, Korea and EU.

Findings further revealed high AFTA utilization rate in the transport sector, in the domestic firms, and in the large firms. Across sectors, users of AFTA were mostly from the transport sector (38.9 percent of firms), followed by food (18.6%) and electronics (11.8%). The high margin of preference (5-43%) in transport products and successful implementation of the ASEAN Industrial Cooperation (AICO) are believed to explain high AFTA utilization in the



transport sector. In the AICO scheme<sup>2</sup>, firms can receive special preferential rates of 0-5 percent. The transport firms claimed that AFTA's preferential rates allowed them to import cheaper raw materials and components, hence reducing production costs.

Domestic firms were also found to have higher AFTA utilization than foreign firms, as it is presumed that the latter export to countries such as the EU and US where the Philippines has no outstanding FTA. Large firms were found to use AFTA preferential rates more than the smaller firms, since the former relatively gain more because they export more, they have export departments that handle documentation requirements for FTA compliance, or they are required to do so, e.g. for their production networks, as subsidiaries or suppliers of MNCs.

In addition, firms which use, have used or plan to use AFTA reported that FTAs have influenced or motivated them to change their business plans and strategies to adapt to FTAs. Firms consider increased market access as a major benefit of using FTAs. They have also attuned their business plans to the FTA market. Findings revealed that AFTA users and those who plan to use it—particularly for SMEs covered in the survey—have changed or plan to change their business plans in response to FTAs. As the SMEs have low AFTA utilization rate, the high rate of business response may reflect the SMEs' means to survive through new product development or intensified marketing.

Major reasons for low utilization or non-usage of AFTA are related to costs and delays associated with rules of origin compliance and AFTA's low margin of preference, which falls below 5 percent for most of ASEAN and overall margin of preference far-off the 5 percent threshold (Medalla and Balboa 2009). However, some analysts also cite low awareness of the

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<sup>2</sup> The AICO scheme is an industrial cooperation program in the ASEAN that aims to promote joint activities between ASEAN-based manufacturing firms. A major incentive from this scheme is that AICO products can enjoy preferential tariff rates of 0-5 percent. Honda Cars Philippines, Toyota Motor Philippines, Philippine Auto Components, Inc. and Ford Motor Company have received special preferential rates of 0-5 percent from AICO arrangements (Wignaraja et. al. 2010).

tariff scheme, which is now streamlined under the ASEAN Trade in Goods Agreement, as the primary reason for the low usage rate.<sup>3</sup>

AFTA's margins of preference on high trade-volume goods (e.g. computer/machinery and electrical equipment) are found to be too small (about 0-1.5 percent) to compensate for the administrative cost and delay of availing preferential tariffs (Baldwin 2007). MFN tariffs on high trade-volume goods in ASEAN are very low (less than 2 percent). In the EU and NAFTA, if the MFN rate is low, exporting firms are inclined to pay the MFN rate even if administrative procedures or delay in complying with the rules of origin is of little cost to them.

In the Philippine study by Wignaraja et al. (2010), low use of AFTA in the food sector was likewise attributed to small margins of preference; while in the electronics sector, low or zero MFN tariff rates and investment schemes available in export processing zones (e.g. duty-free importation and tax and non-tax incentives) or outside processing zones (e.g. tax holidays for customs manufacturing bonded warehouses) give little motivation to use AFTA preferential rates.

Moreover, the textile industry seemed to use FTA more unlike the electronics and precision machinery industries where general tariffs are already low (Hiratsuka et. al. 2009). This again illustrates that the margin between the MFN tariffs and the FTA preferential tariffs gives incentive for firms to utilize FTAs. A substantial reduction in FTA preferential tariffs may encourage non-participating firms or industries to start using FTAs in their business operations.

#### *Assessment of Philippine Private Sector*

A study conducted by the Asian Development Bank (2005) determined that the private sector dominates the Philippine economy, generating on average 95 percent of GDP and employing 92 percent of the registered workforce. The study cited the benefits of the openness model in terms

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<sup>3</sup> As reported in the Business World, August 25, 2010. An article entitled "Despite missed chances, ASEAN still good for RP." The author Jessica Anne D. Hermosa quotes Dr. Ganeshan Wignaraja about the causes of the low usage rate of AFTA.

of encouraging private sector participation in the power sector, telecommunications, and water supply. However, as mentioned in the introductory part, the openness model did not generate the economic transformation experienced by many other economies in the region. This is highlighted by the consistent fall in the investment rate from 2000 to 2009.

The ADB attributes this to the deteriorating investment climate in the Philippines. This is characterized by growing fiscal deficits, vested interests that appear to increasingly influence both legislative and judicial proceedings, and the weakness of the public sector in creating and enforcing freely competitive and/or regulated markets.

The private sector assessment was followed by another ADB study which revealed the following critical constraints to private investment and entrepreneurship:<sup>4</sup>

- Tight fiscal situation;
- Inadequate infrastructure, particularly in electricity and transportation;
- Weak investor confidence due to governance concerns, in particular corruption and political instability; and
- Inability to address market failures leading to a small and narrow industrial base.

### *Impact of the AEC*

This section looks into the impact of the AEC in terms of addressing some of these fundamental constraints. For the most part, these factors will prevent the private sector from participating actively in the AEC and will limit the benefits to the Philippines. Hence, policy measures that will increase utilization of ASEAN agreements and other FTAs directly flow from the above list of critical constraints (e.g. measures to expand fiscal space and improve physical infrastructure).

The most promising development related to the AEC is the establishment of the National Single Window in the Philippines. This is related to trade facilitation. Planning and implementation of

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<sup>4</sup> ADB (2007), pages 49-50.

the project was overseen by a steering committee led by the Department of Finance and composed of agencies linked to the Bureau of Customs (BOC). The National Single Window project is expected to substantially speed up customs processing for importers and exporters and enhance transparency and efficiency in transactions with BOC.

The mandate for a national single window emanates from ASEAN Agreements including: Agreement to Establish and Implement the ASEAN Single Window (ASW) signed by ASEAN Trade Ministers in December 2005, the Protocol to Establish and Implement ASW signed by the Finance Ministers in December 2006 and the ASEAN Economic Community Blueprint signed by President Gloria Macapagal Arroyo in November 2007. Among the obligations of the contracting parties in these agreements is to ensure that line ministries and agencies cooperate with and provide information to lead agencies and make use of ICT in their national single windows to further expedite customs procedures within ASEAN.

In March 2010, there was a soft launching of the NSW system for ten agencies. The activities accomplished thus far includes: network connection work for Metro Manila agencies, executive briefings to department and agency heads, agency and importer system training, and onsite system support for agency users. Some agencies started to go live in as early as May 2010 and 31 agencies are targeted to go “live” by July 2010.

## **Understanding the Private Sector in the Philippines**

### *Response of Philippine private sector to AEC*

The view of the Philippine private sector about the AEC can be discerned from the following statement of the Philippine Chamber of Commerce and Industry about the full implementation of AFTA-CEPT by 2010:<sup>5</sup>

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<sup>5</sup> Philippine Chamber of Commerce and Industry “Position Paper on the Full Implementation of the AFTA-DEPT by 2010. Downloaded from [http://www.philippinechamber.com/index.php?option=com\\_content&view=article&id=625:pcci-position-on-full-implementation-of-afta-cept-by-2010&catid=34:asean&Itemid=199](http://www.philippinechamber.com/index.php?option=com_content&view=article&id=625:pcci-position-on-full-implementation-of-afta-cept-by-2010&catid=34:asean&Itemid=199)

“Given this, while supportive of efforts to deepen integration and further the liberalization of the country vis-à-vis the ASEAN region, the Philippine Chamber of Commerce and Industry, the recognized voice of Philippine business, recommends the deferment of the Philippines’ accession to the full implementation of the AFTA-CEPT in 2010. We agree with the 5-year deferment proposed by Secretary Arthur Yap of the Department of Agriculture. We call for the retention of status quo for ALL sectors to give time to domestic manufacturing and agricultural industries to enhance their efficiency and competitiveness.

For the commodities which remain in the sensitive list but are to be lowered to the 0-5 percent tariff level by 2010 namely swine, poultry corn, sugar and rice, the last two considered most sensitive products, we agree with the position of the Fair Trade Alliance (FTA) and strongly recommend the highest trade flexibility to ensure food and livelihood security.

We strongly recommend the adoption of safeguard measures such as trade remedies, non-tariff barriers and effective anti-smuggling mechanisms to accompany liberalization efforts and to provide protection to domestic industries against the influx of imports and smuggling. This should be done on top of the implementation of a status quo for the reduction or total elimination of tariffs under the CEPT regime.

Underlying the industries’ problem is the cost of doing business in the country; the cost of production in countries such as Thailand, Indonesia, Malaysia and Vietnam, is substantially lower than in the Philippines, hence the difficulty of competing with the prices of other major producers from the region.”

The statement reflects the ambivalence of the private sector with regard to the openness model of development. While it is true that inadequate infrastructure is a major constraint, many sectors were also given time to adjust to greater competition. Thus, while part of the analysis makes it appear that the constraints are extraneous to the private sector and all that is required is for government to provide good governance and address supply side constraints, it would be useful to look into the “deeper” constraints to economic growth.

#### *The Private Sector as part of the problem*

An interesting issue would be whether institutional factors can partly explain the low investment rate (Table 3). This was recently attempted by Bocchi (2008) when he analyzed why investment

in the Philippines did not respond to higher economic growth in 2005-2007. One major reason is the dominance of corporate conglomerates in strategic sectors such as agriculture, maritime and air transport, power, cement, and banking. These corporate conglomerates do not have an incentive to invest and expand their operations since their main source of profitability is a captured market. In turn the resulting higher costs in these sectors discourage investment in sectors that have strong backward and forward linkages with them, particularly in manufacturing.

The analysis of Bocchi dovetails with the finding of Felipe and Lanzona (2006) that even at the height of trade liberalization, the degree of monopolization of the economy was increasing. As evidence they point to an increasing trend in the price-markup ratio between 1980 and 2003. These results corroborate what is well known about the Philippines, that is, the country is characterized by a lack of “culture of competition”. Monopolies and cartels are accepted as a part of doing business, an attitude that can be readily explained by institutional factors.

A case in point is the Philippine aviation industry. While the adoption of open sky policy may be well on track, new entrants have to contend with the uneven playing field in Philippine aviation market, which is largely dominated by the Philippine Airlines (PAL). PAL still receives the fiscal incentives and other unconditional guarantees it once enjoyed as a government corporation (Aldaba 2008). Furthermore, terminal space and landing slots are dominated by PAL, which managed to secure sole ownership of an airport terminal originally intended to serve as the country’s domestic terminal. Allegation of institutional weakness and regulatory capture is also observed in the failure of Civil Aeronautics Board (CAB) to collect from the Philippine Airlines (PAL) the mandated regulatory fees. CAB, a government regulatory agency charged with the supervision and regulation of air carriers, has likewise been accused of interfering in favor of PAL in bilateral air rights negotiations.<sup>6</sup>

By allegedly controlling the country’s ‘gateways’ through CAB (and its ‘zero sum’ policy), PAL has not only ignored the needs of millions of Overseas Filipino Workers (OFWs) for frequent,

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<sup>6</sup> Rimando, L., 2008, ‘PAL controls gateways through CAB, say experts’ *ABS-CBN News*, 02 March 2008, viewed 10 April 2010, <<http://www.abs-cbnnews.com/03/02/08/pal-controls-gateways-through-cab-say-experts>>.

cheaper and shorter flights, but has shunned inconceivable economic opportunities and benefits for the Philippines from potential tourists, and trade and business linkages.<sup>7</sup>

Another example of institutional weakness is in the Philippine power sector. Despite the moves to deregulate the country's energy sector through the passage of the Electric Power Industry Reform Act of 2001 (EPIRA), there remains a cap on foreign ownership and cross ownership, and the congressional franchise requirement on energy transmission and distribution. This casts doubt not only on the effectiveness of EPIRA and but also on the capability Energy Regulatory Board (ERB) to regulate the market and apprehend erring agents. Already a large private electricity distributor has been accused of favoring allied companies essentially subsidizing costly and inefficient firms with consumers ending up paying higher energy prices (SEPO 2009).

The Philippines may have made significant strides in deregulating the telecommunications industry but cases of abuse of power by a dominant player are well-documented. The Philippine Long Distance Company (PLDT), owns the backbone facility, and has the most number of fixed line subscribers. PLDT has been accused by other carriers of exploiting its market power by allegedly delaying interconnection, granting unequal access and predatory pricing.

In addition to these, latest government pronouncements like the passage of Executive Order No. 261 and 264, grant protection and safeguard measure on ad hoc basis to selected manufacturing industries, particularly cement, ceramic tile, clear float glass, and related sectors where charges of cartel-like practices abound. The apparent reversal to traditional protectionist practices can effectively turn off investors, as this not only implies unfair and uneven playing field, but also reflects the unreliability and unpredictability of government statutes and institutional weakness in enforcing rules and regulations (Aldaba 2008).

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<sup>7</sup> Ibid

## *The Role of Institutions and Culture*

Taking advantage of the opportunities provided by the openness model of development requires effective institutions. Institutions are defined as a “system of rules, beliefs, norms, and organizations that together generate a regularity of social behavior.”<sup>8</sup> Stable and credible institutions are important for the development of the rule of law, the enforcement of contracts, and the protection of property rights. The latter are important pre-conditions for the support of anonymous exchange and long-term contracting especially for credit, venture capital, and technological innovation. Economic development, therefore, is virtually impossible without the appropriate institutional support. The contents of policies themselves assume second-order importance since whether or not policies are taken and the degree to which they are implemented become matters that are endogenous to prevailing institutions and political economy (De Dios 2008).

The Philippines is an example of a country where “the exogenous introduction via colonial experience of political and economic institutions amid great and persistent social inequities and a parallel network of informal, personal, and kin-based institutions, clearly placed such institutions beyond the reach of the larger part of the population.”<sup>9</sup> As a result, the formal institutions have not been given the proper respect and became largely ineffective. Instead what became dominant almost by default were primordial institutions, such as the clan or family, or religious and ethnic affiliations, with their workings being superimposed upon the formal political process (De Dios 2008).

Consequently, what evolved in the Philippines was a semi-feudal economy dominated by elite factions. Instead of encouraging competitive behavior, a culture of ‘rent-seeking’ was engendered. The political and economic elite used state institutions as instruments of wealth accumulation. It was deemed that more money could be made by redistributing wealth through the political process than by actually creating wealth.

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<sup>8</sup>De Dios (2008) citing the definition of A. Greif (2005): *Institutions and paths to and the road to the modern economy: lessons from Medieval trade*. Cambridge University Press.

<sup>9</sup> De Dios (2008), page 27.



This is the context in which the absence of a “culture of competition” can be explained. What has dominated is a national oligarchy (De Dios and Hutchcroft 2003). In this system “there emerged a substantial homogeneity of interests on major issues of economic policy (including, of course, a commitment to prevent genuine land reform) beyond which it was far more advantageous for families to use their influence to gain particularistic favors than to seek generalized policy change favoring the interests of any given sector.”<sup>10</sup>

Weak institutions and an oligarchic private sector are therefore two sides of the same coin. A gridlock has evolved wherein stronger institutions are required to loosen the grip of the oligarchs but at the same time the influence of oligarchs has to be reduced in order to strengthen institutions. Admittedly the openness model of development has yielded favorable outcomes in terms of less monopolistic power, more diversified economic activities, and a healthier policy debate. However, unless there are major political and social reforms, economic transformation will not be possible.

Future analysis of economic development constraints should consider a multi-disciplinary approach which can put more emphasis on the “deep parameters” affecting economic performance. For example, related to the institutional dimension, culture and values can partly explain the lack of social cohesion, spotty entrepreneurship, and general inability to establish a credible and selfless political leadership in the Philippines. A Weberian framework would certainly cite the inconsistency between religion and capitalist development in the Philippines. Meanwhile, values such as *ningas cogon*<sup>11</sup> have definitely adversely affected economic growth. However, even if this analysis was accurate, effective policy prescriptions would still be

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<sup>10</sup> De Dios and Hutchcroft (2003), page 48. This was a description of the situation in the Philippines in the mid-1950s but is applicable to the present day.

<sup>11</sup> “Ningas Cogon” is an old Filipino expression, which literally means “grass flash-fire”. It refers to cogon dry grass which blazes furiously when set alight, but only for a few minutes before turning to cold ashes. When applied to society, it refers to people who are enthusiastic about something but then lose interest quickly. It applies particularly to personal effort and business ventures. Some sociologists have cited this as a general weakness of Philippine society which is inconsistent with successful entrepreneurship.

elusive.<sup>12</sup> At best, the analysis would yield guidelines that will make policymakers aware of the limitations of economic reforms and enable them to contextualize these reforms.

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<sup>12</sup> For example, a policy of "changing religions" is not feasible and is actually foolhardy.

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