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Policy Reforms and Institutional Weaknesses: Closing the Gap

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POLICY REFORMS AND INSTITUTIONAL WEAKNESSES: CLOSING THE GAP

Gilberto M. Llanto and Eduardo T. Gonzalez[1]

I. INTRODUCTION

Coming out of the destruction wrought by the Second World War, the Philippines seemed to be better prepared than other countries in Southeast Asia to break from the ranks of poor, developing countries. At that time in the not-so-distant past, the Philippines, with a relatively better educated work force, abundant natural resources and a democratic system of governance inherited from its former colonizer, the United States of America, held a lot of promise and potential for growth and development. The supreme irony is that the promise and potential seen in the fifties have remained as unrealized promise and untapped potential well at the dawn of the 21st century. The 'boom-bust' cycle of Philippine economic growth during the post-War period, an erratic growth record at best, shows that the country has somehow missed pathways to growth and development. Thus, today the Philippines is one of the slowest-growing economies in the region.

The World Bank (2005) reported that from 1985 to 2003, per capita gross domestic product increased only by about 0.7% per year, well below the 3.7% average of neighboring countries (Indonesia, Malaysia, Myanmar, Thailand and Vietnam). It was in the 1970s that the economy last experienced a sustained period of rapid growth, according to the same World Bank report. The 1997 East Asian financial crisis has contributed to the decline in economic growth and the relative economic stagnation experienced by the country in the last few years. There was very moderate economic growth at around 5% a year since 2003 but other ASEAN countries, which were more adversely affected by the East Asian financial crisis, have once again galloped ahead of the faltering Philippine economy. The same spectacle in the eighties when investors studiously ignored and bypassed the country, pouring massive capital and technology into Malaysia, Indonesia and Thailand, seems to be re-emerging. Indeed, private investments have largely bypassed the country, which denied it tremendous opportunities for tapping not only much-needed financial capital but also technology and innovations, so crucial for acquiring competitiveness in global markets. Comparisons with other countries show that the Philippines "remains at the bottom of the list of overall competitiveness rankings and various business environment indicators" (World Bank 2005), which does not augur well for growth, trade and competitiveness.

The result of economic decline and stagnation is deep poverty, which has remained a major concern. Notwithstanding the propaganda of the government, data show that the incidence of poverty appears to have risen from 36.9 per cent in 1997 to 39.5 per cent in 2000 even as other ASEAN countries have experienced a significant reduction in poverty incidence. Orbeta (2004), keeping score of poverty incidence in the ASEAN region, noted that the current Philippine poverty incidence in both rural and urban areas is much higher than those of neighboring countries. Poverty incidence in Malaysia was 7.5% in 1999, while in Thailand and Indonesia it was 9.8% and 18.2% respectively in 2002. Vietnam's poverty incidence in 2002 was only 28.9%. Based on the international poverty threshold of US$1 per day, the Philippines had 15.5% of population having less than US$1 per day while in Malaysia, the rate was 0.2% in 1999; in Thailand, Indonesia and Vietnam, the rates were 1.9%, 7.5% and 13.1% in 2002, respectively.

What ails the Philippines?

This is a complex and difficult question to answer but we submit that the weaknesses and in some instances incompetence and downright corruption of Philippine institutions have much to do with the country's dismal performance in economic growth and poverty reduction. Bad governance has much to do with those weaknesses and incompetence. The 2004 World Bank investment climate assessment ranked corruption as a top barrier to doing business in the country. It cites an estimate made by the government itself of 'potential leakage (i.e., corruption, underscoring supplied) in combined public-private transactions, which included purchases for build-operate-transfer (BOT) projects for 2001,' . . . amounting to 'Pesos 74 billion.' To its credit, the government has attempted to address the corruption problem by introducing a procurement law, conducting so-called 'lifestyle checks' of officials and employees in the revenue collecting agencies, that is, the Bureau of Internal Revenue and the Bureau of Customs, and making several pronouncements of imposing the full strength of the law on corrupt bureaucrats. However, weak political leadership and ineffective institutions have undermined the effort.

This paper is about the importance of effective institutional and regulatory frameworks in orchestrating the policy development process in a developing economy such as the Philippines and the need to create competent institutions to 'nudge such process in the direction of implementing better policies' (Dee 2006). The policy development process can sometimes be very difficult and demanding given competing interests, weak leadership and inequitable distribution of income and wealth. The policy development process is not a disembodied phenomenon but is nested in an institutional setting. There can be no effective policy development process if institutions are ineffective, dysfunctional and corrupt. The recent experience of developing Asian countries that have successfully found

pathways to sustainable development, e.g., Thailand, Malaysia among others, shows that it is not sufficient to have efficient policies, it is equally, if not more important, to have effective institutions and good leadership. A combination of efficient policy, enlightened leadership and competent institutions is indispensable to growth and development. For instance, a country may enact a competition law in support of the market economy, which establishes "a framework for promoting the competitive process and economic efficiency" (Guasch and Spiller 1999, p. 288) but it will need an effective operational structure to enforce the competition law. In this regard, we may cite recent developments in other countries, which created both the policy framework as well as the institutional structure to enforce good policies. Chile created the Preventive Commission and the Resolutive Commission, which are both administrative anti-trust commissions that enforce competition law[2]. Mexico created the Federal Commission of Competition to ensure adherence to competition law. Peru passed Decree Law 25868 that created the Institute for the Defense of Competition and Intellectual Property. Australia has the Productivity Commission, the Australian Government's principal review and advisory body on a broad range of economic and social issues, including competition policy, productivity, the environment, economic infrastructure, labor markets, trade and assistance, structural adjustment and microeconomic policy and regulation.

The paper is organized into four sections. After a brief introduction, section II discusses gaps in Philippine policy development process that is brought about by a tradition of weak governance, institutional weaknesses and weak leadership. The section uses as backdrop a stocktaking of the recent policy reform experience in domestic shipping to support our thesis that the policy development process will falter if institutions supporting it are ineffective or dysfunctional. Conversely, political will and the presence of the right institutions are crucial to move forward the development effort. The experience in the telecommunications sector shows a regulatory agency that is willing to undertake reforms but is held back by institutional limitations. The third section examines strategic triggers for reform while the final section explores institutions and strategies to support the policy development process.

II. A TRADITION OF WEAK GOVERNANCE

A governance crisis

The late Swedish economist Gunnar Myrdal coined the term "soft state" to refer to developing countries that lack a disciplined and capable bureaucratic culture, a cogent societal fabric, and a strong political will to overcome such weakness. As Myrdal put it, a soft state has "deficiencies in legislation and in particular law observance and enforcement, a widespread disobedience by public officials on various levels to rules and directives handed down to them,

and often their collusion with powerful persons and groups of persons whose conduct they regulate" (Myrdal, 1970). In the light of its faltering attempts in policy development process, the Philippines easily classifies as a soft state under this definition. Not surprisingly, the aspects of a soft state extend over those of a poorly or fairly governed state. That means there is something fundamentally wrong with the way social institutions, set of roles, rules, decision-making procedures, and programs that serve to define social practices and guide the interactions of those participating in these practices, are established and operated.

Institutions, whether formal or informal, are the means through which authority is exercised in the management of resources of the state. They make up, in other words, the enabling environment. The observable aspects of this environment that are important to consider, according to Kaufmann (2003), are: (1) the process by which those in authority are selected and replaced (*voice and external accountability* and *political stability*); (2) the capacity of government to formulate and implement policies (*government effectiveness* and *regulatory quality*) and (3) the respect of citizens and the state for institutions that govern interaction among citizens (*rule of law* and *control of corruption*).

While regulatory quality looks at the policies themselves, i.e., at the incidence of market-unfriendly policies as well as perceptions of the burdens imposed by excessive regulation, government effectiveness focuses on "inputs" required for the government to be able to produce and implement sound policies and deliver public goods. These inputs include the quality of the bureaucracy, the competence of civil servants, the independence of the civil service from political pressures, and the credibility of the government's commitment to policies.

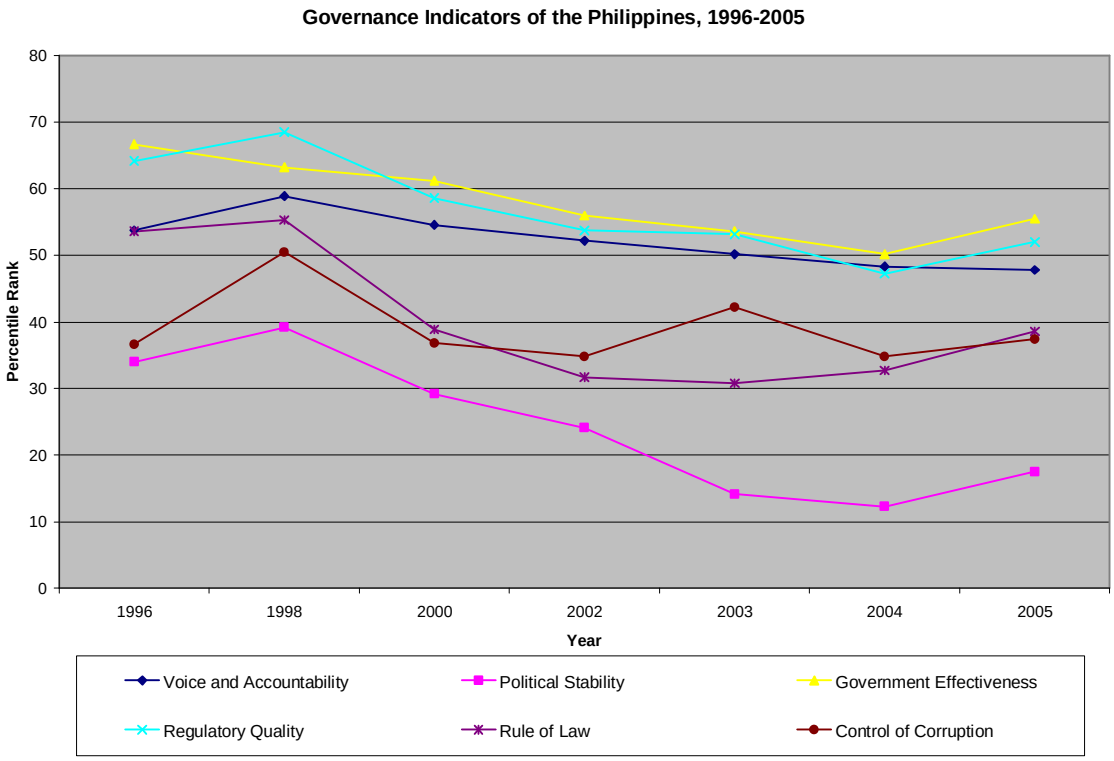
Rule of law measures the confidence and success of a society in developing an environment in which fair and predictable rules form the basis for economic and social interactions. Rule of law means the existence of checks and balances, regular and predictable regime succession, a formally independent judiciary, among others. It measures the effectiveness and predictability of the judiciary, the enforceability of contracts, and even the perceptions of the incidence of crime. Theory suggests that systems governed by the formal rule of law are likely to perform better than those in which rules may be arbitrarily changed (North, 1990).

On these counts of governance, the Philippines has received vulnerable marks suggesting that the country (which faces very serious development challenges) risks being ineffectually managed and being transformed into a failed state. In 2004, the Philippines got a 32.7 percentile rating on the rule of law, 12.3 on political stability, 50.2 in government effectiveness, 34.8 in control of corruption, 47.3 in regulatory quality and 48.3 in voice and accountability[3]. The score denotes weak government capacity to produce and implement good

policies and deliver public goods, unsatisfactory legal and regulatory frameworks, less than satisfactory observance of the rule of law and middling attempts to combat corruption. The mediocre governance performance is dimmed by political instability, with the World Bank suggesting that the score placed the Philippines in a state of "governance crisis".

Although the country experienced a modest improvement in almost all governance indicators (except Voice and Accountability) in 2005 compared to 2004, historical trends from 1996 reveal that the overall quality of Philippine governance has declined (Figure 1)[4]. The score lends itself to pessimistic reading of the Philippine development experience and expectations for the future unless drastic action is taken by the political leaders to improve the quality of Philippine governance. Political stability and the rule of law showed the largest decline in the country's score, dropping from a 34 and 53.6 percentile score, respectively, in 1996 to 17.5 and 38.6 in 2005. Philippine rule of law, which measures among others the country's capacity to enforce contracts and the quality of its police and courts, is rated poor.

Figure 1. Governance Indicators of the Philippines 1996-2005

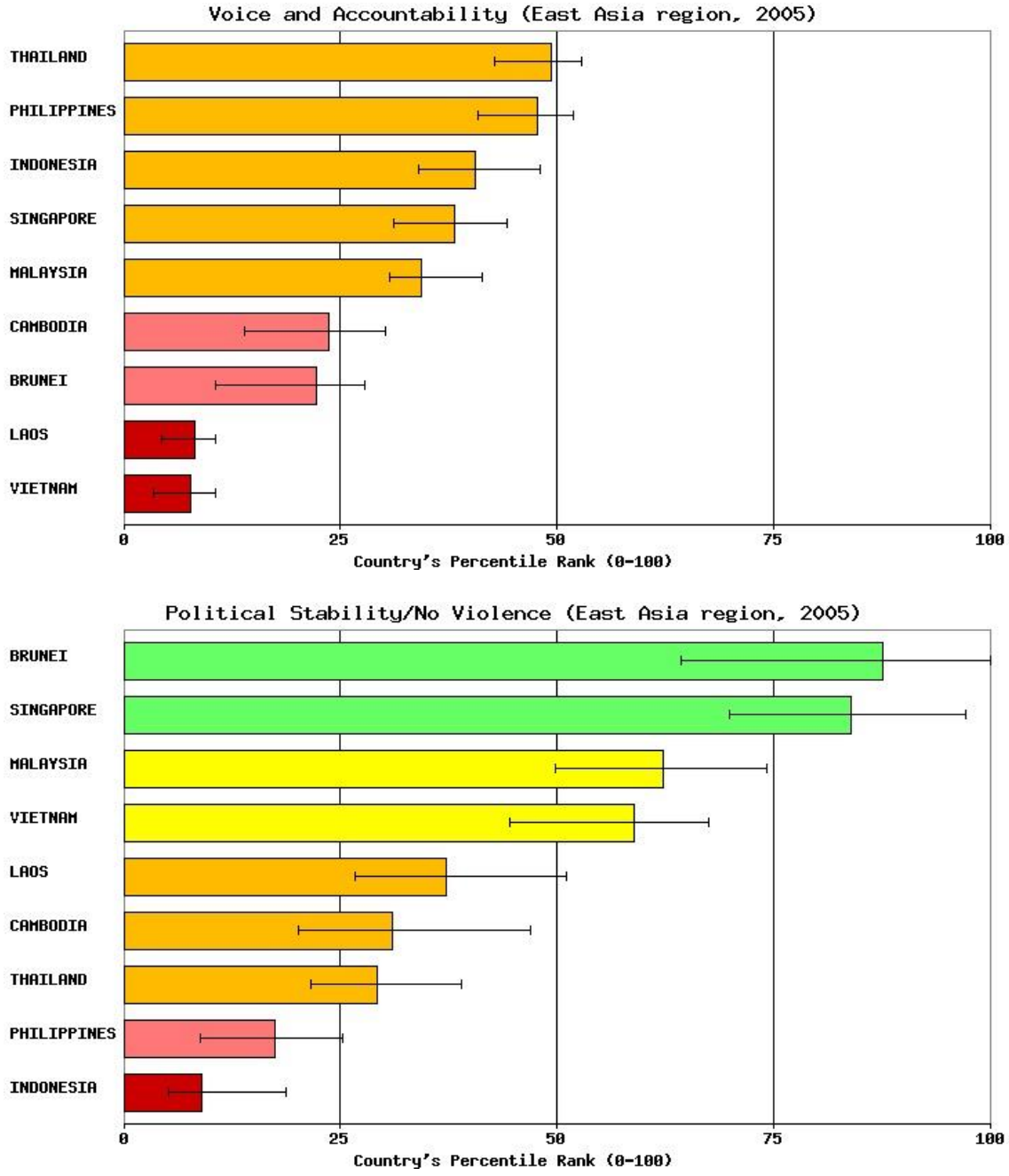


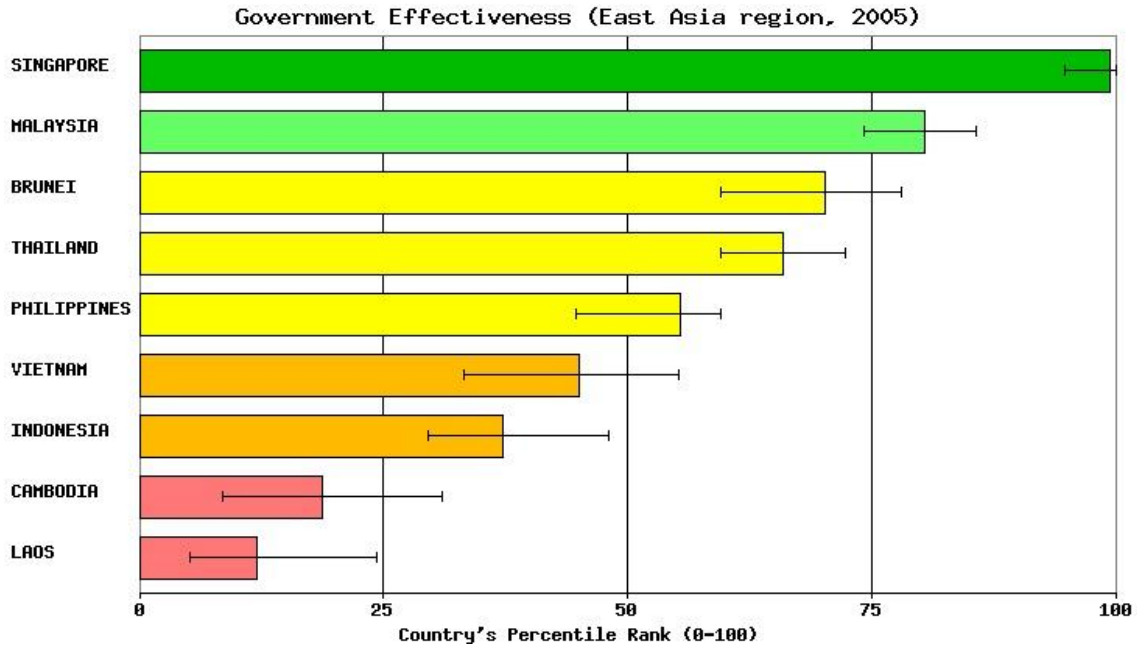
Source: Kaufmann, D., A. Kraay, and M. Mastruzzi 2006: Governance Indicators for 1996-2006

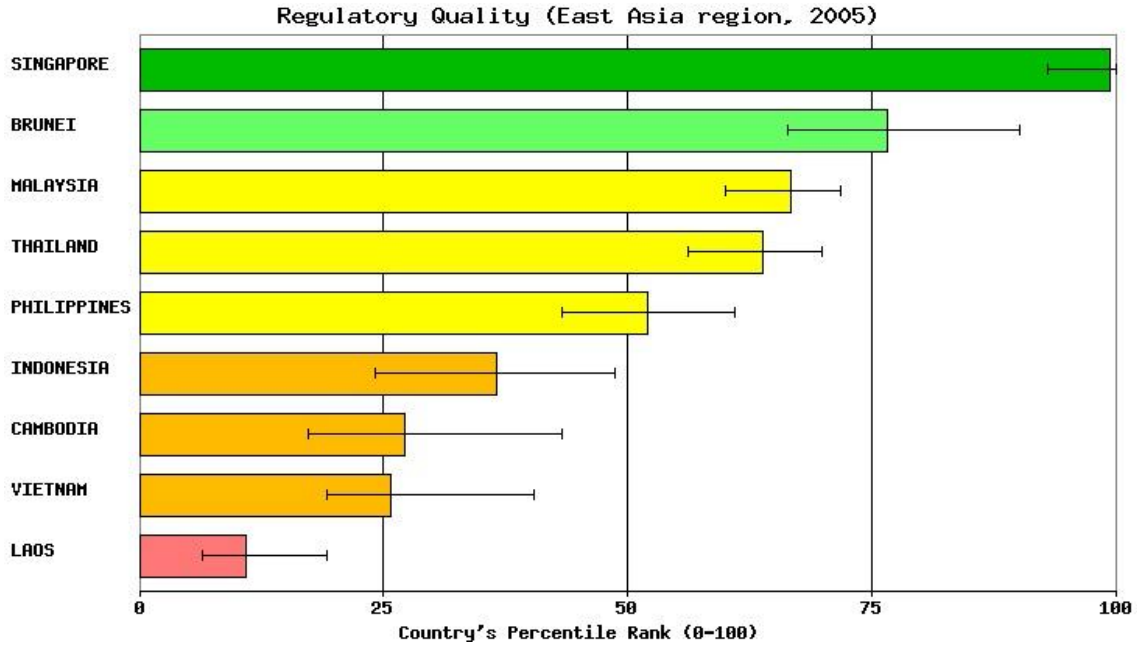
The dismal state of Philippine governance is made more apparent when compared with other ASEAN countries. The country's percentile score in almost

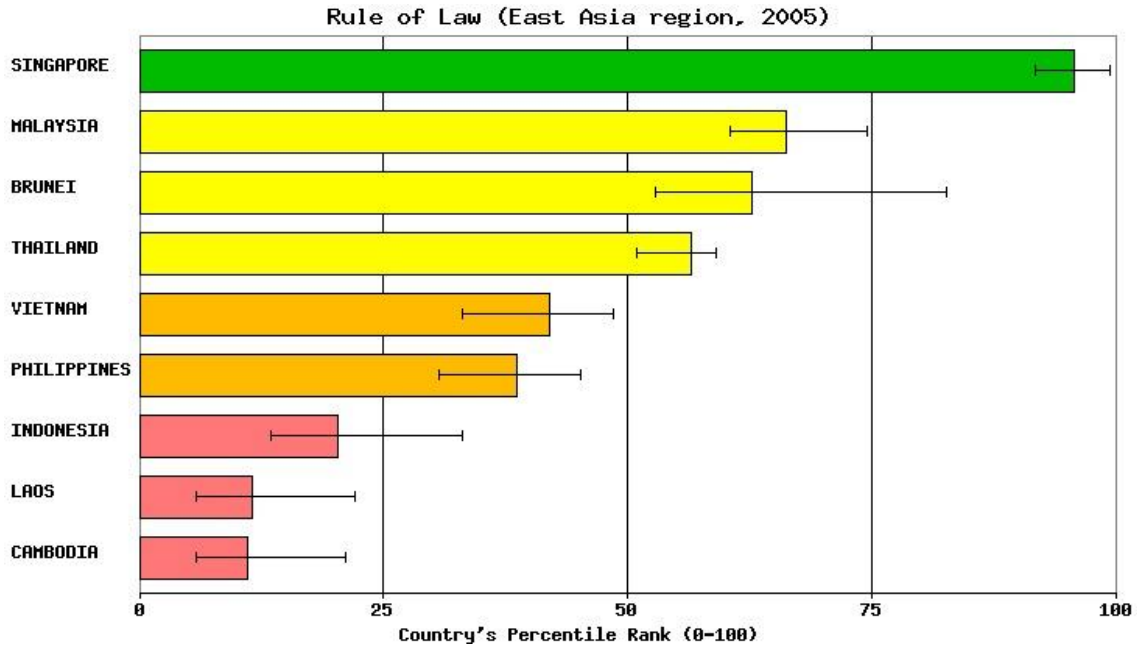
all governance indicators for 2005 indicate that the Philippines always comes out in between the scores of the its more affluent neighbors (Singapore, Malaysia, Brunei and Thailand) and the emerging economies (Vietnam, Cambodia, and Laos). Figure 2 shows that in almost all governance indicators in 2005, the Philippines has not been up to par with the more developed nations in the ASEAN. This highlights the precariousness, vulnerability and mediocrity of governance in the Philippines.

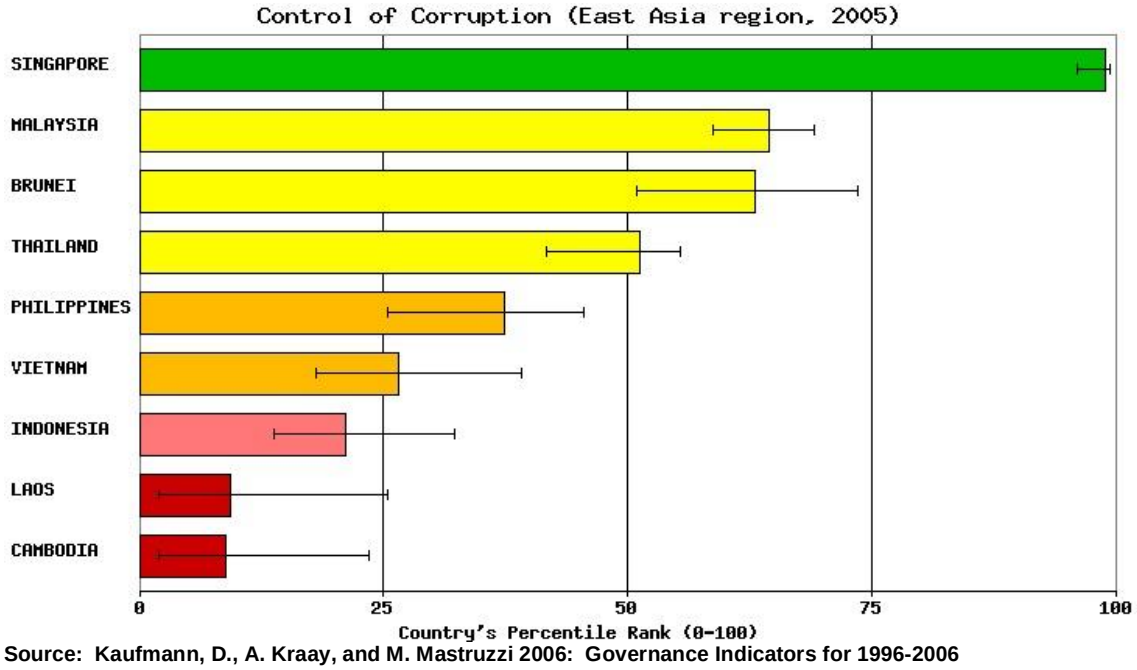
Figure 2. Governance Indicators in the ASEAN region, 2005




Government Effectiveness (East Asia region, 2005)
SINGAPORE
MALAYSIA
BRUNEI
THAILAND
PHILIPPINES
VIETNAM
INDONESIA
CAMBODIA
LAOS
0
25
50
75
100
Country's Percentile Rank (0-100)


Regulatory Quality (East Asia region, 2005)
SINGAPORE
BRUNEI
MALAYSIA
THAILAND
PHILIPPINES
INDONESIA
CAMBODIA
VIETNAM
LAOS
0
25
50
75
100
Country's Percentile Rank (0-100)





Source: Kaufmann, D., A. Kraay, and M. Mastruzzi 2006: Governance Indicators for 1996-2006

Existing institutions and governance quality ("context" as used here) have a profound impact on reform efforts. They shape the way the interests of actors are aggregated and shaped. Context also determines the degree of complementarity between new and existing institutions, which ascertains how likely effective and sustainable the institutions will be (Fritzen, 2006).

The literature suggests that struggles over institutional redesign involve conflict among powerful institutional factions. Each actor will assess his or her degree of support or resistance to any changes in institutional rules based on how his or her power and resource accumulation strategy are enhanced or diminished by these changes (Fritzen, 2005).

In Philippine political economy, the different factions and vested groups, which are in conflict, have their origins in the political and economic power of the economic elite. The power center is a centralized presidency that orchestrates the execution of policy and allocation of spoils. Such concentration of power at the top blends with the decentralized power of families and clans, within the context of a "neo-patrimonial" political system (Azfar, et al., 2000). The flow of power is from regional elites to central state authorities (Franco, 2000). The national electoral system, which is nominally competitive (incumbency does not assure re-election---Franco (2000)), is a curious set of first-past-the-post contests, and mainly yields the president, senators and local-council (*sanggunian*) representatives who are elected at large, as well as Congress members elected from geographic constituencies (along with a small number elected from party lists). The need to share the spoils of political victory often incites a scramble by politicians across parties to join the winning presidential candidate's party (Azfar, et al., 2000).

Because the president has discretion over disbursement and big-ticket government contracts, licensing authority, and fiscal management powers---a pattern appropriated from the American presidential system---politicians have to ally themselves with the chief executive to ensure funding for key projects and a major share in the patronage resources of the government. In turn, in the absence of effective political parties, the president has to count on local elites for electoral support and mobilization. As a result, local elites can leverage local power effectively during elections and, in-between, ask for major concessions, through the Congress, from the central government (Rocamora, 1995). The leverage that the chief executive has on local politicians is matched by the leverage that local politicians have in their ability to collect votes from their local bases of power (Igaya, 1999).

This local-central symmetry is perpetuated when Congress members routinely engage in party switching to bolster the ranks of the ruling party in successive elections, a practice which in turn stiffens the lack of any real programmatic or ideological separation among Philippine political parties (Franco, 2000). One result of this system is that the Philippine legislature by and large does not mediate differing interests; its policies, laws and resource priorities are seen widely as directly favoring powerful constituencies (Gonzalez and Mendoza, 2002). In a way, the Philippine legislature, thus, is orientated towards a spoils system designed to enrich the incumbents' insatiable lust for and grip on political and economic power. Also, minorities have little voice (other than as local majorities), especially in national politics (Azfar, et al., 2000). As suggested

by De Dios and Ferrer (2001) as well as Mendoza (2001), these political contests for control of resources are quite intense since the state "disposes a significant amount of resources and exercises discretion over a wide sphere." More often than not, politicians themselves design and modify institutions to stay in power. Voting arrangements, constitutional rules, financing of campaigns and political parties, and other institutions are maintained or revised to keep incumbents in office. Horrendous policies and institutions can be best understood from the perspective of entrenching the incumbents (Djankov, et al., 2002).

Various interpretations of Philippine political economy commonly suggest the likelihood of "capture" of the state and its instrumentalities by vested interests based on political clans (De Dios and Esfahani, 2001). Public agencies serve as conduits for capture of both policies and public resources. State capture implies that corruption is not always merely a sideshow; instead, the very political and economic forces associated with capture play a pivotal role in shaping policies and political economy outcomes (Kaufmann and Kraay, 2005) in the process blurring the separation between public duties and private interests. When economic and political forces are closely aligned, the very actors which must adopt and implement policies to curb corruption may face weak, or even negative incentives to do so---all the more so when institutional rules of the game affect resource accumulation strategies (Fritzen, 2006).

Yet, for all its weaknesses, the Philippines may still be far from being a failed state. After all, a mediocre score is still a conditional passing mark. To slip into the status of a failed state, institutions have to collapse dramatically, something that seems unlikely to happen in the Philippines. But that score precisely puts the country in a middling status, unable to soar but risking going under unless radical institutional and policy reforms are introduced and unless the political leadership aligns itself with the common good and welfare of the country. Thus, the country has little choice but to push reforms much harder than usual to break out of this crippling bind. To do nothing is to sow the seeds of a failed state.

Regulatory capture and expropriation

Regulatory agencies are a point of political access for purchasing major influence over government policy. Arguably, major regulators are the focus of demands to align governmental preferences with the interests of firms and individuals seeking (or maintaining) influence over public policy. Regulatory capture also suggests purchase of laws and policies to get both the legal framework and the policymaking process out of shape---in a systematic striving for concentrated rents. Captor firms seek to shop for privileges *a la carte* directly from the state---such as individualized protection of their initially weaker property rights (World Bank, 2000). Representation in the regulatory process could cause regulators to allow incumbent firms to earn excess profits, perhaps as a reward

for cross-subsidizing select users (such as government officials). Regulatory capture has encoded advantages in both old and new rules and institutions for narrow vested interests. In effect, the Philippines, as a rent state, has generated a *market for rules* (Fabella, 1999), with the 'products' such as laws, rules, policies, regulations and even legal interpretation going to the highest bidder.

Expropriation, on the other hand, arises due to collective action initiatives. Political intervention is often biased in favor of organized groups. In general, expropriation can arise if (1) user groups are well-organized in the regulatory process, and cause service to be provided below cost, and (2) an election may cause political pressure to be placed on regulators to favor users against suppliers (Noll, 1999).

Experience in the Philippines shows the extent and potential deleterious effects of expropriation and political intervention. The Electric Power Industry Reform Act (EPIRA) created a Wholesale Electricity Spot Market (WESM), designed to be one of the most advanced electricity markets in the world. This created incentive problems in which government's policy ultimately favored certain groups. In order to attract wide participation in the WESM, government has opened the door for the involvement of electric cooperatives (ECs). To ensure the quality of participating ECs, government has set out prudential requirements under the WESM rules that must be achieved. However, most ECs lack the financial and technical capability to trade in the envisioned market. They would need to be strengthened or restructured to be able to participate in the WESM. However, buckling under intense pressure and lobbying, Congress inserted Section 60 in the EPIRA law and the government wrote Rule 31 in the accompanying implementing rules and regulations (IRR) to condone the debts of these cooperatives subject to the provisions stipulated in the mentioned statute to help them achieve financial viability. Not only may this provision be unsustainable since NEA, acting as the guarantor of these ECs, has its own attendant financial problems, it also creates the wrong incentives for defaulting debtors such as those electric cooperatives. It is, thus, doubtful whether debt condonation could improve the efficiency and financial capability of these ECs. The World Bank (2004) notes that the poor credit rating of some ECs will also be a barrier to their participation in WESM.

Another example is the issue of cross-ownership of generation and distribution utilities. Patalinghug and Llanto (2005) showed the flaw in the cross-ownership provision in the EPIRA. It allows a company or related group to own, operate, or control 30% percent of the installed generating capacity of a grid and/or 25% percent of the national installed generating capacity. This provision opens up the possibility for a distribution company to enter into supply contracts with its generation subsidiaries, and create hidden profits for the conglomerate. MERALCO's supply contracts with Lopez-owned Sta. Rita and San Lorenzo power plants are singled out as classic cases of the disadvantageous nature of the cross-ownership provision of the EPIRA. MERALCO has been accused of

buying power from its affiliated IPPs at higher prices compared to the price charged by the NPC[5]. However, MERALCO asserts that it sources about 55% percent of its total power supply from the NPC, and that its IPP rates would go down per kilowatt hour if the plants would be dispatched at minimum energy quantity (MEQ) or the maximum contracted outputs of about 83 to 86% percent of their installed capacities.

The Philippine telecommunications sector provides yet another example of a potential good policy bowing down to organized groups. In 2004, as the fiscal crisis came into full view, the government proposed to tax Short Messaging Services (SMS) or text messages. It was calculated to rake in around 500 million pesos annually. However, the proposed bill to legislate this new tax faced stiff opposition from both consumer groups, such as TXTPower, and the mobile phone corporate giants Smart and Globe. The result was that the bill never saw the light of day. Even though the proposed tax had a potential beneficial effect given the fiscal troubles the government experienced, it was defeated by the interest of organized groups. The same opposition also was evident in the phone metering issue. Phone metering was seen as a measure to encourage the efficient use of landlines. Local landline calls in the country remain un-metered although most of other countries have adapted this charging scheme for their local calls long ago. Opposition from groups such as the Philippine League for Democratic Telecommunications and the Philippine Internet Service Organization effectively killed this scheme before it was even tried and tested.

All regulatory processes are inherently conflict-ridden, and participants in the regulatory process seek to influence that process to their own advantage by using all means available to them. Influence is exercised through a variety of approaches: (a) submitting information to regulators that supports a favorable decision, (b) seeking intervention by political allies, and (c) finding mechanisms for protection against highly unfavorable outcomes, among others.

The choice of and successful implementation of reform initiatives will depend to a great extent on whether an enabling or constraining policy environment is created, on whether or not effective institutions are present and finally, on whether or not incentives for change are at hand. This requires assessing political culture, as it relates to the way authority is exercised, and the extent to which power is deployed across different institutions. Pinpointing where the discretion is would be a significant step in breaking the links between money and influence, and reversing regulatory capture. Political finance goes to the heart of the country's political culture. This is antithetical to the culture of governance which is invariably linked to accountability. Governance and accountability's goal is to destroy patron-client structures and replace them with explicit and transparent rules and norms of conduct.

In the end, poor development outcomes reflect inadequacies in institutional structures and weak governance. To be sure, the patron-client

structures in the Philippine political system have conditioned the responses of the political actors to policy development, and, thus, set the stage for policy failure. To a significant degree, this lack of enduring success in governance has resulted in poor development outcomes. It seems that the country's political managers have opted for weak institutions---unstable regulatory formations, a "market for rules", agencies that are vulnerable to regulatory capture---to meet their personal strategic objectives. This suggests the critical importance not only of policy reforms but also of fostering effective institutions and good governance in altering the course of Philippine development.

Stocktaking: gaps in regulatory and institutional frameworks[6]

This section discusses the recent policy development process in domestic shipping, and telecommunications, which are a study in contrast[7]. The initial policy reform efforts in the telecommunications sector by the Ramos administration gained ground and eventually have been sustained up to the present time. The drive for a better policy environment in the telecommunications sector created a positive response from investors and consumers alike, which have become strong constituency for reforms. There is a tangible wave of investments by various players in the information and communications technology industry. On the other hand, both the Aquino and Ramos administrations initiated critical policy reforms in the inter-island shipping industry but under succeeding administrations, the reform initiative appeared to waver, grinding to a virtual standstill in the last few years. High shipping costs have stalled the drive for competitiveness, trade and growth. Worse, passenger safety continues to be compromised by the failure to meet safety regulations and minimum service standards in domestic seafaring vessels.

Lack of competition despite deregulation

Deregulation made headway in several strategic industries such as oil, telecommunications, air transport, inter-island shipping, banking and insurance. Government ownership or control of these "commanding heights" of the economy was privatized fully or partially in industries such as iron and steel, fertilizers, telecommunications and banking. These reforms led to improvements in the policy environment and introduced competition in the local economy but the gains and improvements in some industries paled in comparison with the promises that were trumpeted. The country's experience in the deregulation of ports and shipping illustrates this apparent failure of deregulation and liberalization to spur competition and growth. In particular, this paper will use the case of the ports and shipping sector to exemplify how government deregulation policy fell short of expectations in inducing competition.

Considering the archipelagic setting of the Philippines, shipping provides the primary means of inter-island commerce and transport. Long before the

Spaniards came to colonize the islands, the natives relied on primitive shipping transport for trade, commerce and movement among the many islands of the archipelago. Trade with Chinese and Arab merchants flourished because of the relatively more advanced shipping transport of their respective countries of origin. Because the bulk of domestic trade and inter-island transport, especially in the Visayas and Mindanao, relies on shipping, sustaining policy reform initiatives in inter-island liner shipping is very critical. The shipping industry contributed about half a percent to gross domestic product during the nineties. Passenger traffic on liner shipping increased from almost 30 million passengers in 1990 to 44 million in 2000. The volume of domestic cargo went up from 58 million metric tons in 1990 to 76.9 million metric tons in 2000. Transit cargoes (import and export cargoes) grew from 597.5 thousand metric tons in 1991 to 757.3 thousand metric tons in 1998.

The regulatory authority for shipping is the Maritime Industry Authority (MARINA), an agency attached to the Department of Transportation and Communication (DOTC). Created under Presidential Decree No. 474 in 1974, it is mandated to provide supervision, regulation and rationalization of the organizational management, ownership, and operations of all water transport utilities, and other maritime enterprises. Before the reforms were instituted, its mandate included the regulation of inter-island rates, regulation of entry/routes and regulation of safety and service standards. All sea-borne carriers and shipping companies, including those in logistics, are regulated by MARINA. The provision of navigation facilities, as well as of maritime communication facilities, has been assumed directly by DOTC. Another agency involved in shipping is the Philippine Coast Guard, which is responsible for policing and safety enforcement.

MARINA exercises its regulatory functions through the issuance of a certificate of public conveyance (CPC), which informs route and safety regulation. At present, there are 694 cargo routes being served by the domestic inter-island shipping industry. To operate on any given route, a shipping company has to secure a permit from MARINA. For a long time, MARINA has subscribed to the ”prior operator” rule, i.e., by raising the hurdle on the entry of a second operator on a route. It required proof of enough traffic to warrant the operation of another carrier. The obvious intent was to avoid “destructive competition”. In 1994, reforms liberalized entry into routes: presumption of need was deemed in favor of the prospective entrant, while the existing operator has the burden of proof that a proposed service is not needed. Routes were opened to at least two shipping operators. To encourage entry in developmental or new routes, the pioneering operator was given protection for a period of 5 years.

This was re-iterated under Memorandum Circular No. 106 (1995) that opened all monopoly routes with 5-year history to a second operator, and allowed rates different from the fork rates to be imposed by vessels with new technological features. Thus, the government limited the protection of operators in missionary or developmental routes from new entrants to only five years, in

contrast to the pre-reform regulation giving protection to the incumbent operator for an indefinite period, i.e., until it has recovered its investment. Operators can also replace old vessels with bigger ones to increase capacity, increase the frequency of port calls, change routes or introduce a new route under certain conditions.

MARINA revised the 5-year period for protecting pioneer operators in developmental routes to include certain conditions. The implementing guidelines of Executive Order No. 185 were revised under Memorandum Circular No. 161 in 2000. New entrants can ply these routes for as long as their entry will not result in ruinous competition. Entry was not allowed when existing operators in a given route carry less than the average annual break-even load as determined by MARINA, when audited financial statements of any of the operators in a given route show losses directly related to their operation for the last two years or such other analogous circumstances as may be determined by MARINA.

With the exception of third class passenger fares and specific non-containerized basic commodities whose rates are set by MARINA, all other passenger fares and cargo rates have been deregulated. Whether there are one or multiple operators on any route, MARINA took a hands-off policy on rates (except for third class passenger fares and basic commodities). Cargo rates are set by negotiation between the shipping company and the cargo owner.

Thus, in the nineties, the Ramos administration issued two executive orders, namely, Executive Order No. 185, which de-monopolized shipping routes and Executive Order No. 213, which deregulated passage and freight/cargo rates (except for non-containerized basic commodities). Deregulation and liberalization were a slow process as it took government 10 long years to introduce those reforms.

The deregulation of passenger and freight rates was finally made a permanent policy under a recently enacted law (RA 9295 - “An Act Promoting the development of Philippine Domestic Shipping, Shipbuilding, and Ship Repair/Breaking, ordaining reforms in government policies towards shipping in the Philippines, and for other purposes”). The law lifted the regulations on the shipping industry by allowing the shipping companies to fix their own rates. It also provided tax and other incentives to encourage the modernization of the industry[8].

While the new law allows shipping companies to establish their own rates, the law’s Implementing Rules and Regulations (IRR) introduced certain conditions to protect public interest, namely: (a) development of routes (entry) to promote competition; (b) MARINA intervention in rate-setting under certain conditions; and (c) right of shippers to question/challenge rate increases. MARINA issued Memorandum Circular No. 153 (which revised the Implementing Rules and Regulations of Executive Order No. 213) removing the Consultative Council (DOSCON) which was organized by liners to provide themselves a

venue for discussing proposed rate increases. The only requirement is publication of proposed rate increase in newspapers of general circulation.

The de-monopolization of shipping routes was intended to increase competition. However, it seems that 10 years after the de-monopolization of shipping routes, 50% and 70% of primary and secondary/tertiary routes, respectively, have remained a monopolistic market. There is lack of effective competition in routes even where there are two or more operators. Calculations made by Austria (2002) show that the domestic shipping industry is highly concentrated, with the five largest operators accounting for 90% of total number of passenger traffic. Less than five out of the 37 operators plying primary and secondary routes are effectively competing. There is in fact a claim by the Distribution Management Association of the Philippines that domestic shipping liners operate in a cartel-like fashion. Table 1 provides an insight into the state of competition in cargo service based on available data (1998). Table 2 shows the state of competition in passenger travel.

Table 1. State of Competition in Cargo Service, 1998

Route Classification	Primary		Secondary		Tertiary	
	No.	%	No.	%	No.	%
Routes with only 1 operator	25	36.2	16	34.8	444	76.7
Routes with at least 2 operators	44	63.8	30	65.2	135	23.3
- Routes with effectively 1 operator	7	10.1	9	19.6	39	6.7
- Routes with substantial competition	10	14.5	6	13.0	38	6.5
- Routes with mild competition	27	39.1	15	32.6	58	10.0
Total Number of Routes	69		46		579	

Source: M. Austria. Philippine Domestic Shipping Industry (2002)

Table 2. State of Competition in Passenger Travel, 1998

Route Classification	Primary		Secondary		Tertiary	
	No.	%	No.	%	No.	%
Routes with only 1 operator	26	50.0	27	58.7	166	77.6
Routes with at least 2 operators	26	50.0	19	41.3	48	22.4
- Routes with effectively 1 operator	5	9.6	7	15.2	10	4.7
- Routes with substantial competition	7	13.5	6	13.0	18	8.4
- Routes with mild competition	14	26.9	6	13.0	20	9.3
Total Number of Routes	52		46		214	

Source: M. Austria. Philippine Domestic Shipping Industry (2002)

Another major policy issue is the crucial importance of ensuring that seafaring vessels meet adequate service standards and safety regulations. From 1995 to 2002, there were on average 162 maritime accidents and 215 fatalities per annum. Sigua and Aguilar (2003) reported that from 1991-2000, the four most frequent causes of maritime accidents were: capsizing (30%), sinking (25%), grounding (21%), and engine trouble (12%). The casualty figures were also very high – averaging 118 fatalities and 152 missing persons on an annual basis[9]. Poor vehicle maintenance, overloading and disregard of safety regulations are contributory factors to the high rate of maritime accidents. It seems that MARINA has failed to ensure the seaworthiness of seafaring vessels, e.g., condition of the hull, engine, navigational instruments, firefighting equipment, life-saving requirements, and others, and to enforce adequate service and safety standards on operators. MARINA has not developed its monitoring capability to protect consumers from unscrupulous practices of shippers and unnecessary risks brought about by the lack of proper vehicle maintenance or the failure to meet service and safety standards.

The government should continue the disrupted deregulation efforts. Under current regulations, third class passenger service is not deregulated. Shipping companies complain that the regulated rates are so low that costs can not be covered. Current regulations also require them to allocate 50% of the vessels' passenger capacity to third class passengers, mostly coming from the lower income groups. The end result is the lack of investments in seaworthy vehicles that meet safety regulations and minimum service standards and failure to provide adequate transport and shipping service to the lower income groups.

Finally, the country has to face the challenge of finding the best option for dealing with high domestic shipping costs. The reported high cost of shipping has negative implications for the overall efficiency, competitiveness and growth of the Philippines. Inefficient port and shipping services reduce the potential income of farmers and producers.

The competition to be given by foreign vessels, which could service Philippine ports once the cabotage law has been lifted, appears to be an attractive solution to high shipping costs. Foreign competition will motivate greater efficiency in the shipping industry, which will bring down shipping costs. The question is will the government have the nerve to further liberalize the shipping industry? Does MARINA have adequate and credible regulatory willingness and capacity to ensure competition in the domestic shipping market and to enforce safety and service standards?

The Medium Term Philippine Development Plan of 1999-2004 has long recognized the needed institutional and policy reforms in the ports and shipping sectors. However, until today those reforms have remained as talking points among the government and various stakeholders such as the business community and lenders such as the World Bank and the ADB. Indeed, the

question is not *what* reforms to make but *whether* and *when* those reforms will ever be made.

Constrained attempts to check behavior of dominant players

The sustained policy reform efforts in the telecommunications sector are directly opposite the experience in the domestic shipping industry. During the pre-reform period situation, service coverage represented only 16% of total land area. Barely half a million telephone lines serviced a population of 60 million people. Distribution of services between rural and urban areas was unbalanced. The government's reform efforts, which started earnestly during the Ramos administration, have born fruit: more industry participants in all market segments, an increase in telephone penetration rates, an improvement in service quality, introduction of value-added services and a reduction in telecommunications costs as the industry regulator, the National Telecommunications Commission (NTC) continues to pursue reform efforts. The World Bank (2005) reports sector revenues for 2002 of PhP145 billion, and an annual growth rate of 7.2% estimated for the following three years. Cellular mobile users grew from 12.1 million in 2001 to 32.9 million in 2004. This makes the telecommunications sector a major source of economic growth

The Ramos administration issued Executive Order 59 mandating the compulsory interconnection of authorized public telecommunications carriers in order to create a universally accessible and fully integrated nationwide telecommunications network. Subsequently, President Ramos issued Executive Order No. 109, which required all cellular mobile telecommunications services (CMTS) operators to install at least 400,000 telephone lines within three years, and international gateway facility (IGF) operators to put up 300,000 lines within five years. The Public Telecommunications Policy Act of the Philippines (R.A. 7925) was passed in 1995 to promote and govern the development of the telecommunications industry and to improve the delivery of telecommunications services. R.A. 7925 addressed the need for an established policy framework in the telecommunications industry. It also laid down the foundation for the administration, conduct, and direction of the telecommunications industry. Republic Act 7925 mandated the privatization of government-owned and operated telecommunications facilities, while deregulating rate and tariff setting, and removing the 12% percent cap on rate of return.

Value-added services (VAS) were also deregulated. A VAS provider that does not set up its own network and relies solely on the transmission, switching and local facilities of enfranchised telephone companies does not need to secure a franchise in order to operate. It only needs to register with the NTC (Kim, 2003). NTC has recently issued a Memorandum stating that Voice over Internet Protocol (VOIP) is a "value-added service" and that it is an enhanced (telecommunications) service beyond those ordinarily provided for by local

exchange and inter-exchange operators, and overseas carriers".[10] VOIP enables users to engage in voice conversations without having to pass through the international gateway facilities of telephone companies, which charge much higher fees for the use of their networks. The NTC explains that "VOIP does not merely involve converting and reassembling voice to and from data packets at the points of transmission and destination. VOIP technology offers far more advanced and different service attributes than traditional voice services. VOIP is an advanced communications application that can converge (sic) voice communications seamlessly with other digital applications".

The bold decision of the Ramos administration de-monopolized the telecommunications industry. It does not mean however, that "no single operator today is able to exercise considerable market power" (Serafica 2001). The NTC regulates end-user rates but the access charge is negotiated between interconnecting carriers. Republic Act 7925 provides that the rates of interconnection must take into account the following (Article III, Section 18):

- the costs of the facilities needed to complete the interconnection;
- the need to provide the cross subsidy to local exchange carriers to enable them to fulfill the primary national objective of increasing telephone density in the country; and
- assurance of a rate of return on the total local exchange network investment that is at parity with those earned by other segments of the telecommunications industry.

Serafica (2001) noted that the actual level and structure of access charges differ, depending on the type of interconnecting service. In theory, an incumbent is reluctant to give access to other entrants supplying the same product. If there is intense competition between incumbents and new entrants, interconnection agreements are less likely because of divergent interests. Under these circumstances, access regulation must be quite forceful (Valletti and Estache, 1999). Unfortunately, Republic Act 7925 has no explicit or forceful rules on access regulation. Instead it specifies that access charges and sharing arrangements between all interconnecting carriers shall be negotiated between the parties. Clear and explicit rules would have made the regulation credible. It is now up to the NTC, the regulatory body, to issue rules and regulations to ensure that the incumbent does not exercise its market power to the detriment of other entrants and ultimately, of the consumers. There seems to be scope for the NTC to make access regulation more efficient and forceful instead of leaving interconnection to the involved parties to negotiate. The law has supported the entry of new players but this is not enough. There is a need for clear and forceful competition rules to ensure fair competition and uphold consumer welfare. In the post-reform era, PLDT, the dominant player, still wields incumbency advantages because of its control of the telecommunications backbone facility.

According to the NTC, four trends are visible in the telecommunications market today:

- Several providers have emerged dominant and financially viable in the submarkets, while the market shares of the other providers have been reduced to almost insignificant levels. These other providers are, thus, unable to compete against the dominant providers. For instance, In 2004, the two largest service providers had a combined net income of P39.2 billion as compared to the net loss of P2.3 billion of the next two largest carriers.
- The precarious financial condition of non-dominant providers is less a consequence of the smallness of their subscribers' base than a product of unregulated price squeezing behavior of the dominant providers.
- Horizontally integrated providers are engaged in cross-subsidization to stem the churn out from fixed to mobile services, to the detriment of non-integrated providers.
- Large providers appear to be leveraging their control of the last mile into the unregulated value-added service market.

These trends point to the core of the market competition problem in the industry today– the hitherto unchecked behavior by some dominant providers of leveraging the power that they hold in one market into another and the increase in concentration ratio in the local exchange market rising from 70% in 1999 to 75% in 2004, and in the cellular market, from 85% to 96% for the same period[11].

The NTC has acknowledged that the the next generation policy reforms would focus on the following: (a) imposition of significant market power obligations; (b) policy to unbundle network elements; (c) policy allowing resale of services; and (d) policy enforcing ex-post regulation of prices. However, the absence of a competition policy framework constrains the NTC from taking a proactive stance in matters affecting the state of market competition. Nevertheless, the NTC has recently issued a policy document on the imposition of significant market power obligations (SMP), in a bid to introduce competition rules in the sector. In a nutshell, SMP will make dominant service providers comply with more stringent *ex ante* regulatory requirements to foreclose opportunities for abuse of market power. Once the threat of exercise of market power is minimized, detailed monitoring of the actual conduct of dominant providers becomes unnecessary. Imposing *ex-ante* obligations, therefore, reduces the need for regulatory intervention over the longer term[12]. Already, the dominant players have made threatening noises of mounting a legal challenge to the announced SMP policy. It remains to be seen whether NTC will have the political will to maintain its chosen market-friendly course.

Binding institutional constraints and likely sources of institutional resistance

The policy reform process in the domestic inter-island liner industry shows a slowdown or even stagnation in the process. MARINA faces the difficult task of instituting compliance with safety regulations and minimum service standards,

and at the same time, supporting policy reforms that will spur more competition and bring down high shipping costs, e.g., issue of the cabotage law, policy on merger and consolidation to ensure efficient service to the public. Weak regulatory capacity hounds MARINA, which has also received its share of political appointees. The practice in the Philippines of having top and middle-level bureaucrats/officials serving ”at the pleasure” of the appointing party, i.e., the President of the country, has contributed to the weakening of regulatory frameworks and the growing low credibility of institutions. The lack of job security or tenure and the threat of reprisal from politicians if their whims and caprices are not given due course, have been contributory factors to the inadequacy and weaknesses of Philippine institutions. There is nothing in the Philippine system of governance and civil service that can shield officials and employees from political interference or reprisal. The end-product of such a weak and corrupted system is mediocre performance, flawed policies, failure to deliver development outcomes, and worse, corruption.

The heavy task of regulation of the telecommunications sector falls on the shoulder of NTC. The advent of new technologies and new applications widens the scope for competition and emergence of more efficient providers, in effect posing a challenge to incumbents. Advances in wireless technology has eroded the market share of fixed line providers and the rise of broadband services open the sector to convergence with deep implications on competition and the regulatory capacity of the regulators. However, dominant players hold considerable economic power and political influence, which could stymie the reforming zeal of NTC.

The NTC commissioners serve ”at the pleasure” of the appointing party, the President of the Philippines, and are not tenured. Thus, the three NTC commissioners are not shielded from political interference, which may create problems about the credibility of the regulatory body. On the other hand, to its credit, NTC has recently demonstrated that it could be a pro-active policy formulating and implementing body. Its position on VOIP as ”value-added service” has created wide opportunities for the deployment of VOIP, which will reduce telecommunications costs. NTC needs to strengthen its capacity in the areas of policy and planning, setting telecom tariffs, and technical know-how to adopt and implement standards of reliability and to address customer complaints, particularly in the mobile phone business. It also has to develop better communication capacity in order to create a broad constituency among the population, e.g., overseas Filipino workers who benefit from low telecommunication costs, as a shield against political intrusion. Not only must it develop its regulatory capacity, it should also strive for financial autonomy. NTC depends on the government for its budget, notwithstanding the fact that it raises substantial revenues from its licensing authority. Unfortunately, a bill providing the NTC statutory independence and financial autonomy has been languishing in Congress. It seems that politicians prefer the status quo where NTC has to beg for its annual budget from self-dealing politicians. Another factor undermines regulatory credibility and it is the requirement for telecommunications operators

to acquire legislative franchise which “politicizes the market entry process unduly” (World Bank 2005, p. 175.).

Measuring up against best-practice benchmarks

Most new regulatory setups depend on a regulatory agency loosely modeled on North American public utility commissions that have developed procedures and credibility over decades (Smith and Wellenius, 1999). Basically, this means (1) as much relevant information is presented to the regulators as is reasonably feasible, (2) the decision makers are neither homogeneous in their biases nor subject to unbalanced external pressure, and (3) neutral arbiters can intervene should an agency make an unreasonable decision (courts, or Appeals Tribunals) (Noll, 1999). To work well, this model of regulation requires certain conditions: a strong administrative tradition, the ability to undertake commitments that endure from one government to the next, and a judiciary that is impartial, immune to government and political pressures, and able to make enforceable decisions. It also requires substantial professional cadres, capable of handling complex regulatory concepts and processes (Smith and Wellenius, 1999).

These suggest, following Noll (1999), the following.

(1) *The personnel of regulatory agencies should be heterogeneous, and have secure and remunerative careers.* The domestic supply of professionals to implement a better regulatory system is low and inelastic, however. And there are few internationally transferable skills in regulation management. There are also incentive problems: regulators may seek to enhance their post-regulation employment by favoring a likely future employer, or, some specialized skills of regulators may be obtained or usefully applied only in organizations that actively participate in the regulatory process.

(2) *The agency can be given independent authority to generate information and even resources, and undertake their own investigations and research on technologies.*

(3) *The agency can be subject to openness requirements.* The agency can be required to conduct all business in public, to refrain from secret contacts with either interested parties or political officials, and to release all relevant information pertaining to a decision as well as a preliminary indication of the decision it is likely to make before the actual decision is made. This is useful for revealing whether the agency's decision is biased and unsupported by facts.

(4) *Decisions of the agency can be subject to review by another body that is freer of representation biases, especially biases affecting participation in the agency's processes, at the instigation of anyone who is dissatisfied with a decision.*

All of these are costly to implement and assume the presence of a highly developed “rule of law” that is not yet present in the country. Some safeguards plausibly are present and affordable (like the transparency processes), so that a recommendation to implement reform along these lines is certainly not out of the question. When good institutional and country features are not in place, however, regulatory effectiveness, and therefore sector development, can be seriously undermined.

What is a feasible solution, when governance is weak? If the objective is not a successful agency but a well-performing sector, alternative measures must be found for establishing a regulatory framework that enables better sector performance even when an effective, full-fledged regulatory agency is lacking. The World Bank indicates that the regulatory strategy should include reducing the need for agency decisions (accelerate competition; write regulatory rules into licenses, contracts, or laws; keep operators’ obligations reasonable, focus licensing on the main operators), enhancing the credibility of regulation (adopt open regulatory processes, harness public support, adhere to international commitments) and generating maximum impact from scarce professional and financial resources by using them effectively (outsource some regulatory tasks and pooling sector knowledge) (Smith and Wellenius, 1999).

It may also be wise to adopt relatively simple “benchmark” systems. The realistic choice is for the country to rely on the cost audits and price decisions in another country (which may however create problems of reliability and domestic political feasibility) (Smith and Wellenius, 1999)

As an illustration for best practice benchmarks from other countries, we look at other countries’ reform experience in different sectors such as telecommunications, power, ports and shipping. Chile has led the way in reform and modernization of the telecommunications sector as the first Latin American country to eliminate the state monopoly on telecommunications services. Through progressive legislation, reforms that directly affected telecommunications occurred in 1982 and 1985. Before the 1982 reform, Chile's telecommunications sector had been dominated by state-owned national companies. Santiago and the central part of the country had been served by the Telephone Company of Chile (Compañía de Teléfonos de Chile--CTC), a subsidiary of Corfo. The southern part of the country was served by two private companies, the National Telephone Company (Compañía Nacional de Teléfonos--CNT) and the Telephone Company of Coihaique (Compañía de Teléfonos de Coihaique). Another Corfo subsidiary, the National Telecommunications Enterprise (Empresa Nacional de Telecomunicaciones--Entel), had controlled Chile's international telephone service and much of the domestic long-distance service (including Easter Island).

Following key pricing reforms in 1987, most of the state-owned telecommunications firms were privatized during the 1987-89 period. The

National Telephone Company of Spain (Telefónica) obtained control of CTC, which has been 50 percent privatized. Entel retained its monopolies. By 1991 Chile had 768,000 telephones. CTC plans called for installing 190,000 new lines in 1992 and investing US$500 million in 1993 in expanding and upgrading the telephone network. This would permit the installation of 280,000 new lines and the replacement of the remaining analog switching systems that were serving 320,000 lines in 1992. In April 1992, however, Chile's monopoly commission ordered Telefónica to sell its stake in one of the two Chilean telephone companies in which it owned shares--CTC and Entel. Telefónica appealed the decision to the Supreme Court.

The result is that today Chile's telecommunications market is booming. The recent award of two Personal Communications Services (PCS) licences attracted interest by both investors and equipment suppliers.

Sector-specific telecommunications rules in Chile are administered by the Subsecretaría de Telecomunicaciones ("SUBTEL") within the Ministry of Transport and Telecommunications. Some regulatory provisions include: (1) the award of licenses to provide telecommunications services on a nondiscriminatory basis, (2) technical standards and interconnection obligations, (3) price controls (for retail services and interconnection) in insufficiently competitive markets, (4) universal service obligations (phased in over time in areas lacking sufficient infrastructure), (5) mandatory access to the customer's choice of long-distance provider (through pre-selection and on a call-by-call basis), and (6) competitive bidding for subsidized telecommunications deployment projects in rural and low-income urban areas. Antitrust rules, which generally prohibit actions or agreements that seek to hinder free competition in economic activities and specifically prohibit the grant of exclusive rights to perform any economic activity, are also applicable to telecommunications providers. The antitrust rules are administered by four separate institutions, some national and some regional.

Levels of competition that Chile has accomplished in its long-distance market are impressive, due in large part to carrier pre-selection and dial-around access requirements. The mobile market likewise has experienced growing competition, spurred by the grant of multiple licenses in the same territories. Internet usage also has increased significantly in recent years, probably due to price restrictions imposed on the dominant local service provider. Finally, Chile has achieved considerable success in deploying "universal service" (a single operating payphone in previously un-served villages) on a cost-effective basis pursuant to a competitive bidding mechanism. In the competitive bidding procedure, the lowest-bidding carrier is awarded a non-exclusive right to construct the payphones (using the cost-effective technology and project design developed by the carrier) and receives the awarded subsidies after completion of the facilities.

Chile's approach of allowing carriers operating in one segment of the market to operate in other segments of the market through separate subsidiaries and subject to prohibitions on cross subsidization seems laudable. The overall regulatory model, particularly the rule authorizing antitrust authorities to determine when market conditions justify eliminating specific price regulations, offers a good compromise between coherence and specificity.

In Australia, the 1993 Hilmer Report influenced policymakers to adopt the current Australian telecommunications regulatory regime. The Hilmer Report based many of its recommendations on a comparative analysis of other regulatory regimes, particularly the New Zealand experience. Under the current regime, general antitrust rules apply to telecommunications carriers. In addition, the antitrust regulator, the Australian Competition and Consumer Commission ("ACCC"), administers a cross-sector access regime requiring access to infrastructure facilities of certain services (pursuant to terms that are agreed upon by the parties or arbitrated by the ACCC) where the Minister of Transport and Communications makes the following determinations: (1) access to the service would promote competition, (2) it would be uneconomical for anyone to develop another facility to provide the service, (3) the facility is of national significance, (4) access to the service can be provided without undue risk to human health and safety, (5) an effective access regime is not already in place, and (6) access to the service is not contrary to the public interest.

There are other complementary telecommunications sector-specific rules, but most of these are incorporated into the antitrust legislation and administered and implemented by the ACCC. Certain technical functions are performed by a new regulatory body, the Australian Communications Authority ("ACA"). The ACCC and ACA are required to cooperate in some matters. Like Chile, Australia has introduced some measure of competition for the provision of universal service through a program of competitive bidding for access to a fund earmarked to provide service outside the main cities.

Australia is credited with achieving varying levels of success in promoting competition in the mobile market (spurred in part by mobile number portability), the international services market, the dial-up Internet market, and the broadband services market. However, the incumbent Telstra continues to control most of the local and long-distance markets. There is also concern about Australia's procedure for mandating access to critical telecommunications facilities. The processes for declaring services subject to access requirements and for arbitrating appropriate terms of access are cumbersome and slow, and access prices may be set too low to allow the facilities' owners to recoup their costs. More generally, however, the Australian approach of allocating the main responsibilities for economic regulation of the telecommunications sector to a telecommunications-specific department within a specialized cross-sector regulator is commendable.

In the power sector, Chile was likewise a pioneer in the early 1980s with the development of a competitive system for electricity generation based on marginal prices. Prices in this market were not truly deregulated (except for the largest consumers who chose to enter into contracts directly with generators) but were based on the short-run marginal costs of generators in the system and the associated least cost dispatch. Two decades later, policymakers in Chile are discussing the desirability of further de-regulating Chile's wholesale electricity market. In particular, the simulated spot market that is in place today would be replaced by a real unregulated spot market in which generators would be free to bid whatever prices they choose, with competition between generators determining the bids and market clearing prices. One major concern that has been raised regarding this spot market deregulation proposal is that the high degree of concentration in the generation segment would enable incumbent generators to exercise market power, leading to prices far above competitive levels. That is why in the 1990s the Chilean government embarked on a program to reduce concentration through divestiture and the encouragement of competitive entry.

The regulatory framework of the Chilean power sector established in 1982 consists of a number of different institutions. The National Energy Commission (CNE, established in 1978 to advise on long term strategy) has responsibility for advising the Minister of Economy on electricity policy, it is also responsible for the setting of regulated distribution charges. A Superintendent of Prices of Electricity and Fuels (SEC) has responsibility for data collection for the purposes of enforcement and regulation, handling of customer complaints and the implementation of service quality fines and customer compensations. In regulation the CNE uses data provided by the SEC on company costs. The law places limits on the number and background of civil servants working in the CNE. The Minister of Energy formally imposes the regulated tariffs and retains control over the issuing of rationing decrees during periods of drought when there is a shortage of hydro-electric generating capacity. The Minister also had responsibility for settling disputes in the CDEC board within 120 days, though this was altered in 1999. Currently disputes go to an Arbitration Panel (of three experts) which has 30 days to issue a judgment. If this is rejected by the CDEC board then the Minister has 60 days to issue a judgment. The Minister is himself part of a 5 member cabinet council which oversees the sector. Merger policy, abuse of dominance and collusion remain within the remit of the Office of the National Economic Prosecutor, Chile's Competition Regulator, which has a regulated utilities division. The Fiscalaria can present cases to the Antimonopoly Commission. This Commission has a Prevention Commission and a Resolution (or appeals) Commission. Companies have the right to appeal to the Supreme Court. This process has been somewhat refined by the 2004 Ley Corta in order to speed up the processing of disputes.

Because of these regulatory reforms in place, the performance of the Chilean power sector in terms of investments, prices, financial performance of

power companies, efficiency, rural electrification, and quality of supply have been impressive.

In ports and shipping regulation, Taiwan seems to be a good model to emulate. The small nation's experience with he port of Kaoshiung provides lessons on good competition and regulation policies translating to unprecedented development. The port of Kaohsiung is the world's fifth largest container shipping center and processes two-thirds of Taiwan's total import and export volume. It has 118 operating berths, occupying 26.6 kilometers of port waterline that can simultaneously accommodate up to 155 ships. The port effectively manages import, export, and transshipment containers and handles up to 8 million TEUs (twenty-foot equivalent container units) annually. Situated at the hub of trade routes linking Northeast and Southeast Asia, the development of Kaohsiung Port has stimulated Taiwan's prosperity. Kaohsiung Port container terminals provide prompt, accurate, and comprehensive logistical services. Its strategic location makes it the ideal choice for a marine transportation hub in East Asia. Of the six leading ports in the Asia-Pacific region (Kaohsiung, Singapore, Hong Kong, Pusan, Shanghai, and Tokyo), Kaohsiung Port's links are closer to the other five ports by an average of 53 hours of navigation time.

In order to facilitate the goal of establishing a transshipment center as well as a modernized maritime managing structure, the MOTC has implemented a policy of cooperation between cities (counties) and ports by organizing "Shipping Affairs Administration" and reforming all port authorities into special public corporate bodies. This more effective administration will integrate marine policies, port construction and development.

III. STRATEGIC TRIGGERS FOR REFORM

Notwithstanding the weaknesses of Philippine institutions, the institutional context is surprisingly strong on some "fundamentals"—a fairly developed nationwide judicial infrastructure, the presence of independent constitutional bodies, civil society watchdogs—but is as yet not strong and effective enough to deliver the minimum necessary underpinnings for long-lasting reforms. These institutions, although not directly involved in policy development, can help provide a stable environment for furthering meaningful policy changes in the country.

Commitment to develop resources and institutional frameworks

A serious policy development process cannot be commanded from the outside, but needs committed leadership from within, correctly from the topmost levels of the state. While pressure for reform can come from below—indeed, this can effectively supply a broad social consensus—any effective program must be supported from the top. *Yet any strategy that relies only on high-level leadership will be vulnerable to the many uncertainties of the political process.* Marshalling

credible commitment should cover key state institutions. A "convergence" of strong players would make for a breakthrough performance in policy development. Broadening the number of stakeholders in various sectors and encouraging their participation in decision-making can end policy biases, while ensuring that the decisions are made above-board, open to the scrutiny of the public.

This also implies that the first order of business is to put constraints on the state's instruments of discretion on franchising, licensing, and policy-making. A good starting point is to devolve this power of discretion and effectively reduce capture by ensuring big ticket items are out of the reach of the few big players who hold concentrated authority. Of course, this might simply decentralize corruption. But at least dealing with greater number of rent seekers restricts any one faction to a limited domain and prevents it from capturing regulations.

At the same time, a key focus of policy reform efforts should be on enhancing accountability and taking maximum advantage of ongoing reforms in public management (for instance, there are current efforts to upgrade public expenditure management in the Philippines). The priorities should include creating new accountable structures within and without agencies, increasing formal channels of access to decision-making (since secrecy is a formula for capture), enhancing oversight through participatory strategies, and deconcentrating political and economic power through deeper decentralization and privatization.

Sustainability also means digging deeper into the underlying sources of institutional weaknesses and strengthening institutions that can resist them. One key measure is to build public service neutrality: ensure that the public service is politically neutral. At this time, the Philippine civil service is heavily politicized and a repository of political patronage. Reform efforts will contribute to a meritocratic public service that will resist policy bias and will encourage decision-making in the public interest. Likewise, there is a strong need to strengthen corporate governance. Restraining business misbehavior obviously will limit the range of public policies that are potentially "for sale".

IV. INSTITUTIONS AND STRATEGIES TO SUPPORT THE REFORM PROCESS

If it were to cast a wide net, the policy development process ought to have substantial economies of scope---appropriate bundling of various ex-ante (capacity building) and ex-post (agency outputs) elements, and benefit spillovers. Seen in this light, how should policy development "services" be assigned to executing agencies in the Philippines?

Following Dee (2006), at least two types of agencies or institutional arrangements can support a wide-ranging process. The first is one that can, on its own, "radiate power" and handle an array of policy analytic instruments for independent policy review. The second type is one that can coordinate policy development across different instrumentalities, ensuring that each unit or office has access to instruments most appropriate to its own initiatives.

Independent policy review

Consider the first type of institution. According to Dee, several factors are central to a well designed institution: independence of approach, economy-wide view, and with adequate resources. If statutory autonomy is the most important factor, presently, no single policy agency would fit the description. Potentially, the National Economic and Development Authority (NEDA)) may be the agency according to Dee's model. The 1987 Constitution ensures it: Article XII, Section 9 provides that "the Congress may establish an *independent* economic and planning agency …which shall, after consultations with the appropriate public agencies, various private sectors, and local government units, recommend to Congress, and implement continuing integrated and coordinated programs and policies for national development." Section 9 further stipulates that "until the Congress provides otherwise, the National Economic and Development Authority shall function as the independent planning agency of the government." However, Congress has yet to pass an enabling law to implement the Constitutional directive.

On the basis of its mandate, NEDA is also well positioned to provide an economy-wide perspective. It is the only agency which has a whole-of-economy outlook, and is well-placed to install institutional strategies that can improve the country's microeconomic policy structure; every other agency is focused on narrow sector concerns.

As a public body with a clear constitutional mandate, NEDA has "latent" powers to mainstream policy development in the bureaucracy and conduct independent policy review but it has not exercised it, choosing instead to act as a mere coordinator of government policies and programs. NEDA is currently hounded by institutional weaknesses, e.g., loss of key technical personnel and inability to find suitable replacements to those who have resigned, transferred to other agencies or retired. Years of coordination of various agency plans, the political leadership's lack of a clear vision and coherent development strategy for the country, and a rather short attention span that is driven by its "coordinative" role, have made NEDA prey to routine national planning management.

A recently issued presidential fiat, Executive Order 230, reorganized NEDA to enhance its ability to coordinate the development planning and policy formulation process. It is tasked to provide technical staff support and assistance, including the conduct of studies and the development of policy measures and

other recommendations. These key ingredients put NEDA right up the policy development alley. Even without the necessary legislation that will transform it into an independent planning agency, NEDA can choose to take advantage of its economy-wide view and exercise its latent powers to plan, review, and act as chief economic advisor to the Executive. The drawback is that NEDA proper as a policy making body is composed of the President of the Philippines and key cabinet secretaries. By its very nature, NEDA is a political organization. It is serviced by a NEDA secretariat that can assume the independent policy review suggested by Dee but the reality, however, is that as a secretariat, it is duty-bound to adhere to the political viewpoint and decision of the NEDA (proper).

Looming in the horizon as an independent policy review body is the Philippine Institute for Development Studies, a research institute created on September 26, 1977 by Presidential Decree No. 1201. PIDS is organized as a non-stock, non-profit government corporation and enjoys a certain degree of financial autonomy because of the endowment provided to it by government upon its creation.

PIDS was established to respond to the critical and growing need for research for planning and policy formulation. In general, PIDS research is envisioned to help government planners and policy-makers in the executive and legislative branches of government. An independent board of trustees who are not political appointees but who were selected on the basis of their integrity, professionalism and academic qualifications, provides policy direction to the research agenda of the institute. The PIDS has proven itself as an independent and impartial policy analyst throughout its more than twenty five years of existence. The research studies and policy analysis conducted by the research fellows collaborating with a network of private and state universities have always taken the interest of the country at large. Its main drawback is the small size of its endowment which has compelled it to seek an annual subsidy from the Department of Budget and Management.

Coordination of policy-making across institutions

The second type of institution is an agency that can exercise an agency-wide or inter-agency coordination. Along this line of thinking, the Department of Budget and Management, as keeper of the purse, would be better placed than other agencies, provided it has the organizational will, capability and incentive to ensure wider policy coordination and to organize and head an inter-agency policy coalition. Its clout rests on the fact that it demands adherence to and implementation of policy reforms as a conditionality for releasing agency funds. It has espoused public expenditure reforms and has openly required various line agencies and corporations to adhere to performance-based and outcome-oriented fiscal culture. It has announced that government budgeting system will

shift to a performance-based system by the year 2007, which creates an environment that demands improved performance by government agencies and imposes accountability for resource use.

Indeed, it is due for a functional shift from purely fiscal management agency to a more expansive public sector management entity, a strategic redirection that could provide a better organizational platform for policy coordination. A path identified by analysts and donors alike is the critical advantage, not only of linking the planning and budgetary functions, but also of integrating the NEDA and DBM into one planning and budget department. But the effort will require strong organizational energy and political will, and may not be realized in the very near future given present political preferences.

Ensuring credibility of existing regulatory agencies

At this stage, absent both an independent policy review body and a coordinating agency, it makes good economic and political sense to place bets on regulatory agencies, providing them with enough authority, independence and resources to handle their job. There is a need to grant statutory independence to these institutions, drawing experience from the successful creation of an independent central bank, that is, the *Bangko Sentral ng Pilipinas*, acknowledged as the only Philippine agency with true statutory and financial autonomy.

Statutory independence can help regulatory agencies face several regulation-related problems more confidently: (1) how to prevent the incumbent firms from extracting unreasonably large profits from its customers (the price regulation problem), given that the incumbent firms do enjoy substantial market power; (2) how to ensure that the incumbent firms deliver quality services (the service delivery problem); (3) how to create market conditions that foster competition (the entry problem); and (4) how to guarantee that regulatory arrangements, if fair and reasonable, are enforceable and politically durable (the commitment problem).

In a context where institutions remain weak and ineffective, there are a few things which can be done to help fortify regulatory agencies, following Smith and Wellenius (1999).

The *first* is to *reduce the need for agency decisions*. It is unwise to expect regulatory agencies to do a lot early in its functional life. The more pragmatic approach is to make regulatory action less necessary. An effective way to do it is to accelerate competition, that is, open the market quickly to new entrants. That makes the job of the regulator more wieldy, as it resolves issues among several influential players or constituencies. The more providers there are, the more the regulator can have access to alternative sources of information on sector issues, lessen the risk of regulatory capture by any one operator, and offset some of the dominant operator's market power.

Competition also accelerates the gains from reform. For instance, when competition was allowed in the core telephony business, it generated powerful incentives for the incumbent to perform better. PLDT sped up investment to catch up with demand only after the Philippine government issued licenses in 1993 for mobile service and for several new international gateways to consortia committed to significantly expanding local telephone facilities in regions throughout the country. By 1996 the number of lines in service had almost tripled, to 1.8 million. Large initial productivity gains by PLDT made it possible to reposition itself for competition, but opening the market prevented it from using these gains to entrench its dominant position.

Another way is to prepare regulatory rules beforehand. If rights and obligations of an operator or class of operators need to be delineated, it is more advantageous and hence advisable to write these into licenses, contracts, or laws. That will facilitate technical assistance for establishing up front a detailed base-case regulatory environment. Specifying initial regulatory rules add up to a fairly robust regulatory framework. For instance, it made practical sense for the Philippine government to immediately introduce some competition in all services by authorizing more operators to provide local, cellular, domestic long-distance, and international telephone services alongside PLDT, the dominant player.

When rules are ambiguous, they invite confusion and disorder. For instance, when interconnection agreements were treated simply as a commercial matter to be agreed between the parties, the outcome left much to be desired. Interconnection disputes arose, with NTC initially not being able to provide effective regulatory adjudication. Every telecom firm would have been better off if NTC were allowed by law to lay down up-front default interconnection terms (both price and technical) which all parties had to follow.

Yet another means to reduce agency decision-making is to keep operators' obligations reasonable. Enforcing tough regulations on operators may seem socially beneficial, but a hard stance can lead regulators to unbearable situations. For instance, requiring new entrants to stick to stiff rollout obligations, with investments that go on the far side of what is commercially viable, risks coercing companies to undertake bad investments, leads operators to demand special privileges (such as longer exclusivity), and makes renegotiation a constant need.

The *second* is to *raise regulatory credibility*. In an environment of weak governance, some critical measures can do much to improve the credibility of regulatory agencies. These include ensuring there are enough legislative provisions on agency jurisdiction, autonomy, access to information, timeliness of the appeal process, enforceability of decisions, staggered terms of office for commissioners, and forbidding the removal of commissioners except for cause. Other measures that are also in order are adopting open regulatory processes to help ensure that decisions will not be overturned arbitrarily, thereby increasing

investor confidence; building public trust and support, especially on issues that are valued by consumers (billing accuracy and practices, quality of service, customer redress, geographic coverage and access by non-subscribers to public facilities like payphones and telecenters).

The *third* is to *use resources effectively*. The focus of regulatory action can shift from relationships between operators and government (licensing) to relationships between operators (interconnection) to relationships between operators and consumers (prices, complaints). That suggests that regulatory agencies may falter if they rely chiefly on internal skills, which are unlikely to vary widely and be deployed in a timely way. Conflicts inevitably arise between incumbent operators and new entrants, between new entrants, between operators and consumers, and between operators and regulators. Regulatory, administrative, and judicial resources may be rapidly deluged by the magnitude and complexity of cases. The agency can instead bank on a broad range of alternative dispute avoidance and resolution methods, including negotiation, mediation, and arbitration. Of course, to avoid dilatory tactics---the incumbent operator may have incentives to let the process last unnecessarily long---the dispute resolution process should include firm deadlines for completing the process, and authority to empower the arbitrator or mediator to decide if the process fails. Information asymmetry---operating companies know more about the sector than the regulator---puts the regulatory agency at a disadvantage, but it is possible to reverse this adverse situation by putting the operators to work for the regulator. For instance, it should be the regulated companies which should prepare detailed proposals for offering new services or revising price schedules. In this case, the regulator can draw assistance from consultants, and subject the proposals to review by other stakeholders.

At the same time, political accountability is perhaps the most crucial constraint needed to boost the performance of regulatory agencies. An important step is to increase the transparency of the decisions made by regulators by ensuring access to information; wider publication and information dissemination with the aid of ICT, and encouraging public debate. In favorable contexts, such mechanisms can be created within regulatory bureaucracies. Measures in place to fortify these institutions will contribute to improving the overall microeconomic foundations of the Philippines' economic performance.

The Philippines has experienced some moderately successful policy reforms since the end of martial rule in 1986 when the Aquino administration restored the democratic framework for the country. Former President Aquino dismantled sugar and coconut monopolies, liberalized trade and the financial markets and started the privatization of state-owned enterprises. Subsequent administrations tried their hand in pushing outward the policy reform envelope. The reforms in telecommunications led to the entry of more players and an improvement in access to telecommunications services. The privatization of the water distribution system in Metro Manila through a competitive bidding of the

concession was initially successful. The water tariffs were substantially reduced from the prevailing tariff imposed by the government-owned Metropolitan Waterworks and Sewerage System (MWSS) and coverage was expanded. But the second of two concessionaires encountered major difficulties a few years after winning the contract and withdrew from the concession.

The locomotive of Philippine policy reforms is faltering. Policy reform is not a sustained but a 'boom-bust' effort, which has created a pathetic and unstable policy environment. Private investors have expressed concern over the situation with a private group pointing out that "except for telecommunications, the Philippines now has a reputation as a risky environment for private infrastructure; investors perceive very high risks and foreign interest in private infrastructure is weak."[1] Somehow, institutional constraints contributed to the factors that have stymied policy reform efforts. Worse, it appears that government finds itself as an enemy of good policy outcomes. The government has either reversed policy in critical areas such as trade and credit or stalled the fruition of good policy, e.g., electoral reforms. An example of a policy reversal is a recently issued executive order, which lifted the prohibition against the provision of loans by government line departments and agencies to so-called target beneficiaries. Both Philippine experience and research unquestionably showed the inefficiency of subsidized credit programs and the huge fiscal cost of providing dole-outs. Learning from this experience, government issued an executive order in 1998 which terminated those subsidized credit programs and encouraged private financial institutions to be more active in the credit markets (Llanto and others 1999). The withdrawal of government line departments and agencies from the credit markets brought beneficial effects: more private financial institutions felt encouraged to provide small clients with access to loans and other financial services; government realized huge savings by stopping funding of subsidized credit programs; micro-enterprises started to get funding from private banks, NGOs and credit unions. However, in September 2006, the government, bowing to self-serving political interests, reversed this policy.

A quick glance at the past policy reform experience shows how much headway the economy can make when there is committed leadership behind the reforms. It also shows how much policy reforms suffer when political expediency overrides good policy choices. The 'boom-bust' cycle of reforms in the Philippine economy recurs because of the incompetence and low credibility of Philippine institutions and weak governance. It seems that unlike the Philippines, other countries find it hard to turn their backs to the policy reform process once they have committed themselves to it. A search for an explanation leads one to the realization that mature political leadership and the presence of competent institutions such as a professional bureaucracy, independent commissions and credible regulatory institutions, which have themselves become an interest group for policy reforms have much to do with their sustained effort along pathways of growth and development.

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END NOTES

[1] Senior Fellow, Philippine Institute for Development Studies and Professor, University of the Philippines, respectively. The authors acknowledge the research assistance of Karl Jandoc. The view and opinions expressed in the paper do not necessarily reflect those of the authors' respective institutions.

[2] The Resolutive Commission is the appeals forum for the Preventive Commission's decisions, and the first-instance forum for some cases. See Guasch and Spiller (1999).

[3] The percentile rank indicates the percentage of countries worldwide (the survey covers 209 countries) that rate below the selected country. Kaufmann and Kraay (2006) grouped countries into a three broad categories: **exemplary** – above 90th/between 75th to 90th; **vulnerable** – between 50th and 75th/between 25th to 50th , **governance crisis** - between 10th to 25th/bottom 10th .

[4] The chart is from the Senate Economic Planning Office (2005).

[5] MERALCO was accused of buying power from Quezon Power at ₱6.54 per kwh, from First Gas-Sta. Rita at ₱5.54 per kwh, and from First Gas-San Lorenzo at ₱4.89 per kwh in December 2002 when NPC supplied MERALCO at only ₱3.62 per kwh. "Enrile Hits Rise in March Electricity Rates, Blames MERALCO PPA Charges," Manila Bulletin, March 12, 2003.

[6] This section draws liberally from earlier research by Austria (2002), Serafica (2001, 1998), Llanto (2004), Llanto and Patalinghug (2005) and Llanto, Basilio and Basilio (2005). Specific citations are dispensed with unless otherwise deemed necessary by the authors of this paper.

[7] Following Austria (2002), the paper limits the discussion of domestic shipping to the inter-island liner shipping industry because this is the sector of the (shipping) industry that is highly regulated and whose viability is highly sensitive to government policy.

[8] Under Philippine practice, an executive order issued by a President can be revoked by a subsequent President. An enacted makes permanent a policy issuance made under an executive order.

[9] Sigua, R and Aguilar, G. "Maritime Incident Analysis Using GIS", 5th EASTS Conference, October 2003.

[10] National Telecommunications Commission, "Memorandum for Voice Over Internet Protocol (VOIP)," March 29, 2005.

[11] Ronald Solis, Chairman, NTC, Speech on Imposition of Significant Market Power Obligations, delivered at the U.P. School of Economics, March 2006.

[12] Ibid.