

# THE POLICY DEVELOPMENT PROCESS AND THE AGENDA FOR EFFECTIVE INSTITUTIONS: THE PHILIPPINES

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# The Policy Development Process and the Agenda for Effective Institutions: The Philippines

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## Introduction

A developing economy such as the Philippines faces the challenge of how to create an enabling environment for economic growth and development. The policy development process leads to the creation of that environment but how does one nudge forward the policy development process? Why are some reforms adopted while others face stiff resistance? The policy development process is not a disembodied phenomenon but is nested in an effectively functional institutional setting. There can be no effective policy development process if institutions supporting and implementing it are ineffective or dysfunctional. Several factors may explain the acceptance of or resistance to reforms, such as the message content of the proposed reform or package of reforms, the relative impacts on various sectors of the economy, the identity of gainers and losers, the presence of a broad coalition of support or lack of it and many others. This paper maintains that acceptance of or resistance to reforms or even of the whole policy development process may be influenced by the presence and active participation of institutions supporting the process. Both the content (message) of the reform and the medium used for acceptance of the reform are equally important. In this paper the “medium” referred to is the set of institutions that help or motivate the policy development process.

A distinction can be made between institutions “supporting” the policy development process and institutions “implementing” it. Typical discussions would focus on the important role of implementing institutions in the development agenda. The recent experience of fast growing ASEAN countries such as Malaysia and Thailand shows that it is not sufficient to have the right development policies; it is equally, if not more important, to have effective (implementing) institutions. A combination of efficient policies, enlightened and strong 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. Implementing

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<sup>1</sup> The author benefited from the research inputs of Karl Jandoc on the Australian experience with MTEF and conversations with Ed Gonzalez on governance and institutions.. This paper draws in part from Llanto and Gonzalez (2006) which is appended as Annex A.

institutions whether formal or informal, are thus, the means through which authority is exercised in the management of resources of the state.

However, the other type of institution, the “supporting” institution has also a unique role in the policy development process and in creating the enabling environment for well functioning markets that would deliver policy outcomes. This paper departs from the usual discourse on the need for effective implementing institutions. Most discussions on the role of ‘institutions’ in the policy development process implicitly assume that those institutions are the ‘implementing’ institutions. The paper discusses the critical role that “supporting” institutions such as independent review institutions or commissions and coordinating institutions can play in moving forward the policy development process. It is common to identify inputs to the policy making process as if these were given<sup>2</sup> but in this paper, those inputs are not taken as given. On the contrary, the paper considers how such inputs are produced and suggests a strategy to improve their production and dissemination to policy makers. The paper uses the experience with current reform efforts of the country in public expenditure management to illustrate the strategic role of “supporting” institutions in producing and providing important inputs to key policy makers for decision making and thus, in nudging forward the policy development process.

The paper discusses not only the instruments for moving forward the policy development process (e.g., the supporting institutions) but also the *process* of moving it forward. Implicitly, the paper acknowledges the limitations of focusing exclusively on what policy reforms are needed or on what institutional arrangements would bring about the policy development process and indicates the need to understand the process itself of the policy development process. It is important to grasp how policy reforms are formulated, reviewed or amended and presented to the public and finally, to decision makers in the executive level, or if needed, to legislators. The end goal of the policy development process is a new state of nature, that is, a reformed environment underpinned by particular reform measures but sometimes the discourse on this process says very little, if at all, about how to shift from a pre-reformed situation to the reformed situation, that is, the dynamics of moving to a new paradigm. To put in proper context the challenges in the policy development process, the next section provides a bird’s eye view of the current situation.

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<sup>2</sup> A comment by Philippa Dee.

## II. The Current Economic Situation, Institutions and the Need for Reforms

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. The irony is that the promise and potential seen in the fifties have remained as unrealized promise and untapped potential as well at the dawn of the 21<sup>st</sup> 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. In the eighties private investors studiously ignored and bypassed the country and poured massive capital and technology into Malaysia, Indonesia and Thailand. 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. This phenomenon seems to be re-emerging.

The result of economic decline and stagnation is deep poverty, which has remained a major concern. Notwithstanding government reports, data show that the incidence of poverty appears to have increased 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.

Notwithstanding the economy's weak performance, it is acknowledged that the growth potential of the country is considerable (World Bank 2005). There are significant natural resources; a large pool of

managerial and entrepreneurial talent; and widespread proficiency in English. Reforms dating from the 80s have resulted in a liberal domestic and foreign investment regime and openness to trade. Remittances of nearly 10 percent of Gross National Produce (GNP) sustain domestic demand. The growth of its Gross Domestic Product (GDP) of over 6 percent in 2004 was the fastest in 15 years (World Bank 2005). There is much room for improvement and growth and this where the policy development process plays a critical role.

The Philippines has experienced some moderately successful economic 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 generally 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. Because of reforms that have strengthened the economy, the Philippines was able to participate actively in global trading markets and had benefited from the economic boom enjoyed by the United States, China and other major countries. It has survived the Asian financial crisis of the late nineties and has managed to grow despite severe geopolitical tensions and the rising price of oil in the last few years. It has, however, remained vulnerable to problems of rising domestic and external debt, the volatility of the oil market and the loss of export markets because of lack of competitiveness of domestic firms and the failure to attract foreign capital and technology in the scale that neighboring ASEAN countries like Malaysia and Thailand have enjoyed and have used to their advantage to fuel their respective economic growth<sup>3</sup>.

The vulnerability of the economy only highlights the challenge to maintain and accelerate the pace of economic policy reform but somehow the reform efforts have stalled. The World Bank's (2005) investment climate assessment identified the poor quality of key infrastructure services, a fragile and underdeveloped financial system, and a perception that contracting and regulatory uncertainty adds costs of doing business as barriers that discourage private investments. Somehow, institutional and political constraints have contributed to the factors that have stymied policy reform efforts. Worse, it appears that sometimes the government itself is 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

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<sup>3</sup> Public debt is more than 100% of GDP. The weak fiscal position has motivated large government borrowing that could have crowding out effects on private credit demand.

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 Geron, 1999; Llanto, Geron and Tang, 1999b). 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.

Thus, in recent years Philippines has slipped in competitiveness rankings and has experienced recent credit and outlook downgrades by the major rating agencies. This is a cause for alarm because regional competition for investments has heated up, with other countries exerting a huge effort to present themselves as better investment alternatives, which are reflected in their higher competitiveness ranking and upgrades in credit ratings and outlook. Private investors have expressed concern over the situation, which seems to picture the Philippines as a risky environment for private investments with potential investors perceiving high risks, e.g., political and regulatory risks.

As earlier stated, the economic policy reform momentum has to be maintained and accelerated. It is an opportunity that can not be wasted because of the high cost to society of not reforming. Why have reforms been inadequate and what gaps are there in the policy making process that may have lead to this shortfall?

The literature suggests that policy reform processes encounter conflict among powerful institutional factors, e.g., vested interests<sup>4</sup>. In Philippine political economy, the different vested groups, which may be in conflict with each other or which may temporarily coalesce for a common objective, e.g., acquire power in a political contest, have their origins in the political and economic power of the economic elite. The power center is a centralized and patronage-ridden presidency that orchestrates the execution of policy and allocation of spoils. Such concentration of power is supported by power of families and clans in the local areas, within the context of a "neo-patrimonial" political system (Azfar, et.al., 2000).

Because the president has discretion over disbursement and big-ticket government contracts, licensing authority, and fiscal management powers, 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

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<sup>4</sup> 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).

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 election periods, 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). The Philippine legislature is thus, orientated toward a spoils systems designed to entrench the incumbents' political and economic power rather than a system to balance and reward competing interests in society with a view to upholding the welfare of those with neither political nor economic power. Politicians themselves design and modify institutions to stay in power or support a particular business interest. Voting arrangements, financing of campaigns and political parties, and other institutions are maintained or revised to keep incumbents in office. In the end, 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). In this context, 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). Thus, policy reforms may be supported or hijacked by powerful families, business groups and politicians with blessings from the top depending on whether or not those reforms would promote their self-interest, e.g., commercial and business interests, and centuries-old hold on political power.

In the face of these roadblocks, it is imperative for the country as a whole to seize the day, so to speak, to build on past reform efforts and work hard to map out a reform agenda for the future. Failure to

pursue further reforms to strengthen the economy could be fatal amidst threats to the multilateral trading framework that has “played a crucial role in the rapid economic growth and rising living standards that most of the world—including the poor—has enjoyed since 1945” (Krueger 2003), the country’s continuing dependence on a few trading partners and a narrow export base and limited fiscal space for development programs and activities. Indeed, in the words of Krueger (2003): “economic reform has to be continuous. That might sound obvious, but it is striking how, over the years, governments of all kinds have tended to think of reform as a discrete process, one that has a clear ending. But that is to misunderstand the nature of economic change. As economies evolve, so should their structures and institutions. Failure to reform impedes progress and impairs the growth of living standards”. What may be the role of supporting institutions?

### III. Supporting Institutions in the Policy Development Process

Following the seminal paper of Dee (2006), there are two types of supporting institutions that can support the policy development process, namely, (a) “an institution that coordinate policy making across different government ministries, ensuring that each ministry or department has access to the policy instruments most appropriate to its policy problems, and that the actions of one ministry or department do not cut across others”, and (b) an institution that “can undertake an independent policy review process, either in reviewing existing regulatory settings (ex post reviews), or reviewing policy proposals before decisions are made (ex ante reviews).” Ex post reviews have the power to evaluate the effectiveness of existing policies while ex ante reviews have the ability to formulate new policy options.

#### *Coordinating institution*

The first type of institution is a coordinating body that can harmonize and synchronize the different development efforts in the government based on a shared development agenda as reflected in the Philippine Medium Term Development Plan. The Philippines has a market-based economy where markets are allowed to work unimpeded unless there are strong reasons and justifications for intervention or regulation. Market competition can deliver efficient development outcomes but government may have additional policy objectives besides economic efficiency (Dee 2006) such as distributive justice, poverty reduction or the improvement of the distribution of income and asset endowments, which are not the concern of markets and the price system (Canlas 2004). Thus, there may be a scope for regulation or intervention and in such instances policy coordination will be indispensable so as not to unduly disrupt the efficient functioning of markets.

The National Economic and Development Authority (NEDA) serves as the national and regional development plan and program coordinator based on its mandate from Presidential Decree 1 (September 21, 1972) and Executive Order 230 (July 22, 1987). It issues the planning guidelines and conducts multi-sectoral and regional consultations for inputs to the development plan, that is, the Philippine Medium Term Development Plan. It is tasked with the coordination of official development assistance and the appraisal of programs and projects and conducts program and project evaluation and on-site reviews and consultations. It has two separate and distinct entities: (a) the NEDA Board and (b) the Secretariat. The NEDA Board is a cabinet level board composed of the major government departments (ministries) and is chaired by the President of the Philippines. The Secretariat provides technical and secretariat services to the different NEDA Committees (Investment Coordination Committee, Infrastructure Committee, Development Budget and Coordination Committee, and the Tax and Tariff Committee, the Regional Development Councils, the Philippine Council for Sustainable Development, National Land Use Committee), inter-agency bodies in governments and other clients such as local government units. It is uniquely situated in the government bureaucracy because it has comprehensive information on the implementation of government programs and projects and policies and has the capacity to give comments on economic policies pursued by the government.

The 1987 Constitution ensures the role of NEDA in the economy. 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 process in the bureaucracy 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 the routine preparation of guidelines for national planning and the packaging of the medium term Philippine development plan.

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 to the area of the policy development process. 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, and in a larger sense, be an effective coordinating body. That NEDA proper is a policy making body chaired by the President of the Philippines may have its drawback as a politicized organization but on the other hand, being the chief policy making body in the bureaucracy has its advantages. It can very well be an effective coordinator of the policy development process. The dynamic tension here is that between the technocrats (in the NEDA secretariat) and the cabinet members, all political appointees, with their own political goals and mandates (NEDA proper) in their respective approach to the policy development process.

A government department or ministry that can exercise an agency-wide or inter-agency coordination is the Department of Budget and Management. Along this line of thinking, the Department of Budget and Management (DBM), as keeper of the purse, would be better placed than other agencies to ensure wider policy coordination and to organize and head an inter-agency policy coalition. However, it has to have the political and organizational will, capability and incentive to exercise a coordinative role in the policy development process. Its clout rests on the fact that it can demand adherence to and implementation of policy reforms as a condition for releasing agency funds. Recently, it has espoused public expenditure reforms and has openly required various line agencies and corporations to adhere to performance-based or outcome-oriented budgeting. 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. The motivation for budgetary reform arises from the need to improve public spending for macroeconomic reasons and to have greater efficiency and effectiveness in the public sector.

There is a general agreement among the oversight agencies about the need to change its existing budgetary system but it took DBM a long time to generate consensus about the need to shift to results-based budgeting and a performance management. Aided by technical assistance grants from donors, the

DBM as a coordinating body has led efforts to reform the budgeting system, working with other oversight agencies (NEDA and the Department of Finance). Thus, convinced that the way to go is to have a performance culture and accountability in government, the incumbent secretary (minister) of the budget publicly announced these budgetary reforms in his presentation to the Philippine Development Forum, a venue for government, donors and stakeholders to assess the country's development strategy and agenda and to agree on common paths for action in Tagaytay City on March 2006.

The current agenda for the Public Expenditure Management Reforms consists of the following mutually supportive and inter-dependent measures<sup>5</sup>:

- The Medium Term Expenditure Framework (MTEF);
- The Organizational Performance Indicator Framework (OPIF); and
- An Accountability, Monitoring and Evaluation framework.

There is inter-dependence among the three measures because the successful pursuit of one necessitates the presence of the others. MTEF is the framework needed for predictable funding to multi-year program, projects and activities. Without MTEF, it would be difficult for OPIF to succeed because departments can not drive their organization for results without predictable budgetary support. Without OPIF, the government does not have an effective mechanism to ensure that policy choices will be prioritized and pursued and to evaluate whether such choices are effective in terms of delivering outcomes. An accountability, monitoring and evaluation framework works hand in hand with both MTEF and OPIF to make certain that resources are truly creating expected impacts delivered by responsible parties<sup>6</sup>. These three components are essential for Results-Based or Performance-Based Budgeting.

Results-Based Budgeting moves away from a control on inputs by oversight departments to measuring and accounting for results. A natural corollary for OPIF is a transparent and well-enforced accountability system and strong monitoring and evaluation capability of the oversight departments and agencies.<sup>7</sup>

The DBM together with other oversight agencies (NEDA and the Department of Finance) under the NEDA committee called the Development Budget Coordination Committee (DBCC) has pursued radical fiscal reforms on the expenditure side. The overall reform effort is known as Public Expenditure Management (PEM) Reform, which is composed of two broad components: (a) Organizational Performance

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<sup>5</sup> <http://www.euforic.org/dpmf/943db>

<sup>6</sup> See *ibid.*

<sup>7</sup> *Ibid.*

Indicator Framework (OPIF) and (b) Medium Term Expenditure Framework (MTEF<sup>8</sup>). DBM documents describe OPIF as “an approach to expenditure management that directs resources towards results and accounts for performance. It enables agencies to focus efforts and resources on core functions and on delivering high impact activities at reasonable costs and quantities.”<sup>9</sup> OPIF is an important instrument in the tool kit of DBM in coordinating the policy development process because it provides an analytical approach (based on a logical framework) linking societal and sectoral goals, organizational outcomes and outputs. A set of performance indicators provides key information on the accomplishments of departments and agencies based on pre-determined targets and measures. Currently, DBM receives technical assistance from donors who drew from the earlier experience of Australia in public expenditure management reform. A description of the main innovation- the outcome-output framework pursued by the Department of Finance of Australia in the 1990s is shown in Box 1.

BOX 1.

The main innovation of the government during the second wave of public sector reforms with the election of a conservative coalition government was its *outcomes and outputs framework* requiring departments to agree with their ministers on the *outcomes*—the government objectives—towards which they are working, and to also agree the on departmental *outputs* which would be produced to help achieve these outcomes. The three objectives of the outcomes and outputs framework are: First, to support the government’s policy development; Second, to support and strengthen departments’ internal management, including staff learning; and last, to strengthen external reporting, for accountability purposes.

The outcomes and outputs framework has the potential to:

- foster agreement among key stakeholders concerning expected standards of performance;
- assist benchmarking comparisons across departments, and between the public and private sectors. This facilitates the ability of the government to take advantage of potential efficiency gains by selecting least-cost service providers. Moreover the shift towards accrual accounting will also facilitate such an approach;
- support the different departments in understanding the logical (and desirably evidenced-based) links between departmental spending, their activities, their outputs, and their contribution to desired outcomes; and
- help departments to cope better with management complexity, particularly when the work of several departments jointly impinges on achievement of a particular outcome objective. This relates to the concept of ‘joined-up government’.

Source: Mackay (2004)

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<sup>8</sup> Under the MTEF, expenditures are driven by strategic and policy priorities, and constrained by the revenues that government projects to generate. It links the policies, plans and the budget over the medium term (three years, as defined by DBM).

<sup>9</sup> Organizational Performance Indicator Framework (OPIF): Fiscal year 2007 Performance Budget for Twenty Departments, August 2006.

As a coordinating body for the work of the entire bureaucracy and government-owned and controlled corporations that require subsidies from the government, DBM has to be able to establish where public sector resources are being used and how effectively the outputs from the use of those resources deliver organizational outcomes. Here we have a combination of a supporting institution (to the policy development process) possessing a potent tool (OPIF and MTEF) to orchestrate the policy development process. Indeed, the DBM is now flexing its muscle to shift from a purely fiscal management agency concerned with budget allocation and cash release to a more coordinative public sector management entity that motivate implementing institutions (e.g., departments, government-owned and controlled corporations) to deliver specific outputs that meet organization outcomes, which in turn contribute to societal/sectoral goals. This is a strategic redirection in its role that provides a better platform for supporting the policy development process.

To illustrate the potential contribution of OPIF (as a tool) and the DBM (as a coordinating body) in the policy development process, I describe below recent work of DBM in developing log frames for at least twenty departments of the national government<sup>10</sup>. The OPIF clarifies roles, functions, and accountabilities among agencies, a key ingredient to support the policy development process. It introduces a tool for better internal governance among the agencies by providing them greater flexibility and control over resource utilization with accountability specified at the same time. OPIF helps in enhancing transparency and improving reporting agency accomplishments to the public and to policy makers. In this way, the policy development process becomes adequately supported.

According to DBM, an early form of the OPIF was introduced in the 1998 budget with BP 206: Agency Program/Activity and Major Outputs. The present OPIF was introduced in the budget preparation process in the 2005 Budget Call. A budget matrix established the linkage between programs/projects/activities (PAPs) on the one hand and the major final outputs (MFOs) on the other. The Budget Call also required agency performance measures through performance indicators and targets by major final outputs. The MFOs refer to goods and services that an agency is mandated to deliver to external clients, that is, the public, through the implementation of agency PAPs.

The mainstreaming process for the OPIF is “an iterative and evolving process”, which DBM leads through a series of workshops, coordination and harmonization meetings with the various agencies. DBM with the help of donors (AusAID and ADB), which provided consultants, rolled out the OPIF in preparation of the 2007 budget. A series of workshops, coordination and harmonization meetings, discussions and “write-shops” were conducted with agencies. In those activities, the DBM directors in charge of rolling out the OPIF were invariably present to provide guidance and coordination. The DBM coordinated the identification

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<sup>10</sup> This draws from the Fiscal Year 2007 Performance Budget for Twenty Department, August 2006.

and development of MFOs, the harmonization of MFOs from the oversight and implementing standpoints, the validation of the OPIF logical framework and alignment of agency MFOs with the log frame/MFOs of the 'mother' department, e.g., log frame of the Bureau of Internal Revenue vis-à-vis the log frame of the Department of Finance. This involved iterations at the department and intra-department level, as well as at the oversight level. Bureau or agency (sub-department) level MFOs and logical frameworks have to be harmonized and linked with that of the whole ("mother") department. An example of a log frame, which was developed by the Bureau of Customs (BOC) and DBM through those workshops, discussions, write-shops, etc., is shown in Box 2.

Based on the experience of DBM in February to May 2006 when the roll out was earnestly pursued, it is necessary to involve the agencies in the process of developing their respective log frames so that ownership and accountability may reside with those agencies. The resulting log frames for at least 20 departments were collected in one document, which will accompany and support the major budget documents, namely, the National Expenditure Program, the President's Budget Message and the 2007 Budget Executive and Staffing Summary. All of these will be submitted by the President to Congress.

The main challenge facing DBM in fully coordinating and leading the utilization of OPIF and MTEF (a three year rolling budget framework) across the bureaucracy is the acceptance by Congress of these radical reforms in public expenditure management. Congress is used to and expectedly prefers annual appropriation in which specific line expenditure items are scrutinized and approved. The annual ritual of budgetary appropriation is an exercise of legislative power over the purse and is jealously guarded by Congress. The budgetary decision calculus, which is exercised annually, provides Congress with a process to allocate resources to sectors and target beneficiaries according to their political importance or to the benefit that accrues to the legislators. Budgetary appropriation is as much an exercise of allocating resources to address development goals as an avenue for the distribution of benefits based on the political calculus. The latter case reflects the characterization given by Kimenyi and Mbaka (1993) to politicians as brokers of wealth transfers between various interest groups. On the other hand, there is the view that reforms start with political initiatives (Aucoin 1990, 1995; Kingdon 1984; Peters 2001; Savoie 2000) and that properly understood in terms of benefits and costs (to losing parties), reforms have a scope for adoption by politicians. There are no easy answers or solutions to this challenge and this is not the occasion to discuss it.

However, it should be noted that the opportunities for reform such as the recent effort to improve public expenditure management do not come as often as reformers such as DBM or NEDA would like them to. Efficiency gains in government may not be properly understood or even appreciated by the voting public, and thus, politicians may dismiss reforms as irrelevant or untimely. Following Williamson and Haggard

(1994), politicians may have a lesser belief in or regard for the benefits of economic reform while the general public, especially specific interests bound to lose certain privileges may even have much less belief in it. As supporting institutions to the policy development process, DBM and NEDA are aware of the shifting sands of policy making and policy reform in the Philippines.

The following features of public policies pointed out by Spiller and Tommasi (2002) and Bambaci, Spiller and Tommasi (2001) in Argentina seem to reflect the Philippine situation: (i) public policies are oftentimes too volatile, being changed too easily with (sometimes minor) changes in political winds; (ii) oftentimes, precisely to avoid that opportunistic volatility, rigid mechanisms are put in place to instrument long term policies; (iii) there is poor coordination among different governmental units operating over interrelated policy arenas (among levels of government . . . , among departments within a given level, among sub-national governments); (iv) some welfare enhancing reforms are not instrumented; and (v) there is underinvestment in capacity building for improving public policies. All the more, these coordinating bodies in the governmental bureaucracy should stay engaged and locked in a continuing dialogue with politicians and the Chief Executive on how best to allocate and use the budget to deliver good policy outcomes and meet societal and sectoral goals. Convincing them that good economics is good politics underpins the reform efforts but the coordinating bodies (DBM and NEDA) need to improve their technical as well as political skills in the policy development process. It is obvious that the benefits of the reforms have to be effectively communicated to the general public to generate a constituency for reforms.

An important element of the communication strategy is to link up with independent policy review institution(s), which provide an objective, third-party assessment of the policy development process.

#### *Independent policy review institution*

The second type of institution can provide an objective assessment of development efforts, do performance reviews and identify future pathways for reform and development. These institutions may be do either *ex ante* or *ex post* reviews or both. *Ex post* reviews are utilized to evaluate the effectiveness of existing policies or past development programs and effort while *ex ante* reviews are used to identify and formulate new policy options. Both types of policy reviews are crucial for the policy development process.

#### *Ex post reviews*

According to Dee (2006 page 71), "there may be an initial role for a review agency to undertake policy review work to identify the indirect budgetary or other costs of poorly targeted or poorly coordinated decision-making. . ." The academic and research community composed of private and state universities,

private research institutes or research centers, and even NGOs engaged in policy watch may fulfill such role to do *ex post* policy reviews. Dee mentions “academic think-tanks, and even private consulting firms, whose resources and expertise could be brought to bear in the policy review process (page 71).” Independent research or evaluations may be commissioned by the government (that is, by the oversight or coordinating bodies namely, the DBM and NEDA) to those entities. An important consideration, however, is the credibility of those institutions, an issue that will be tackled later in this section.

Looming in the horizon as an independent policy review body is the Philippine Institute for Development Studies (PIDS), 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. It is partly supported by an annual subsidy from the government because of the small size of the endowment fund relative to the research agenda and work plan that are submitted to and approved by its Board of Trustees.

PIDS was established to respond to the critical and growing need for independent 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 Chairman of the Board is the Secretary of Socio-economic Planning. He is not appointed to the Board but is a de-facto member by virtue of his position as Director General of NEDA. PIDS is an agency attached to NEDA for administrative supervision only.

The PIDS has proven itself as an independent and impartial policy review institution and analyst throughout more than twenty five years of existence. The research studies and policy analysis conducted by the research fellows, who also collaborate with a network of private and state universities have always taken the interest of the country at large. Its main drawbacks are (a) the small size of its endowment fund, which has limited its research scope and activities and (b) its dependence on the government for an annual subsidy to augment the endowment fund, which leaves it vulnerable to political intervention. It is noted that the annual subsidy has to pass muster the scrutiny of the Congress.

An important feature of the policy review agency is its credibility. In the case of the PIDS, it has the desirable characteristics of an independent policy review institution. The minimum requirement for an appointment to a fellow position is a Ph.D in Economics, Statistics or related sciences. The research associates are holders of masters’ degrees while the research assistants are graduates of reputable universities. Its research agenda is vetted by an independent team of experts from the fields of economics,

law, public administration and other fields, who are hired by the Board of Trustees to prepare and submit for Board approval a rolling five-year research agenda covering critical topics and issues in the policy development process. It has statutory independence, consults publicly and widely and has an economy-wide view in providing recommendations. A network of researchers from other organizations, e.g., private universities, complements the PIDS research team and thus, addresses any skill gap.

Following Dee's understanding of "credibility," another distinguishing feature is that "policy reviews not be consistently ignored without cost." A strategy is "to make the reviews mandatory" and additionally, "to empower the review institutions to subpoena evidence from stakeholders, if necessary." These desirable features are absent in the Philippine experience with independent reviews. It is true that Philippine policy makers take cognizance of the results and recommendations of independent reviews but they can also at the same time studiously ignore them. The political calculus comes to the picture. It seems that the policy makers/decision makers consider the political weight of the constituencies that support the recommendations for policy reform and that of opponents of reform who sense the danger of losing privileges and advantages because of the reform effort. In this regard, the "marshalling of countervailing interests against a particular vested interest" is a further strategy "for maintaining credibility."<sup>11</sup> The strategy calls for turning "countervailing interests" into "powerful allies of policy review institutions." The linking strategy may work well for PIDS, which is not geared for advocacy. It sees as its principal mandate the production of independent policy reviews, research and analysis, which are turned over to the public domain by way of publications, seminars, workshops, testimonies in hearings arranged by various Congressional committees. There is no conscious effort to advocate for support of the policy recommendations by PIDS fellows; instead those recommendations are left to the market place of ideas to compete with other positions and findings. The real world politics of reform requires a broad-based coalition of support that politicians will find difficult to ignore lest they experience the erosion of support which makes tenuous their hold to power. Fortunately, in the Philippines, there is a range of civil society organizations that are on the watch for policy reforms and that are willing to advocate for those reforms, using a diversity of tactics, e.g., public forums, conferences, even street marches. The challenge is to forge a strong link between independent policy review institutions such as the PIDS and those civil society organizations and similar interest groups. Thus, the combination of a supporting institution such as an independent policy review institution and civil society watch dogs may prove to be strategic in the policy development process.

### Ex ante reviews

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<sup>11</sup> Phrases in quotation marks are from Dee's paper (page 72).

Another vital element in the policy development process is the periodic conduct of *ex ante* reviews, which are important instruments for deciding on competing policy options. This kind of review may entail an evaluation of proposed spending priorities of departments, proposed reforms, and others.. The experience of Australia in this regard is quite instructive as the evaluation exercise helps pinpoint accountability, reduce cost (generate savings) and thus, leads to good policy choices.

The evolution of Australia's evaluation capacity paved the way to improved governance. It assisted the Cabinet in decision-making and prioritization over the construction of the budget, and in supporting internal program management within line departments. Eventually, every aspect of Australian governance fell under the influence of formal program evaluations, including its budgetary institutions.<sup>12</sup> In response to a looming fiscal crisis in the early 1980's, the newly-elected reformist Labor government of Australia embarked on an ambitious wave of public sector reforms that eventually brought down the share of federal government outlays in GDP from 30% in 1984-85 to 23% in 1989-90. Central to these reforms is the introduction of a medium-term expenditure framework (MTEF). The effect of this included some initial tangible changes, namely:

- Substantial autonomy for departments in their spending of administrative expenses (including salaries), but with these administrative expenses being strictly cash-limited;
- Greater surety about future resource availability to departmental managers via a system of three-year forward estimates of administrative and all other program expenses; and
- A major reduction in the number of departments through amalgamation, to achieve less balkanized policy advice and to encourage the internal reallocation of resources through portfolio budgeting.

In time, the Department of Finance (Australia) undertook a diagnostic review and discovered that (a) there is a lack of integration of evaluation into corporate and financial decision-making; (b) evaluations tended to focus on efficiency and process issues rather on the more fundamental question of overall program effectiveness—i.e., whether or not programs were actually meeting their objectives; and (c) a poor level of evaluation skills and analytical capacity; and last, that the role of central departments in evaluation, especially the Department of Finance was unclear. The findings in this diagnostic study was the basis for the Department of Finance to seek and eventually secure consent of the Cabinet to a formal, ongoing evaluation strategy for all departments in late 1988.

Over 530 evaluation reports were published between 1993 and 1997) that provided a growing 'library' of evaluation findings which were exposed to peer scrutiny mainly because the Department of Finance made available a register of published evaluation reports.

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<sup>12</sup> This section draws from Mackay (1998 and 2004).

These evaluations were heavily utilized in the budget process. It has provided the Cabinet a basis for the development of policy options. For instance, in the 1990-91 budget about A\$230 million (around US\$175 million) of new policy proposals were deemed to have been directly or indirectly influenced by the findings of an evaluation. This had risen to A\$2300 million by 1994-1995. The proportion of new policy proposals influenced by evaluation rose from 23% to 77% over both periods. The box below shows an example of the influence of evaluation in the budget and how it influenced the Australian government in its prioritization.

### **An Example Of The Use Of Evaluation To Help Government Cut And Reprioritize Its Programs**

In the 1996-97 Budget the new government was determined both to reduce and to reprioritize government spending. Particular focus was given to labor market and related programs, which accounted for spending of A\$3,800 million annually (about US \$2,900m).

The Minister for Employment articulated the government's overall policy goal as being to provide assistance to the long-term unemployed and to those at risk of entering long-term unemployment. This focus was adopted both for equity and efficiency objectives — the latter pursued by achieving a better matching of labor supply and demand. At the same time, she wanted to achieve better value for money from labor market programs in the tight budgetary environment.

Australian and international evaluation findings were drawn on heavily to help guide the policy choices made. The Minister highlighted the relative cost-effectiveness of different labor market programs. A key measure of this was estimated by calculating the net cost to government for each *additional* job placement from different programs — as measured by the *increased* probability of an assisted person being in a job 6 months after they had participated in a labor market program. (The baseline was a matched comparison group of individuals who did not participate in a program.)

Evaluation findings showed that the JobStart program, which provides wage subsidies, had a net cost of A\$4,900 per additional job placement, whereas the JobSkills program, which was a direct job creation program, had a net cost of A\$76,600. The Minister noted that "the Government will be ... concentrating its efforts on those programs which have proven most cost-effective in securing real job outcomes". As a result, the JobStart program was retained while the JobSkills program was substantially scaled back and more tightly targeted to jobseekers who were particularly disadvantaged.

Total savings to the government from its reduction and reprioritization of labor market programs were about A\$1,500 million over two years.

Cabinet also commissioned a series of major evaluations of its new labor market programs and of the new arrangements for full competition between public and private employment service providers.

*Source: Senator Vanstone (1996); DFFTYA (1996, 1997); Commonwealth of Australia (1996).*

*Source: As quoted in Mackay (1998)*

Turning to the Philippine situation, the government has some rudimentary instruments for this kind of evaluation or reviews, which if improved, may be used to identify accountability. The DBM conducts an Agency Performance Review (APR) to review the performance of departments and agencies. One

constraint is that DBM tends to rely on the information and data submitted by the departments and agencies because of the lack of mechanism for getting more objective data, and inadequate monitoring and evaluation systems at the department/agency level. Compliance may be inadequate because agencies do not feel compelled to make a good accounting of their performance because it seems that the general attitude is that they would anyway get the usual budget (baseline) plus x%. On the other hand, the NEDA prepares another “accountability” document, the Socio-Economic Report (SER) but it has a fundamental weakness: inability of NEDA to validate reported outcomes and the tendency of agencies to provide mostly general information. There may be a scope for developing an instrument for policy review and evaluation using as basis the experience with the APR and SER. An independent policy review institution may be tasked to undertake this. The end result could be a powerful instrument for budget and performance review to facilitate prioritization among competing policies.

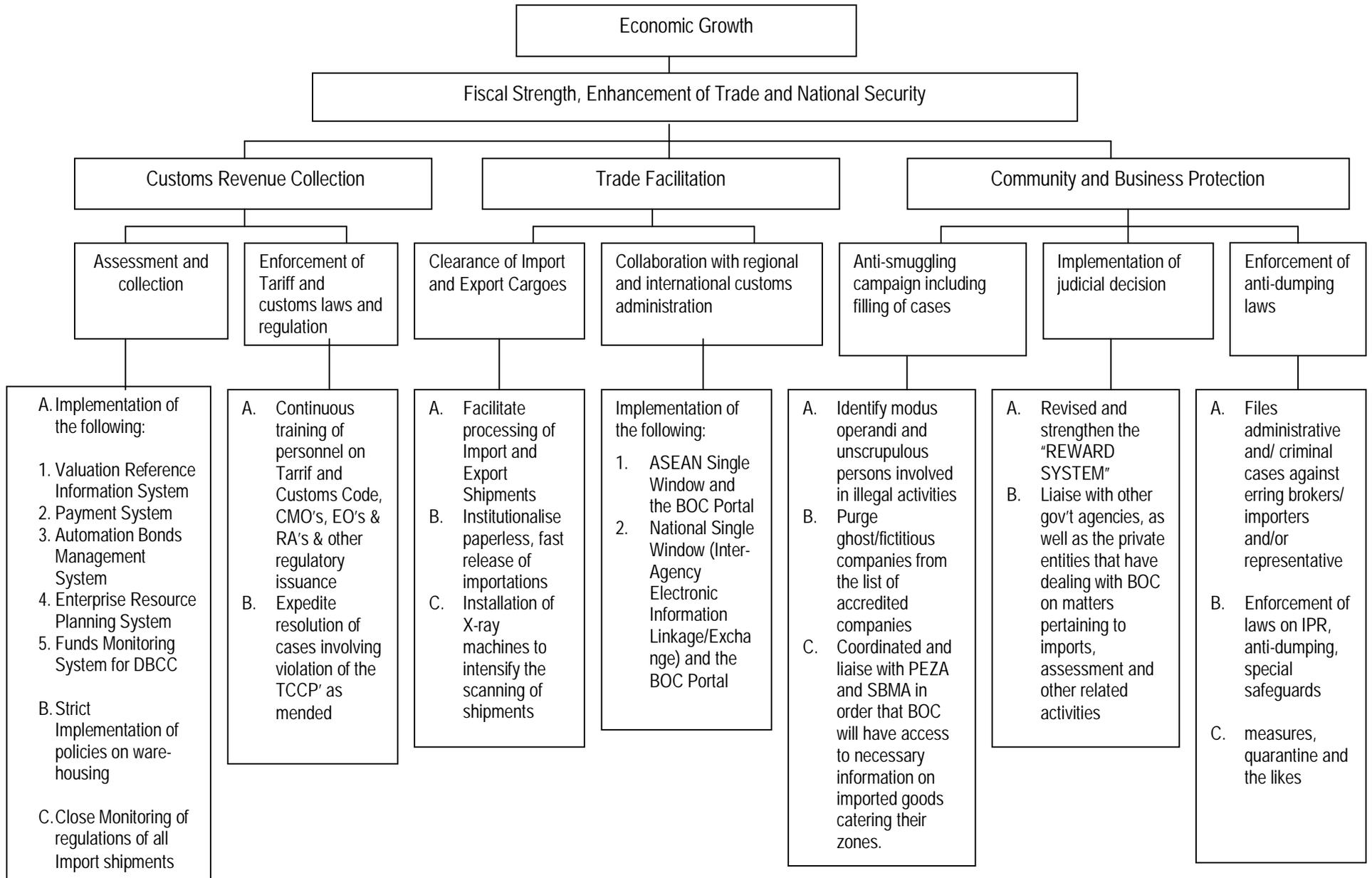
Of course, there may be synergy between both *ex ante* and *ex post* reviews. The findings from the reviews of existing policies by PIDS could be used by the departments (ministries) such as DBM and NEDA in improving its own evaluation or review of government policies and programs. It may be possible for the departments to use the results of *ex post* reviews done by independent policy review institutions such as the PIDS in their *ex ante* policy formulation process. The end result, like that of Australia, is a clear-cut, transparent, and evidence-based method of prioritization and implementation of government programs and spending priorities. Such evidence-based methods or instruments could be a powerful tool to blunt the constant attempts of vested groups allied with corrupt politicians to subvert national welfare in favor of their self-serving interests.

#### IV. Concluding Remarks

The policy development process needs the effective implementing institutions as well as supporting institutions. The case for latter is not as explicitly acknowledged compared to the former. The paper showed the need for both coordinating bodies and independent policy review institutions to support the policy development process. It highlighted the role of particular coordinating and policy review institutions in the policy development process and identified how they may be strengthened or transformed into more effective institutions. As well, the paper discussed various tools used by coordinating and policy review institutions to support the policy development process such as workshops, seminars, independent policy analysis, publications, linking with advocacy groups and building broad coalitions in support of the policy development process.



PROPOSED BOC LOGFRAME



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## Annex A

### POLICY REFORMS AND INSTITUTIONAL WEAKNESSES: CLOSING THE GAP

Gilberto M. Llanto and Eduardo T. Gonzalez<sup>i</sup>

#### 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. The 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 21<sup>st</sup> 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 do 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 government reports, 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 a very difficult and demanding route 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 effectively functioning 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<sup>ii</sup>. 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 weak governance and institutional weaknesses.. The section uses as backdrop a stocktaking of the recent reform experiences in domestic shipping and telecommunications to support our thesis that the policy development process requires robust institutional regulatory frameworks. 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 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 enough 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.

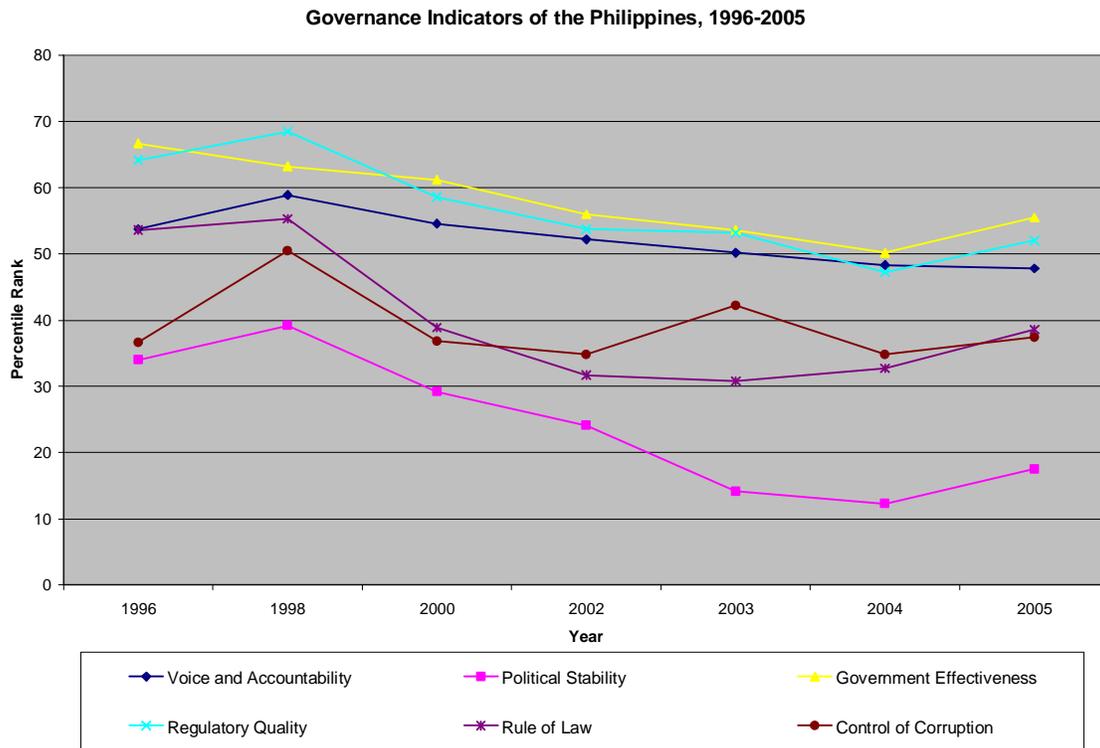
Rule of law measures the confidence and success of a society in developing an environment in which fair and predictable rules form the basis for economic and social interactions. Rule of law means the existence of checks and balances, regular and predictable regime succession, a formally independent 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<sup>iii</sup>. 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)<sup>iv</sup>. 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

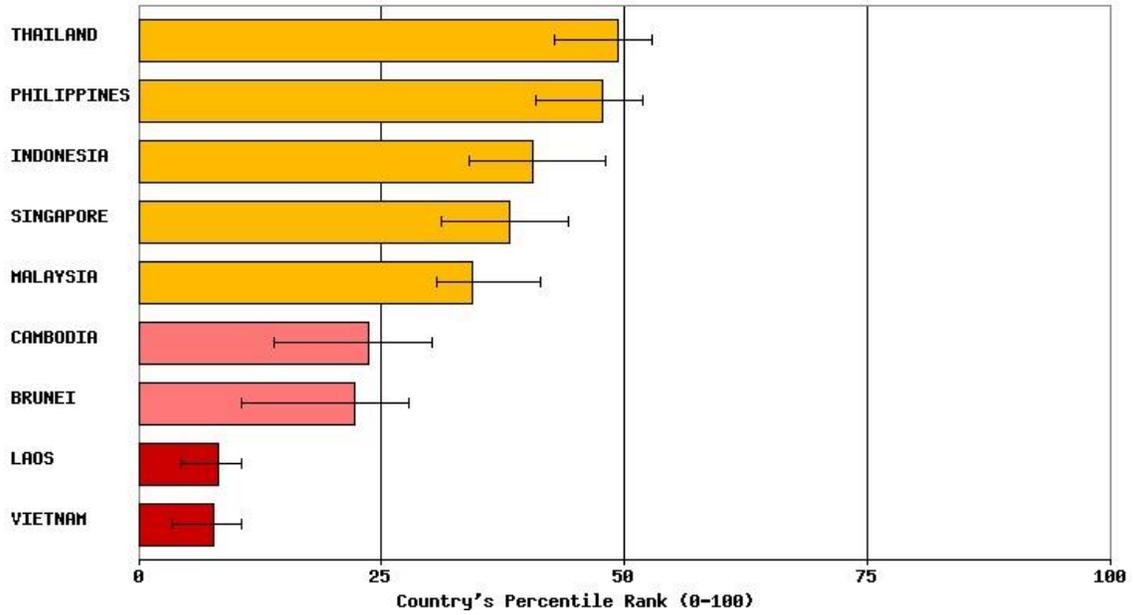


Source: Kaufmann, D., A. Kraay, and M. Mastruzzi 2006: Governance Indicators for 1996-2006

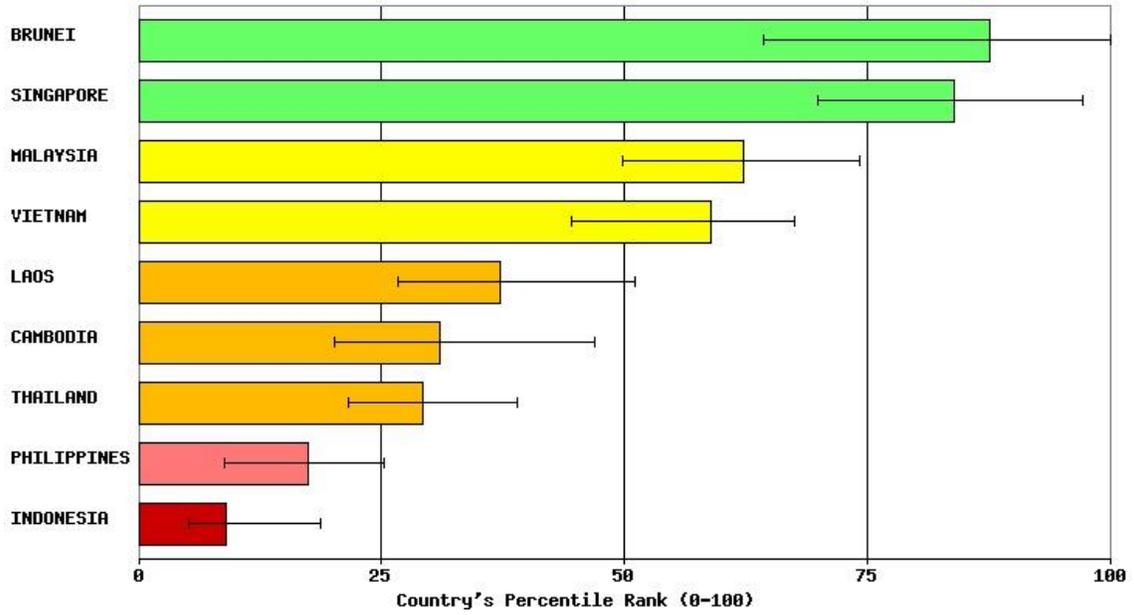
The dismal state of Philippine governance is made more apparent when compared with other ASEAN countries. The country's percentile score in almost all governance indicators for 2005 indicate that the Philippines always comes out in between the scores of the its more affluent neighbors (Singapore, Malaysia, 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

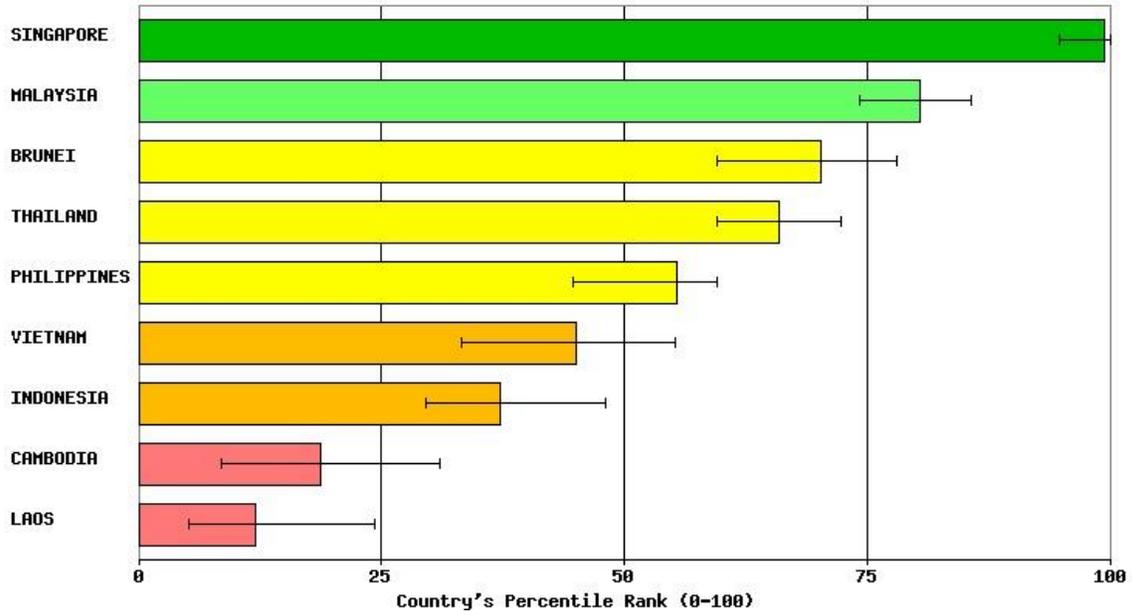
Voice and Accountability (East Asia region, 2005)



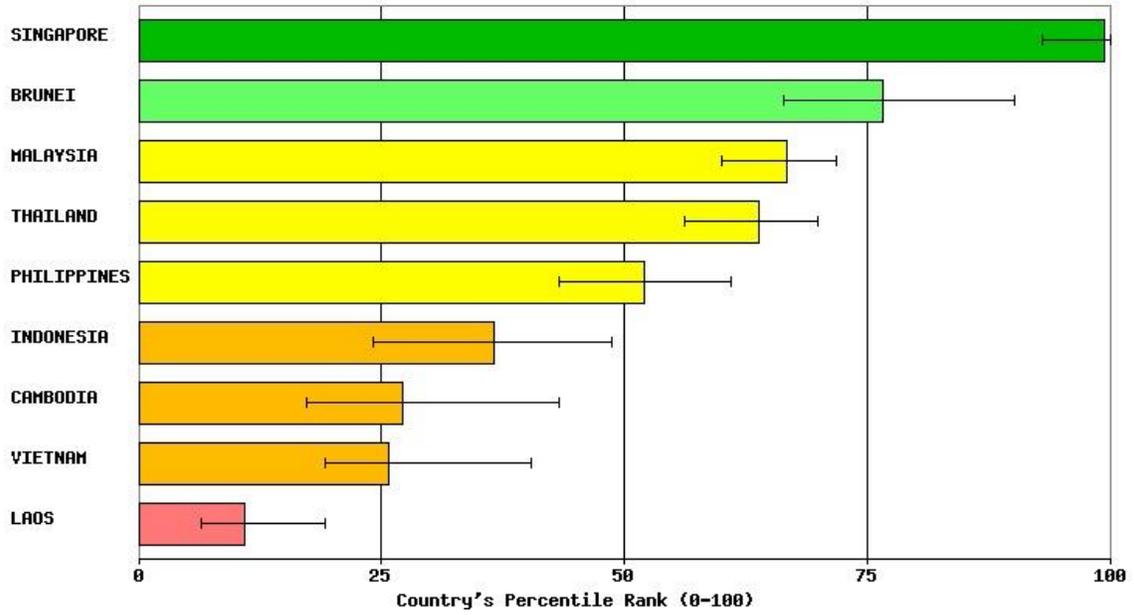
Political Stability/No Violence (East Asia region, 2005)

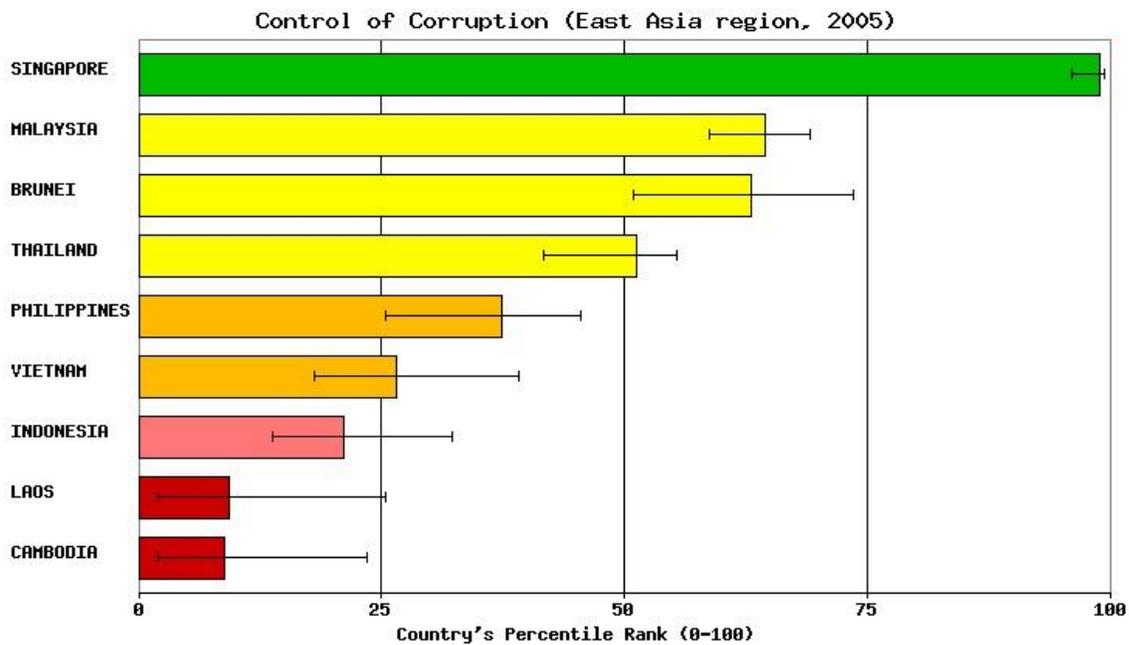
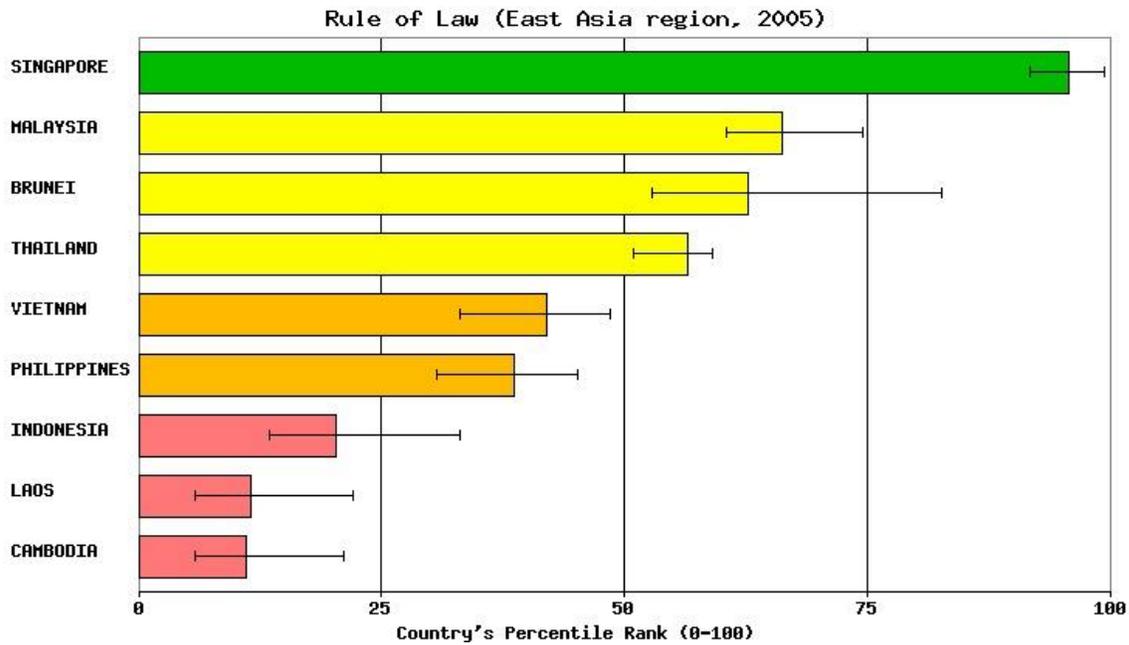


Government Effectiveness (East Asia region, 2005)



Regulatory Quality (East Asia region, 2005)





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). The Philippine legislature is thus, orientated toward a spoils systems designed to entrench the incumbents' political and economic power rather than a system to balance and reward competing interests in society with a view to upholding the welfare of the those with neither political nor economic welfarepower. 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 over 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 risks 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). Effectively 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, 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. The deleterious effect of cross-ownership has been cited in the popular press. MERALCO has been accused of buying power from its affiliated IPPs at higher prices compared to the price charged by the NPC<sup>v</sup>. However, MERALCO asserts that it sources about 55% percent of its total power supply from the NPC, and that its IPP rates would decrease 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.

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: attempts to improve in regulatory and institutional frameworks<sup>vi</sup>

This section discusses the recent policy development process in domestic shipping, and telecommunications<sup>vii</sup>. 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 slow down 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. This will be MARINA's stance 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 when such other analogous circumstances exist.

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<sup>viii</sup>.

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. Subsequently, RA 9295 repealed MARINA M.C. No. 153. Under Section 4 of the IRR, MARINA, through the Administrator, shall intervene pursuant to the Rules on Summary Procedure as prescribed in Marina M.C. 74-A which includes the conduct of public hearings and consultations.

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.<sup>ix</sup> 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<sup>x</sup>. 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)

MARINA contends that the presence of high-speed crafts in a number of ferry and developmental routes indicates an improvement in shipping service competition. Austria (2002) notes, however, that the profitability of the high-speed craft industry may be difficult to sustain. The study pointed out that these crafts are inappropriate, given the country's current level of development, because they generally cater to the A-B crowd or those belonging to high-income group of the society. Domestic sea passengers come mostly from the low-income groups. These high-speed crafts are good only for short distance travel but then again most passengers in these routes are C-D crowd and a few businessmen who travel to places not within the reach of air transport. Thus, this type of vessel does not seem to adequately address the outstanding need of the greater number of the population in many different islands of the archipelago for more reliable and safe sea craft.

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<sup>xi</sup>. A similar report was done by the Transnational Diversified Group, under the assistance of JICA, in 2003 also indicating high numbers for the same causes of maritime accidents. The JICA report show that the three categories mentioned above account for about 58 percent of all maritime accidents. Poor vehicle maintenance, overloading and disregard of safety regulations are contributory factors to the high rate of maritime accidents. MARINA has taken steps 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 but there is much more room for improvement. MARINA has to develop further 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.<sup>xixiii</sup> Furthermore, given that these accidents involve lack of navigational safety measures such as buoys, markers, and designated sea lanes to mark shallow waters, MARINA should actively advocate the improvement of these safety measures to diminish the occurrence of these avoidable accidents.

**Table 3. Summary of Major Causes and Nature of Maritime Accidents**

<b>Causes of Accidents</b>	<b>Percent</b>	<b>Nature of Accidents</b>	<b>Percent</b>
Natural Causes	36	Vessel traffic-related (i.e., collision, ramming)	27.5
<i>Big waves and strong winds</i>	59	Capsizing	19.1
<i>Typhoon</i>	35	Sinking	16.6
Human Error	24	Grounding	13.8
<i>Negligence in duties</i>	18.3	Vessel performance-related (i.e., engine trouble, ship damage)	8.1
<i>Defective equipment/engine trouble</i>	16.1		

*Source: Transnational Diversified Group (2003)*

The government should continue and expand deregulation efforts. Under previous regulations, third class passenger service is not deregulated. Shipping companies complain that the regulated rates are so low that costs can not be covered. Those regulations also require them to allocate 50% of the vessels' passenger capacity to third class passengers, mostly coming from the lower income groups. Although these regulations are somehow being superseded by RA 9295 and its IRR by deregulating third class passenger service and canceling the 50% imposition of capacity to third class passengers, the challenge of lack of investments in seaworthy vehicles that meet safety regulations and minimum service standards must nevertheless be met. Moreover, the failure to provide adequate transport and shipping service to the lower income groups still remains to be an unsolved problem. Thus, the government has to review the situation very carefully to find out what deters private investments in this sector.

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. Although there may be exogenous factors which increase shipping costs, such as high fuel cost, the government has to take a closer look at the discouraging impact of high interest rates, high insurance premiums, high taxes and lack of comparable government support programs for the domestic shipping industry. High fuel costs are really determined by the vicissitudes of the international market. However, high interest rates and high insurance premiums apparently reflect the inefficiency of the domestic shipping sector which may be improved with a comprehensive and workable competition policy. Providing government support to the development of the domestic shipping industry is something that is within the scope of MARINA advocacy.

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.<sup>xiv</sup> Foreign competition will motivate greater efficiency in the shipping industry, which will bring down shipping costs.<sup>xv</sup> 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?

*Recent efforts by MARINA*

Attempts have been made by MARINA to be an institution responsive to the needs of the domestic shipping industry. The following have been provided by MARINA to show recent efforts for the improvement of the industry:

1. RA 9295 deregulated fare setting with the objective of keeping tariff competitive and affordable. MARINA, though, still retains intervention power supposedly to protect and safeguard the interest of the general public.
2. The quasi-judicial functions of MARINA are now governed by RA 9295 and its IRR. Efforts have been made in simplifying franchising requirements and procedures by dispensing with the tedious requirement and procedures provided in the Public Service Act (PSA) and related MARINA Circulars. Entry to routes has been liberalized and the Certificate of Public Convenience (CPC) is now issued to the shipping operator/company to provide greater flexibility to them and to achieve optimum utilization for their fleet.
3. The law also provides the necessary assistance and incentives for the continued growth and modernization of the Philippine domestic merchant fleet.
4. The current effort of the DOTC, MARINA, PPA and DBP in jointly implementing the RO-RO Terminal System (RRTS) can be seen, not only in terms of promoting fleet modernization, but also in paving the way for a seamless travel crucial to facilitate the agro-tourism link among the islands. It is seen as a step closer towards the concrete realization of inter-modal transport.
5. Even as a liberalized and conducive environment is being fostered by the government for vessel acquisitions and operations, MARINA has simultaneously given its serious attention to the improvement of maritime safety in domestic operations, especially in the light of the numerous maritime accidents that have been occurring through the years. Government programs in this regard were essentially guided by the need to address the attendant concerns related to vessel seaworthiness, the need to insure crew competence, and the provision of essential aids-to-navigation.
6. The decision of MARINA to adopt and implement the International Management Code for the Safe Operation of Ships and for Pollution Convention (ISM Code) for domestic ships required to be classed according to certain sizes through the issuance of Flag State Administration Advisory No. 8 and MARINA Memorandum Circular No. 159, is one of the serious efforts to foster and enhance maritime safety culture and environmental protection.
7. As part also of continuing efforts to foster a systematic, uniform and effective conduct of ship safety inspection of all registered domestic ships, MARINA formulated and adopted the Ship Safety Inspection System (SSIS) through the issuance of Memorandum Circular No. 203.

These are steps in the right direction and MARINA should continue to implement reforms and ensure competition in the shipping sector. The Medium Term Philippine Development Plan of 1999-2004 has long recognized the needed institutional and policy reforms in the ports and shipping sectors. Indeed, the question is not *what* reforms to make but *whether* and *when* those reforms will ever be made and implemented.

*Constrained attempts to check behavior of dominant players*

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 Pesos 145 billion, 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".<sup>xvi</sup> 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" (Seráfica 2001). The NTC regulates end-user rates but 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.

Seráfica (2001) noted that the actual level and structure of access charge 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 Pesos 39.2 billion as compared to the net loss of Pesos 2.3 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 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<sup>xvii</sup>.

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 law seems to constrain 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<sup>xviii</sup>. 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*

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. The top leadership of MARINA is composed of political appointees who serve at the pleasure of the President of the Philippines.<sup>xix</sup> The issue is whether reform efforts in MARINA or any other government agency or corporation can be better served by managers who are political appointees or by career bureaucrats. It is well-known that even middle level managers, e.g., directors are political appointees as well whose careers are dependent on their ability to please their political patrons. This issue is crucial for the continuity of reforms.

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 as in Australia, something similar to the Productivity Commission) (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; and (4) *Decisions of the agency can be subject to review by another body that is free 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 practices 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 was appealing 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) licenses 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 that 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 in 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 Fiscalía 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 Kaohsiung draws 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. The harbor effectively manages import, export, and transshipment containers, with a container handling capacity of up to 10 million TEUs annually. 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, 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)---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 tele-centers).

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."<sup>1</sup> 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. 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

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<sup>ii</sup> 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).

<sup>iii</sup> 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 .

<sup>iv</sup> The chart is from the Senate Economic Planning Office (2005).

<sup>v</sup> 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.

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<sup>vi</sup> 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.

<sup>vii</sup> 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. However, MARINA contends that by virtue of RA 9295 and its IRR (effective December 2004) this sector is not highly regulated.

<sup>viii</sup> 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.

<sup>ix</sup> There are suggestions that the shipping industry exhibit signs of being a natural monopoly. Austria (2002), however, points out that economies of scale and size were shown to be an insignificant barrier to entry in the industry.

<sup>x</sup> Recently, MARINA has been bombarded with requests from ship operators to intervene to stem the supposedly ruinous entry of new shipping companies. The subsequent action of MARINA on these requests will show the seriousness of the agency to protect whatever modest gains competition policy have so far been accomplished.

<sup>xi</sup> Sigua, R and Aguilar, G. "Maritime Incident Analysis Using GIS", 5th EASTS Conference, October 2003.

<sup>xii</sup> MARINA contends that given its limited manpower complement, it manages to put in place its monitoring and intervention mechanism to protect the public from unscrupulous practices of shipping operators. This is also the task of the Department of Trade and Industry (DTI) through its Philippine Shippers Bureau and Consumer Welfare and Trade Regulation Group. The question remains, however, on how active MARINA is in its relation with the mentioned groups.

<sup>xiii</sup> MARINA stresses that a number of new vessels are being acquired in recent years that boasts to be better equipped than previous acquisitions. This translated into purportedly notable improvements in the quality of shipping services being provided in the major routes and in secondary routes as well. That these translate into improved passenger safety will still depend on MARINA's capacity to implement extant safety standards.

<sup>xiv</sup> MARINA noticed that as a result of the deregulation policy under RA 9295, a considerable number of foreign entities signified their interest to go into joint ventures with domestic shipping operators and/or to provide funds for ship financing. The question remains whether the Cabotage Law will be feasibly relaxed in order for these foreign companies to enter the industry and give the domestic firms ample competition.

<sup>xv</sup> MARINA points to the unpleasant experience of Indonesia in relaxing their Cabotage Law. Also, they contend that due consideration should be given to the Reciprocity Principle in the lifting of the Cabotage.

<sup>xvi</sup> National Telecommunications Commission, "Memorandum for Voice Over Internet Protocol (VOIP)," March 29, 2005.

<sup>xvii</sup> Ronald Solis, Chairman, NTC, Speech on Imposition of Significant Market Power Obligations, delivered at the U.P. School of Economics, March 2006.

<sup>xviii</sup> *Ibid.*

<sup>xix</sup> For instance, the MARINA Administrator and two Deputy Administrators are Presidential appointees.