

# **Built on Dreams Grounded in Reality**



**Economic Policy Reform in the Philippines**



**The Asia Foundation**

**Built on Dreams, Grounded in Reality:  
Economic Policy Reform in the Philippines**



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Economic Policy Reform in the Philippines



**The Asia Foundation**

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# **Built on Dreams, Grounded in Reality: Economic Policy Reform in the Philippines**

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Email: tafphil@asiafound.org

Editorial team: Raul V. Fabella, Jaime Faustino, Mary Grace Mirandilla-Santos, Paul Catiang, Robbie Paras

Book and cover design by: Gerard D. Baja (bajagerard@gmail.com)

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**Jaime Faustino and Raul V. Fabella**

## **Message from The Asia Foundation**

Despite the improved performance of its economy in the recent past, the Philippines continues to lag behind its neighbors Indonesia, Malaysia, and Vietnam. Perhaps more importantly, the percentage of families living in poverty has not been reduced, and in fact has recently increased. Widespread corruption, coupled with weak legal and regulatory systems, impede the nation's development and ability to provide economic opportunities to its citizens.

For over a decade, The Asia Foundation has sought to help foster sustained economic growth in a globally competitive environment. As a relatively small organization, The Asia Foundation seeks to address strategic issues that hamper reform through innovative programs that leverage our close partnerships with productive reformers throughout the country. For instance, the Transparent Accountable Governance (TAG) program sought to improve the climate for investment and business in cities through collaboration between mayors and the private sector to reduce corruption and red tape. Under the Policy Reform Program, funded through a cooperative agreement with the United States Agency for International Development (USAID) between 2006 and 2008, the Foundation and its partners addressed key policy issues focused on greater competition in the maritime sector, air transport, and power industries, as well as additional relevant reform sectors, including securing property rights. The "Economic Growth Hubs, Infrastructure, and Competitiveness" project, which runs between 2009 and 2012, also funded by USAID, concentrates on targeted activities that aim at better-performing economic growth hubs through the development of tourism enterprise zones; more rational provision of infrastructure through the promotion of public-private partnerships; expansion of the Subic-Clark logistics hub; and implementation of the Residential Free Patent Law to increase urban residents' access to titles residential properties.

As the Foundation chose to try to focus its limited resources on strategic activities, there naturally arose the question of what reforms are likely to be successful and which are not. Development practitioners have begun to evaluate aid effectiveness, and the Foundation felt it could contribute to the debate by disseminating a better understanding of competitiveness and

economic reform in the Philippines. This is based on an examination of cases—successful and unsuccessful—to help ground theoretical debates in reality.

This publication would not have come to fruition without the support of our development partners. For many years, USAID has partnered with the Foundation in supporting some groundbreaking policy reforms in the Philippines. In turn, the Australian Agency for International Development (AusAID) recognized the need to increase understanding of the reform process in the Philippines and backed the Foundation’s efforts in researching and documenting the case studies found in this book. We hope that the reform cases featured, in line with the political economy approach, will inform future projects of the Philippine government, non-governmental organizations, and development agencies. Finally, to our partners and the dedicated local reformers who championed change within their respective sectors, I would like to express our gratitude for their hard work, astuteness, and tenacity. The Philippines is a better place due to their commitment in bringing about lasting reforms.



**Steven Rood**  
Country Representative  
The Asia Foundation, Philippines



## Message from USAID

USAID's work in the Philippines seeks to promote sustainable, broad-based economic growth, which has proven to be effective in reducing poverty, enabling sustainable basic service delivery, and expanding opportunities for people to live healthy and productive lives.

Over the past 50 years, USAID has supported Philippine efforts to promote a more competitive economy and produce higher levels of investment and growth. Since 1961, USAID has provided the Philippines with more than US\$4 billion in economic assistance. This assistance has helped develop the country's infrastructure, increase agricultural productivity, spur micro-enterprise growth, promote sustainable environmental management, improve health and nutrition, strengthen education, and foster democracy and decentralization. USAID continues to support the development goals of the Philippine government, particularly in areas that address constraints to trade and investment, improve regulatory quality, and promote transparent and accountable public institutions.

Development must be led and driven by the leadership and citizens of developing countries, underscoring the importance of country ownership and responsibility in pursuing their own development priorities. USAID believes that the best way we can serve the developing world is to create the conditions where our assistance is no longer necessary, replaced over time by efficient local governments, thriving civil societies, and vibrant private sectors. In the Philippines, USAID has effectively collaborated with local counterparts and stakeholders as change agents—or development entrepreneurs—who have the cultural knowledge and in-country expertise to ensure that assistance leads to sustainable growth. Based on our experience, donor assistance is made more effective if it is based on a careful reading of the local context and conditions, a judicious choice of counterparts, and the mobilization of a domestically driven reform constituency. In this case, the role of donors is to support reform initiatives by local reform-minded stakeholders.

Over the years, the partnership between USAID and The Asia Foundation has been built on this fundamental premise of empowering and capacitating local groups and associations that seek to bring about reform in various sectors of Philippine society. This approach stresses local ownership and

initiative by engaging private stakeholders and civil society organizations, as they seek to participate in the development process and collaborate with government representatives and officials.

In this collection of case studies, this approach of bringing about policy change through local private sector agents sheds some light on how successful reforms ultimately happen. The deregulation of the telecommunications sector, the liberalization of civil aviation, the introduction of Roll-On/Roll-Off transport policy in the domestic shipping sector, and water privatization are some of the more successful reforms of the past two decades. These reforms were made possible because of determined political leadership, support from a broad-based coalition of stakeholders, and change agents that helped push these reforms through the bureaucracy. In particular, recognizing the link between public institutions, coalitions, and private agents, and an understanding of the complex political economy context are required to advance reform. As the reform cases highlighted in this book show, those who seek effective and sustainable reforms must first understand the intricate interplay between many separate entities, agents, and actors. This topic is both critical and timely, as the Philippines moves forward with a new president and a new reform agenda centered on better governance, reduced corruption, and poverty alleviation.

Congratulations to The Asia Foundation and its local partners for an insightful book that contributes to a better understanding of economic policy reform in the Philippines.



**Gloria D. Steele**  
Mission Director  
USAID Philippines

## **Message from AusAID**

Development involves realizing positive change—change that makes goods and services more affordable for people; change that promotes more and fairer competition; and change that ultimately leads to improvements in the lives of the majority of people and especially the poor.

While development theory offers many alternative explanations of change, our understanding of how positive change takes place in practice can only be gleaned from detailed analysis of the process, dynamics, and actors involved.

The case studies presented in *Built on Dreams, Grounded in Reality* analyze economic policy reforms in transport, water supply, telecommunications, property rights, commodity marketing, and taxation. They illustrate the sometimes unpredictable and unexpected processes through which important reforms can be achieved as well as some cautionary tales of how reform efforts can become stalled or thwarted.

The case studies not only make compelling reading, they also present a strong argument for adopting a new approach to understanding and supporting reform initiatives—one that is based on: careful analysis of the local context; an in-depth assessment of key stakeholders and their differing motivations for supporting change; taking advantage of opportunities as they arise; and perseverance, sometimes over many years.

The recently released policy statement on Australian Aid—*An Effective Aid Program for Australia: Making a real difference—Delivering real results*—emphasizes the importance of enhancing the effectiveness of Australian Aid. As we strive to improve the impact of our development assistance in the Philippines in support of reforms that will lead to meaningful, measurable, and sustainable improvements in lives of poor people, there is much that we and others in the development community in the Philippines and other countries can learn from this fascinating set of studies.

We commend The Asia Foundation and all the contributors to this publication for making an important contribution to our understanding of how

reforms can take place in the Philippine context, and we look forward to being part of future efforts to support further positive change in the Philippines.

Maraming salamat.



**Titon Mitra**  
Minister Counsellor  
AusAID - Philippines



## The Asia Foundation



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## Profile of Organizations

The Asia Foundation is a nonprofit, non-governmental organization committed to the development of a peaceful, prosperous, just, and open Asia-Pacific region. The Foundation supports Asian initiatives to improve governance, law, and civil society; women's empowerment; economic reform and development; sustainable development and the environment; and international relations. Drawing on nearly 60 years of experience in Asia, the Foundation collaborates with private and public partners to support leadership and institutional development, exchanges, and policy research.

With 18 offices throughout Asia, an office in Washington, DC, and its headquarters in San Francisco, the Foundation addresses these issues on both a country and regional level. In 2010, the Foundation provided more than \$98 million in program support and distributed nearly one million books and journals valued at over \$42 million.

The United States Agency for International Development (USAID) is the principal agency responsible for managing U.S. Government assistance programs in more than 100 developing countries around the world. USAID was officially established in the Philippines on November 3, 1961.

USAID Philippines' current programs focus on strengthening peace in conflict-affected Mindanao, promoting good governance, increasing economic opportunities, protecting the environment, strengthening health services, and improving basic education.

The Australian Agency for International Development (AusAid) is the Australian Government's agency responsible for managing Australia's overseas aid program. The objective of the aid program is to assist developing countries reduce poverty and achieve sustainable development. In the Philippines, Australia's aid program has an overarching objective to assist the Philippines to meet its development goals, especially in reducing poverty, increasing economic growth, improving basic education and enhancing national stability and human security.



## About the Authors



### Raul V. Fabella

Dr. Fabella is a professor of Economics at and former dean of the University of the Philippines School of Economics where he teaches Advanced Microeconomics and does research in the emergence and impacts of institutions and regulatory regimes. He earned his MA in Economics from the UP School of Economics and his Doctorate from Yale University. He is a member of the National Academy of Science and Technology.

In July 2011, President Benigno Aquino III conferred on Fabella the Order of National Scientist for his remarkable contributions as an academician and economist. He is one of only 37 National Scientists in the country.



### Jaime Faustino

Mr. Faustino manages the Economic Reform and Development Program at The Asia Foundation Philippine office.

Born in the Philippines, Faustino moved to the United States when he was twelve years old. In 1985, he graduated from Duke University (B.A. History) and is a proud Blue Devil. For several years he lived in Alaska, Mexico, Nicaragua, Spain, and Berkeley, California in the U.S. In 1988, he returned to the Philippines and studied at the University of the Philippines (M.A. Political Science, 1992). As a third culture kid, Faustino bridges the gap between Philippine partners and international development agencies.

For Faustino, his wife Therese and three kids, life is a purposeful adventure.



## **Enrico L. Basilio**

Mr. Basilio is the founding president of the REID Foundation, Inc., a private, not-for-profit think-tank doing policy research and advocacy on public-private partnerships, transport, infrastructure budget, tourism, and education. He is also a convenor of the Philippine PPP Coalition, and the Philippine representative (alternate) to the ASEAN High-level Task Force on Connectivity. He was a professor of Economics for 17 years at the University of Asia and the Pacific, and vice president at the Center for Research and Communication for eight years.

Basilio currently serves as alternate champion of the National Competitiveness Council (NCC) Infrastructure Working Group; co-chair of the Export Development Council (EDC) Networking Committee on Transport and Logistics; and chairman of the Philippine Chamber of Commerce and Industry (PCCI) Infrastructure Committee. He is a fellow of the Foundation for Economic Freedom and the Transport Science Society of the Philippines.



## **Maria Cherry Lyn Salazar-Rodolfo**

Ms. Rodolfo is a faculty member of the University of Asia and the Pacific School of Economics. She serves as a member of the Board of Trustees and vice president of the REID Foundation, Inc. and is a fellow of the Center for Research and Communication. She finished her undergraduate degree in Management-Economics from Ateneo de Manila University and her Masters Degree in Industrial Economics from the Center for Research and Communication. She is currently pursuing doctoral studies in Economics at the Ateneo de Manila University. She is a member of the Air Transport Research Society, International Association of Tourism Economics, and Foundation for Economic Freedom.





## **Mary Grace P. Mirandilla-Santos**

Ms. Santos is an independent researcher on telecommunications and ICT policy, and ICT for development. She is currently a consultant for telecoms and ICT research at The Asia Foundation and the Asian Development Bank. She finished her BA in political science and recently completed the course requirements of her Masters in public administration at the University of the Philippines. Her most recent studies include the political economy of telecoms policy reform and the impact of the internet on politics in the Philippines.

Santos dreams of a Philippines where Filipinos can make a living and be fulfilled in their own country, and where citizens are not only happy, but also educated, healthy, and secure.



## **Calixto V. Chikiamco**

Mr. Chikiamco is an internet entrepreneur, a book author, and a writer on political economy. His interests cover business, technology, and political economy. He serves as a property rights consultant to The Asia Foundation and is currently the president of the Foundation for Economic Freedom, an organization committed to good governance and economic and political liberty. He writes a monthly column on political economy in his capacity as board member of the Institute of Development and Econometric Analysis Inc. (IDEA Inc.) He's the Founder and CEO of two Internet companies. He finished AB Economics summa cum laude from De La Salle University and MPS in Media Administration from Syracuse University in New York.



## **V. Bruce J. Tolentino**

Dr. Tolentino is The Asia Foundation's Country Representative in Afghanistan. Prior to that, he directed and managed the Foundation's economic reform and development programs. A citizen of the Philippines, he served as Deputy Minister for Policy, Planning and International Trade of the Department of Agriculture from 1986-1993, and concurrently as Executive Director of the Agricultural Credit Policy Council of the Central Bank of the Philippines from 1986-1990. He has served as team leader and chief of party for projects funded by the World Bank, ADB, USAID, UNDP, FAO and other donors in Asia and Africa.

Tolentino received university-level training in Mass Communications at St. Louis University and graduated with a B.S. and M.A. degree in Economics at Xavier University in the Philippines. He earned his Ph.D. in Economic Development and Rural Finance from the East-West Center and the University of Hawaii.



## **Beulah "Ching" de la Peña**

Ms. de la Peña has been working on agriculture policy in the Philippines for the past 25 years. She was with the Department of Agriculture until 1991 and has worked as an independent consultant since. She has degrees in Statistics from the University of the Philippines and Development Planning from the Institute of Social Sciences in the Netherlands.



## **Karl Kendrick Chua**

Dr. Chua is country economist of the World Bank for the Philippines. His work focuses on tax policy and administration, public expenditure management, macroeconomic management, and statistical development. Chua completed his MA in economics in 2003 and PhD in economics in 2011 at the University of the Philippines School of Economics. Prior to joining the World Bank, he was lecturer of mathematics and economics at the Ateneo de Manila University and was consultant for several local and donor-funded projects. He also trained as a systems analyst in Andersen Consulting. His current research interests include the political economy of tax reform and local government fiscal capacity.

## Foreword

### Agents and Coalitions in the Politics of Institutional Reform

Adrian Leftwich<sup>1</sup>

A spectre is haunting the aid business. It is the spectre of aid effectiveness. Many bilateral development agencies—in part because of the fiscal crisis—are reviewing their aid policies in order to satisfy electorates that their aid spending is achieving value for money and that targets are being reached. Spurred no doubt by the gloomy prospects for achieving many of the Millennium Development Goals in many countries—those in Africa are especially problematic—(Bourguignon et al., 2008) there is much debate about how to improve, if not transform, aid and development policies and practices, or whether aid is of much use for development anyway.

Though not an entirely new debate, it has been reflected in a series of books over the last few years, each of which has questioned the conventional policy paradigms that have shaped development thinking and policies over the last few decades. These have been largely technical in approach, institutionally formal in conception and often driven by the requirement to meet various targets and outputs (logframery).

Bill Easterly's *The White Man's Burden* (2006) pointed out that the *planners* have set goals and often externally shaped objectives, policies and institutions and have eclipsed the *searchers*—those internal agents of change, as in Japan at the time of the Meiji restoration who devised locally appropriate solutions to the challenges of Japanese development by adopting, adapting, and innovating to local conditions. Roger Riddell's study, *Does Foreign Aid Really Work?* (2007), called for new ideas that could address the limitations of aid policies and also for a greater openness in development agencies to new ideas rather than remaining locked-in on path-dependent old practices, procedures and programming templates. The series of case studies in a recent World Bank publication, edited by James Manor (2007), on *Aid That Works*, underlines many of the ideas in the other books, and emphasizes in particular the notion that one size does not fit all, and that local participation is crucial in shaping the institutional arrangements that will facilitate growth, stability, effective service delivery, and greater inclusion. Dambisa Moyo's recent challenging book on aid and Africa, *Dead Aid* (2009), recommends a steady but targeted tailing off of aid, excepting only humanitarian emergencies. She suggests that this would be likely to result in reduced corruption (as aid offers

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<sup>1</sup> Dr. Leftwich is the Research Director of the Developmental Leadership program (DLP) at [www.dlprog.org](http://www.dlprog.org). The Asia Foundation is a partner organization in the DLP.

easy rents for those in power), the emergence of African entrepreneurs and an increase in growth rates.

Three common themes stand out about these recent books and debates—all of which are echoed in other literature.

First, the one-size-fits-all approach simply does not work. Country specificity is far too complex and requires far greater nuance and policy specificity, depending on the many contingent factors, levels of development and political circumstances. General policy prescriptions involving structural adjustment, democratization, freeing up markets, decentralization, capacity building, reducing tariffs, and many of the other elements that went into the Washington Consensus in the 1990s regularly ran into difficulties shaped precisely by such local contingent factors and processes—and configurations of power and interest—which were not at all congenial to those prescribed changes (Rodrik, 2006).

Secondly, it is clear that institutions matter for development—no ordered or predictable pattern of economic, political, or social interaction is possible without legitimate rules of the game that are understood and accepted by the players of the game who are required to abide by them. But as Esther Duflo and Abhijit Banerjee (2011) have rightly pointed out in their important new book, it is important to distinguish between **INSTITUTIONS** and *institutions*. Whereas the former refer to the big generalised **INSTITUTIONS**—democracy, decentralization, property rights, rule of law, accountability—they are all, in practice, made operational where they exist in very different, local and specific *institutional* forms and arrangements. For example, even in the so-called liberal democracies, the forms and particulars of democratic institutions and politics differ greatly; so do the forms and particulars of property rights, or authority and powers at various decentralized levels of decision-making. In directing our attention to the lowercase *institutions*, Duflo and Banerjee come at the same issue of specificity from a different route. They suggest that it is important to work out what works in any given structural context and to encourage that, not to suggest—let alone impose on a conditional basis—off-the-shelf arrangements or policies, based as they often have been on the normative *desiderata* of western policy-makers or politicians.

Thirdly, and crucially for the purposes of this foreword and the essays in this collection, the implications of the first two themes converge in policy and operational terms on the need for care, modesty, experimentation, country specificity, policy diversity, and understanding of context—and especially the political context, as DFID has pointed out recently in reviewing a decade of research into governance and politics (DFID, 2010). More significantly still, if country context matters, and if appropriate, legitimate and locally specific institutional arrangements are the only ones that will really work, then all

these implications draw our immediate attention to the role of human agents—the individuals, organizations, or formal and informal coalitions within developing countries—who not only have to design and shape the institutional and policy environment, but also have to make them work and survive. We are not only dealing with politicians and policy-makers here, but also with officials and bureaucrats across as well as up and down the public service, and key players outside government, in the private sector.

In short, although none of the studies referred to above say as much, the net and most important implication of the debate is to bring the idea of agency back to thinking about developmental change (Leftwich, 2010). It is to redirect our attention not simply to the institutions or policies that will work, but to the role of human agency in shaping and sustaining them in very different institutional, structural and political contexts.

This book of essays has as its focus the way in which *development entrepreneurs* worked politically to bring about (though not always, as some of the cases show) some very important institutional changes in the Philippines. These are classic illustrations of lowercase institutional change, not uppercase INSTITUTIONAL change, and illustrate dramatically what Duflo and Banerjee call the “surprising power of small changes” (Duflo & Banerjee, 2011: 247). The idea of development entrepreneurs gives concrete expression to the idea of agency, though in each and every case, these development entrepreneurs were not single, solitary, isolated, or sole agents of change. On the contrary, they were brokers, facilitators, doers, shakers, movers, operators, orchestrators, and activists who knew when, where, and how to mobilize other people (some in key places), interests, ideas and resources to bring about institutional innovation or change in the specific context of the Philippines’ political and institutional environment. What is interesting about all these cases of developmental entrepreneurial activity is that every one of them was in a very different sector, and a range of different local strategies and framing of the issues was used. Moreover, the development entrepreneurs knew how to recognize when the policy window was open: that is, that an opportunity had arisen that made the chances of success greater than before. They knew when and how to seize the moment, when, and how to move, whom to form alliances and coalitions with, and how to navigate the formal and informal political institutional architecture. In short, they were able to use the windows, the critical junctures, or the triggers, to mobilize politically in support of key institutional changes or innovations.

The idea of the development entrepreneur is an important example of the role of human agency in change and has rarely been used or followed up in development thinking or policy terms. But it is not a new concept or approach to the understanding of institutional change in more mainstream political

science, as applied in the OECD countries. Indeed, the closely related concept of “policy entrepreneurs” was first introduced by John Kingdon in 1984 in his classic study, *Agendas, Alternatives and Public Policies* (Kingdon, 1984 and 2011), in an attempt to understand the policy process in the USA. Kingdon made the point that such entrepreneurs can be found at many points in the process—he or she might be an academic, a cabinet secretary, an elected politician, a minister of state, a lawyer, a senior bureaucrat or a lobbyist. Paul Pierson refers to such agents as “institutional entrepreneurs,” (Pierson, 2004: 136-7) who are able to mobilize a coalition of interests around a policy or institutional solution to a collective action problem. Moreover, he points out that actors who straddle a series of socio-political networks are especially well placed to engage in successful political work to bring individuals or organizations together in some formal or informal alliance or coalition around a common policy. So being connected can make a considerable difference to the success of the development entrepreneur and her or his prospects for mobilizing an effective—even winning—coalition of interests.

So, is it possible that the failure to recognize, *respect*, and to support the role of local agency—and especially of developmental leaders, entrepreneurs, brokers and coalitions—is at least *one* of the key reasons why aid and development policies and programs have had such patchy success? After all—as many of the books mentioned above point out—some of the most successful modern development stories (Botswana, Singapore, Taiwan, Mauritius, South Korea, China and India, for example) have not been major recipients of aid, or not for long, if at all, after short initial bursts. In all these cases—both despite and because of their immense differences with respect to size, endowments, populations, cultures, and pre-existing politico-institutional traditions and settings—it was the role of local leaders in both public and private sectors who negotiated and shaped the locally appropriate institutions that created the environment for growth, and sooner or later, poverty reduction.

Of course, a parsimonious theory of political, institutional or policy change is never likely to be developed, and it would be ridiculous to attempt a single factor explanation of institutional change which hinged solely on the role of agency. The social world is too complex, differentiated, and shaped by accidental or contingent events, as Francis Fukuyama has pointed out recently (Fukuyama, 2011: 23). However, the way local actors or agents may be helped to explore and exploit whatever structural space is allowed to them is important, and therefore understanding that local context is crucial.

Thus, if the international community is looking for innovative ways of working for progressive institutional or policy change that can promote growth and political stability, reduce poverty, and extend inclusion, then there is no better place to start than where, when, how, and under what circumstances

it can act (in the short, medium, and long term) to support the emergence or activities of local *developmental* entrepreneurs, leaders, and coalitions rather than supine, collusive, or predatory ones. This book offers an important set of illustrations of just how that has been and can be done.

In conclusion, if aid is to be more effective, the international community may need to focus far less on externally concocted policies and formal institutional advice. Rather, donors and other organizations may need to work out how they can connect with individual and collective indigenous developmental agents and agencies—at national and sub-national levels and in all sectors and issue areas—so that the locals who will really make history happen are better empowered, supported, and encouraged.

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## Abstract

### *Built on Dreams, Grounded in Reality: Economic Policy Reform in the Philippines*

The challenge of changing institutions that structure human interaction to produce better development outcomes is a central problem for development thinkers, development agencies and practitioners.

This volume of case studies on Philippine economic policy reform contributes to the discourse on institutional change a better understanding of how human actors engender change. The cases trace the political battles involved in five successful and two unsuccessful reform efforts in telecommunications, sea transport, civil aviation, water privatization, property rights legislation, tax administration and the grain sector.

The cases highlight that 1) the reform is an iterative, non-linear and highly context-specific process; 2) technical analysis is insufficient to achieve reform; 3) political economy analysis and political action are equally important; 4) committed local leadership is the principal reform driver; 5) development agencies can play critical supportive roles but need to move towards less rigid and more locally-owned projects.

The volume concludes with an operational approach for achieving institutional change referred to as *development entrepreneurship*. The approach consists of 1) a recognition of the iterative process of change that calls for a combination of technical analysis, political economy analysis and political action; 2) local leaders, referred to as development entrepreneurs, who take personal responsibility for achieving development outcomes; and, 3) a project structure that allows development agencies to support local partners through grants and not contracts.

*Development Entrepreneurship* provides one compelling pathway for development agencies to incorporate politics, manage risk, improve aid effectiveness, and more importantly, improve the lives of people in developing countries.

The book is published by The Asia Foundation with support from the United States Agency for International Development and AusAID.



Wreath-laying ceremony at the Luneta Park on June 19, 2011 during National Hero Jose Rizal's 150th birthday. It was raining, but many people still came, armed with their umbrellas and strong will.

Photo by Erwin Tiamson

# Chapter 1

## Engendering Reform

Jaime Faustino and Raul V. Fabella

There is recognition that long-term development requires supportive institutional reforms. The traditional approach to reform assumes that the hurdles are primarily financial and technical, and that dialogue and conditionality can influence the political behavior of country partners (Unsworth, 2009). But in the Philippines—and in most developing countries—the promise of this approach remains unfulfilled. Institutional economist and president of the Ronald Coase Institute, Mary Shirley (2005), notes that despite the dreams, resources, and good intentions of aid-givers, appalling poverty remains the lot of most people in aid-recipient countries.

There is increasing consensus that technical knowledge of what is needed, while necessary, is insufficient for achieving reform.<sup>1</sup> Increasingly, development agencies are incorporating political economy analysis in an effort to broaden operational considerations to include those processes through which policy reform is negotiated and won (World Bank, 2008). The emerging consensus seems to be that a healthy understanding of the politics of change, and grappling with how and why change occurs in particular contexts, will show how little influence outside actors have. Greater modesty among aid agencies is in order (Brown, 2009).

Despite the sincere efforts exerted,<sup>2</sup> groping is still largely the norm in the arena that Pycroft (2010) calls *acting politically*. Aid agencies still find it very difficult to inject political analysis and political engagement into operational and policy programs (Leftwich, 2009). This challenge was also the observation of the 2009 Joint Donor Workshop (Foresti & Wild, 2009).

This book is an effort to address this challenge. It seeks to contribute to the discourse on politics, institutional reform, and development practice by starting from actual experiences. The goal is to unpack the process and distill lessons from successful and unsuccessful reform episodes drawn from the Philippines. Five are successful reform cases: introducing competition and liberalization in telecommunications, civil aviation, and sea transport, the privatization of the water service in the capital city, and the passage of a property rights law to allow for faster administrative titling of residential

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<sup>1</sup> See, for example, Commission on Growth and Development (2008, p. 2) and World Bank (2008, p. i).

<sup>2</sup> For example, the World Bank Institute's Capacity Building Program on "Facilitating Change and Engagement for Results: Addressing the Implementation Challenge."

lands. Two unsuccessful cases are examined: reforming the tax administration agency and a government corporation involved in the grain-rice sector. In addition to the case studies, the book includes an overview of the evolution of development thinking.

The concluding chapter presents an operational approach that may help development practitioners and agencies incorporate technical and political dimensions for institutional change. Referred to as *development entrepreneurship*, the approach covers the following:

1. The essential reform elements necessary for institutional change: technical analysis, political economy analysis, and political action.
2. The role, traits, and characteristics of human agents who manage the reform elements.
3. The project structure that envelops the reform program and manages the institutional risks of development agencies.

This chapter is divided into three sections. The next section provides an introduction to the concepts in development to contextualize the cases. The subsequent sections provide a summary of the case studies and conclude with the major findings from the cases.

## **Politics and the Challenge of Reform**

Pushing policy reform is a complex, multi-directional, fragmented and unpredictable process. Besides being highly non-linear and discontinuous, it is also very political. As such, development agencies and practitioners are confronted with two challenges. One is risk associated with sovereignty infringement. It is a common observation that development agencies normally shy away from the political economy aspects of projects in view of the institutional risk involved. However, this institutional-risk aversion is costly, as it also heightens the risk of project failure (Tolentino, 2010).

A second issue is complexity. Given the diversity of the reform universe, no one-size-fits-all formula applies. Idiosyncrasy appears to be the rule. Confronted with these daunting challenges, many development agencies and practitioners opt to hew closely to the more familiar “technical fix” approach.

For those interested in addressing the challenges, a useful starting point for political analysis of reform is the concept of political settlement among various actors and interest groups. Parks and Cole’s (2010) description covers all the relevant bases:

[T]he term “political settlement” is commonly used to describe the informal power arrangements or “social order” in a country... The

critical element that holds a political settlement together is the alignment of interests within the dominant elite coalition and the dynamic relationship between elite interests and the broader array of interests in the society. Institutions are viewed as malleable—as the product of ongoing conflict, negotiation, and compromise among powerful groups, with the ruling coalition shaping and controlling this process... As a result, political settlements should not be interpreted as one-time events, but rather as rolling agreements between powerful actors.

Political settlements could also be more technically described as stable equilibrium solutions to coalitional games played by various elite factions in the pursuit of their own narrow self-interest (North, Wallis, & Weingast, 2009). As such, they may exclude the interest of the great majority of the polity or treat it as residual. Public goods that benefit all and underpin economic growth may be severely underprovided. It is in this context that thinking about reform must begin. If institutional change is to happen, the underlying political settlement must also change.

### The Elite Matters

As the idea that *politics matters* gains wider acceptance, an interesting refinement in thinking involves how elites respond. Elites are those whose influence on decision-making and whose share in the benefits are disproportionate to their number in the polity. The political settlements framework puts emphasis on the concept of power, how it is distributed among competing and cooperating groups, and how it is used in pursuit of group interests. The focus is thus on powerful actors—those endowed with the capacity to shape the behavior of others (Parks & Cole, 2010). The elite, however, is not a monolithic faction, and that fact, properly exploited, can contribute to facilitating policy reform. In particular, there may be *core coalition* elites and *excluded* elites. James Robinson (2010) claims that disunity of elites or elite decay can trigger institutional change, as can changes in elite preferences. He proposes further that understanding how elites form around sets of institutions and how elites change over time are necessary to understand the persistence of institutions in developing countries. Nor can we, Robinson observes, ignore histories, which shape elite perception and behavior; and thus, institutions.

There are historical junctures when the non-elites play a role in forging radically new political settlements. We may call these *revolutionary junctures*, which play an important part in history. The routing of the Kuomintang regime under Chiang Kai Shek in China in 1949 by the Communists under Mao

Zedong ushered in a new political settlement that privileged pro- non-elite proclivity. This chapter deals with changes in political settlements of more modest proportions.

There is a need to engage the various real holders of political veto, if the universe of standing political settlements is to be induced to put greater weight on more inclusive development. We recognize that playing elite politics also runs the risk of re-enforcing elite power and dominance, but it is a risk worth taking.

### Local Context Matters

P. T. Bauer, one of the most forceful critics of foreign assistance going back to the 1950s, strongly advocated indigenous development by ground-level entrepreneurs in the developing world. Bauer had in mind indigenous economic entrepreneurs of the Schumpeterian variety.<sup>3</sup> The kind we observe in these studies we have come to call *development entrepreneurs*, persons in pursuit of social change who are indigenous to the locality. The reason why many technical formulae fail when imported from an alien culture is that operational success is context-dependent. Formal laws that do not have local cultural moorings do not necessarily displace indigenous rules, which many times drive these formal laws underground, creating a smoldering conflict and cultural schizophrenia. Imported institutions have to undergo radical adaptations to be effective in a different context. Thus, Easterly (2006), on his part, concludes that “the only true path to development is an indigenous one and in finding that path it is better to rely on the searchers than the planners.” He adds that searchers do not know the answers in advance, because the local context need not conform to accepted templates; planners, by contrast, think they do.

Deng Xiaoping’s *Socialism with a Chinese Character* (1984) was not just an exercise in political sloganeering; it was a remarkable recognition that the Chinese psyche, deep down, thrives on truck-and-barter and risk-taking, and that suppressing these indigenous characteristics in the name of Socialism will kill Socialism. It still is the most stirring example of indigenization and confirms what Leftwich (2009) correctly recommends as the pursuit of “locally appropriate and feasible institutional and policy arrangements necessary for tackling a series of nested collective action problems.”

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<sup>3</sup> See, for example, Bauer (1959). For a comprehensive discussion of Bauer’s critique of foreign aid and insights on indigenous development in the Third World, see Shleifer (2009) and Thomas (2010).

## **Institutions Reflect Underlying Politics**

The importance of institutions in the development arena is now canonical. We quote Rodrik and Rosenzweig (2009):

Economists increasingly acknowledge the importance of institutions—the rules of the game in a society—and the nature of political and power struggles that lie behind them... issues of governance, politics, and power are no longer a sideshow; they constitute a central element in the field.

Development outcomes can no longer be understood apart from the institutions that litter the landscape. But institutions are emanations of the politics of the landscape. For institutional change to persist, it must be introduced into—and form part of—the universe of political settlements.

The current thinking on institutions and development reviewed by Booth (2011) gives salience to the following:

- The quality of institutions is more important than other factors (say, policy or geography) in explaining per capita income growth (Rodrik, 2003; Rodrik et al., 2004).
- There is still little understanding as to which are the “right” institutions.
- It is now widely understood that institutions are context-specific. What may be good for promoting growth and reducing poverty in one country may not do as well in another (Unsworth & Moore, 2010; Levy, 2010).
- Institutional change is a function of politics (Improving Institutions for Pro-Poor Growth [IPPG], 2010).

Booth (2011) concludes that the current instruments, approaches, and modalities of development agencies have serious limitations. They should be, he suggests, less supply-driven and more sensitive to context, especially to the political environment.

## **Summary of Cases**

While interesting claims can be made from above the clouds, they can only find confirmation at ground level. This volume, therefore, starts by carefully looking at seven actual Philippine cases of reform effort, both successful and unsuccessful. The cases of success include reforms in telecommunications, sea transport, civil aviation, water services privatization, and property rights. What are successful reforms? Successful reforms occur when behaviors and incentives are permanently changed to and the collective welfare of society is advanced. They have the necessary feature of sustainability (see, e.g., Parks &

Cole, 2010).

The emphasis in these case studies is the process, more than the substance, of institutional change. Authors were instructed to focus on:

- the chronology of policy battles around the status quo;
- the identification of defenders and opponents of the status quo;
- the role of leaders, elites, and coalitions;
- the role of astute analysis, flexible responses, pure grit, and dumb luck;
- the role of development agencies, other international organizations, and local partners.

## **Sea Transport Reform**

Enrico Basilio, himself a significant actor in the reform process, traces the political battles that successfully introduced a new sea transport policy, known as Roll-On/Roll-Off (RO-RO), which resulted in increased competition in maritime services and reduced domestic logistics costs. The battle here was fought within the executive branch of government, where the territorial contest was over executive orders (EO). The narrative highlights the people, their struggle, the dead ends, the groping for a breakthrough, and finally, the success of the advocacy. It recounts how the original reform target (regulatory overhaul), although considered first-best for consumer sovereignty, proved too intractable politically. Confronted with strong and committed opposition in the government and in the shipping industry, an alternative approach (RO-RO) was adopted primarily to increase the political feasibility for reform.

More importantly, the policy shifted initiative away from the government regulator and firmly into the hands of private operators. Subsequent conjunctures in the political landscape made RO-RO compelling. Intense coalition-building that strung together private business users, regional political interests, and allies within and without the government helped the advocacy along. This created the political pressure behind the RO-RO advocacy and eventually provided the political support for President Gloria Macapagal-Arroyo to issue the policy. Needless to say, this came over the objections of close presidential allies and the regulatory agency (the Philippine Ports Authority) whose interests—as revealed in the case study—were jointly served by the status quo.

The strategy to celebrate consumer sovereignty by allowing choice of transport modality changed the whole policy environment and essentially eroded the once-formidable market power of Load-On/Load-Off (LO-LO) players. A facilitating role was played by the United States Agency for International Development (USAID) and a US-based development consulting firm.



## Civil Aviation Reform

Another battle fought within the ambit of the executive branch was in civil aviation. Cherry Lyn Rodolfo, herself a significant actor in the reform process, documents the campaign that was started in 1992 by various individuals to push civil aviation liberalization. The Civil Aeronautics Board (CAB) was an agency in the executive branch with a long tradition of displaying a bias toward the status quo: a monopoly by the flag carrier.

Responding to the clamor for private sector representatives in the CAB, the administration under President Fidel Ramos appointed three personalities from the private sector: Victor Limlingan, a professor at the Asian Institute of Management; Jose Claro Tesoro, a transport law expert; and Rogelio Estacio, a retired army general. All turned out to be consumer sovereignty advocates. They constituted the majority on the CAB Board.

Consumer sovereignty is served by giving the consumer more options, which the incumbent carrier resisted. The idea was to allow entry of more carriers into the domestic market and the international service. EO 219, issued by President Ramos in January 1995, defined the national interest in aviation from the viewpoint of consumers rather than that of the carriers—a landmark posture. But how to translate this into actual fact? Finding that the usual route, a congressional franchise, would take too long, the Board settled on a temporary operating permit which, however, risked being challenged in court. It was indeed challenged, but the courts upheld the CAB decision. On the international service front, full liberalization (open skies) encountered a determined opposition from inside the CAB and by the incumbent, so the advocates shifted attention to a more limited target: “pocket open skies” for a designated regional airport, the Diosdado Macapagal International Airport (DMIA). The logic was simple: the political settlement favoring restrictive air access was stronger at the national level but weaker in particular localities where the elite interests were particularly fissured. The sitting president—being from the province where the DMIA is located—was exploited as a conjuncture. USAID, working with The Asia Foundation, also played the role of facilitator in the pocket open skies battle. In this attenuated form, the liberalization squeaked through.

The initiative’s remarkable success at DMIA began to change beliefs and perceptions nationally. In March 2011, President Benigno S. Aquino III issued Executive Order No. 29, or EO 29, providing for increased air access to all secondary gateways in the Philippines.

## **Water Privatization Reform**

The third case involved both the executive and the legislative branches of government. Raul V. Fabella documents the journey to the successful privatization of the government-run water service in Manila. Water service in Metro Manila used to be provided by a government-owned and -operated corporation, the Metropolitan Waterworks and Sewerage System (MWSS). The service was dismal, marked by long service interruptions and long water queues. President Ramos, apprised of the possibility of private provision by foreign players interested in acquiring and running the water service in Metro Manila, became its chief advocate.

How do you privatize a heavily foreign-indebted state corporation with a highly politicized, severely over-manned, civil service law-protected workforce?

First, President Ramos, leveraging his success with the earlier Power Crisis Act, got the Legislature to pass a law, the Water Crisis Act, which allowed difficult decisions to be made, but also set a tight deadline. The help of the International Finance Corporation (IFC) in the preparation of the bid papers and the concession contract was critical. Aggressive reduction of the manpower complement by 30 percent, and a substantial increase in the water tariff signaled credible commitment by the government. The appointment of a very credible MWSS administrator, Angel Lazaro III, with a mandate to privatize the agency, reinforced the signals. As a result, the private sector bidders flocked to bid aggressively, resulting in a spectacular discount for the consumers. Consumer sovereignty was served. This case is of interest, because despite the fact that a decidedly popular chief executive of the land was the originator and patron of the reform, the journey was arduous, and success was never a guaranteed outcome.

## **Telecommunications Policy Reform**

A case that straddled both the executive and legislative branches, as well as the judiciary, was telecommunications market reform. Mary Grace Mirandilla-Santos, a telecoms and information and communications technology (ICT) researcher who has worked with development entrepreneurs over the past decade, documents the extremely iterative, uncertain, and spasmodic process of reform, particularly the struggle for two important telecommunications sector reforms, viz., the introduction of competition by the administration of President Ramos (1992-1998) and the resolution of interconnection under President Joseph Estrada (1998-2001). The story started during the watch of President Corazon Aquino (1986-1992) with inconsistent efforts at liberalization. It got a tremendous boost under President

Ramos in the wake of the painful truth stated by the visiting Singapore Senior Minister Lee Kuan Yew, that in the Philippines, “[n]inety-eight percent of the population is waiting for a telephone connection, and the other two percent for a dial tone.”

The focal person in this struggle was Jose Almonte, a former army general who found himself heading President Ramos’s famous kitchen cabinet. For Almonte, who harbored a deep disdain for what he termed “unearned income,” the first order of business was to dismantle the legal franchise of the incumbent telecommunications operator, the Philippine Long Distance Telephone (PLDT) Company. This first took the form of two executive orders: EO 59, which mandated interconnection among telecommunications companies, and EO 109, which introduced the Service Area Scheme, subsequently enacted into law. The battle in Congress was led by Senator John Osmeña and a few dedicated consultants. These policy instruments introduced competition in the sector, opened the window for other players and rapid technological changes to sneak in, and overturned the whole telecoms landscape. Despite multiple players, however, the interconnection problem arose because one player controlled the telecoms backbone and was maximizing the rents from ownership. This called for a deeper regulatory intervention, which was made easier by a deft intermediation by President Estrada. The case study also touches on the crucial role of the courts in implementing reform through its role as final arbiter.

## **Property Rights Reform**

A case that largely unfolded in the legislative branch involves residential property titling. Calixto Chikiamco, who himself led and saw action in the legislative trenches, traces the legislative battle involving a major land titling act, the Residential Free Patent Act. In the Philippines, there are about 24 million parcels of land, of which close to half (46 percent) are untitled. Of the untitled, about 7.8 million parcels are residential. Occupiers often hold only tax declaration certificates, which cannot serve as collateral for bank loans. This represents an enormous dormant capital.

The case study recounts the beginnings of the effort to unleash this capital, the people who bought into the idea, and various dead ends that were encountered. It highlights the importance of resilience in the face of setbacks to the first, more encompassing, reform target. This involved crafting an alternative, more politically feasible—if less ambitious—reform objective (second-best vs. first-best solution), which diminished the ranks of the opposition and produced an alignment favorable to change. The narrative emphasizes the importance of political mapping of potential friends and

foes, coalition building among those of kindred interests, the use of networks built in the past for other purposes, cashing in reciprocal obligations for past favors, the deployment of teams of experts with detailed inside knowledge of the inner workings of the land titling and legislative processes, and the role of determined individuals who kept the fire burning in lean times. Also highlighted is the role of USAID working via an intermediary, The Asia Foundation, which facilitated the team's work, especially in the second phase.

This case answers to the Coasean efficiency imperative to reduce the transaction cost of exchange—in this case, the exchange of capital. The passage of the law in March 2010 is, however, only the beginning of a series of crucial steps to final titling that is still being implemented. The team of determined agents continues to clear the remaining hurdles. The iterative search process for a politically-feasible reform, coalition building, and the role of a committed team of like-minded agents are highlighted.

This book also examines three reform efforts that have not achieved the intended outcomes. Again, the emphasis is on the political process and events that led to failure.

### **National Food Authority (NFA) Reform**

Bruce Tolentino and Beulah Maria de la Peña document the history of the grains sector interventions by the government. They lay down the current regulatory environment and detail the efforts to reform the National Food Authority (NFA), the lead government agency tasked to help the grains farmers through subsidy and to stabilize grains prices through a monopoly to import. The case is especially informative on the role of the international aid agencies in grains sector reform efforts with USAID, the Australian Agency for International Development (AusAID), and the Asian Development Bank (ADB) as principal donor-players. Many of these initiatives fit the mold of the traditional prescriptive approach to reform.

The study begins with highlighting how an initiative to remedy a presumed market failure (the abuse of market power by grains traders) became a government failure (a sizeable fiscal drain that extended subsidy to only two percent of paddy production while allegedly serving as a cash cow for importing authorities). Tariffication of quantitative restrictions, consistent with the General Agreement on Tariff and Trade (GATT)-World Trade Organization (WTO) rules and the Association of Southeast Asian Nations (ASEAN) Common Effective Preferential Tariff, was always successfully skirted. The example of one long-running program, the Grains Sector Development Programs (GSDP), funded by the ADB—which promised policy and institutional reforms in return for investments (funded by loans

conditioned on delivery) in irrigation and grains technology—highlighted the problems common to the other initiatives: meaningful policy and institutional reforms were postponed. The GSDP was discontinued in 2003. The USAID-funded technical assistance—the Accelerating Growth, Investment, and Liberalization with Equity (AGILE) project—also met a similar fate when it advocated for deeper institutional change in the NFA.

The authors carefully draw a map of the political players who benefit from the NFA status quo and why they form a formidable coalition. They also identify one of the proximate reasons for failure: the frequent changes in the grains sector bureaucracy, viz., the Secretary of Agriculture, and the lack of any continuity in the grains sector policy and programs. The case study highlights how the frontal, prescriptive approach of aid agencies has fallen short, and suggests that perhaps a less ambitious tack (say, of longer tenure for the authorities involved) may work.

### **Bureau of Internal Revenue (BIR) Reform**

Raul V. Fabella and Karl Kendrick T. Chua document the multiple efforts over the years to reform tax policy and administration in the Philippines. Tax administration reform, in contrast to tax policy, has always been resisted and frustrated by insiders in the Bureau of Internal Revenue (BIR). Relative successes were attained during emergency rules when the political center was endowed with decree-making powers, but even these never got sustained. In a democratic regime with fragmented veto power, reform is even more difficult.

The BIR was the subject of numerous reform projects supported by aid agencies, like the large taxpayer system and tax computerization projects supported by the World Bank, the Value-Added Tax Information System (VATIS) project by the ADB, and the Run After Tax Evaders (RATE) Program by the Millennium Challenge Corporation (MCC), among others. But when implemented, they tended to be quickly eroded, either by neglect or active resistance. The resistance of front-line tax collectors is especially interesting, because they have the power to restrict tax revenue flow into the government coffers, which manifests itself as rising fiscal deficit, which in turn raises the interest rate on government borrowing. BIR commissioners faced with this dilemma tend to let inherited tax administration alone, however leaky, and concentrate on tax policy to raise revenue. The case study highlights the story of one reform-minded commissioner, Rene Bañez, who dared to introduce radical administrative reforms (a switch to performance contracting for front-line collectors), which, however, needed legislative approval. Some strategic mistakes contributing to the failure are identified. The shifting and eventually half-baked political support by the higher authorities also contributed. Bañez

was finally forced out when the determined insider opposition succeeded in reducing the revenue flow to a trickle and in carefully orchestrating press attacks.

The case study highlights the danger of advocating for a reform whose political feasibility is weak. It suggests a conundrum: administrative tax reform is most compelling when there is a fiscal crisis, when the authorities are most vulnerable to fiscal blackmail, and when political feasibility is also weakest.

### Findings from the Cases

A number of regularities that can inform development thinking and practice emerged from the cases:

- 1. Institutional change is an iterative, non-linear, and context-specific process.** Akin to probing and groping, successful reform involves the embedding of technically sound policies within the murky and ever-shifting world of politics and coalitions. While the process is protracted and unpredictable, it can be influenced to produce positive development outcomes.
- 2. Technical and political dimensions play equally important roles for achieving reform.** There is a universe of reforms, some of which are technically sound, and others, politically possible. Each reform case sought the elusive option that is both technically sound *and* politically possible at specific moments in time, and at critical junctures amid the seeming chaos. Discerning this elusive combination is an iterative process that combines three reform elements: technical analysis, political economy analysis, and political outcomes.
- 3. Political action is a critical ingredient for institutional change.** Political constraints revealed in the course of the groping required detours and strategic responses by individual leaders. Political action includes negotiating the complex socioeconomic and political terrain of reform, building coalitions, and aligning various interests toward the achievement of the developmental outcome. The goal of political action is to convince those with political capital to spend it on technically sound, politically possible solutions.
- 4. Committed local leadership is the principal driver of reform.** In all cases, there are individuals, whom we refer to as development entrepreneurs, who took responsibility for the reform challenge and

for seeing to the achievement of the outcome. They are generally self-motivated; that is, with or without a helping hand from others or from development agencies, whether within or without the government, these individuals continue to pursue the reform and development outcome. But the resources at their disposal are very limited. Relative financial independence and time-space flexibility seem to characterize these individuals.

**5. In some cases, development agencies can play a critical but supporting role in achieving reform.** Some of the successful cases point to a promising project structure that allows development agencies to increase aid effectiveness and manage institutional risks. In that structure, development agencies work with intermediary organizations and local partners through flexible, outcome-oriented grants.

## Conclusion

This chapter began with an exploration of essential concepts in institutional reform and development. In his reflection on the state of our understanding of development, Booth (2011) notes that institutions rule, but the right institutions are “context- and time period-specific, and institutional change is not self-generating.” The cases of reform initiatives documented confirm the view that the process of reform is a political equivalent of a war—protracted even in the most favorable of circumstances, unpredictable in the extreme, and subject to the vagaries of the fickle political winds. Reform advocates who hope to do more than stir the pot cannot avoid mastering the formal and informal rules of the local political game. Development agencies are increasingly interested in incorporating politics into their technical assistance programs. In the final chapter, we will revisit this to suggest a promising approach to managing institutional risk and increasing aid effectiveness.

Confronted with daunting odds, reformers began their journey with a dream of a better country through more responsive institutions. In the end, progress was achieved by grounding those dreams in the realities of political economy. Reform advocates, with the help of development agencies in some cases, developed and implemented strategies, which combined sharp technical and political economy analysis and astute political action. Today, Filipinos take for granted the ability to activate a mobile phone in a few minutes, the ₱1 promotional airfares, and 24-hour water service. These are real instances of Banerjee and Duflo’s (2011) “quiet revolution” where “it is possible to make very significant progress against the biggest problem in the world through the accumulation of a set of small steps [...] These changes will be incremental,

but they will sustain and build on themselves.” The following case studies illuminate the difficult battles fought, and in some cases won, and the heroic individual efforts and sacrifices made to turn the dream of a better country into reality.

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A Philtranco bus (en route to Manila coming from Iloilo City) rolls out of a RO-RO vessel at Caticlan Port, Aklan.

Photo by Richard Abrina

Originally appeared in "Linking the Philippine Islands through highways of the sea," Center for Research and Communication, Manila, 2008.

## Chapter 2

# A Market-Oriented Policy Reform Option: The Philippine Roll-On/Roll-Off (RO-RO) Experience

Enrico L. Basilio<sup>1</sup>

Utilizing the recommendations of past research studies conducted by the Japan International Cooperation Agency (JICA), the Norwegian Shipping Development Company (SHIPDECO), and the United States Agency for International Development (USAID), development entrepreneurs, as early as 1991, pushed for the adoption of a market-oriented strategy that would effectively address and promote competition by offering the market an alternative sea transport system. After more than a decade, in 2003, Executive Order (EO) No. 170 was issued to promote the Roll-On/Roll-Off (RO-RO) shipping mode—which allows vehicles containing cargoes to roll on and off a ship, thus doing away with cargo handling—as a means of linking the various islands of the Philippine archipelago via the so-called “moving bridges.” With strong support from the market (shippers, business, and logistics service providers), the RO-RO policy was implemented, RO-RO links were established, and RO-RO’s promised benefits were delivered. Despite previous reservations about RO-RO, the port authority now supports what became a legacy program of the Arroyo administration: the Strong Republic Nautical Highways (SRNH). This case study ends with (a) an analysis of the economic impact of RO-RO on transport cost reduction and improvement of transport efficiency, promotion of regional trade and tourism, agricultural productivity, logistics and distribution, and area development; and (b) the prospect of an Association of Southeast Asian Nations (ASEAN) RO-RO network to enhance regional connectivity.

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## The Importance of Maritime Transport on Regional Growth and Development

Maritime transport remains the most important and widely used mode of inter-island transport in the archipelagic Philippines. In 2009, it facilitated roughly 72 million metric tons of domestic cargoes as well as the movement of more than 40 million Filipinos and foreign tourists visiting the beautiful islands of the country.

In recent years, the increased competition in the air transport sector due to deregulation and liberalization has exerted downward pressures on airfares. Despite this, maritime transport remains to be a cheaper alternative for moving around the country—definitely the choice of low-income travelers.

A necessary condition for the growth and development of the countryside and for addressing rural poverty is the availability of a continued and reliable maritime transport service. The presence of an efficient logistics and transportation network between the economic metro-powerhouses of Manila and Cebu (among others) and the underdeveloped rural provinces is critical to increasing economic interaction and integration.

### The Maritime Sector: Pre-Reform Period (prior to 2003)

According to an Asian Development Bank (ADB) (2010) report, the country's inefficient maritime transport sector has (a) effectively constrained countryside development, and (b) stymied efforts to improve the productivity and competitiveness of the exports and tourism sectors.

The lack or inadequacy of such vital connections isolates some island provinces (see Table 2.1).

**Table 2.1. 2005 Poverty Incidence in  
Select Poorest Provinces in the Philippines**

| Province    | Poverty Incidence (%) |
|-------------|-----------------------|
| Sulu (ARMM) | 63                    |
| Masbate     | 63                    |
| Tawi-Tawi   | 56                    |
| Romblon     | 55                    |
| Camiguin    | 53                    |

*Note:* Five of the top 10 poorest provinces in the country fall under the category of island provinces.

*Source:* National Statistical Coordinating Board.

This isolation, to a large extent, reflects the poverty and underdevelopment of these island provinces. In many cases, the isolation provides no incentive to increase agricultural production or farm productivity, as their markets are relatively small. This translates to low income for farmers and fisher-folk. The isolation of agriculture-producing islands from other islands where larger markets exist serves as a major constraint to economic and social interaction and integration.

Where maritime service is available, inefficiencies and high transport costs undermine the distribution of products and movement of people. The Development Bank of the Philippines (DBP) (2001) reveals that the inefficiencies in the transport of agricultural products resulted in high levels of wastage and spoilage: 40 percent of harvested fruits and vegetables, valued at ₱30 billion,<sup>2</sup> go to waste due to spoilage; 20 percent of annual corn production, valued at ₱4.5 billion, is lost due to spillage. Therefore, any improvement in productivity at the farm level goes down the drain, since the same farm produce cannot be distributed efficiently. On the export side, a Center for Research and Communication (CRC) study (Santiago & Basilio, 2007) indicates that the cost of exporting from Manila (which includes domestic trucking and cargo handling) is 10-20 percent higher than our ASEAN competitors like Thailand and Indonesia. On top of this are the added costs of domestic trans-shipment.

### **Flawed Port Policy**

The main port policy is enshrined in the Charter that created the Philippine Ports Authority (PPA). The policy made the port authority both an enterprise and a regulatory agency.<sup>3</sup> As an enterprise, the PPA owns, develops, maintains, operates, and generates income from its ports. As a port developer, the PPA has, through the years, established a port system consisting of more than 100 public ports throughout the country. It has also allowed the development of private non-commercial ports and a few private commercial ports. As a port operator, the PPA outsources the operation of its major terminals to the

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<sup>2</sup> Foreign exchange was at ₱ 44 to US\$1, as of December 2010. See <http://www.xe.com/> for the latest rate.

<sup>3</sup> Aside from PPA, there are a few independent ports authorities created by law to regulate specific ports. For example, Subic Freeport is under the Subic Bay Metropolitan Authority (SBMA); Port Irene is under the Cagayan Economic Zone (CEZA); the Mindanao Container Port is under the Phividec Industrial Authority (PIA); Autonomous Region of Muslim Mindanao (ARMM) ports are under the Regional Port Management Authority (RPMA); and Cebu ports are under the Cebu Port Authority (CPA). Nonetheless, the PPA remains the more important port authority due to the extent and coverage of its port network.

private sector while maintaining ownership.<sup>4</sup>

As a regulator, the PPA oversees the entire Philippine ports system, made up of both public ports (PPA-developed) as well as private ports (whether commercial or non-commercial). Port regulation is carried out in these areas:

- Issuance of a permit for the construction of a private port.
- Issuance of a permit for the operation of a private port.
- Approval of petitions for rate increases (in cargo handling, port dues, et cetera).
- Collection of shares from cargo-handling revenues (10-20 percent) and port dues of private commercial ports (50 percent).

In 2006, the House of Representatives Committee on Oversight conducted an inquiry,<sup>5</sup> and in its report (2006), concluded that the PPA suffers from a conflict of interest because it benefits from its own regulation. As a regulator, the PPA reviews and approves petitions for rate increases submitted by cargo-handling operators. However, since the PPA gets a share from cargo-handling revenues,<sup>6</sup> such petitions are approved in most cases. It is no surprise, then, that cargo-handling rates increased annually from 1998 to 2008 (Table 2.2). Prior to the RO-RO policy, port operation was naturally biased in favor of cargo-handling (the more cargoes handled and the higher the rates, the higher the income of the PPA). As a government-owned and -controlled corporation (GOCC), the PPA was then able to contribute more to the Philippine treasury.

The committee report further noted that the PPA is also able to use its regulatory power to protect itself from competition, sometimes at the expense of public interest. A good case in point is the Harbour Centre Port Terminal, Inc. (HCPTI), a private commercial port adjacent to the port the PPA runs in Manila. When the HCPTI requested the PPA for a permit to handle foreign “containerized” cargoes, the latter refused because of the direct competition that HCPTI would have posed to the PPA port. But when the PPA granted HCPTI a permit for foreign “non-containerized” cargoes in 2004, a huge segment of

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<sup>4</sup> PPA awards long-term contracts (25 years) to private companies for the operation, management and upgrade of certain PPA ports. PPA remains the port owner. It is only the operation of the port that is awarded to the private sector. Examples: MICT is operated by ICTSI, while South Harbor is run by Asian Terminals, Inc.

<sup>5</sup> As a result of House Resolution 01032, 13<sup>th</sup> Congress, Session No. 13-2RS-035 (2005, November 29).

<sup>6</sup> Section 3 of LOI 1055-A allows PPA to share at least 10 percent from cargo-handling revenues. In the past, PPA share is as much as 30 percent. In 2005, President Arroyo placed a cap on PPA’s share—10 percent for domestic and 20 percent for international ports.



the PPA's market in that area transferred to HCPTI.<sup>7</sup>

**Table 2.2. Increases in Cargo-handling Rates**

| YEAR | DOMESTIC     |                 | FOREIGN         |                 |
|------|--------------|-----------------|-----------------|-----------------|
|      | Arrastre (%) | Stevedoring (%) | Arrastre (%)    | Stevedoring (%) |
| 1998 | 12           | 40              | 8               | 40              |
| 1999 |              |                 | 20              |                 |
| 2000 | 10           | 10              | 8               | 8               |
| 2001 | 10           | 10              | 10              | 15              |
| 2002 |              |                 | 10 <sup>a</sup> | 10 <sup>a</sup> |
| 2006 | 15           | 15              |                 |                 |
| 2007 |              |                 | 10              | 10              |
| 2008 |              |                 | 8               | 8               |

*Note:* <sup>a</sup> 10% rate increase was granted only to the operators at Manila International Container Terminal (MICT) and South Harbor.<sup>8</sup>

*Source:* PPA.

## Reforming the Maritime Industry

Traditionally, the reform process requires a review of the existing policy, which identifies areas that require revisions or amendments, and repeals or the introduction of new provisions. Reforming a policy requires legislative and/or administrative action, depending on the nature of the policy (i.e., a congressional act, executive order, administrative order, et cetera) being

<sup>7</sup> In 2004, PPA granted HCPTI a permit to handle foreign non-containerized cargoes. The competition HCPTI provided in said market segment benefited the economy from better service and lower cost. At least 70 percent of the market shifted to HCPTI from South Harbor (a PPA-owned port) because of service and lower cost (by 30-40 percent). Another example: The PPA, over the last decade, has been trying to issue an administrative order that would mandate the handful of private commercial ports operating within 27-km radius from PPA ports to convert into non-commercial port status. This highlights the PPA's aversion to competition.

<sup>8</sup> Cargo-handling rates increased almost every year from 1998-2002 prior to the establishment of the nautical highways in 2003. The private sector questioned this practice arguing that the PPA's mandate is, first and foremost, to be a [port] service provider and not an income-generating agency. Moreover, the private sector contended that any income generated by the PPA over and above its needs to provide the service is a tax burden. Since the implementation of the RO-RO policy in 2003, cargo-handling rates increased only once, in 2006. The reason is clear: an increase in cargo-handling rate makes RO-RO a more viable sea transport alternative.

changed. This case study was undertaken to explore and explain the process of promoting a policy that offered the market an alternative to the status quo. From this specific case, it is expected that some lessons can be inferred for possible application to reform initiatives in the future or in other sectors of the economy.

The ideal way to effect reform in the port sector is to correct its flaws, especially those that deal with the conflict of interest and those that are anti-competitive. However, this approach requires legislative action. A World Bank-Philippine Institute for Development Studies (PIDS) study (Llanto, Basilio, & Basilio, 2005) proposed amendments, such as (a) separating the PPA's developmental and regulatory functions, (b) eliminating the provision that allows the PPA to share from cargo-handling revenues, (c) increasing private sector representation in the PPA Board, and (d) crafting a program that would pave the way for the privatization or devolution of public ports. There had been numerous attempts and initiatives in the past to reform the port policy. Various bills were filed in Congress, but none prospered.

In light of this, a new policy was proposed to (a) undermine the PPA's conflict of interest and (b) provide the market with an alternative transport service that would complement, but at the same time, offer competition to the conventional shipping service.

## **The Technically Sound Solution**

Past studies done by the JICA, USAID, and SHIPDECO in the early 1990s recommended the extensive use of RO-RO shipping as the most appropriate mode of sea transport for an archipelagic country like the Philippines, because it is simple and does away with certain port-related activities, like cargo handling. The technical studies also assert that using RO-RO would reduce transport costs and improve transport efficiency and service quality, due largely to the elimination of cargo-handling costs, which on average account for about 30 percent of sea transport costs. However, it would also inevitably reduce the income of the PPA and its cargo handlers.

There are several reasons why the RO-RO recommendation did not take off in the past. Most of the big shipping lines have converted their second-hand imported RO-RO ships from Japan to accommodate cargo handling as imposed by the PPA. Some of the shipping lines even went into the cargo-handling business themselves. The PPA reasoned that its ports do not match and/or are not equipped to handle RO-RO ships. In reality, there were some cases where the port matched the RO-RO ship and RO-RO service was provided. However, shippers still paid cargo-handling charges even when no

actual service was provided.

Newspaper articles attacking the RO-RO project began to appear, with liner-shipping executives citing safety as a prime concern and arguing that using RO-RO was like going back to the Jurassic Age. These articles were issued in order to dissuade the policymakers from adopting the policy recommendation anchored on RO-RO.


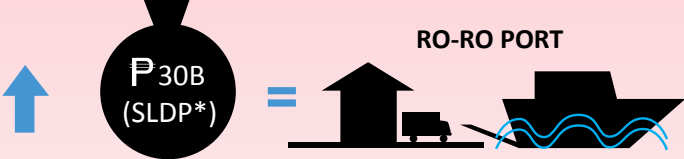
### Building the Constituency for Reform

In waging an effective policy reform campaign, it is important to identify the parties that will support or oppose the reform initiative based on their incentives for supporting or opposing such an agenda. After identifying the players (within and outside government), it is equally important to continually educate them about developments in the advocacy battle, as they may play the role of talking heads in policy debates.

### Mapping the Political Economy of Reform

The major movers in the maritime reform battle are listed in Table 2.3.

**Table 2.3. Pro- and Anti-Port Policy Reform**

| PARTY   | MOTIVATION  |
|---|---|
| <br>Development Bank of the<br>Philippines |  <p><b>RO-RO PORT</b></p> <p>Had a P30-billion credit facility called <i>*Sustainable Logistics Development Program</i>, which has a component funding RO-RO port/terminal development and shipping. Without the policy in place, however, the private sector was not keen to invest in such an activity.</p> |

## PARTY

## MOTIVATION



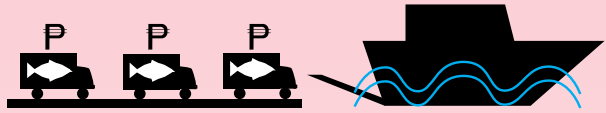
National Economic  
Development Authority



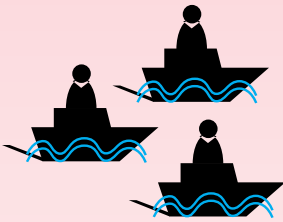
Regional economic development  
and trade; promotion of  
competition in the provision of  
transport services



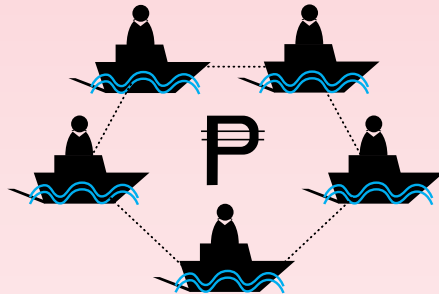
Department of Agriculture  
and agricultural producers



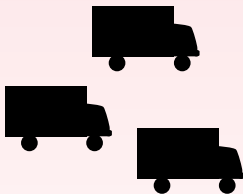
Efficient and cost-effective transport of agri-fishery products



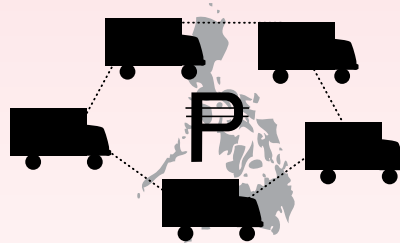
RO-RO Operators



Expansion of network; greater investment opportunities



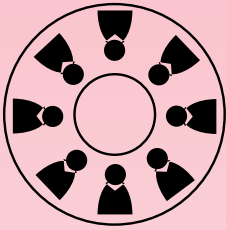
Trucking Companies



Expansion of trucking service and network (instead of being  
limited in a specific geographical area. For example, from being  
able to deliver to any point in Manila, truckers can now deliver to  
any point in the Philippines).

## PARTY

## MOTIVATION



LGUs



Coastal municipalities/cities with natural sheltered coves ideal for RO-RO operations



Department of Transportation and Communications (DOTC) and its attached agencies: Philippine Ports Authority (PPA)



PPA

RO-RO has fiscal implication on PPA. PPA stands to lose some income from cargo handling and may find it difficult to raise cargo handling rates since doing so increases RO-RO's viability.



Cargo-handling Operators/  
Port Workers



Displacement, loss of income.

(It should be pointed out, however, that the need for cargo handling service will not disappear completely because not all cargoes can be shipped through RO-RO)



Domestic Conventional/Liner  
Shipping Operators, Airlines



Competition from RO-RO;  
Investments in cargo-handling  
operations and equipment

Source: Compiled by author.

## Advocating Policy Reform

In order to succeed, the policy reform advocates needed to get the issue onto the agenda of a principal policymaker. The advocates sought to identify the main policy decision-maker who could order the captured agency to carry out the policy reform. Once identified, the next task was to formulate a plan that would place the issue on the radar screen of the principal policymaker. Knowing the Arroyo administration's concern for Mindanao's development, the reformers made sure that the issue was always raised and included in the resolutions of any major conference organized in Mindanao (e.g., the Mindanao Food Congress, the Mindanao Business Conference, the Mindanao Shippers Conference, etc.). In these conferences, the high cost of transporting goods from Mindanao to Manila was always top of the agenda, with RO-RO shipping recommended as the solution.

In early January 2002, days after President Arroyo announced that she would not run in the 2004 presidential election, heads of various industry associations,<sup>9</sup> together with some Cabinet secretaries<sup>10</sup> and local government executives, wrote a letter to President Arroyo endorsing the issuance of an executive order (EO) that would define the RO-RO policy and stating that the policy prescription is consistent and within her 10-point agenda. Conspicuously absent in the letter were the signatures of government agencies concerned with port operation, namely the PPA, the DOTC, and the Maritime Industry Authority (MARINA).

The president called for a meeting of the proponents of the policy with the concerned agencies to thresh out the details and agree on the proposed policy reform. Except for one detail (limited distance coverage for RO-RO shipping to

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<sup>9</sup> These included the Export Development Council (EDC), the Federation of Philippine Industries (FPI), the Philippine Chamber of Commerce and Industry (PCCI), the Philippine Exporters Confederation (PHILEXPORT), the Supply Chain Management Association of the Philippines (SCMAP), the Development Bank of the Philippines (DBP), and the Northern Mindanao Shippers Association (NORMINSA).

<sup>10</sup> The National Economic Development Authority (NEDA), the Department of Agriculture (DA), the Department of Environment and Natural Resources (DENR), the Department of Finance (DOF), the Department of Internal and Local Government (DILG), and the Area Fund Management Offices (AFMO) in the ARMM.

50 nautical miles<sup>11</sup>), all of the proposed provisions—i.e., elimination of cargo handling and wharfage, simplification of the documentary requirements, issuance of the necessary permits, like the environmental compliance certificate (ECC) and foreshore lease agreement (FLA)<sup>12</sup> within a prescribed period—were carried. The domestic shipping industry was concerned that RO-RO would compete directly against their main profitable and longer liner routes, e.g., Manila-Cebu, Manila-Iloilo, Manila-Bacolod, hence the distance limitation.

### Issuance of EO 170—The RO-RO Policy

On January 21, 2003, President Arroyo issued EO 170 (see Appendix 2-A) in Malacañang without any fanfare. MARINA praised RO-RO shipping as an innovative shipping service. In a newspaper article, MARINA was quoted as saying, “...the roll-on/roll-off system is the most viable and efficient way in transport [*sic*] domestic goods... Use of ro-ro [*sic*] ships cut transport time by 50 percent” (MARINA says RO-RO most viable, efficient transport, 2002).

The main concept behind the Road-RORO Terminal System (RRTS) is the “integration of the various islands through a seamless system of land and sea transport that forms part of the national highway network.” The vision is to establish complementary national transport systems (the PPA and the RRTS) for greater efficiency, competitiveness, and regional economic growth. The RRTS affords shippers the freedom to choose how their cargoes will be shipped and promotes private investments and private sector-LGU collaboration in transport and logistics.

In a nutshell, the objectives of the RRTS are (a) to reduce transport costs from Mindanao to Luzon through the Visayas, specifically the cost of inter-island transportation, through the establishment of a safe, efficient, and

<sup>11</sup> Arguing that RO-RO shipping is supposed to cover only short routes (as moving bridges), maritime regulators limited the distance coverage to not more than 30 nautical miles. However, considering the president’s desire to initially establish a RO-RO system that would connect all islands in the Western Seaboard from Batangas (Luzon) to Dapitan (Mindanao) via the islands of Mindoro, Panay and Negros, the limit was increased to 50 nautical miles (since the Roxas-Caticlan route is roughly 48 nautical miles). Later on (three months after the EO was issued), the liner-shipping sector advocated for the removal of the 50-mile limit so that they themselves could avail of the benefits provided for by the RO-RO policy.

<sup>12</sup> The ECC certifies that an undertaking will not cause significant negative environmental impact. The FLA is an agreement between the government and the applicant containing specific terms and conditions about the use of foreshore lands, marshy lands, and other lands bordering bodies of water for purposes other than agriculture. Both are issued by the DENR.

cost-effective RRTS; (b) to enhance tourism, transportation, and commerce throughout the country; (c) to facilitate the government's agro-fisheries modernization and food security programs; and (d) to promote private sector participation in the establishment, construction, and operation of RRTS facilities (RO-RO ports and ships). Summarized below are the salient features of the RO-RO policy as embodied in EO 170 (see Appendix 2-A):

- (a) the RRTS forms an integral part of the national highway network;
- (b) no cargo handling since the cargoes are rolling cargoes;
- (c) no wharfage dues since RRTS terminals are not ports;
- (d) simplified documentary requirements;
- (e) fixed annual supervision fee paid to the PPA, the Cebu Port Authority (CPA) and MARINA;
- (f) privatization of public RO-RO ports;
- (g) a toll fee based on lane meter shall be charged to all rolling cargoes;
- (h) existing private port operators are encouraged to convert their operations to RRTS; and
- (i) financing of RRTS-SRNH projects will come from the DBP under its Sustainable Logistics Development Program (SLDP).

### **The Impact of RO-RO on the Philippine Economy**

Since its implementation in 2003, RO-RO has had quite an extensive economic impact in the Philippines. For one, it changed the structure and operations of the maritime industry. It provided the market not only an alternative mode of shipping but a much simpler and more cost-effective way of moving goods. And because of RO-RO's operational efficiency vis-à-vis the traditional shipping system, as well as the elimination of other costs associated with traditional shipping (e.g., cargo-handling costs, wharfage dues), the market saw a dramatic reduction in transport costs. Moreover, big liner shipping companies increased their investments in RO-RO ships. In fact, one of the dominant liner shipping companies created a new subsidiary company to handle its RO-RO business (see box story below).



### **Aboitiz Unit Phases out Container Ships**

by Katrina Mennen A. Valdez, *The Manila Times*

2GO Express has started phasing out its container ships and will completely venture in roll-on, roll-off (ro-ro) [*sic*] ships instead, the company's top executive announced Friday. In a press briefing, Sabin Aboitiz, president and CEO, said the ro-ro [*sic*] service "eliminates a log of the middle steps in the supply chain" as it does away with the need for warehouses. Clients can send and receive cargo as if it was running on dry land, because the truck runs on the road, gets on the boat and rolls off at the port, then drives to the end destination," Aboitiz elaborated.

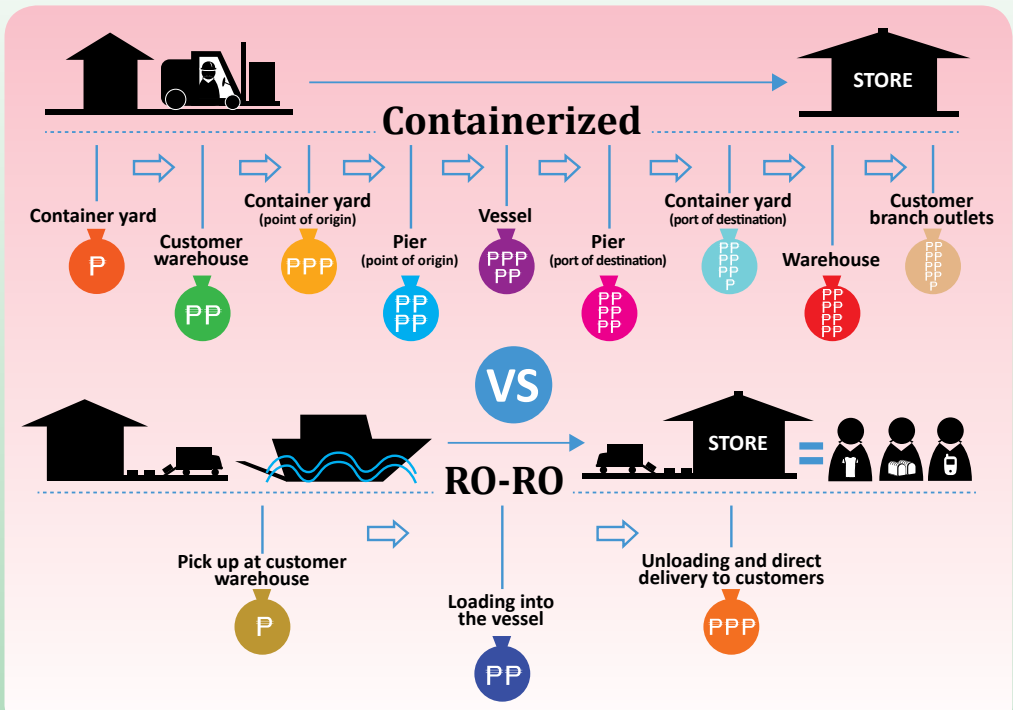
Mike Camahort, senior vice-president and chief operating officer of 2GO Solutions, explained: "In terms of time, it takes an average of six days using a container ship and just an average of three days via ro-ro, with less handling and waiting. All trucks are bar-coded, so customer can log on to online page and see where the cargo is anytime."

The company, which started its ro-ro [*sic*] service in 2004, will start replacing 100 container ships with ro-ro [*sic*] ships this year, a process it expects to complete within the next five years. Relatedly, the company's (ro-ro) [*sic*] volume as of December 2006 was twice higher than the year before.

Jerome Santos, sales manager, informed that 2GO ro-ro [*sic*] service currently services Jollibee, Nestlé, URC, and Mercury Drug, its first client for the service.

*Source: Valdez (2007).*

Figure 2.1 shows the operational efficiency of RO-RO service vis-à-vis the traditional shipping system while Table 2.4 highlights the cost savings of RO-RO transport.



**Figure 2.1. Comparison of Traditional (LO-LO<sup>a</sup>) and RO-RO Shipping**

*Note:* <sup>a</sup>LO-LO means load-on/load-off shipping. This method of shipping requires cargo handling.

*Source:* Aboitiz Transport System Road RO-RO terminal system (RRTS) 2GO Presentation (n.d.).

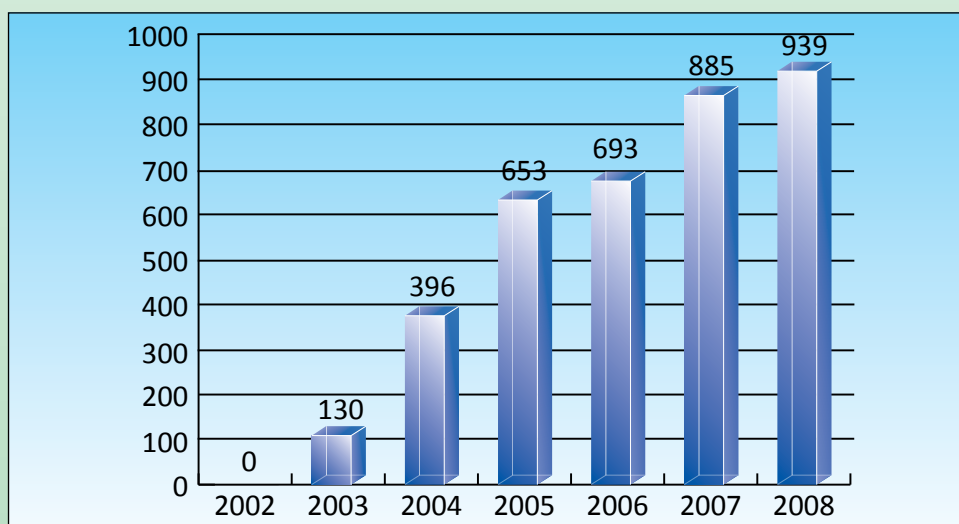
The RO-RO system likewise promoted tourism and agricultural productivity. For example, since its introduction in 2003, RO-RO passenger traffic (a significant number are local and foreign tourists) has been on the rise. Figure 2.2 shows the substantial growth in passenger volume in the Roxas-Caticlan RO-RO link, en route to the famous tourist spot, Boracay. With the help of RO-RO, tourism receipts in Boracay from 2003 to 2006 rose by more than 50 percent, in Iloilo by 30 percent, and in Dapitan by 200 percent. Moreover, with the completion of the Central Nautical Highway in 2008, the islands of Cebu, Bohol, and Camiguin have become more accessible to tourism.

**Table 2.4. Comparative Cost of Conventional vs. RO-RO Shipping**

| Type of Commodity (Route)   | Traditional<br>(in ₱) | RO-RO<br>(in ₱) <sup>a</sup> | Savings<br>(%) |
|---|-----------------------|------------------------------|----------------|
| <b>Liquid CO<sub>2</sub></b> <sup>b</sup> (Bacolod - CDO <sup>c</sup> ) | 225,000               | 71,664                       | 68             |
| <b>Medical kits</b> (Iloilo – Bacolod or Dumaguete)                     | 10,000                | 4,000                        | 60             |
| <b>Beer</b> (Manila - Calapan)  | 30,400                | 13,000                       | 57             |
| <b>Electronics</b> (Manila - Cebu)                                      | 26,000                | 14,000                       | 46             |
| <b>Motorcycles</b> (Manila - Dumaguete)                                 | 95,000                | 50,000                       | 47             |
| <b>Live cattle</b> (Guihulngan, Negros - Manila)                        | 90,465                | 51,500                       | 43             |
| <b>Fish</b> (Iloilo - Manila)   | 20,000                | 14,000                       | 31             |
| <b>Assorted Fish</b> (Zamboanga City – Bato, Cebu)                      | 32,000                | 23,360                       | 27             |
| <b>Dry goods</b> (Manila - Cebu)  | 50,000                | 40,000                       | 20             |

Note: <sup>a</sup>Inclusive of return trip. <sup>b</sup>CO<sub>2</sub> = carbon dioxide. <sup>c</sup>CDO = Cagayan de Oro.

Sources: ADB (2010); Based on interviews with the shippers and truckers 2009.

**Figure 2.2. Passenger Traffic in Roxas-Caticlan, 2002-2008 (in '000)**

Source: Philippine Ports Authority.

In agriculture, its impact mainly lies in the increased productivity as RO-RO paved the way for farmers to reach a broader market. Access to bigger markets provides incentives for farmers to increase productivity.

Logistics and distribution would never be the same without RO-RO. The best example is the experience of Nestlé Philippines. Prior to the establishment of the RO-RO system, Nestlé had 36 distribution centers scattered nationwide. Due to infrequent shipping schedules, large inventories were kept in warehouses. With the RO-RO system, Nestlé today only operates three distribution centers because the delivery trucks and container vans now serve as moving warehouses.

The Big-E Food Corporation is another beneficiary of the efficient transportation offered by the RO-RO service. RO-RO enabled the company to access new markets and reduce transport time, costs, and inventory carryover. Big-E closed down three of its nine warehouses as a result. Total logistics savings is estimated at \$52,000 per month.

RO-RO also serves as a catalyst for area development. The small RO-RO port developed in Roxas, Oriental Mindoro, for example, paved the way for the municipality's rapid economic growth. The tremendous growth in vehicular traffic, i.e., rolling cargoes, increased the number of gasoline stations from two to seven. New businesses opened up (see Table 2.5). Even the revenue generated by the municipality improved.

**Table 2.5. Economic and Business Indicators**

|                                | 2003    | 2004    | 2008    |
|--------------------------------|---------|---------|---------|
| Shipcalls                      | 818     | 2,181   | 2,596   |
| Ship Passenger Traffic         | 130,199 | 652,769 | 939,055 |
| Cargo Volume (MT) <sup>a</sup> | 37,026  | 174,275 | 428,895 |
| No. of Vehicles Served         | 9,269   | 44,487  | 75,517  |
| Bus Operators                  | 0       | 6       | 10      |
| Business Establishments        | 690     | 853     | 861     |

*Note:* <sup>a</sup>MT = metric tonnes.

*Source:* Basilio, Faustino, Acena, & Hernandez (2010).

**Table 2.6. Pilar Port-Related Revenue Collection (in ₱ '000)**

| Year | Port-Related LGU Revenue |
|------|--------------------------|
| 2006 | 1,640                    |
| 2007 | 2,400                    |
| 2008 | 4,430                    |

*Source:* Municipality of Pilar Treasury Office.

The expansion of the RO-RO network also opened new business opportunities for transport companies. The Vallacar Transit Corporation, the largest provincial bus company in the country using RO-RO for its inter-island routes, experienced rapid expansion of its bus fleet. On the other hand, some RO-RO shipping operators (like Montenegro Shipping) have expanded into allied businesses like bus operations and RO-RO port development and operation.

In sum, the economic impact of RO-RO is truly far-reaching. First, the Philippine RO-RO experience showed that the real driver of growth, investment, employment, and poverty reduction is the private sector. Secondly, it can also be seen that the correct policy environment with relatively small public investments can yield large benefits. Thirdly, the Philippine RO-RO experience showed the value of a connected network. Not only does it have a high impact on local economies despite minimal economic activities prior to RO-RO, but because of it, new growth centers also unexpectedly emerged. Finally, the network effects of RO-RO broadened the scope of its impact.

## Conclusion and Recommendations

The opening of the RO-RO network, also called the Strong Republic Nautical Highways (Western, Central, Eastern and East-West Lateral RO-RO connections), linked the country's major islands of Luzon, Visayas, and Mindanao to facilitate a more efficient and seamless movement of goods and people. The RO-RO network likewise opened new markets for agri-fishery producers, stimulated regional trade, tourism and area development, and reduced sea transport costs.

The RO-RO system also presents investment opportunities under the public-private partnership (PPP) modality. The government—through the port authorities and/or local government units—may tap the private sector in

the development and operation of RO-RO terminals or network of terminals.

Looking at the Philippine RO-RO experience, it is interesting to note that reform is possible despite the presence of adverse incentives against it. As long as (a) the alternative policy is market oriented (and therefore will generate market support), and (b) there is a substantial coalition (a reform constituency of ideologues, reform-oriented Cabinet secretaries, progressive local executives, and industry advocates) committed to pushing the reform agenda—reform can happen. It can also be argued that a successful, if partial, reform (second-best solution) can unlock economic potentials of certain industries, sectors and even regions and rupture the ramparts of the remaining obstacles. This is the lesson derived from documenting the battles for the RO-RO policy.

Despite difficulties in policy reform advocacy (due to opposition of vested interests, institutional incentives, politics, and regulatory capture), the RO-RO experience nevertheless demonstrates that success can be attained if the right policy reform is pushed. It need not be the first-best solution, as long as it will gain positive benefits to the economy.

The success of the reform initiative hinged on several factors: (a) the presence and strong commitment of ideologues and reform-oriented private individuals and groups (industry associations, NGOs); (b) champions in the Cabinet and government; (c) the viability of the proposed policy reform; (d) the correct strategy or the ability to bring the issue to the attention of the main policymaker—in this case, President Arroyo became the best salesperson for the RO-RO program and even considered it part of her legacy. The PPA, for its part, had to toe the line. The domestic shipping industry that opposed RO-RO before now benefits from the opportunities that it brings. And while the RO-RO policy started with the Arroyo government, the present Aquino administration is continuing the program both domestically and regionally.

The recent sea tragedies involving RO-RO ships do not diminish the positive impact of RO-RO as an effective sea transport system for an archipelagic economy like the Philippines. What is needed from the proper authorities is to ensure that (a) the RO-RO ships are seaworthy (i.e., safe and secure, and run by qualified and competent crew/seafarers); and (b) that ship operators comply with safety and security standards and invest in the upgrade, improvement, and modernization of their RO-RO ships.

There is a move to legislate the EO into a RO-RO law (since an EO can be easily rescinded through an issuance of another EO). But this concern is no longer relevant. The policy is now deeply rooted in the market and in the

public mind. The market and the public will be the greatest enemy of any attempt to reverse the policy.

Three recommendations that are expected to enhance the policy and maximize its economic impact on the market remain:

1. Expansion of the RO-RO service by allowing Chassis RO-RO (CHA-RO). RO-RO service, as currently defined in EO 170 s. 2003 is limited to self-driven rolling cargoes. This recommendation requires an amendment of EO 170 and is supportive of the ASEAN RO-RO initiative.
2. Declaration of all roads that form part of the RRTS as national roads. This will effectively and rightfully place these roads under the purview of the Department of Public Works and Highways (DPWH) and will mandate the DPWH to develop and maintain these roads and to ensure connectivity between the road network and RO-RO ports and terminals.
3. Development of road stations (P5-10 million) instead of expensive ports (P50-150 million). This concept is expected to generate greater private sector and LGU participation in the RRTS by bringing down the cost of investment without sacrificing safety and security.

It is encouraging to note that the RO-RO success in the Philippines can be replicated in other economies of archipelagic Southeast Asia (aSEA). The Master Plan on ASEAN Connectivity listed the ASEAN RO-RO Network initiative among the “flagship priority projects” for implementation.

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The Diosdado Macapagal International Airport (DMIA), located in Clark, Pampanga, used to be a U.S. military airbase before it was closed down in 1991. It is now a hub for domestic and international civil aviation in the Philippines.

Photo by the Clark International Airport Corporation (CIAC)

# Chapter 3

## Exploring the Political Economy of Civil Aviation Reforms in the Philippines

Maria Cherry Lyn Salazar-Rodolfo

International civil aviation is the major bridging element for international tourism, the trade of high value goods, and the mobility of people. It accounts for 98 percent of international visitor arrivals, moves 54 percent of Philippine merchandise export value, and transports 98 percent of Overseas Filipino Workers (OFWs). Even business process outsourcing industries, which rely on the mobility of regional staff, require adequate connectivity. The competitiveness of these service industries depends, to a large extent, on access to markets enabled by the availability and frequency of flights and seats, as well as competitive travel or shipping costs.

Institutions shape the availability and sustainability of air access infrastructure. According to North (1993), institutions form the incentive structure of a society; the political and economic institutions, in consequence, are the underlying determinant of economic performance. As humanly devised formal (rules, laws, constitutions) and informal (reputations, conventions) constraints, these institutions serve to structure interactions and define the incentive structure of societies, and specifically, economies. These constraints can influence the returns on economic activities by restricting agents' behaviors and incentivizing them in different directions. Institutions can also be viewed as "political settlements" between various groups in society, which can be changed according to the changing relative strengths of these groups (see Parks and Cole, 2010 and Chapter 10 of this volume).

In the case of international aviation, Gillen (2009) explains that the bilateral air service agreements (ASAs or bilaterals) and market liberalization policies are examples of these formal institutions that shape the strategic behavior of airlines and the users of air services, which in this case are enterprises like airports, hotels, tour operators, and shippers. The bilaterals, an international framework that emerged from the 1944 Chicago Convention, established the rules that govern the entry of airlines into markets (see box story below). This framework became the basis for the exchange of traffic rights and the ASAs as matters for negotiation between states, not carriers. Gillen (2009) further notes that the international experience in the past 60 years revealed that the property rights for market access were, by default,

given to nations. They, in turn, transferred those rights to their national airline, thus leading to highly protectionist or “predetermined” agreements and unproductive activities that consequently increase transaction costs.

Nations have traditionally viewed domestic capacity building in many sectors as their mandate. This was true especially of the so-called “commanding heights industries”: transport, utilities, steel, chemicals, power, etc. Rules and restrictions that favored domestic capacity building through the bloated producers’ surplus were adopted, even if this meant limiting and penalizing consumer choice and surplus. This was part and parcel of the “import substitution era.” This was true as well in the Philippine aviation industry. In time, it became clear that these rules conflicted not only with consumer welfare, but also with the development of more promising sectors. The conflict is highlighted in this case study.

This case study explores the political economy of the policy changes in the international civil aviation sector of the Philippines during the period 1995-2009. The battle pitted the claims of producers against those of consumers. The study aims to examine how the policy shifts and changes in the rules of the game happened. It particularly focuses on the context of the reform, the process by which political settlements evolve, and the roles of actors, agents, and groups who played crucial roles in the changes. It is, however, not meant as an assessment of the economic impact of these changes.

The case study starts with an outline of the policy shifts in civil aviation starting from 1952 to 1991. Sections 2 through 4 then explore the battle for property rights for market access during three subsequent periods in time. The second period covers the years 1992-1997, when the Ramos administration initiated a series of bilateral air talks to expand air traffic rights, and issued Executive Order No. 219 (or EO 219), which finally introduced effective competition in the domestic aviation market. The third period (1998-2004) includes the implementation of the so-called “progressive liberalization” policy under the Estrada (1998-2000) and Arroyo administrations (2001-2004). These administrations are best remembered for the one-year Republic of the Philippines (RP)-Taiwan air row (to be discussed in the following sections) and the initiatives to position Clark International Airport as a major gateway, respectively. The final period (2005-2009) discusses how Clark International Airport gained significant market access under unilateral and bilateral reform initiatives. Section 5 concludes by identifying some lessons in policy reform and the unfinished agenda in civil aviation reform.

## **The 1944 Chicago Convention and the Five Freedoms (Restrictions) of the Air**

The ASAs are trade agreements between governments and contain administrative (soft) and economic (hard) provisions. They define the number of airlines that can only be allowed to service the markets, route structures, flight frequencies, seats, the type of aircraft, costs of doing business, and tax policies, among others. The soft provisions cover taxation, exemption from duties on imported aircraft parts, airport charges, and transfers of funds from ticket sales from abroad, and so on. The hard provisions cover pricing and capacity limits.

The Chicago Convention defined only five freedoms of the air<sup>a</sup>:

**1<sup>st</sup>** The right to overfly foreign territory, for example en route from one country to another

**2<sup>nd</sup>** The right to make a non-traffic stop in another country, for example to refuel

**3<sup>rd</sup>** The right to carry passengers from the home country to another country

**4<sup>th</sup>** The right to carry passengers to the home country from another country

**5<sup>th</sup>** The right to carry passengers between two countries by an airline of a third country, with the route beginning or ending in the home country

The ICAO<sup>b</sup> identified three supplementary freedoms, which, however, are not officially recognized:

**6<sup>th</sup>** The right to carry passengers between two foreign countries by stopping or connecting in the home country

**7<sup>th</sup>** The right to carry revenue traffic between two countries without extending the route to the home country

**8<sup>th</sup>** The right to carry passengers between two domestic points within a foreign nation; this is also known as cabotage

### *Sources:*

<sup>a</sup> International Air Transport Agreement (1944).

<sup>b</sup> International Civil Aviation Organization (ICAO) (1996).

## **1952-1992: Evolution of Civil Aviation Policies: Pre-Liberalization Period**

The following is a brief review of the main policies and issuances of the pre-liberalization period.

In 1952, the Philippine Government passed the Civil Aeronautics Act (Republic Act No. 776 or RA 776), which empowered the Civil Aeronautics Board (CAB) and the Air Transportation Office (ATO) (a) to promote adequate, economical, and efficient service by air carriers at reasonable charges; and (b) to promote competition between passenger airlines and other carriers to the extent necessary for ensuring the development of the Philippine air transportation system. These two agencies regulated the economic and technical aspects of the industry. Two executive orders, EO 125 and EO 125-A, mandated the ATO to establish and prescribe rules and regulations for the inspection and registration of all aircraft owned and operated in the Philippines and all air facilities.

In 1959, RA 2232 was passed. This law designated Philippine Airlines (PAL), a private company then, as the country's national flag carrier in recognition of its role in security, defense, and the promotion of international trade. PAL was re-nationalized in 1978.

In 1973, the Marcos administration pursued a one-airline policy through Letters of Instruction (LOI) 151 and 151-A, which repealed Section 4 (e) of RA 776 and established the monopoly of PAL in both international and domestic operations. This policy effectively weeded out the other two existing carriers, Filipinas Orient Airlines and Air Manila, Inc. The passage of Presidential Decree (PD) No. 1590 or PD 1590 in 1978 gave PAL a new franchise, but with a provision that the franchise should not be interpreted as an exclusive grant of privileges. Furthermore, PD 1466, also implemented in the same year, reserved certain categories of traffic to PAL. These included the transport of persons or cargoes that use government funds, or loans and credits, that are guaranteed by the government. Hence, even if new players had entered the industry, PAL would have retained its monopoly over this category of air traffic. The industry thus remained a monopoly between 1973 and 1994, compelling the government to regulate fares to prevent PAL from engaging in monopoly pricing by capping the airline's return on investment to 12 percent (Manuela, 2009). The return on investment (or ROI) regulation allowed PAL to recover losses through government subsidies and to charge higher fares in high-density markets to subsidize unprofitable routes. Despite being extremely inefficient and a drain on government coffers, the cross-

subsidization allowed PAL to provide airline service in thinly traveled routes.

In 1988, EO 333 was issued. The Aquino administration revoked the one-airline policy, making an initial attempt to introduce competition. In 1989, to cater to the demand for permits to fly domestic routes, the CAB introduced an accreditation system that (a) created the rules for the grant of permits, (b) classified airports (categorized as rural, secondary, and trunkline), and (c) established the guidelines for the allocation of seats and frequencies by airlines in those routes. This system, however, did not foster effective competition because it only allowed two carriers in the initial stages of the policy implementation, and it restricted airlines from choosing their routes and frequencies, since these were subject to route profitability and traffic demand. The greatest impediment was the challenge imposed by the Congress on the constitutionality of the CAB, which granted the permits to new operators without any legislative franchise (Austria, 2000).

In 1989, during the hearing on the application of Cebu Air, an emerging airline, for a congressional franchise, the House Committee on Corporations and Franchises contended that, under the present Constitution, the CAB may not issue any Certificate of Public Convenience and Necessity (CPCN) or temporary operating permit (TOP) unless the individual or entity concerned possesses a legislative franchise. The CAB had to accede to the Congressional order. The aviation industry reacted by challenging the CAB in the Court of Appeals (CA), as evidenced in the case of *Avia Filipinas vs. CAB*.<sup>1</sup> On October 30, 1991, the CA ruled that the legislative franchise was not a prerequisite to the issuance of a CPCN, and that the Constitutional provision in Article XII, Section 11 granted certain administrative agencies the power to grant licenses to authorize the operation of certain public utilities. The CA held that in accordance with its mandate, under Section 10 of RA 776, as amended by PD 462, the CAB could issue not only a TOP but also a CPCN, even in the absence of a legislative franchise.

Although originally owned by private entrepreneurs since its establishment in 1941, PAL was under government control from 1978 to 1991. The move towards the privatization of PAL first came in 1992, in line with the Aquino administration's policy of privatizing state-owned companies. PR Holdings won the bidding for 67-percent share of the company in 1992.

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<sup>1</sup> CA G.R. SP No. 23365 (October 30, 1991).

## **1992-1997: Liberalization of Civil Aviation<sup>2</sup>**

When President Ramos assumed office in 1992, he was confronted with an aviation industry dominated by PAL, a monopoly widely noted for its inefficiencies. At the top of Ramos's agenda was the dismantling of monopolies, or the reduction of monopoly power that prevailed in key strategic sectors such as aviation, inter-island shipping, telecommunications, and banking.

There was a clamor for private sector representation in aviation policymaking. Following Ramos's directive to liberalize aviation policy, the Department of Transportation and Communications (DOTC) Secretary Jesus B. Garcia, who served as ex-officio chairman of the CAB, appointed Victor S. Limlingan, a professor at the Asian Institute of Management; Jose Claro Tesoro, a lawyer specializing in transportation law; and Rogelio Estacio, a retired Philippine Air Force general, as new members to represent the private sector in the CAB. At the time, the CAB retained the executive director from the previous administration, Silvestre Pascual, who was a career public servant. Panfilo Villaruel, Jr., ATO chief, was the fourth member, who acted as ex-officio vice-chairman.

The CAB addressed three major issues: the congestion of the Ninoy Aquino International Airport (NAIA), the poor performance of international tourism, and inefficiencies in domestic aviation markets. The CAB responded to these issues by promoting Mactan-Cebu International Airport (MCIA), liberalizing international air services, and pursuing the issuance of EO 219.

### **Promotion of MCIA as a Secondary Gateway**

The CAB decided to aggressively promote MCIA as an alternate international gateway due to the congestion at NAIA. This decision enabled the entry of direct flights from cities like Hong Kong to MCIA, which eventually benefited passengers, especially OFWs from the regions of Visayas and Mindanao.

### **Liberalization of International Air Services to Support Tourism**

The CAB was challenged to support the tourism industry, which was lagging behind its Association of Southeast Asian Nations (ASEAN) neighbors in terms of air access, and was badly hit by the political uncertainties and the effects of the global economic recession in the early 1990s. To support

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<sup>2</sup> This section is based on a paper by Dr. Victor S. Limlingan presented at the Development Entrepreneur Workshop in Manila, Philippines in February 2010.



the tourism development program of Secretary Vince Carlos, DOTC Secretary Garcia (who was also pursuing the deregulation of the telecommunications industry) temporarily ceded the CAB chairmanship to Secretary Carlos, and designated the three private sector representatives to chair the air panels, effectively placing the chairmanship with those who were knowledgeable about the air liberalization policy of the Ramos administration. With the policy support of the CAB executive director, the CAB was able to initiate a large number of air talks, averaging one air talk per month during the period 1994-1995, a record that was unmatched until the period 2007-2009.

The CAB prioritized regional hubs like Hong Kong, Singapore, South Korea, and Japan for amendments of air agreements in order to generate the fastest increase in access since hubs like Hong Kong had a number of flights to the DOT's target European markets, namely Britain, Germany, France, and Italy.

### **Deregulating the Domestic Aviation Market: Passengers versus Tuna**

The deregulation of the domestic aviation market embodied in EO 219 was driven by the situation in Mindanao in 1994. In March of that year, CAB member Limlingan was invited to speak on civil aviation policies at the Mindanao Air Summit. When he arrived in Davao City, he was presented with a petition from the Davao City Chamber of Commerce and Industry, Inc., signed by its president, Joji Ilagan-Bian, asking the CAB to direct PAL to change its Manila-Davao flight schedule from the present 3:40 AM to 6:00 AM, or failing that, to direct PAL to apply a special discounted rate of 20 percent (compared to the regular rate) for the 3:40 AM flight, which PAL had already done before in the case of the *Bulilit* Flight.<sup>3</sup>

Limlingan's inquiry from CAB Director Pascual revealed that the early morning schedule of PAL was meant to service the tuna catch coming from General Santos City, which would be flown in time to connect to the PAL flight to Narita, Japan. It was more likely that the tuna buyer in Tokyo had a choice of buying the tuna elsewhere, while the passenger to Davao had no choice. When asked if PAL could be directed to reduce its fares, given that a rescheduling of the flight was not feasible, the Board was informed by CAB staff that PAL would first have to file a petition with the CAB to offer a fare other than that based on the present formula. When questioned further about the most feasible alternative to improve the air services for the people of Davao, the response was "competition."

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<sup>3</sup> PAL tagged as *bulilit* (little) its domestic flights that arrive and depart in the ungodly hours or very early in the morning, especially during the 1980s.

It was then the CAB decided to adopt a policy of deregulating the domestic airline industry. The reform also entailed allowing a new entrant, but Pascual raised the issue of the legislative franchise requirement and the delay it would cause. It would take three years before a new entrant could effectively compete with PAL, and at least a year and a half to successfully secure a legislative franchise. Upon approval of its franchise, it then had to apply for each and every route that it would fly. The incumbent carrier could challenge the new entrant by arguing that a particular route was already being adequately serviced. Assuming that the new entrant was finally authorized to ply the Manila-Davao route, it would need another six months to set up operations.

Unwilling to accept the three-year delay, the Board instructed the CAB executive director to fast track the process. Pascual recommended the issuance of a TOP while the legislative franchise was still pending in Congress. In the meantime, the Board prepared the draft EO on liberalization on the instructions of President Ramos. After the public hearing held by the DOTC and the CAB, President Ramos signed and issued EO 219 on January 3, 1995. The EO took effect on January 22, 1995. The EO, entitled “Establishing the Domestic and International Civil Aviation Liberalization Policy,” removed restrictions on routes and flight frequencies, encouraged at least two operators in any route, and allowed free entry and exit in any unprofitable routes. With regard to fares, markets with at least two operators were deregulated, while regulation still applied in single-airline markets. It defined national interest primarily from the purview of the users rather than the providers of air services. This national interest would best be served by encouraging competition in both the domestic and international routes. The EO enabled the entry of Grand Air, and later, Cebu Pacific, Asian Spirit, and South East Asian Airlines (SEAIR).

Even before EO 219 was issued, the policy’s intent to introduce competition was already challenged by PAL, as evidenced in the Supreme Court (SC) case of PAL vs. CAB and Grand Air, and as illustrated below using the SC General Roll (G.R.) No. 119528.<sup>4</sup>

As a new entrant, Grand Air filed for a CPCN on November 24, 1994<sup>5</sup> and requested the issuance of a TOP on December 14, 1994. PAL, as a holder of a legislative franchise, opposed the application for a CPCN on the grounds that the CAB had no jurisdiction until the latter had first obtained a franchise to operate from Congress, citing the Congressional order and Opinion No. 163 of the Department of Justice (DOJ) addressed to CAB Executive Director Arturo

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<sup>4</sup> See PAL vs. CAB and Grand International Airways, Inc. (1997).

<sup>5</sup> CAB Case No. EP-12711, as cited in Supreme Court G.R. No. 119528.

Corona in 1989.<sup>6</sup> PAL also argued that Grand Air's application was deficient in form and substance.<sup>7</sup> Furthermore, approval of the application would violate the equal protection clause of the Constitution and only result in ruinous competition. According to PAL, there was no urgent need and demand for the services requested.

On December 20, 1994, the CAB denied PAL's opposition, citing the CA decision of 1991. On December 23, 1994, the CAB promulgated Resolution No. 119(92) approving the issuance of a TOP in favor of Grand Air for a period of three months. On January 11, 1995, PAL moved for the reconsideration of the issuance of the TOP, but the same was denied in CAB Resolution No. 02(95). The CAB justified its assumption of jurisdiction over Grand Air's application and cited EO 219 as grounds for denying PAL's opposition. Section 2.1 of EO 219 provided that a minimum of two operators in each route or link shall be encouraged, and that routes or links presently serviced by only one operator shall be open for entry to additional operators.

On March 21, 1995, upon Grand Air's request, the CAB extended the TOP for a period of six months. On April 3, 1995, PAL filed a case against the CAB and Grand Air with the SC, seeking to prohibit the CAB from exercising jurisdiction over the issuance of a CPCN, and to annul and set aside a TOP in favor of Grand Air for the Manila-Cebu, Manila-Davao, and converse routes. On March 26, 1997, the SC, in its G.R. No. 119528, dismissed PAL's case due to lack of merit and directed the CAB to continue hearing the application of Grand Air for the issuance of a CPCN, thereby upholding the CA ruling of 1991.

Both the CA and SC rulings on the legislative franchise enabled the implementation of the liberalization policy of President Ramos in the mid 1990s.

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<sup>6</sup> The DOJ opinion stated that, "A franchise is the legislative authorization to engage in a business activity or enterprise of a public nature, whereas a certificate of public convenience and necessity is a regulatory measure which constitutes the franchise's authority to commence operations. It is thus logical that the grant of the former should precede the latter."

<sup>7</sup> The application does not indicate a route structure including a computation of trunkline, secondary, and rural available seat kilometers (ASK) which shall always be maintained at a monthly level at least 5 percent and 20 percent of the ASK offered into and out of the proposed base of operations for rural and secondary, respectively. It does not contain a project or feasibility study, projected profit and loss statements, projected balance sheet, insurance coverage, list of personnel, list of spare parts inventory, tariff structure, documents supportive of financial capacity, route flight schedule, contracts on facilities (hangars, maintenance, lot, etc.).

## 1998-2004:

### “Progressive Liberalization” of International Airline Services

This period contrasts with the previous because of the slow progress in the implementation of the liberalization policy due to the lack of implementing rules and regulations (IRRs).

#### The Estrada Administration and the RP-Taiwan Air Row

EO 219 did not have any IRRs when Estrada assumed office in 1998. In 1999, his administration, through the Civil Aviation Consultative Council (CAAC), seemed intent on implementing the liberalization policy initiated by Ramos, when it launched a policy on *progressive liberalization* of bilaterals. This policy, however, was not well defined, and there were no guidelines on how such liberalization policy would be achieved.

In 1997, PAL's management bought 34 new planes, financed largely by debt, as part of its re-fleeting and modernization program. But PAL had to declare bankruptcy as a result of the Asian financial crisis in 1998. Its fleet reduction from 54 to 22 planes led to a net loss of 1.2 million seats in the international market.

PAL was placed under receivership<sup>8</sup> in 1999 and underwent a rehabilitation program. It recommended the review of the air agreements with Taiwan, South Korea, Hong Kong, and Singapore to ensure its viability. PAL also requested the government to look into the TOP of airlines like Emirates Air (granted by the CAB under the Ramos administration). It described these demands as providing “a level playing field.”

PAL argued that the other Asian airlines were “poaching” (Arpon, Aquino & Baetiong, 2000) or “robbing” passengers from PAL, and that Filipinos bound for the US were flying on these airlines from Manila instead of the direct flights by PAL to Los Angeles and San Francisco. PAL claimed that this was a violation of the so-called “Sixth Freedom Traffic Right” defined by the 1944 Chicago Convention. As a result of this Sixth Freedom exercise, the Asian carriers were accused of dumping capacity and undercutting PAL's fares. Hence, to “level the playing field” given PAL's bankruptcy and downsizing, the CAB demanded that Asian carriers, beginning with the officially designated Eva Air and China Airlines of Taiwan, reduce their capacity to the level of PAL, which was the only officially designated carrier of the Philippines at the time.

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<sup>8</sup> Receivership is a type of corporate bankruptcy in which a receiver is appointed by the court or creditors to run the company and to recoup as much of the company's unpaid loans as possible.

### **RP-Taiwan Air Row: The Chips that Restored the Flights.**

The Philippine Government reduced the air seat entitlements of Taiwanese carriers from a maximum of 9,600 seats<sup>9</sup> to 3,000 seats per week because PAL, with its downsizing, could only provide 2,000 seats a week. Taiwan countered with an offer of 6,500 seats a week and refused to negotiate. For a period of almost one year from October 2, 1999,<sup>10</sup> there were no direct flights between the Philippines and Taiwan.

How was the conflict finally resolved?

The legislative branch of government, specifically the Congressional Committees on Tourism, Transport, and Foreign Affairs,<sup>11</sup> conducted inquiries and wrote letters to the Economic Coordinating Council, President Estrada's economic "super body,"<sup>12</sup> calling for the immediate resolution of the conflict and the sustainability of liberalization. They noted that the abrogation was done in order to protect PAL, whose majority stakeholder, Lucio Tan, was known to be a close friend of the President's (*Far Eastern Economic Review*, 2000). They noted the importance of Taiwan as the country's third largest tourism market, fourth largest trading partner, fifth largest source of foreign investment, and host of more than 100,000 OFWs.

The executive branch of government, particularly the Department of Tourism (DoT) and the Department of Trade and Industry (DTI), responded to the appeals made by tourism and trade interest groups, such as the Management Association of the Philippines, the Joint Foreign Chambers of Commerce, the Freedom to Fly Coalition, and the National Union of Workers in the Hotel and Restaurant Industries. The Economic Coordinating Council instructed DTI Secretary Mar Roxas to review the country's aviation policy in light of the clamor from the Cebu Province to open the Mactan gateway to international flights. The more compelling reason, however, was the

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<sup>9</sup> Based on the 1996 agreement between the Manila Economic and Cultural Office (MECO) and the Taiwan Economic and Cultural Office.

<sup>10</sup> On January 28, 2000, both the Philippines and Taiwan signed a compromise agreement to resume flights, allowing Taiwanese carriers to operate combined 17 passenger flights weekly on the Manila-Taipei route, equivalent to 4,800 seats. On February 15, flights between Manila and Taipei finally resumed after four months of suspension due to the strong protest by PAL regarding the continued "poaching" of passengers by the Taiwanese carriers. The CAB was also reported to have acted on the advice of the MECO. Flights were suspended again after a month.

<sup>11</sup> These committees were headed by Representatives Rosenda Ocampo, Rodolfo Tuazon, and Lualhati Antonino, respectively.

<sup>12</sup> This council was composed of the chiefs of the Bangko Sentral ng Pilipinas (BSP), the Department of Finance (DOF), the Department of Budget and Management (DBM), the National Economic and Development Authority (NEDA), and the Department of Trade and Industry (DTI).

mounting complaints from the electronics and semiconductor industries that were affected by the lack of direct flights between the Philippines and Taiwan. Based in Subic, Zambales, Acer (a Taiwanese firm) complained to President Estrada that as a result of delays in the delivery of its inputs, their exports could not be shipped within 24 hours anymore—time lags reached anywhere from three to five days. President Estrada ordered the air talks with Taiwan and tasked Ambassador Rod Reyes, MECO’s managing director, to lead Manila’s negotiating panel together with DOTC Secretary Vicente Rivera.

In his speech during the 26<sup>th</sup> Philippine Business Conference at the Fiesta Pavilion in Manila Hotel on October 12, 2000, President Estrada stated two important accomplishments of his administration:

Sixth, turning to more specific issues, actions such as the recent air services resolution with Taiwan will not be reversed. I mention this not only for its own sake, but also for what the resolution signals in a more profound way. I have always been consistent in my pursuit of the national interest—in this case with respect to PAL and air services—and that pursuit of national interest is not limited by any “friendships” I may have.

To enhance investments, international and domestic arrivals in our major tourist destinations, I will implement more vigorously the “progressive liberalization” civil aviation policy of my administration by ordering an increase in the number of direct flights by international airlines to the airports in Cebu-Mactan, Davao, and General Santos City. As a complement, the domestic airports in Panglao Island, Bohol, and Surigao City will be rehabilitated.

Under the Ramos administration, the CAB was seen as instrumental in introducing competition in Philippine aviation. The CAB defended its stance during the Estrada administration, arguing that it only acted on behalf of the air-negotiating panel, and that it was only right that the interests of the local carriers were strongly considered (Porciuncula, 2007). The role of the CAB as regulator of capacity in international services continued through the Arroyo administration, raising questions on what its role should really be in a more deregulated environment.

### **The Arroyo Administration (2001-2004)**

When President Gloria Macapagal-Arroyo assumed office in January 2001, there were still no IRRs for EO 219. Industry sources attributed the

RP-Taiwan air row to the lack of the IRRs. The Economic Mobilization Group (EMG) Task Force formed by President Estrada and headed by Rafael Lotilla of the NEDA assumed the lead in drafting the IRRs for EO 219, which the CAB finally promulgated in November 2001.

The relatively poor state of international tourism has long been attributed to, among others, the lack of incoming air seats to the Philippines. In 2001, President Arroyo heeded the request of the tourism industry to gain representation in the CAB in order to address the access issue. She appointed Alberto A. Lim, president of the Ten Knots Development Corporation (El Nido Resorts) as the private sector representative to the CAB. During his three-year term, Lim pushed for the interests of tourism, trade, and OFWs by supporting the amendments of the bilaterals.

The Philippines pursued air talks for additional seat or frequency entitlements with Singapore, Brunei, Macau, and South Korea from August 2001 to November 2001. The Singapore agreement changed the designation policy from dual to multiple designations, enabling the entry of other Philippine carriers such as Cebu Pacific in 2005 and Air Phil Express and SEAIR in 2010.

In 2001, there was public demand from the Pampanga constituents for the utilization of the airport infrastructure assets left by the Americans in 1991. By virtue of EO 62 (series of 1993), the Philippine government mandated the Bases Conversion Development Authority (BCDA) to prepare and implement a comprehensive and detailed development program for the former Clark Air Base as a major civil aviation complex for international passenger and/or cargo transport, and the former Subic Naval Base as a special economic and freeport zone ensuring the free flow of goods and capital in accordance with prescribed rules. Two other policies, EO 80 (series of 1993) and EO 174 (series of 1994), established the Clark Development Corporation (CDC) and designated the Clark Special Economic Zone as the site of the future premier international airport.

It is no surprise that President Arroyo, who hails from Pampanga, supported this move to prioritize the development of Clark's airport. In December 3, 2003, EO 253 was issued providing for the expansion of air services to Clark International Airport, later renamed the Diosdado Macapagal International Airport (DMIA) and the Subic Bay International Airport (SBIA). This policy opened up the DMIA and the SBIA to international air cargo operators and regarded the increase in commercial air cargo as an

enhancement of trade and investment opportunities for the Philippines. The IRRs were approved and issued in March 2005 and amended under CAB Resolution No. 16 (series of 2005).

### **2005-2009: Secondary Gateways Development Policy**

By the end of President Arroyo's second term, the DMIA already handled 560,000 international passengers in 2009, transported by four international carriers: Asiana, Cebu Pacific, Tiger Airways, and Air Asia, with occasional charter flights by Shenzhen Airlines and Hong Kong Express. Cebu Pacific started to hub in late 2009, beginning with flights to Singapore and Hong Kong. By the end of 2010, Cebu Pacific had added Bangkok to its list. As a result of the 29 bilateral air talks held from May 2007 to December 2009 by the air panel, the DMIA now had about 10 million seat entitlements (from only 600,000 in 2001) for use by local and foreign carriers.

How did the DMIA become the most liberal secondary gateway in the country today?

### **The “Unfair” Advantage of DMIA**

The DMIA enjoyed an “unfair” advantage of being endowed with excellent airport infrastructure assets and a strategic location—within 3 to 4 hours' flight from the key markets in Asia Pacific.

Despite its assets, the DMIA was underutilized. In 2003, only 7,483 international passengers used the airport. The environment in the Clark International Airport Corporation (CIAC) changed when President Arroyo, a *Kapampangan* (a native of Pampanga, the province where the DMIA is located), appointed Victor Jose Luciano, also a *Kapampangan*, to head the CIAC beginning in 2004. Luciano's topmost agenda was to market and sell the airport as a destination for carriers and service the constituents of Central and Northern Philippines, thus providing choice and lower travel costs to the passengers.

### **Why It Took a Decade for Clark to Develop—The Bilaterals, Again**

As a secondary gateway, Clark has been part of the ASAs since 1993, but no scheduled carrier utilized it until 2003. In general, many carriers



did not use entitlements to secondary gateways because they were already using all of their entitlements on main trunk routes, primarily to NAIA. To develop secondary gateways such as Cebu and Clark, they would have had to reduce their flights to NAIA and take the business risk of establishing traffic to new gateways. In more recent times, new regional airlines showed interest in exploring the secondary gateways, but either they were not officially designated to fly to the Philippines, or the entitlements were too limited. The result: since it was safer for legacy airlines to stay on trunk routes, secondary gateways remained underutilized.

### **From Liberalized Charter to “Pocket Open Skies” for Clark**

The liberalized charter policy under CAB Resolution No. 23 (series of 2005) aimed to enhance the development of secondary gateways. This enabled Asiana Airlines and low-cost airlines like Air Asia and Tiger Airways to mount flights to Clark. The CAB rationalized this unilateral policy on the following grounds:

[T]he liberalization of international charter services that shall allow international operations to such developmental routes and gateways with or without readily usable allocations can help achieve the objective of promoting the growth and viability of developmental routes and gateways.

In June 2005, President Arroyo declared the development of the Clark-Subic corridor as part of her 10-point legacy agenda. In January 2006, she issued EO 500, granting foreign air carriers unlimited air access to DMIA and SBIA.

The initial strategy of the Clark stakeholders in providing a more stable environment for Clark’s development was to push for “pocket open skies,” embodied in EO 500. The policy allowed foreign air carriers designated by states with an ASA with the Philippines to apply for the waiver of any restriction or limitation on capacity, type of aircraft of non-cabotage traffic rights imposed by the ASA, and without asking foreign governments to grant the same to Philippine carriers, similar to the strategy of China for Hainan Island.

For the local carriers, the provisions of EO 500 were unconstitutional due to the lack of reciprocity. They insisted that the policy should only be

limited to carriers that were officially designated to fly to DMIA under an ASA with the Philippines. They argued that there were safety and security concerns with allowing foreign air carriers that had not yet been officially designated under an ASA with the Philippines to fly to Clark. During this time, the low-cost carriers Tiger Airways of Singapore and Air Asia of Malaysia were not yet officially designated to fly to DMIA under the RP-Singapore and RP-Malaysia ASAs, respectively.

On August 22, 2006, EO 500-A (series of 2006) was issued. Under EO 500-A, only officially designated carriers were qualified to apply for waivers to operate strictly Third and Fourth Freedom Rights only. The grant of unlimited Fifth Freedom Rights was calibrated based on its impact on the Philippine carriers and the domestic civil aviation industry.

The Clark stakeholders protested EO 500-A and urged President Arroyo to amend it with a new EO, dubbed as the proposed EO 500-B, reinstating the liberal provisions of EO 500.

The local carriers considered the issuance of EO 500, EO 500-A, and the proposed EO 500-B as detrimental to national interest due to (a) the removal of reciprocal access to the Fifth, Sixth, and Seventh Freedom markets; (b) the lowering of the CAB's standards; (c) the adverse impact on their routes; (d) the violation of provisions of the Philippine Constitution; and (e) the weakening of the Philippine negotiating position during air talks. They claimed that the unilateral pocket open skies in Clark did not conform to the bilateral approach of the Chicago Convention. The carriers—PAL, Cebu Pacific, and Pacific East Asia Cargo—also raised these concerns in their letters to the DOTC Secretary Leandro Mendoza, who in turn reiterated them in his response (November 13, 2006) to the request for comments (October 2, 2006) on the proposed EO 500-B by the Office of the President. These arguments appeared in a full page-ad entitled “EO 500 B: Threat to National Interest”<sup>13</sup> and were supported by the group Save Our Skies.

The supporters of the proposed EO 500-B issued a full-page ad entitled “EO 500 B: A Key to Promoting National Interest”<sup>14</sup> in response to the issues raised by the local carriers and to reiterate their position expressed in various letters to President Arroyo. They argued that reciprocity referred to the

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<sup>13</sup> See “EO 500 B: Threat to National Interest” (2007). The ad was a letter addressed to President Arroyo and signed by the heads of PAL, Cebu Pacific, Air Philippines, Zest Air, and PEAC.

<sup>14</sup> See “EO 500 B: A key to promoting national interest” (2007). This was signed by 19 groups and individuals—the governor of Pampanga, several mayors, as well as national, international, and local business chambers.

broader interests of the economy—of the users of air services and not just the local carriers, as is consistent with EO 219—and not only to the exchange of air rights in ASAs. Reciprocity also referred to the net socio-economic benefits in terms of employment and income opportunities for Clark and the country.<sup>15</sup> The reciprocal benefits would be captured in the business and traffic to be generated by foreign air carriers, which would likewise benefit the local carriers through lower developmental costs and traffic for their domestic routes, since cabotage was not allowed by the Constitution. The supporters claimed that the proposed EO's grant of non-cabotage traffic rights was limited to the Third, Fourth, and Fifth Freedom Rights only as officially defined under the Chicago Convention. They argued that the process of designation was a "political process" and did not determine the fitness and competence of carriers to operate, and that safety and security were issues addressed by the policies and operating standards of the ICAO.<sup>16</sup> The CAB and the Civil Aviation Authority of the Philippines (CAAP) would continue to exercise their regulatory functions by requiring carriers to secure Foreign Air Carriers Permits and Airline Operating Certificates to ensure that air carriers meet all international industry standards.

The period 2006-2009 was marked by a clash between two groups, toward engendering the liberal air policy environment that Clark now enjoys compared to other gateways: the supporters of the proposed EO 500-B on one hand, and the group of local carriers and the DOTC-CAB on the other. These two groups clashed in the Office of the President (OP) and in the media.

The first group of supporters of the proposed EO 500-B was the local stakeholders of Pampanga and Central Luzon. These were the businessmen, specifically groups such as the Clark Investors and Locators Association, the Metro Angeles Chamber of Commerce and Industry, the Greater Clark Visitors Bureau, the Chamber of Real Estate and Builders Association-Angeles Chapter, the Pampanga Chamber of Commerce and Industry, the Subic Chamber of Commerce and Industry, the Five Chambers of Central Luzon (now known as the Association of Business Chambers of Central Luzon), the Filipino-Chinese group of Angeles, and associations of air services users such as the The local political elite, composed of the offices of the mayors and congressman, the provincial and local councils of Pampanga, the Subic-Clark Alliance for Development Council (SCADC), the CDC, the Subic Bay Metropolitan Authority, and the CIAC, wanted the favorable business tailwind provided by greater air traffic. The support was manifested in various resolutions, letters to the

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<sup>15</sup> Letter of the National Competitiveness Council to President Arroyo endorsing replacement of EO 500-A (January 5, 2007).

<sup>16</sup> In separate memos issued to the Office of the President, dated May 13 and May 2, 2007, respectively.

President, and public statements.

The other group of supporters was composed of the national stakeholders: the National Competitiveness Council, the Joint Foreign Chambers of Commerce, the Philippine Chamber of Commerce and Industry, the Makati Business Club, the Association of Schools of Public Administration in the Philippines, which all supported the local elite of Central Luzon and the development of the DMIA as part of the national agenda, i.e., competitiveness through industries such as logistics and tourism. These organizations viewed greater consumer sovereignty via competition as favorable to national development.

For a time, the supporters were hopeful that President Arroyo would still sign the proposed EO, despite the joint venture investment by Cebu Pacific and SIA Engineering (a Singapore-based company) for a maintenance, repair, and overhaul facility inside the Clark Aviation Complex, and the opposition from PAL. From January to March 2008, the CIAC and the SCADC worked with the CAB and the Office of the Presidential Legal Counsel to prepare a version to be submitted to President Arroyo. On July 9, 2008, President Arroyo met with Congressman Carmelo Lazatin, CIAC officials, and stakeholders from the business and OFW communities at the Clark White House in Pampanga. During that meeting, she presented her version of the proposed EO 500-B and requested comments from the Clark stakeholders. Through Congressman Lazatin's office, the stakeholders expressed their agreement with the President's version. President Arroyo ended up not signing the proposed EO 500-B.

### **The Bilateral Reform Path**

For Clark, the four-year struggle for reform to make the DMIA an aviation logistics center nevertheless reaped significant benefits (e.g., the inclusion of separate route structure and liberal entitlements for Clark) through the bilateral path, and was simultaneously pursued with the proposed EO 500-B.

At the Cabinet level, the call for air talks was strongly supported by the CIAC and the SCADC. Since July 2007, the group of SCADC Chairman Edgardo Pamintuan, CIAC President Luciano, and CIAC Executive Vice President (EVP) Alexander Cauguiran persistently appealed to President Arroyo to direct the Philippine air panel (a) to schedule and accelerate the air talks, specifically with Macau, Hong Kong, Thailand, Singapore, Malaysia, Taiwan, Australia, and New Zealand; (b) to provide capacity entitlements to gateways like Clark, Cebu, and Davao as priority over Manila; (c) to accept all offers for bilateral open skies with Clark and Subic; and (d) to appoint the airport authorities of secondary gateways to the air panel. Clark found an ally in President Arroyo,

who agreed with the CIAC that the air talks were too slow.

The local carriers did not oppose the bilateral path to reform where they had the opportunity to calibrate capacity and gain the reciprocity they asked for in terms of airline seats, frequencies, and routes. Nonetheless, even as members of the air panel, they could not oppose President Arroyo's directive to accelerate liberalization through the air talks. Cebu Pacific likewise emerged as the strongest advocate for conducting more air talks in order to gain access to markets such as Hong Kong, Macau, China, Thailand, Malaysia, Indonesia, Japan, and Taiwan. As a result of the active involvement of the CIAC in the air panel, the talks with Macau, Hong Kong, and Bangkok provided significant capacity increases on Clark-specific routes, eventually allowing Cebu Pacific to base an aircraft in Clark.

### **Lessons, Policy Issues, and Challenges**

For the gains of aviation liberalization to be sustained and expanded, experience has shown that in a country such as the Philippines, where political debts have traditionally strongly influenced policymaking and biased the benefits toward the entrenched interests, it is very important to mobilize the downstream users of air services and the potentially benefited local elite to demand change. This exploits the fissures in the extant political settlement. It is only through the active involvement of the users that the property rights over market access can be duly transferred to them for their use and benefit. Consumer sovereignty must be fought for, and enshrined by, consumers. Even then, there is no guarantee that they will land the prize. In this particular case, the effort landed a different and somewhat inferior, though still-useful, political settlement. Reform advocates are wise to expect that getting their first-best political settlement, however superior, may be unrealistic, as politicians pay attention to other concerns. Nevertheless, they need not be deterred.

As expected, there are complementary reforms that President Benigno Aquino III's administration will have to address in order to ensure that his expanded pocket open skies, which now cover all secondary gateways, are utilized productively for tourism, trade, and airports. The soft aviation infrastructure, especially regarding regulatory capacity, must be upgraded. The hard infrastructure—the air control equipment, for one—must also be upgraded. The NAIA has suffered humiliating downgrades from foreign air safety watchdogs. In terms of investment climate, foreign air carriers have been leaving the country since 2001. Capacity has been slow to increase due

to the tax regime (common carriers tax and gross Philippine billings, and their pertinent rules and regulations) and the payments charged to international airlines for overtime, meals, and transportation allowances for Customs, Immigration, and Quarantine personnel. These practices make the Philippines very unattractive to foreign air carriers, especially the long haul carriers, as an investment destination.

EO 29 is already a testimony that the Aquino administration is truly capable of making bold reforms for the Filipinos. The industry is hopeful that the reform package will be completed before 2016 so that Filipinos will enjoy the gains from enhanced connectivity and tourism growth, even before the end of his term.

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Water from a spring at Sitio Sapinit, Antipolo City, where residents have yet to enjoy a piped water system.

Photo by Rodillo Catalan

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# Chapter 4

## The Privatization of the Metropolitan Waterworks and Sewerage System: How and Why It Was Won

Raul V. Fabella

On August 1, 1997, water and sewerage service in Metro Manila, which used to be delivered by the state-owned and -operated Metropolitan Waterworks and Sewerage System (MWSS), was turned over to two private concessionaires. It was the largest water service privatization up to that point. It is now considered a singularly successful structural reform in the annals of Philippine political economy. This case study attempts to explain how and why it happened and to draw object lessons for future policy battles.

### Shifting the Boundary of the State

The privatization of MWSS was a tectonic shift in the boundary between the state and market in the Philippines. Where state ends and market begins, a debate of great moment on the world stage in the 20<sup>th</sup> century (see, e.g., Yergin & Stanislaw, 1998, for a lively account) remains alive, and indeed, re-emerges as a very lively issue in the wake of the 2008 Global Financial Crisis. The years following the collapse of the Marcos regime in 1986 saw the start of a march, if somewhat spasmodic, toward greater reliance on the market. By contrast, the decade prior to 1986 experienced an even deeper level of state encroachment on the market. President Corazon Aquino (1986-1992), wanting to undo the trend, created the Committee on Privatization (COP), and mandated a return to private hands of hundreds of state-owned corporations and other assets. The COP privatized 122 government-owned and -controlled corporations (GOCCs) under Aquino. Also of great moment was the enactment of the Build-Operate-Transfer (BOT) Law, which was the legal basis for private sector participation in infrastructure projects. By the end of Aquino's term (mid-1992), the Iron Curtain had evaporated and the market ideology was triumphant. President Fidel V. Ramos (1992-1998)—who enjoyed a vastly favorable tailwind both in ideology and financing—pursued state disengagement with more vigor and ambition.

The 1990s under Ramos saw a determined deregulation effort in the oil, transport, and telecommunications industries, which delivered substantial early harvests for consumers in certain economic sectors. Ramos secured from Congress the passage of the Electric Power Crisis Act to successfully address the crippling power brownouts that followed his inauguration. The

view that the state should disengage from economic activities where the market has a demonstrated superior competence—or as was more often the case, where the state has demonstrated unusual incompetence—had by then just been codified in the Washington Consensus (For further discussion, see Chapter 9 of this volume). The experience of MWSS privatization could not be told apart from this global tectonic shift in beliefs in favor of the market and global competition.

### The Make-or-Buy Decision

Oliver Williamson, winner of the Nobel Prize in Economics (2009), introduced the make-or-buy efficiency rule (1975; 1985; 2002), which, while first applied to the delineation of the boundary between firms and markets, equally applies here: the natural economic boundary between the state and the market is determined solely by comparative competence. Where procurement of goods and services via the market is socially cheaper by reason of comparative competence, the state should buy from the market the good or service it is expected to provide. Where comparative competence favors the state, the state should then make. But what makes such common sense boundary rule compelling?

The answer advanced by Nicolo Machiavelli is competition and imminent threat. Enlightenment Europe was a motley continent of nation-states constantly at each other's throats, testing each other's political boundaries. The survival of any state was constantly challenged. How best to ensure survival? Machiavelli (1513/1909-14) observed in *The Prince* that where the survival of the state was the paramount end (which in his view justifies any means), a prince (ruler)

[...] should show himself a patron of merit, and should honor those who excel in every art. He ought accordingly to encourage his subjects by enabling them to pursue their callings, whether mercantile, agriculture, or any other [...] so that this man shall not be deterred from beautifying his possessions from the apprehension that they may be taken from him...or [...] from opening a trade through fear of taxes [...] (XXI, 9).

This was, as far as is known, the earliest recognition of the comparative competence of market actors in the creation of wealth and the value of property rights protection. Competition and Darwinian selection among states lead to an efficiently bounded, and thus prosperous, state.

The ruler is always confronted with the temptation to impose ever more

onerous exactions to fatten his treasury. But this blunts the flowering of private initiative, which is the engine of future economic growth. It is economic growth that will ensure the fiscal integrity of the state treasury. A state in chronic fiscal need is easy prey to its enemies. Machiavelli saw prosperity as the real warranty of political survival of the state and, by implication, of the ruler.

The view we embrace here is partly Machiavellian and Darwinian: episodes of the state ceding ground to the market are linked to global and inter-state competition, sometimes armed but mostly friendly, in the effort to improve one's standing in the world. The threats to survival emerge in various guises, such as a fiscal bankruptcy, which show up when the ruler increasingly violates the efficient boundary rule (see, e.g., Cook & Fabella, 2002).

Using the same comparative competence lens, this case study offers an inquiry on how the MWSS privatization came about and how market regulation supplanted state ownership in water services procurement. It is the goal of this endeavor to ferret out the lessons that can be learned, the circumstances that can be replicated, and the pitfalls and missteps that can be avoided. We are especially interested in the footprints left by change agents. We will endeavor to add to the understanding already contained in some outstanding publications (see, e.g., Dumol, 2000).

The circumstances surrounding the episode are rather different from the other successful reforms. In normal episodes, a group outside the universe of formal policymaking advocates an idea for which it seeks buy-in from a champion or a set of champions operating inside that universe, who then wages trench warfare within the walls to get the idea accepted and operationalized into an executive order (EO) or a law (e.g., a republic act passed by Congress). In the case of MWSS privatization, the highest political authority—the president—appeared to have owned the idea right from the start. Thus, the struggle to engender the buy-in by a champion did not happen. His own awareness of the idea appeared to have been triggered by a series of overtures by private entrepreneurs interested in running MWSS for their own profit. What was interesting was the emerging milieu that made President Ramos and his advisers even entertain what seemed to be, at that juncture, such a preposterous idea.

The following are several important issues related to the privatization and regulation of water and sanitation services in Metro Manila that will be addressed in this chapter:

1. Was the gamble taken by the political authority in 1997 justified by the subsequent harvest?
2. Why was the dismal performance of the pre-1997 MWSS tolerated for so long?

3. Who were the main advocates of change and what strategies were employed to overcome the forces lined up against the reform?
4. Since this project required drawing in private sector players, how did the private players address the risks they faced?

Clearly, because of the nature of the case, standard tests of significance cannot be carried out. The issues are addressed in what is known as a “thick description” of reality, more historical and anecdotal, than a “thin description” associated with statistical tests. We will start with the performance of the enterprise five years after privatization.

### **MWSS Privatization: Performance After Five Years**

On February 21, 1997, the concession contracts for the privatization of the MWSS were signed. On August 1, 1997, water supply and sewerage service management and operation in a service area with a population of 11 million, spanning 14 municipalities and cities, were turned over to two private concessionaires. MWSS became, by virtue of a Concession Agreement or CA<sup>1</sup> (1997), the Regulatory Office (RO) tasked with regulating the activities of the concessionaires and the implementation of the CA.

The East Zone was awarded to the Manila Water Company, Inc. (MWCI hereafter), a consortium of four companies led by a Filipino entity, the Ayala Corporation, and three foreign partners, United Utilities, Bechtel, and the Mitsubishi Corporation. The West Zone was awarded to Maynilad Water Services, Inc. (MWSI hereafter), a consortium of two companies led by another major Filipino entity, Benpres Holdings Corporation, and a French foreign partner, Suez Lyonnaise des Eaux.

The only true test of a policy change is the welfare outcome for the targeted beneficiaries. In the case of providing water services, it is reflected by the price and quality of the service delivered. Low price is no consolation when the service is unavailable when needed or unusable when available. This was the normal state of affairs in the Philippines when a state-owned and -operated enterprise acted as service provider. Price and quality have to be combined and analyzed in tandem. The levels of analysis used here are post-privatization outcomes before the start of the first rate-rebasing exercise versus (a) pre-privatization standards, (b) regional standards, and (c) targets set by the CA at the commencement of concessions.

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<sup>1</sup> “CA” here means Concession Agreement. It is different from the “CA” mentioned in other chapters, which refers to the Court of Appeals.

## Regional Comparison: Efficiency Indices

Table 4.1 gives a snapshot of the water service performance in the Southeast Asian Region based on the most recognizable indices before privatization (1996) and post-privatization (2002) for Manila and the two concessions.

**Table 4.1. MWSS Performance: Pre-Privatization (1996), Post-Privatization (2002), and other Asian Water Utilities (1996)**

| City          | Water Availability<br>(hours/day) | Water Coverage<br>(% of population) | Non-Revenue Water <sup>2</sup> | Staff per 10 <sup>3</sup> Connections |
|---------------|-----------------------------------|-------------------------------------|--------------------------------|---------------------------------------|
| Singapore     | 24                                | 100                                 | 7                              | 2.0                                   |
| Hong Kong     | 24                                | 100                                 | 36                             | 2.8                                   |
| Seoul         | 24                                | 100                                 | 35                             | 2.3                                   |
| K. Lumpur     | 24                                | 100                                 | 36                             | 1.4                                   |
| Bangkok       | 24                                | 82                                  | 38                             | 4.6                                   |
| Average ('96) | 24                                | 96                                  | 30                             | 2.6                                   |
| Manila ('96)  | 17                                | 67                                  | 61                             | 9.8                                   |
| Manila ('02)  | 21                                | 79                                  | 62                             | 4.1                                   |
| MWCI          | 21                                | 82                                  | 53                             | 4.1                                   |
| MWSI          | 21                                | 79                                  | 69                             | 4.1                                   |

Sources: McIntosh & Yñiguez (1997); MWSS Regulatory Office (2002).

The message was unequivocal. The improvements in water availability (from 17 to 21 hours), water coverage (a 12-percent rise), non-revenue water (NRW) (a 2-percent fall), and staff (a 58-percent reduction) over the pre-privatized outfit were dramatic. The chasm in water service performance between Manila and other Association of Southeast Asian Nations (ASEAN) cities' average—so glaring before privatization—was at last beginning to close, although the gap was still considerable in NRW, water coverage, and staffing. However, the gap was expected to continue narrowing. It is unlikely that Manila will ever catch up with the front-runners despite privatization,

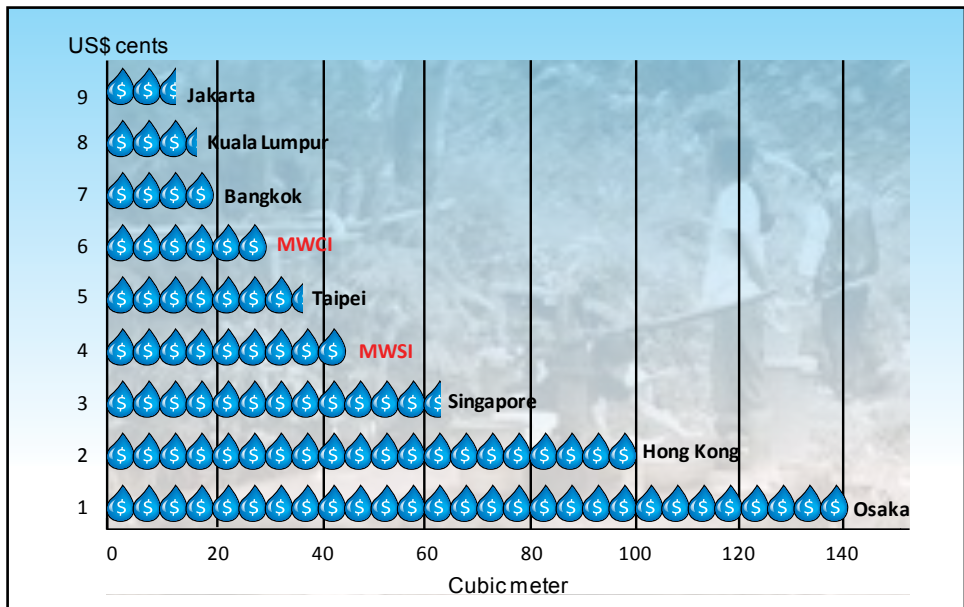
<sup>2</sup> Non-revenue water (NRW) does not bring in revenue due to leaks, theft and illegal connections, or improper metering. It is also free water used for standpipes, cleaning reservoirs, or fighting fires (ADB, 2007).

since the closure of the remaining gap requires substantial improvement in governance, where the Philippines remains weak. In general, the performance of the market and market players is greatly influenced by the quality of governance.

For example, the presence of sizeable illegal settler communities raises the cost of water service. The high cost of prosecution due to long delays and judicial leniency makes water theft less forbidding. Indeed, water theft was made a criminal offense only with the National Water Crisis Act of 1995 (Republic Act [RA] No. 8041 or RA 8041).

### Regional Comparison: Price

Figure 4.1 shows the regional price per cubic meter of water in 2002. The MWCI and MWSI rates are based on pre-rate rebasing rates as of March 2002. The new tariffs put Manila in the middle of the pack as to price, trailing only Hong Kong and Singapore.



**Figure 4.1. Water Cost (US cents/cubic meter) based on 30 cubic meter monthly bill.**

Source: Rivera (2003b).

### Performance vs. Pre-Privatized Standards

We now move to the analysis of water service performance of pre- and post-privatized MWSS. Table 4.2 gives the water service performance of



MWCI and MWSI for 2001 and 2002, the 2001 benchmark targets, and pre-privatization standards.

Based on pre-privatization standards, the combined performances showed much improvement: water coverage (18-percent rise), staff per 1,000 connections (58-percent fall), water availability (hours, 24-percent rise), and number of staff (49-percent drop). On NRW, MWCI did better but MWSI did worse. Both performed much better in extending services to the urban poor (83,000 connections). On sewer coverage, MWCI did badly and MWSI did better. Starting in 2000, both MWCI and MWSI brought their water quality into compliance with the bacteriological requirement of the Philippine National Standards for Drinking Water (PNSDW).

**Table 4.2. Water Service Performance for 1966, 2001, and 2002**

| Service Indicators  | <sup>a</sup> Prior to Privatization           | MWCI        |                     |                     | MWSI        |             |             | Combined 2002 | Gains (% Increase) |
|---|---|-------------|---------------------|---------------------|-------------|-------------|-------------|---------------|--------------------|
|   |   | Target 2001 | Actual 2001         | Actual 2002         | Target 2001 | Actual 2001 | Actual 2002 |               |                    |
| Population served based on official no. of water service connections (millions) | 7.3   | 4.26        | 3.2                 | 3.4                 | 6.7         | 5.3         | 5.2         | 8.6           | 18                 |
| Official no. of water service connections                                       | 779,380                                       | 378,670     | 352,982             | 369,699             | 574,590     | 577,637     | 573,194     | 942,893       | 21                 |
| Water production (mid) annual average   | 2,800   | 1,234       | 1,724               | 1,658               | 2,257       | 2,417       | 2,363       | 4,021         | 44                 |
| Water coverage (%) (based on official no. of connections)                       | 67  | 77.1        | 76                  | 82                  | 87.4        | 79          | 78          | 79            | 18                 |
| Water availability (hours)  | 17  | 24          | 21                  | 21                  | 24          | 21          | 21          | 21            | 24                 |
| No. of staff  | 7,638   | 1,386       | 1,530               | 1,516               | -           | 2,594       | 2,366       | 3,882         | 49                 |
| Staff per 1,000 connections   | 9.8   | 3.7         | 4.3                 | 4.1                 | -           | 4.5         | 4.1         | 4.1           | 58                 |
| Reported no. of leaks   | 27,053  | -           | 40,454              | 38,225              | -           | 41,242      | 98,611      | 136,836       | -                  |
| No. of leaks repaired   | 20,585  | -           | 39,688              | 37,461              | -           | 38,508      | 92,189      | 129,650       | -                  |
| Non-revenue Water (%)   | 61  | 16          | 48.29               | 52.66               | 31          | 66.25       | 68.68       | 62            | -                  |
| Services extended to the urban poor (water service connections)                 | Water improvement for depressed areas (WIPDA) | -           | <sup>a</sup> 14,504 | <sup>b</sup> 22,160 | -           | 61,370      | 63,370      | 85,890        | -                  |

Notes: <sup>a</sup> With equivalent 50.549 household connections. <sup>b</sup> With equivalent 63.910 household connections.

Source: MWSS Regulatory Office (2002).

We now view the evolution of the water tariff through five years. Table 4.3 gives the tariff trajectory for MWCI and MWSI. For MWSI, the tariff on cubic meters of water rose more than threefold from ₱4.96<sup>3</sup> in 1997 to ₱15.46 in 2002. This table also shows, together with the dates, the motivation behind the adjustment, e.g., Accelerated Emergency Price Adjustment (EPA) and Foreign Currency Devaluation Adjustment (FCDA). For MWCI, the tariff rose from ₱2.32 to ₱6.75, a little less than threefold.

**Table 4.3. Post-Privatization History of Adjustments for the Average Water Tariff**

|             | Period   | Average Tariff<br>(peso/m <sup>3</sup> ) |
|-------------|--|--|
| <b>MWCI</b> | 1997-1998  | 4.96                                     |
|             | 1999   | 5.80                                     |
|             | Jan 1 – October 19, 2001                               | 6.58                                     |
|             | Accelerated EPA – October 20, 2001                     | 10.79                                    |
|             | FCDA (Jan – March) 2002                                | 15.46                                    |
| <b>MWSI</b> | 1997-1998  | 2.32                                     |
|             | 1999   | 2.61                                     |
|             | 2000   | 2.95                                     |
|             | January – March 2001                                   | 2.95                                     |
|             | Provisional implementation of final award (April 2001) | 3.22                                     |
|             | Accelerated EPA – November 2001                        | 4.22                                     |
|             | FCDA (Jan – March ) 2002                               | 6.75                                     |

*Source:* UPecon Foundation (2002).

The tariff trajectory appears to be in a steep rise for two reasons: (1) the initial tariff was the winning bid, which was extraordinarily low (₱2.32 for MWCI and ₱4.96 for MWSI versus the pre-turnover tariff of ₱8.00); and (2) the five years under scrutiny were indeed very turbulent, being beset by the Asian financial and currency crisis (heavy depreciation of the peso and considerable reactive inflation) and the El Niño phenomenon, which reduced water supply.

<sup>3</sup> Foreign exchange rate was ₱44 to US\$ 1, as of December 2010. See <http://www.xe.com/> for the latest rate.

Thus, compared to the pre-privatization tariff of ₱8.00, the MWCI 2002 tariff per cubic meter of water was still low, while the MWSI 2002 tariff was about twice as much. But given the turbulence in those years, it is inconceivable that the tariff—were there no privatization—would have stayed at ₱8.00 per cubic meter, while the quality of service would have remained dismal.

## Water Quality

The quality of piped water determines its use. Poor-quality water is not potable and, if drunk, can cause illness. For potability, poor-quality piped water has to be boiled properly, or a bottled alternative has to be procured, both of which are costly. A low official price only disguises the real high cost of piped water. This is a case where the benefits of MWSS privatization are patent. Table 4.4 gives the bacteriological quality of piped water from 1997-2002 by concessionaire.

Water quality is gauged by the number of coliforms, specifically fecal coliforms. Note first that the number of determinations (tests) increased almost ten-fold in the case of MWCI and eight-fold in the case of MWSI. This reflects the seriousness with which the concessionaires view water quality. For MWCI, the number of determinations containing coliforms fall from 7.0 percent in 1997 to 0.3 percent; corresponding percentages for MWSI were from 5.0 percent to 0.7 percent. Note that the pre-privatized quality (1997) did not satisfy the PNSDW, which requires that at least 95 percent of samples taken during the year be coliform- and *E. coli*-free. MWCI became compliant in 1998; MWSI in 2000. Water quality was an undeniable harvest after price!

**Table 4.4. Bacteriologic Quality of Water in the Distribution System**

|             | Fecal Coliforms             | 2002 | 2001 | 2000 | 1999 | 1998 | 1997 |
|-------------|-----------------------------|------|------|------|------|------|------|
| <b>MWCI</b> | Total no. of determinations | 6234 | 6040 | 5586 | 5104 | 4652 | 639  |
|             | No. containing coliforms    | 21   | 25   | 19   | 36   | 91   | 45   |
|             | % containing coliforms      | 0.3  | 0.4  | 0.3  | 0.7  | 2.0  | 7.0  |
| <b>MWSI</b> | Total no. of determinations | 7549 | 8793 | 8577 | 8742 | 6520 | 910  |
|             | No. containing coliforms    | 52   | 41   | 45   | 267  | 205  | 43   |
|             | % containing coliforms      | 0.7  | 0.5  | 0.5  | 3.0  | 3.0  | 5.0  |

Source: MWSS Regulatory Office (2002).

The problem with quality is related to property rights issues on the one hand and the previous MWSS neglect on the other. Aqueducts of raw water supply from the Balara Treatment Plant were occupied illegally by squatters. On top of that, manholes and auxiliary structures were left grossly untended. These at once resulted in contamination and allowed privately profitable illegal connections to be installed. The theft and the asset neglect were probably part and parcel of the illegal income supplements of some MWSS personnel, which were well known. MWCI did two things that further reduced the scope of water theft: (a) it closed manholes and upgraded its assets to make illegal connections more difficult, and (b) it installed proper water service connections to these communities. This proved crucial for water quality improvement as the same time that it reduced NRW.

### **Complaints and Responsiveness**

Responsiveness is another important dimension of service. Table 4.2 shows that in 1996, the percentage of reported leaks attended to and repaired was 74 percent. It rose to 97 percent in 2002 for MWCI and 93 percent for MWSI, for a combined responsiveness of 94 percent. Leaks contribute to NRW and erode the bottom line. The bottom line was never a concern for the state-owned and -operated MWSS, whose leadership was not rewarded for increasing revenue. This is a clear example of the importance of a “residual claimant” that comes to play with privatization. This responsiveness may also explain the increased number of complaints regarding leaks (from 27,000 in 1996 to 132,000 in 2002).

### **Service to the Poor**

Both concessionaires devised a program to provide water service connections to the urban poor. This activity was incentives-compatible because water loss is associated with illegal occupancy, and thus, urban poverty. As observed in the case of MWCI, hand-in-hand with a crackdown on illegal connections and the tap-proofing of the aqueducts and connectives, legal water connections now were made available in these areas. Table 4.2 shows that by 2002, MWCI had provided 22,160 connections, while MWSI had provided 63,370 connections to poor households, thus making billed water available even to squatter areas. This reduced the opportunity for water syndicates to steal water, thus reducing NRW. The combined new connections to poor areas were 9 percent of total service connections. Previous provisions of water by the state to squatter communities, when available, took the form of public outlets, access to which was, in theory, free. But in practice, water was ferried by water carriers for a fee. Where even this was not provided,

trucked water was the only resort, and this meant that the effective cost of water ran at least three times the official tariff.<sup>4</sup>

### **Collateral Benefits**

The first collateral benefit was macroeconomic: suddenly, MWSS was no longer a fiscal burden to the economy. Just as suddenly, the exploitation of the majority subsidizing Metro Manila residents disappeared. The continuous availability of good quality water impacted the intensity of private coping activities that caused substantial negative externalities. For one, the acquisition of privately financed and owned deep wells, which directly tapped the water table diminished, at least according to anecdotal evidence (artesian well service used to be a thriving industry). Residents acquired water pumps that ensured sufficient water flow in those precious few hours when tap water was available (of course, the incremental water access by residents was a prisoner's dilemma game: with everyone fitted with pumps, nobody got an advantage; power and capital were just wasted). Business establishments spent a lot of money putting up auxiliary systems to ensure continuous availability. These negative externalities have now been mitigated. The quantification of these collateral benefits had yet to be done, but it should be substantial.

### **Evaluation**

The growing pains that the MWSS privatization experienced through the first five years were numerous and daunting. But in the end, it is the outcome that either celebrates or damns this momentous shift in the boundary between the state and the market in the Philippines. Would Metro Manila water users have been better served without privatization?

There is no question that substantial efficiency gains in numerous areas have been realized. There are fewer staff members per 1,000 connections, and better water availability and coverage. NRW remains too high, although it has improved for one concessionaire. There is no doubt that the ownership effect and incentives compatibility are working their magic here. The gains in water quality are especially telling. Water procurement as a source of corrosive rent-seeking has clearly diminished. The view that water service has become a regular private business with its superior standards is momentous.

Water tariff, too, is now subject to intense scrutiny by a combination of private and public entities combining to form the regulatory environment.

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<sup>4</sup> In some waterless areas, rationed water costs 20 to 60 times more than utility water per liter. In unserved areas in Antipolo City, for example, truck-rationed water cost ₱50 per container (150 liters), as of January 2011.

This means more thorough accountability to the public. The burden now lies with the private concessionaires to prove that water tariff adjustment petitions are backed by prudent expenses. Even with the tariff adjustments, water tariffs are still lower than they would have been without privatization, especially when implicit state subsidy is removed. The latter is due to the public recognition of debt liabilities via the *concession fee*. The contribution of the concessions to fiscal integrity in terms of concession fees is estimated at ₱100 billion. It must be recognized that MWSI stopped paying the concession fee in 2001 in violation of its contractual obligation. But that is another story.

Did the gamble pay off? The numbers are unequivocal in their answer: yes.

### **The Old Order: Why Was the Pre-1997 MWSS So Robust?**

There are two interesting angles whence to view the MWSS privatization. One is to view the experience as a case of a *contractual and regulatory game* focusing on incentives of players, their actual behaviors during the episode, the response of regulators, and the eventual outcomes. The second angle is to view the episode as a game of *social change*—the supplanting of one stable equilibrium by another. The object of the second is to inquire into how the various interests either converged on or were induced to coalesce toward—or at least to refrain from opposing—the emergence of a new equilibrium. This means looking into the circumstances that changed the payoff matrix governing the behavior of players in the old equilibrium. The process that led to the emergence of a new equilibrium and the intervention of various change agents is the interest of this chapter.

Water is a basic commodity, and thus is highly politicized. Water service pricing in Metro Manila—where crucial political decisions are made, compromises are reached, and where social unrest is most feared—could make or break a political leadership. This was a crucial consideration in the determination of the old equilibrium.

### **A Bad Stable Equilibrium: The Pre-Privatization MWSS**

The MWSS was a GOCC, and thus was subject to the usual Commission on Audit (COA) rules on procurement and the Civil Service Law governing the hiring and firing of manpower. As a GOCC, it could also contract foreign currency borrowing, blessed with automatic sovereign guarantees for infrastructure development. Otherwise, investment was financed by official development assistance (ODA). Needless to say, its water tariffs were set with one eye on the preference of political authorities who hire and fire the members of the governing MWSS Board of Trustees. By 1997, the MWSS dollar debt was at

US\$1 billion, and it periodically sought and received fiscal subsidy from the government (“increased equity” in official guise) to service its debt.

Its performance as a water utility was dismal (see Table 4.1). MWSS was plagued by the usual problems associated with state-owned and –operated enterprises. There was little or no accountability. It operated with a soft budget constraint where the state treasury was the ultimate guarantor. Severe over-manning shared with other state agencies was not a surprise. That a pre-privatization retirement program accepted by about 30 percent of the work force came about without any decline in water service tells of over-manning. MWSS had 9.8 employees per 1,000 connections, over thrice the Asian regional average of 2.6. Water was available only 17 hours a day on average versus 24 hours in other SEA cities. Its NRW was 61 percent of total, twice the regional average of 30 percent. Its coverage was 67 percent of total population, a full 30 percent less than the regional average. Still and all, poor performance was seldom a trigger for meaningful reforms in the Philippines. It was a stable, low-level equilibrium.

The pre-privatization MWSS was thus a mess. Its water service was remarkable more for the interruptions than availability. Its US\$1-billion debt was a fiscal burden due in part to its dismal NRW performance and due to the lack of political will to adjust rates. Incentives toward greater efficiency and sustainability did not exist. And yet it persisted.

The unspoken dominant political attitude back then was, “Don’t raise the tariff; reduce the service quality.” This attitude is, of course, very politically clever and is the counterpart of a “slow boil.” Service erosion can be sold as equal sharing of pain. Reducing service hours to a district by four hours hits both the posh subdivisions and squatters of the district. Raising tariffs, on the other hand, hardly reduces water use by the rich but should considerably reduce or shut off that of the poor! This form of water rationing is in keeping with the general populist tendency at work elsewhere in the polity and consistent with the *nominal equity norm*.

Politicians were, and still are, especially comfortable with it. They did not have to confront a noisy opposition to tariff adjustments. Quality erosion did not inspire as much opposition. Water tariff was dirt cheap and subsidized by taxpayers in general. The masses—unable to see beyond nominal equity—appreciated the low tariffs. The rich, on the other hand, could afford powerful water pumps and water storage facilities, and if need be, artesian wells to maintain 24-hour service. This was also a case of the Mancur Olson effect: the noisy minority (Metro Manila residents) forcing transfer to themselves via subsidized water from the disorganized majority (the rest of the nation).

This rule had, however, a massive downside for some, and increasingly

for all. (a) For those still uncovered by the service (39 percent of the Metro Manila population), there was no money available to extend the service, which meant they continued to pay through the nose for water (up to four times the official tariff for trucked water). For those without a piped system, water was accessed from communal faucets through costly water carriers. (b) Those entities that required water on a 24-hour basis had to provide their own continuous supply: costly pumping equipment and storage installations, which raised the cost of doing business.

Thus, the *nominal equity norm* was served at the expense of substantial *operative inequity*. Other problems followed. The non-availability of water for a great many people created demand for illegal connections that raised NRW. The proliferation of private deep wells worsened the common resource problem associated with the underground water table. The system was headed to a crisis, but on tiptoe. Everyone who had the wherewithal had time to adjust, to develop his or her own defensive scam. Before long, vocal vested interests emerged to defend the system, however abysmal. Continuous quality corrosion did not grate as much as price adjustments.

The MWSS Board, whose membership was appointed by the political authority, often as a form of political patronage, internalized the authority's tacit preference, and went along as the safest path to retirement or to other juicier positions. It did not matter that the system incurred an ever-rising deficit; it faced a soft budget constraint where the state treasury was the ultimate guarantor.

There was no incentive for government agencies like the MWSS to behave otherwise. Multilateral lending institutions and private loan syndicators were given *implicit* or *explicit sovereign guarantees* for their loans, the best possible arrangement for creditors in least developed countries (LDCs). They were not penalized by escalating inefficiency and losses, and had no incentive to monitor the use of the loans.

The MWSS workers were protected by a maze of civil service rules, and thus have virtually airtight or permanent security of tenure. Their ranks tended to be bloated by accommodation of political jobseekers. They were paid little, but were expected to do little.

The mess represented by pre-privatized MWSS was sustained by indefinitely postponing remedies and reckoning into the future. The losers either could not find a voice or were hampered by a public good market failure: the cost of protest was private but the benefit was public. Among the former was the taxpayer-at-large who subsidized water for Metro Manila users. The business sector—still largely dominated by domestic market-oriented players—could pass on the high cost of business to consumers. The sectors



that competed in the world market, burdened by higher cost of business, did not yet constitute a viable political force. Finally, information on viable alternatives was not available to the highest decisionmakers in case they were curious. State ownership of basic service provision was the inherited norm.

The pre-privatized MWSS was a manifest, stable, low-level equilibrium with all the players pursuing their best interests, given the rules of the game and the observed payoffs. The winners were sustained by an Olsonian dynamic, where the losers (i.e., the general public), finding resistance too individually costly and the benefits of successful resistance too diffuse, went passively along (Olson, 1965). The payoff structure left little room for change.

This old order does not surrender its grip without a radical change in the payoff matrix of the game. Since the internal forces cancel each other effectively in a stable equilibrium, the shock has to come from the outside. But from where?

### **Globalization and the Winds of Change**

President Ramos was the undisputed father and champion of MWSS privatization (see next section for an elaborate account). But whence came the inspiration and conviction? Ramos came to power in 1992 following the collapse of the Iron Curtain, symbolizing the triumph of the market ideology. We contend that the post-1989 globalization provided the ingredients and wherewithal for this (at about 1993, still contrarian) view. We elaborate below.

#### **The Allure of Privatization: Fiscal Deficits and Global Competition**

The 1990s was a singular decade for globalization in East Asia. Massive foreign investment—both portfolio and equity—and the radically altered geo-economic landscape, changed the perceived opportunities of players and the payoff structures. One over-arching concern was the perennial problem of fiscal deficit. The political authority—confronted by severe fiscal constraints—began in the early 1990s to embrace privatization and deregulation as a way to reduce demands on the national treasury (Cook & Fabella, 2002). These were also the growth-driving policies identified by the Washington Consensus and were, in no small way, pushed by the multilateral banks. Reinforcing the emerging conviction, its efforts in telecommunications and transport deregulation were beginning to bear tangible harvests.

Another over-arching influence was the compelling claim of globalization as a door to progress. To secure the country's place in the emerging global economy, the cost of doing business had to be reduced. Increasing awareness of Von Thünen competition (see, e.g., Fabella, 2000), where rival locations

compete for hovering *smart capital* on the basis of non-traded complementary factors—e.g., hard and soft infrastructure and worker skill—made basic services salient. You could not provide these conditions if you were perennially in the fiscal red. Globalization forced the authorities to recognize a crisis where once there was just dismal water service. Other globalization-related factors helped bring the situation to a boil:

- (a) *The Tiger Economy aspiration of the Executive Branch.* The Ramos administration assumed power after the success of the “export platform” idea—made salient by the Japanese Direct Foreign Investment (DFI) to East Asia in the wake of the Plaza-Louvre Accords yen appreciation—was recognized. Tiger economies were then recognized as having ridden the export superhighway and attracted direct foreign investment (World Bank, 1993). The dismal performance of MWSS could only serve to discourage export competitiveness and DFI. You could not compete in the global marketplace with bad infrastructure. You could not provide the proper infrastructure if you were in a chronic fiscal mess.
- (b) *The growing recognition of the traded goods sector,* especially the export sector, as an engine of growth was palpable in the rhetoric of the day, and its clamor for competitive cost of doing business was being heard in the decision circles. Indeed, then-Senate President Edgardo Angara made a competitive exchange rate the subject of his plenary speech to the 1994 Economic Summit, where he called for the upward adjustment of the exchange rate from ₱25 to ₱35 per US\$ in the wake of the massive devaluation of the Chinese yuan. That it was widely attacked and eventually ignored showed that the support for the export sector did not yet extend beyond rhetoric.
- (c) *Expansion of the information set of the political powers I: The role of overtures by foreign players:* Around 1994, a Malaysian firm, together with Biwater, a British water service provider, proposed the privatization of MWSS by direct purchase. In late 1994, Biwater also presented its own bid as an “unsolicited proposal” under the BOT Law. In 1995, a third negotiated bid offer was received, this time from a large real estate firm in a joint venture with a foreign group (Dumol, 2000). The information set of the authorities thus expanded on two counts: (1) these bids revealed clearly the existence of possible, financially able, interested parties in the privatization of water; and (2) at least one viable alternative mechanism to state water provision, the straight purchase and ownership by a private group.

- (d) *Expansion of the information set of the political powers II (Successful templates)*: The Buenos Aires and Macau Exemplars were most salient. Lyonnaise des Eaux, a French water company, and the partners in the privatization of the Buenos Aires and Macau water systems, reported to key figures on the performance of those projects. NRW fell to 14 percent from 44 percent in Macau. In Buenos Aires, water tariff actually fell. In both cases, the winner was determined by a competitive bid (Dumol, 2000). President Ramos and Department of Public Works and Highways (DPWH) Secretary Gregorio Vigilar became sold on the idea. Together with then-MWSS Commissioner Angel Lazaro and a contingent of stakeholders, especially MWSS labor, Vigilar visited Argentina for a first-hand look. Visits to France and the UK were also organized. That the model had been tried and had succeeded outside of the Organization for Economic Co-operation and Development (OECD) ambit was especially compelling.
- (e) *Electric Power Crisis Act as template*: President Ramos enjoyed enough political capital with Congress to enact the Electric Power Crisis Act of 1993, which gave the president the power to negotiate BOT contracts for power supply and generation to address the crippling power crisis in the early 90s. This underpinned the successful address of the power crisis.
- (f) *National Water Crisis Act of 1995*: After the success with the power crisis, Congress readily passed the National Water Crisis Act, which gave President Ramos the power of negotiation in the water sector and privatization of water utilities. It additionally gave MWSS the power to retrench personnel and made theft of water a criminal act. This law also gave the president a six-month mandate to privatize the sector.
- (g) *Procurement of supply and capacity via the new BOT Law*: This had proven successful not only in solving the power crisis, but also in the procurement of new capacity in a way that entailed substantially reduced immediate fiscal burden.
- (h) *Multilateral agencies* were eager to lend technical assistance and advisers to prepare the ground. The International Finance Corporation (IFC) was especially crucial as technical adviser.
- (i) *Lee Kuan Yew*: The much-publicized public flogging of the Philippine telecoms infrastructure by visiting Singapore Senior Minister Lee Kuan Yew shattered the national tolerance for bad service in general, and supplied no small amount of impetus for deregulation at that time.

The confluence of events by the mid-1990s made the political authority singularly bullish toward reform, rendered the public receptive, and put potential objectors on the defensive. The grip of the old ethos was loosening.

### **A Happy Confluence of Events**

Clearly, the clinching of the privatization of MWSS was a milestone in Philippine political economy. Few, if any, would have bet that in a little over two years, from June 1995 to August 1997, the turnover of management and operation of such a large and complex system would really come to pass.

While privatization of some sort had been ongoing from the late 1980s through the early 1990s, most cases were either straight sale of state assets or greenfield BOT contracts. None were as politically sensitive or as complicated as drinking water in the capital city.

The privatization came through by a happy—if perhaps unique—confluence of events. In the mid-1990s, with the power crisis a vivid memory, foreign exchange turned from chronically scarce to abundant. Japanese banks were especially eager to lend at hitherto unknown low rates. Foreign investors were spoiling for any and every profit toehold in the *Pacific Century*. Dumol (2000) views this as luck when he observes the timing of the endeavor: “How much luckier can we get!”

The strong buy-in by the President of the Republic, the choice of a very able team to complete the job, and the constant monitoring of the process were crucial ingredients for the success of the MWSS privatization. But the buy-in itself was triggered by a confluence of events that made the idea compelling and promising: (a) new information on emerging alternatives to state procurement and provision provided by globalization, (b) the existence of private players willing and able to finance the project, (c) the impetus from the undiplomatic and frank Lee Kuan Yew, (d) the demands of the traded goods sector for lowering the cost of doing business, (e) the emerging orthodoxy regarding the export platform path, and (f) the desire to reduce the claims on the state treasury. Finally, the recent successes in telecoms deregulation and BOT procurement in the power sector eased the way for the more difficult privatization of water service via a concession contract. The government, however, needed to address the reluctance of the private sector to sign a 25-year contract with the government. We now, therefore, turn to what the government did to ease the entry of the private players.






## How MWSS Privatization Was Won: Oppositors and Dumb Luck













This account depends largely on Mark Dumol's "The Manila Water Concession: A Key Government Official's Diary of the World's Largest Water Privatization" (2000). As chief of staff to one of the key players in the game, Secretary Vigilar of the DPWH, Dumol occupied a front-row seat in the crafting and nurturing of the process that led to the clinching of the holy grail of MWSS privatization.




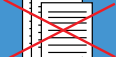


















### The Chronology of Events

Following Dumol, we constructed the following chronology (Table 4.5):

**Table 4.5. Chronology of Events in MWSS Privatization**

| Year | Month    | Event   |
|------|----------|---|
| 1993 | June     |  <p>President Ramos broaches the idea of a 'water crisis' to newly appointed DPWH Secretary Vigilar</p>  |
| 1994 | June     |  <p>Ramos meets with investors proposing to purchase MWSS by a negotiated deal; gets excited with their promised water service overhaul; forms an interagency committee to study proposal.</p> |
|      | July     |  <p>Ramos creates the MWSS Privatization Committee; research starts</p>  |
|      | December | <p>Biwater submits an 'unsolicited proposal' under the expanded BOT Law</p>   |
| 1995 | June     |  <p>National Water Crisis Act passed</p>   |
|      | July     |  <p>The French Government approves a grant of \$1 million to finance the technical feasibility study of the privatization project</p>  |

| Year | Month        | Event   |
|------|--------------|---|
| 1996 | September    | <p>A large local firm backed by multi-national corporations tenders a negotiated privatization proposal, which is also rejected</p> <p>Development Bank of the Philippines (DBP) approves a loan to further finance the cost of hiring the lead adviser for the project</p>   |
|      | November     |  <p>MWSS hires the International Finance Corporation (IFC) as lead advisor on the project for \$6.2m</p>   |
|      | March        | <p>Investors register interest</p>  |
|      | May          | <p>Investors provide data for due diligence</p>   |
|      | July         |  <p>MWSS approves the privatization strategy</p>   |
|      | August       |  <p>Bidders are pre-qualified</p>   |
|      | Oct. to Nov. |    <p>MWSS meets bidders for pre-negotiation of contracts</p>  |
|      | December     |   <p>MWSS approves pre-qualified bidders</p>   <p>MWSS issues tender documents</p>   <p>Ramos approves privatization strategy</p> |

| Year | Month       | Event  |
|------|-------------|--|
| 1997 | January     |   Ramos approves CA  |
|      |             |   CA opposition mounts legal challenge   |
|      |             |   Bidders submit their bids  |
|      |             |   Court of Appeals issues TRO  |
|      |             |    Court of Appeals lifts TRO |
|      | January 23  |   MWSS opens bid documents   |
|      |             |   MWSS endorses award recommendation to COP  |
|      | January 31  |   COP endorses recommendation to Ramos   |
|      |             |   Ramos approves award of contract   |
|      | February 21 |   Government and winners sign CA   |
|      |             |  Winners take over their respective concessions   |
|      | August 1    |  |

Source: Dumol (2000).

## Major Change Agents

Ramos was, in no uncertain terms, the principal of principals in the MWSS privatization project. The other players all agreed that the project was the President's very own baby. In June 1993, Ramos met with the newly appointed DPWH secretary and broached, among others, the idea of confronting what he called the "water crisis," which was unexpected, since a water crisis was not yet part of the popular discourse. Apparently, the dismal performance of water service morphed into a crisis in Ramos's mind. This prompted Secretary Vigilante to convene a series of water summits, which created a consciousness of the water problem. The crisis view was being hawked. It was not that people were unaware of the water problem; they just thought there was nothing that could be done. They did not think it a crisis, but a predicament that had to be lived through and managed with local remedies (water pumps, water storage, plastic buckets, etc.). But what could be done about it in the long run? In June 1994, Ramos entertained a private group of investors (representing a Malaysian firm and its partner, Biwater) interested in purchasing MWSS outright on a negotiated basis. To this meeting he invited Vigilante, who was tasked to study the proposal. The follow-up calls from Ramos showed his excitement at the prospect. The inter-agency committee set up to study the matter rejected the proposal on the belief, most common at that time, that potable water was too politically incendiary to be passed on to private hands. Besides, how does one sell an agency whose value is unknown, and perhaps unknowable? But the proposal left its mark; the proponents painted a picture of a completely transformed water service. The privatization bug had bitten.

That Vigilante was the secretary of DPWH was a godsend for the project. He was a no-nonsense bureaucrat who cut his teeth in the Philippine Army Corps of engineers and in seeing through large infrastructure projects with dispatch and honesty. He was a can-do man. President Ramos set out to make him a true believer in water reform. He sent the secretary on visits to projects abroad, one of which turned out to be Macau, which had seen a successful privatization of its water service. In May 1995, Vigilante visited France and the UK to see their water projects and toll roads. Vigilante came out of these trips a proselytizer for water privatization. There is nothing like actual operating templates to focus the mind.

When it was clear that MWSS privatization was the way forward, Ramos wangled from Congress the passage of the National Water Crisis Act, which granted the president the time-bound power to privatize water utilities, the power to reorganize MWSS, and the criminalization of water theft—meaning that chief executive officers (CEOs) of companies caught stealing water could go to jail. This was to prove crucial in clearing legal objections to the project



and making potential bidders confident that they could collect the tariffs if they won the contract.

It was also clear that the current leadership of MWSS would not be best positioned to abolish it, and this called for a new administrator. Ramos chose the highly respected Dr. Angel Lazaro III, but the latter balked for good reason. MWSS was a quagmire of failed procurement projects. Lazaro ran a successful consulting firm and thought rightly that he would be caught in a no-win situation. This was clearly an instance of good quality and well-intentioned people fleeing from the snake pit of state bureaucracy. It was a job trying to convince him to accept, and he did so only on the condition that he would be allowed to exit right after the concessions were handed over to the winners. Lazaro was to prove crucial in giving the effort credibility and in taming the forces within MWSS that were viscerally opposed to privatization.

### **External Forces**

It is said that bad equilibrium cannot be upended without new impulses flowing from the outside to change the equation. External forces that could be viewed as globalization dividends also weighed in the process of water privatization. These served to expand the information set and the expertise fund. The privatization offers coming from 1993 to 1995 were very pivotal in convincing the authorities that the water problem had at least one way out: privatization. They also brought to the authorities' attention the existing LDC templates in Macau and Buenos Aires. The World Bank manuscript on the Buenos Aires privatization by Idelovitch and Ringskog (1995) were especially cherished by those tasked to push the agenda and seeking to change other peoples' minds on the matter. Errors committed during the early 1990s could also be avoided.

Even after the authorities became convinced that privatization was promising, going about it was unknown territory. Experts had to be identified and terms of reference had to be drafted, and this cost money and seed financing. Here, the French Embassy came through with a grant of US\$1 million for the financing of the technical feasibility study of the project. It also arranged for the visits of point persons to France and French water projects elsewhere. The UK Embassy also arranged visits by relevant project personnel to England for a look-see. When the IFC team to advise on the Umiray-Laiban Dam BOT Project came over in July 1995, the idea of the IFC becoming the principal adviser of the MWSS privatization was brought up. The MWSS Board approved the IFC advisory contract on November 10, 1995. This proved to be central in the design of the bidding and the drafting of the CA, which were highly technical undertakings.

## **Identifying Opponents and Preempting Objections**

An undertaking as large and unfamiliar as this will encounter many obstacles and objectors along the way. Each of these is sufficient to derail the whole enterprise. This is especially pronounced in a third-world country with a fractious brand of politics.

### **Legality and Challenges**

As mentioned, the passage of the National Water Crisis Act was momentous as a legal basis for the project. The merit, as well as the drawback, of the enabling law was the time-bound provision: the President was given six months to privatize. The advocates interpreted this as six months to initiate the process, not to complete it. This was subject to challenge in court. To preempt the opposition, the President had to issue an EO to that effect on or before December 7, 1995.

Executive Order No. 286, or EO 286, was issued on December 7, 1995 to beat the deadline of process initiation, but the mention of privatization was minor. A stronger EO seemed called for, showing presidential approval of the MWSS privatization. In March 1996, EO 311 was issued to the effect. As expected, prior to the bidding proper in January 1997, a temporary restraining order (TRO) was served by a Manila city judge in favor of a group wanting to implement a major water supply project, which feared being orphaned by the progress of the MWSS privatization.

Judge Inocencio Maliaman, who presided on the TRO case, declared the TRO expired on a technicality interpretation. This allowed the bidding to proceed. Before the end of January 1996, and after the winners had been determined, another TRO was issued, this time by the Court of Appeals. The contention was that the six-month period had elapsed. Here the EOs issued were material in convincing the court that the CA was being honored. If the opponents raised the legality issue to the Supreme Court, it would have languished for years and stopped the process in its tracks. This showed how tenuous the process was and how dumb luck played a role.

### **Preempting the Political Challenge**

When the winners and their bids became headline news, the reception was euphoric, in view of the promised huge reduction in water tariff. But as usual, there were nitpickers and gadflies. The first salvo was that this was “too good to be true,” and so there was a catch somewhere that would cost the public dearly. Three senators questioned the contract, but their objections were simply and effectively addressed. Going through the CA with a fine-

toothed comb did not reveal any anomaly. The whole process was zealously transparent and designed to be so to preempt future challenges. There was no challenge from the losing bidders, who were themselves involved in the process of drafting the contract. And of course, the huge reduction in the tariff was the nonpareil evidence of correctness in the eyes of a public so used to political double talk. This was the outcome of the reassurance game played by the state to reduce the risk facing the bidders (see, e.g., Fabella, 2010) before the actual bid. The experience shows the wisdom of meticulous transparency and anticipating objections even before they arise: in other words, thoroughness.

### **Preempting MWSS Labor Challenge**

MWSS had 8,000 employees—13 employees per 1,000 connections—which was two to five times the workforce of comparable Asian cities. The Civil Service Law gave state employees rather rigid protection. How did one whittle down this number so as to attract bidders to tender? This was Lazaro's challenge. The National Water Crisis Act passed in June 1995 authorized the reduction of the MWSS workforce. The employees viewed Angel Lazaro's appointment as the signal to privatize, and they were restive. To calm the field, Lazaro met with the workers and proposed to them a set of criteria, which if met, would forestall the privatization. The standards proved too tough to be met, but the initiative brought the workforce into the conversation, which proved important. Lazaro then managed a retrenchment program consisting of: (a) a generous package for early retirement, which was accepted by 30 percent of the workforce; and (b) a generous program accepted by the remaining workers: termination prior to takeover with tax-free severance pay and rehiring by new owners on probationary basis. Those not rehired (another 25 percent) were given full retirement benefits less severance pay. The government shouldered the cost of retrenchment. The CA carefully detailed the obligations of the concessionaire in respect to the rights of the workers. This reduction in the workforce would play a big part in the willingness of the private sector to play.

### **Lessons**

Time would vindicate the faith and hard work of the advocates of MWSS privatization (see first section of this paper). It would be the largest water service privatization in the world and would make Manila a stopover for parties curious about or interested in water privatization. It also made one of the concessionaires a world player in water service privatization.

## Ensuring the Low Tariff Outcome: Addressing Private Business Risks

It is clear that what muted opposition to the MWSS privatization was the sizeable reduction in the tariff contained in the winning bids. Without this reduction, the adverse reaction might have led to the derailment of the project. The team tasked to privatize was very conscious of this need. We are therefore interested in how this came about.

### Credible Commitment and Signaling Game.

Since this water privatization enterprise involved drawing in the private sector in an embrace that would last decades, the government had to signal a new order of business. Dealing with the Philippine state was known to be fraught with uncertainty, and businessmen shun incalculable risks. To see the project through under such a time constraint (it had to be locked up before the 1998 presidential elections and the end of President Ramos' term, the limit set by the National Water Crisis Act), the government undertook two crucial steps:

1. It raised the tariff rate per cubic meter of water by 38 percent from about ₱5.00 to about ₱8.00 five months prior to actual contract closure; and
2. It offered a generous early retirement plan for employees, which reduced the work force by 30 percent.

These actions had the following effects: (a) they made the intended concessions more attractive to bidders and, more importantly, (b) they constituted a manifest political will signaling a departure from business-as-usual—which meant that the state, as a counterparty, cannot be relied upon to deliver on its contractual obligations as it is prone to sway with the fickle political wind. A state that, by contrast, can risk public opprobrium by raising tariffs to this extent and can whittle down the workforce by this much (thanks to the National Water Crisis Act)—both unheard-of events—can be trusted to follow through. These actions were clear proxies for a *credible commitment* that reduced uncertainty and led to lower tariffs (see e.g., Fabella, 2010). Thus, one important source of business risk—the state as an unreliable counterparty that holds all the aces—was addressed.

President Ramos's complete embrace of the project—manifested by his constant hovering presence throughout the run-up, dismantling hurdles along the way, and making the necessary phone calls—was the last straw that broke the back of the old equilibrium.

### **Risk Associated with Information Scarcity.**

The two years it took to privatize MWSS resulted in potential gross miscalculations, both by the state and the private players. Due to the shortness of the run-up period, there was no time to set up a properly legislated regulatory infrastructure for water. The Regulatory Office was itself set up as part of the CA. It had no statutory independence from the political principal. MWSS morphed, by virtue of the CA, from a water and sewerage service provider to a regulator. If it failed badly in the first, how could it succeed in the second? Additionally, the requisite expertise to regulate water utilities was conspicuously absent. While expertise could be quickly outsourced at a price (e.g., UPecon Foundation and Thames Water, who were hired as consultants), could it suddenly realistically excise the very source of its previous failure—political interference—from its decisions? This would become a big issue later.

How was this risk addressed? The CA provided for disputes over claims to be adjudicated by an appeals panel consisting of three members: (1) one nominee from the concessionaire; (2) another from the regulator, MWSS; and (3) one international expert nominated by the foreign chambers of commerce. This would take the Philippine courts, noted to be fickle, out of the dispute resolution. This was yet another confidence-building measure.

There were other potential pitfalls that would test the adjudication platform. One is the exchange rate and the concession fee obligation of the concessionaires to service dollar-denominated debt. Most East Asian countries were—throughout the 1990s—battling without much success the appreciation of their currencies. If the direction of peso movement were to be forecast based on the previous 10 years, it would have been appreciation. The peso had appreciated from about ₱26.00 to ₱25.00 per US dollar in the mid-1990s. The noise from the Central Bank of Philippines leadership was “depreciation over my dead body.” Exporters in Cebu Province burned the Central Bank governor’s effigy for his “strong peso policy.” So, the betting was that the peso would continue to appreciate. It went the other way in the Asian financial crisis of 1997.

Due diligence was made more tenuous by the extremely bad record keeping of the old MWSS. Bad or missing records are systemic in most state institutions where corruption is rampant. But in the mid-1990s, and due to the shortness of the decision period, that risk of inadequate due diligence could be glossed over. The nature of the business meant that *due diligence* was heavily biased toward type I errors: adjudge healthy and deal with a tumor later if it arises.

How were these risks addressed? The CA provided potential relief in the form of price adjustment mechanisms that could compensate for downside

surprises: *emergency price adjustment* annually and *rate rebasing* in perhaps five (optionally) or certainly 10 years. These would serve to reimburse the concessionaires for costs prudently incurred. This meant that there was less risk of a “winner’s curse,” the danger that the winners might have been so optimistic as to render the business unviable. This had risks for the regulator. Indeed, the authorities were concerned that, due to these relief windows, bidders could plunge and try to recoup in the rate-rebasing exercise. In a world characterized by severe path dependence and first-mover advantage, getting a toehold—however tenuous—was the usual strategy. Plungers, of course, would need to have very deep pockets to sustain losses for at least five years (if lucky), or worse, 10 years. This meant that the privatization rules were biased in favor of players with deep pockets that might not necessarily be the most efficient operators. There is risk to plunging; even when the claims are truly meritorious, there always is the danger that large tariff adjustments will become politically unpalatable and may be vetoed. Plungers can also exploit the weakness of the system by reneging on deliverables and not getting punished due to regulatory weakness. Again, the appeals panel could be brought to bear if disagreements arose.

Finally, and as a *coup de grâce*, the Department of Finance (DOF) issued a *performance undertaking* guaranteeing that the government would respect its obligations in the contract. This was no small gesture, according to insiders.

### And They Came.

The moves to reduce the risks for participants succeeded in attracting bidders. Table 4.6 gives the bidding consortia and their other interests.

**Table 4.6. Pre-qualified Bidding Consortia**

| Pre-qualified Consortium  |                                  | Business Interests  |
|---------------------------|----------------------------------|---|
| Local Sponsor             | International Operator           |   |
| Metro Pacific Corporation | Anglian Water International (UK) | Property development, telecoms, etc.<br>UK-based water and sewerage operation   |
| Ayala Corporation         | North West Water (UK)            | Property development, telecoms, electronics, banking and financial services<br>Water and Sewerage Operation in Manchester area; a division of United Utilities Ltd. |

| <i>Local Sponsor</i>   | <i>International Operator</i>              | <b>Business Interests</b>  |
|------------------------|--|--|
| Benpres Holdings Corp. | Lyonnaise des Eaux<br>(later Ondeo)        | Property development, power generation and distribution, telecoms, electronics, banking and financial services<br>A global player in the field of environmental services |
| Aboitiz Holdings Corp. | Campagne Generale des Eaux (later Vivendi) | Power generation and distribution, financial services, etc.<br>A global player in the field of environmental services, telecoms, entertainment, etc.                     |

Source: Rivera (2003a).

The Ayala Group was heavily into real estate, telecommunications, manufacturing, and banking. The Benpres Group was into power generation, power distribution, telecoms, and most of all, media via the giant ABS-CBN group. Their calculations may include considerations of cognate interests within the conglomerate as affected by the ownership of the water company. No matter. The authorities probably preferred that the winning bids be infected with the winner's curse—that is, so optimistic that the business was not viable.

### **The Die Is Cast.**

In a sense, however, this might have been unavoidable. The size of the resources involved meant that only very large Filipino business groups could participate, and this is a very small set in an LDC. Capital market and institutional imperfections additionally ensured this to be a small set. That the Philippine Constitution mandates a 60-percent Filipino participation meant that foreign players could not participate and win on their own, which exacerbated the situation.

The designers of the privatization project were aware of the dangers. They were also aware that if it did not go through before the hard legal deadline, it might never go through. The gamble had to be taken, and the political authorities never hesitated. And the gamble paid off.

## Summary and Conclusion

The privatization of MWSS was clearly a triumph of the principle of comparative competence—the private sector proved more competent at the delivery of water and sewerage services than the state. How it was clinched is a parable for those seeking to whittle down the compass of incompetence and inefficiency in a weak-governance environment. Where the state is weak and therefore easily hijacked, it is much better to cede territory to the market. In the terminology of Williamson (1985), it is well advised to just *buy* from the market. A classic objection may be interposed—weak governance environments also tend to produce weak markets characterized by market failures, so the state may have no alternative but to *make*. In the story just told, globalization made a difference by strengthening the hand of the market, providing new information, new templates and expertise, and new partners and sources of financing for local private business.

The MWSS privatization showed how precarious the journey to success can be. This observation is even more salient, since the project was owned right from the beginning by the President, who enjoyed considerable political capital. That political capital got translated into the National Water Crisis Act of 1995, which the President extraordinarily leveraged when it came to water procurement. Without this enabling law, it would have been difficult for the project to clear the labor objections to privatization. It could have stumbled and gotten scuttled at several junctures along the way. In one instance, progress depended on an interpretation by a judge which amounted to a mere technicality. Had the legal question of the validity of the award been raised to the Supreme Court, the delay would have been fatal. Luck did play a part.

Choosing the right people to manage the project was crucial. They had the right credentials and were viewed as having no hidden agenda that would cast doubt on the enterprise. They, in turn, had staff members who were idealistic and committed to the pursuit of the holy grail. The team—realizing its own technical limitations—recruited the best help available in the world, which, when availed of further, gave the enterprise added validity. Recognizing further that the state was viewed as an unreliable and risky partner, the team enshrined transparency as a rule of procedures, which muted potential objections and preempted legal challenges. It opened the regulatory environment to inputs from the market players. Additionally, it employed effective signaling and credible commitment devices to attract and induce aggressive bids from the private bidders. The response was so enthusiastic that the outcome justified itself in the eyes of the public. In the end, fortune favored bravery and thoroughness.



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## Chapter 5

# Unleashing the Power of Competition: The Philippine Telecommunications Reform Story

Mary Grace P. Mirandilla-Santos<sup>1</sup>

Telecommunications (*telecoms* from here on) in the Philippines prior to the 1990s was in very poor shape compared to its neighboring Asian countries. The fixed-line teledensity, or the number of telephones for every 100 individuals living within an area, was only 0.91, and had been so for two decades prior. Reforms were initiated by executive power in 1993 that liberalized the sector; these were codified into a law passed by Congress in 1995. The response of the market was sure and immediate. Teledensity rose rapidly, reaching 9.05 in 2000 or an 800-percent increase in just 10 years. Access to telecoms services expanded exponentially when investments shifted to mobile phones. From almost nil in 1990, there were over 74 million mobile phone subscribers in 2009 (81 percent penetration,<sup>2</sup> or a mobile teledensity of 80.98). There is no doubt that the mobile phone has helped the country leapfrog the development path in telecoms and now serves as the Filipino's universal access tool, which was traditionally fixed lines. In fact, in 2000, mobile phones had already overtaken fixed-line use in the Philippines by over 100 percent—a similar trend seen in other developing countries in Asia.<sup>3</sup>

Before the huge success in telecoms, this rapid progress seemed impossible in the Philippines—a country saddled by a weak state, poor institutional capacity, and strong vested interests. Yet these pro-competition, market-oriented reforms, which introduced irreversible changes in telecoms as well as other economic sectors, were initiated by forces within the government. This achievement has been attributed to various factors. Salazar (2007), for one, argues that telecoms reform “occurred through a coalition for reform that outmaneuvered vested interests.” Some point to the influence of strong executive leadership, which pushed key actors in both government and the private sector to expand and improve services for political, economic, and

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<sup>1</sup> I would like to thank Rene Santiago for sharing his stories and for contributing to the analysis of the telecoms liberalization era. My utmost gratitude to Jaime Faustino, from whose ideas and actual experience in reform work this paper drew inspiration. Apart from content-editing the paper, Dr. Raul Fabella also helped ensure that this undertaking is grounded on sound economic theory. Finally, thanks to all my interviewees who generously shared their valuable time and inputs to this study.

<sup>2</sup> For a population of 92 million in 2009, based on latest census estimates.

<sup>3</sup> In Cambodia, mobile phone subscribers overtook fixed-line subscribers as early as 1993. See ITU (2001).

personal reasons. Others see it simply as a manifestation of a global trend in technological advancements that could not be stopped.

This chapter recounts how the reform battle was fought in the telecoms sector, who the central players were, and what they did to engender the reform that allowed emerging technologies to be adopted despite formidable odds.

### **1967-1985: Monopoly, Politics, and the Old Order**

Prior to the 1960s, telecoms services in the Philippines were mainly provided by a single private operator, the Philippine Long Distance Telephone (PLDT) Company, established on November 18, 1928 by Public Law No. 3436<sup>4</sup> under the American Colonial Government. In March 1967, American company General Telephone and Electronics (GTE) Corporation, which set up PLDT, began negotiating to sell its 28-percent controlling shares a few years before the expiration of the Laurel-Langley Agreement (Salazar, 2007). GTE was already in discussions with a group of Filipino investors led by Enrique Zobel of the Ayala Corporation, who got together with Benigno “Ninoy” Aquino, Jr. and the latter’s brother-in-law, Pedro Cojuangco (Salazar, 2007; Coronel, 1998). However, after President Ferdinand Marcos (1965-1986) took office, high-level government officials reportedly urged GTE not to sell to Pedro Cojuangco’s group, as they were allied with the Liberal Party’s leadership who competed with, but lost to, Marcos (Nacionalista Party) in the 1965 election (Esfahani, 1994). Instead, GTE was told to deal with the owners of the Philippine Telecommunications Investment Group (PTIC), a holding company formed by some Filipino businessmen led by Ramon Cojuangco (Pedro’s first cousin), said to be a Marcos crony (Esfahani, 1994; Coronel, 1998). PTIC was to pay GTE US\$7 million in cash and US\$7 million in promissory notes from a loan guaranteed by the Development Bank of the Philippines (DBP)<sup>5</sup> (Esfahani, 1994). Since then, PTIC has controlled PLDT through inter-locking shareholdings (Salazar, 2007).

### **Marcos and PLDT’s Virtual Monopoly**

For decades, PLDT was in a dominant position, largely due to its ownership by a politically influential family and the support of high-level government officials whose own interests were aligned with that of the company (Coronel,

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<sup>4</sup> Public Law No. 3436 granted PLDT a 50-year franchise, later on amended by Republic Act No. 7082 or RA 7082 (August 3, 1991), extending the franchise to another 25 years. See [http://www.congress.gov.ph/download/ra\\_08/Ra07082.pdf](http://www.congress.gov.ph/download/ra_08/Ra07082.pdf).

<sup>5</sup> The DBP is a development financial institution owned by the Philippine Government.

1998). During the Marcos regime, much of which was under martial law,<sup>6</sup> PLDT remained a virtual monopoly. With “privileged access to [Malacañang],”... “its competitors were kept at bay...” (Coronel, 1998).

PLDT’s business encompassed the local exchange carrier (LEC) service, the long-distance national backbone (inter-exchange carrier or IXC), the international gateway facility (IGF),<sup>7</sup> and international services in both voice and record.<sup>8</sup> Meanwhile, other carriers operating at that time were either engaged only in one segment or in specialized niches (e.g., paging and telegrams), domestic only or international only.

In the domestic market, PLDT accounted for about 94 percent of the country’s telephone network. It owned and controlled a national transmission backbone through which all voice calls had to pass for long-distance connections. PLDT’s LECs were located in profitable areas in Metro Manila and other major cities. The remaining six percent of the network, maintained by small, local operators—the PAPTELCO (Philippine Association of Private Telephone Companies), also called mom-and-pop affairs—was scattered throughout the provinces and rural areas (Lichauco, 2006). Eventually, PLDT bought these small players out, including the telephone system of the government (Salazar, 2007). PLDT would choke calls to other telecommunications companies (or telcos), driving smaller companies into bankruptcy (Salazar, 2007, 109-110; Henares, 2003). PLDT’s status was very secure under the Marcos administration. In one account, an upcoming LEC competitor, the Pilipino Telephone Corporation (Piltel), was reportedly ordered to stop rolling out additional landlines (Zita, 2005; Ure, 2004). PLDT would buy out Piltel later on.

Despite the financing available to PLDT (prior to the debt payment moratorium declared in October 1983), the LEC service remained poor and limited. The overall business model was unfavorable to LEC service expansion and manifested a combination of market and government failures with catastrophic impact. There was no incentive to expand LEC service because of the huge capital needed for laying down copper wire connections and low returns. Therefore, it made more business sense (i.e., lower unit cost or higher margins) to concentrate the roll-out in areas with higher population density

<sup>6</sup> On September 21, 1972, Marcos issued Proclamation 1081, declaring martial law over the entire country. On January 17, 1981, Proclamation 2045 was issued, formally ending martial law.

<sup>7</sup> IGF services consist of international transmissions, switching and network management facilities, which serve as point of entry and exit in the Philippines of international traffic between the national network and point/s outside the Philippines.

<sup>8</sup> A record is a service designed or used primarily to transfer information that originates or terminates in written or graphic form.

than in sparsely populated ones mostly located in the rural areas. The result was a low fixed-line teledensity of 0.8 in 1977, which had barely changed 10 years after. Telecoms, however, is not a purely for-profit business, but also a utility that provides an important public service, thus creating the need for a Congressional franchise and regulation. But in a case of *agency capture*,<sup>9</sup> public welfare is often undermined to protect private business interests.

Undoubtedly, PLDT flourished under a friendly policy environment under Marcos. In June 1973, Marcos issued Presidential Decree (PD) No. 217 (or PD 217),<sup>10</sup> aimed at “spreading ownership among a wide base of the people.” This became the basis of the *telephone subscriber self-financing* concept<sup>11</sup> used by PLDT to launch its “Subscribers Investment Plan” (SIP) where each new subscriber had to invest ₱900<sup>12</sup> to ₱5,000 in PLDT preferred stocks as prerequisite for the installation of a landline (Contreras, 2000). In reality, observers saw PD 217 as an indirect tariff adjustment disguised as investment, which transferred the cost of providing a telephone service to new subscribers.

Until the late 1980s, PLDT operated the IGF, with no effective competition. Although there were other players, the voice call market was dominated by PLDT, as all international calls had to terminate through its facility. With international traffic being lopsided—inward calls outnumbered outward calls—PLDT’s foreign exchange income surged. It was in PLDT’s favor that international voice call pricing was unregulated and settled through negotiations.<sup>13</sup> PLDT also dominated the cellular mobile telephone services (CMTS) or mobile phone market, although operations were handled by a different company, Piltel, supposedly to avoid the image that PLDT was monopolizing all services.<sup>14</sup>

The existing political and administrative structure effectively prevented new players from entering the telecoms market. The government justified

<sup>9</sup> Agency capture (or regulatory capture) is when the industry being regulated is able to gain control over the regulatory process, diverting it from protecting the public (Olson, 1965). Also read Shapiro (2010).

<sup>10</sup> PD 217 was also known as “Establishing Basic Policies for the Telephone Industry.”

<sup>11</sup> The concept provides that “a telephone subscriber finances part of the capital investments in telephone installations through the purchase of stocks, whether common or preferred stock, of the telephone company.” See Section 1, no. 4 of PD 217. Retrieved from [http://www.lawphil.net/statutes/presdecs/pd1973/pd\\_217\\_1973.html](http://www.lawphil.net/statutes/presdecs/pd1973/pd_217_1973.html).

<sup>12</sup> Foreign exchange rate was ₱44 to US\$1, as of December 2010. See <http://www.xe.com/> for the latest rate.

<sup>13</sup> Negotiations were between domestic carriers and PLDT, and between PLDT and foreign carriers.

<sup>14</sup> Personal communication with Nestor Virata, former PLDT official and consultant, March 2, 2010, Quezon City, Philippines.

PLDT's virtual monopoly position because of the incumbent's supposed universal service obligation through cross-subsidies, primarily from its international call revenues (Ure, 2004). This reasoning was borrowed from the American Telephone and Telegraph Company (AT&T), which promoted itself as a natural monopoly in the U.S. in the early 1900s (Zita, 2005). The *natural monopoly* doctrine posited that "from a societal point of view, the highest degree of efficiency exists with just one operator in the market," (infoDev & International Telecommunication Union [ITU], 2008) either a government-regulated or government-owned monopoly. While there are circumstances where this view is defensible, it has largely been debunked. Institutional economist and telecoms expert William Melody, citing the impact of changing technologies, pointed out the overall ineffectiveness of regulated monopoly at achieving public service or efficiency goals (Melody, 1989). The dismal teledensity in the U.S. pre-1940 best manifested this failure. Melody's contentions helped convince the U.S. regulator, the Federal Communications Commission (FCC), to open its telecoms market to new players (Parker, 2002).

Being the incumbent fixed-line operator, PLDT had the unique advantage of maintaining a nationwide backbone. However, as years passed, PLDT's inability to meet its public service commitments would become manifest. Under its virtual monopoly, installed fixed-line teledensity stagnated at around 1.0 for two decades until 1990 (Zita, 2005; Salazar, 2007). Without threat of competition, PLDT did not feel compelled to invest to expand or improve service. On the other hand, the regulator—the National Telecommunications Commission (NTC)<sup>15</sup>—failed to enforce service quality obligations or the obligation for a cross-subsidy from the lucrative to the missionary segments that would have financed universal service, due mainly to absence of policy.<sup>16</sup>

Despite the telecom sector's poor performance, how was PLDT able to maintain a seemingly favored position? Why did its monopoly persist for so long? Apart from the fact that PLDT's was a government-supported monopoly, was this a case of "the old system creat[ing] opportunities for rentseeking and politicking" (see Abad, 2005) on different fronts, ensuring that all the crucial decision centers shared in the largesse? Decades later, it would be revealed through a Supreme Court (SC) ruling that President Marcos himself

<sup>15</sup> The NTC is the government agency tasked with regulating the telecoms industry. Although an independent regulatory agency, the NTC remains under the administrative supervision of the Department of Transportation and Communication (DOTC). With respect to its quasi-judicial functions, the NTC's decisions are appealable to the Court of Appeals and the Supreme Court.

<sup>16</sup> Personal communication with Jose Luis "Linggoy" Alcuaz, former NTC Commissioner, March 23 2010, Pasig City, Philippines.



was a majority owner of PLDT and acquired wealth illegally through dummies in PTIC and Prime Holdings, Inc. (PHI) (Yuchengco v. Sandiganbayan, 2006; Panaligan, 2006; Ruiz, 2007). In other words, it was part and parcel of the “political settlement” (see Parks & Cole, 2010) of that time.

### **1986-1992: Changing Political Landscape, Changing Policy Direction**

The business model that nourished PLDT started to unravel after Marcos was deposed in 1986 and democratic institutions were restored. The excesses of martial law and the economic crisis provided the impetus for the political upheaval leading to a mass uprising in 1986 that placed Corazon Aquino<sup>17</sup> (1986-1992) in power (Intal & Llanto, 1998). In an attempt to rid the government of all traces of the Marcos regime, the Aquino administration went on a policy reversal binge. In 1987, a new Constitution was ratified.<sup>18</sup> That same year, the Department of Transportation and Communications (DOTC)<sup>19</sup> issued Department Circular No. 87-188 to rationalize and guide the orderly and competitive development of telecoms. For the first time in decades, the rules of the game had changed. It was no longer business-as-usual for PLDT (Coronel, 1998).

PLDT had to change tactics to stay on top. Decisionmaking was no longer centralized and a larger coalition of stakeholders—the regulator, bureaucrats, Congress, and the courts—had to be dealt with. The newly free press, where some crucial battles were fought, also introduced a big change. The market was now open to new players, but government officials, depending on their loyalties, had the power to either block or make entry difficult at two stages: first, by the awarding of a franchise<sup>20</sup> by acts of Congress, and second, by getting a permit or license to operate—a Certificate of Public Convenience and Necessity (CPCN) or Provisional Authority (PA)<sup>21</sup>—from the NTC. If all else fails, the courts could issue decisions that either barred or derailed operations of new players. But from the same government also came individuals who

<sup>17</sup> A mass uprising on the Epifanio Delos Santos Avenue (EDSA) to unseat President Marcos that began on February 21, 1986. Four days later, Marcos fled the country and Corazon Aquino, wife of recently assassinated oppositionist, Senator Benigno Aquino, Jr., was sworn in as president.

<sup>18</sup> The 1987 Constitution added Congress’s mandate to regulate and prohibit monopolies in commercial mass media (Section 11 [1], Article XVI), which was under strict State control during the Marcos regime.

<sup>19</sup> The DOTC is the primary policy, planning, programming, coordinating, implementing, regulating, and administrative agency of government focused on transportation and communications services.

<sup>20</sup> A franchise is awarded by Congress (House of Representatives and Senate) by passing a Republic Act. Franchised telcos are called public telecommunications entities (PTEs).

<sup>21</sup> The PA requires carriers to demonstrate their technical and financial capability to carry out a service. It describes the service, rate structure, and regulations governing that service (Serafica, 2001).

pushed for the initial reforms that would forever change the structure of Philippine telecoms.

### IGF Licenses: Starting a Crack in the Dam (1989)

One such government reformer was then-NTC Commissioner Jose Luis “Linggoy” Alcuaz who, in October 1989, granted an IGF CPCN to Philippine Global Communications, Inc. (Philcom)<sup>22</sup> and Eastern Telecommunications Philippines, Inc. (ETPI),<sup>23</sup> something unheard of in a PLDT-dominated industry. But the politically savvy commissioner knew how to maneuver through the highly politicized regulatory system. It helped that Alcuaz was reputed to be aligned with Peping Cojuangco and Ramon Mitra, known to be PLDT allies. This, he felt, made PLDT let its guard down on his actions.<sup>24</sup> Alcuaz first granted a license to Philcom, which was closely allied with PLDT.<sup>25</sup> There was no opposition to Philcom’s license, and it was able to interconnect with PLDT with ease (G.R. No. 94374 (1995)). The second grantee, ETPI, was seen by PLDT as a viable competitor. Thus, to obviate expected opposition, ETPI’s IGF license was tied to the installation of fixed lines.<sup>26</sup> PLDT challenged the NTC’s action in court, and in August 1992, the SC ruled in the telco’s favor.<sup>27</sup> However, the decision became controversial after reports came out suggesting that the high court’s ruling mirrored the PLDT counsel’s language and tone.<sup>28</sup> Whether true or not, this led to the SC justice’s resignation days after and prompted a review of the ruling months later (Coronel, 1998). In February 1995, the SC reversed its original ruling, granted ETPI’s Motion for Reconsideration, and dismissed PLDT’s petition.<sup>29</sup> Although it was more the carelessness of the presiding judge that set off the reversal, this case highlighted the power of the judiciary to set the policy direction by either supporting or overturning the regulator. Looking back, Alcuaz also recounted how certain NTC officials

<sup>22</sup> Philcom is a PTE founded by the Radio Corporation of America (RCA) in 1924, first awarded an international telecom license in 1965 and a 25-year nationwide telecoms franchise in 1994.

<sup>23</sup> ETPI is a PTE with latest legislative franchise under RA 9172. Retrieved from [http://www.congress.gov.ph/download/ra\\_12/RA09172.pdf](http://www.congress.gov.ph/download/ra_12/RA09172.pdf).

<sup>24</sup> Personal communication with J. Alcuaz, March 23, 2010.

<sup>25</sup> Philcom was reportedly 40 percent owned by Microwave Communications Inc. (MCI), a US company, and 60 percent by Filipinos, including the chairman of, and a lawyer for, PLDT (Henares, 2003; also see Salazar, 2007).

<sup>26</sup> The NTC granted the IGF license to Eastern Telecom on November 14, 1989.

<sup>27</sup> On August 27, 1992, the SC sided with PLDT’s arguments that an IGF is part of a telephone system. Therefore, ETPI first had to obtain the correct Congressional franchise before it could operate such a facility. See G.R. No. 94374 (February 21, 1995). The SC decision was penned by Justice Hugo Gutierrez.

<sup>28</sup> Reports were published by major newspapers on January 28, 1993. See Administrative Matter (AM) 93-2-037 SC. (1995, April 25). Retrieved from <http://www.chanrobles.com/cralaw19958.htm>.

<sup>29</sup> See G.R. No. 94374 (February 21, 1995).

seemed to have acted on PLDT's behalf by attempting to block the entry of competitors.

Despite this rare regulatory win over a dominant industry player, President Aquino subsequently let go of Alcuaz. Some suspected that this was because of the IGF licensing, given that the Cojuangcos of PLDT were relatives of the President.<sup>30</sup> However, Alcuaz himself denies this, saying that if Aquino had been protecting PLDT, she would not have appointed Josie Lichauco, a known PLDT critic, to replace him at the NTC. Alcuaz believes that he was fired due to his public pronouncements about a coup, several of which plagued the Aquino administration.<sup>31</sup>

### **Breaking the Mobile Sector Open (1992)**

Prior to 1988, PLDT dominated the CMTS or mobile sector. Its first cellular service, known as “car phones,” used expensive European analog technology that cost US\$6,000 per unit.<sup>32</sup> Naturally, these phones were unattractive to consumers and investors, a problem compounded by the lack of external financing.<sup>33</sup> A mobile phone was then seen as an elitist technology.

But that scenario would change rapidly in the 1990s, as the CMTS market opened to new players. In early 1992, Congress granted franchises to new operators, one after another. Although already moot, DOTC issued Department Circular No. 92-269 or the Cellular Mobile Telephone System Policy in November 1992, to allow open entry to the mobile market, subject to the availability of frequency spectrum. At the tail end of Aquino's term, a number of players were granted franchises.

However, most of the new entrants still depended on PLDT's nationwide backbone to interconnect their cell sites, an advantage the incumbent used to its full extent. Competition was also stifled by the proprietary technologies used by various mobile carriers who initially offered costly analog services. Similar to the LEC market before, mobile subscriptions were exclusive to specific handsets provided by a carrier.

### **From Analog to Digital: Technology Upends the Mobile Sector**

The adoption of new, appropriate technologies proved to be a crucial factor in engendering competition in telecoms. Islacom was the first to

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<sup>30</sup> PLDT pioneer, Ramon Cojuangco, was a cousin of President Cory Aquino. His son, Antonio “Tony Boy” Cojuangco, succeeded him as PLDT chair after his death in 1984.

<sup>31</sup> Personal communication with J. Alcuaz, March 23 2010.

<sup>32</sup> A similar U.S. phone cost around \$1,500.

<sup>33</sup> Personal communication with N. Virata, March 2, 2010.

introduce GSM (Global System for Mobile Communications) digital technology capable of short messaging service (SMS) or “texting”. Globe, which bought Islacom, offered free intra-network texting, which attracted many new subscribers. Other GSM-enabled mobile carriers soon followed suit. Texting quickly gained mass popularity, replacing expensive voice calls and radio paging, then dominated by Easycall and Pocketbell.

### **Overview of Philippine Cellular Mobile Carriers and Their Franchises**

**Pilipino Telephone Corporation (Piltel)**, which incorporated in 1968 and initially operated LEC services, began offering analog mobile services in March 1991 under the Mobiline brand. On March 27, 1992, it was given a Congressional franchise, amending its original franchise to allow it to provide various types of telecommunications services. Piltel became a subsidiary of PLDT in 1980.

**Smart Communications, Inc. (Smart)** was established by technology entrepreneurs in 1991 and awarded a franchise for “integrated telecommunications, computer, and electronic services” on March 27, 1992.

**Globe Telecom, Inc. (Globe)** began operating wireless long-distance message services in the Philippines until it was sold to the Ayala Corporation in 1974. On March 19, 1992, a merger between Globe and the Clavecilla Radio Corporation, a domestic telco, was approved, which allowed the transfer of the latter’s franchise to the former.

**Isla Communications Inc. (Islacom)** was incorporated in 1990 and awarded a franchise for “mobile telecommunications” on April 10, 1992. In 2001, it became a 100-percent owned subsidiary of Globe.

**Express Telecommunications Company, Inc. (ETCI) or Extelcom** was granted its first franchise in 1958 as Felix Alberto and Company, Inc. to establish radio stations for domestic and transoceanic communications. Its franchise was amended in 2009 to include wire and wireless telecoms systems.

See Appendix 5-A for more company detail and the recent history of mobile carriers.

Companies that failed to adapt to technological advancements had difficulty catching up. Smart first used the less capital-intensive analog-based technology, then gradually shifted to GSM within three to four years.<sup>34</sup> This delayed shift, however, also created problems for Smart in terms of interconnecting with Globe, which led the texting boom. By the time Smart launched its GSM service, subscribers were already hooked on Globe's SMS. Smart experienced some difficulty in enticing Globe subscribers to switch (Serafica, 2002), and it would take some time to interconnect with Globe.

PLDT/Piltel, on the other hand, clung to its fixed-line business and assigned mobile phones to the luxury niche market, which estimated no more than 10,000 customers. Using analog AMPS (Advanced Mobile Phone System),<sup>35</sup> Piltel suffered terribly when cellular fraud and cloning became rampant. It later shifted to the U.S.-standard CDMA (Code Digital Multiple Access),<sup>36</sup> which, although a digital technology, could not offer SMS.

Despite the initial snag in interconnection, new players were in and ready to invest in digital mobile technology for mass communication. This juncture presented a window of opportunity to usher in real competition as it gave new players, like Smart and Globe, a good break to expand their business. The granting of multiple mobile licenses also shifted the lucrative segments—from IGF and IXC to CMTS. The paradigm shift resulted in the immediate response of the market. And when disruptive technology was introduced, competition became irreversible. However, as the next sections will show, support from all fronts—the executive, legislative, and judiciary—was necessary to set the reform in stone, tame the industry players, and make competition viable.

### **1992-1995: Liberalization—Unleashing the Power of Competition**

The next president, Fidel V. Ramos (1992-1998), retained the pro-competition stance started by Aquino, who endorsed him in the presidential election. Despite the hostile political environment,<sup>37</sup> Ramos, a former military man, was able to implement his vision to break up monopolies (Ramos, 2001) and create a level playing field, using various tactics in and outside of government. In Congress, Ramos gained the support of the speaker of the House

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<sup>34</sup> Personal communication with Orlando Vea, April 8, 2010.

<sup>35</sup> See definition of AMPS at <http://www.leapforum.org/published/internetnetworkMobility/split/node37.html>.

<sup>36</sup> See definition of CDMA at <http://www.webopedia.com/TERM/C/CDMA.html>.

<sup>37</sup> Only two of the 24 senators (one of them his sister) and 38 of the 205 congressmen belonged to Ramos' party. See Bernardo & Tang (2008).

of Representatives (HOR), which allowed him to obtain the Lower House's backing of his proposals (Bernardo & Tang, 2008). Within Malacañang, it was Ramos's national security adviser, General Jose T. Almonte, who led a faction that pushed for deregulation in key sectors. The aim was to dislodge what Almonte calls "East Asia's richest, most durable and least socially responsible" entrenched elite (Coronel, 1998; Tesoro & Lopez, 2000). Armed with the belief that "only by cutting down its power to monopolize markets can [the oligarchy be forced] to compete and innovate" (Almonte, 2005), Almonte designed Ramos's reform program, which included the dismantling of the telecoms monopoly.

In civil society, Ramos's government encouraged the formation of the Movement for Reliable and Efficient Phone Service (MORE Phones), a broad coalition formed in 1993 that gave a face to the disorganized public uproar against PLDT's poor performance<sup>38</sup> and drummed up the consumer clamor for better telecoms services. The coalition organized public rallies, issued press statements, and attended public hearings in both Houses of Congress. But most of all, it had the backing of the "People's 2000" network, an Almonte brainchild organized through Serafin Talisayon, a professor at the University of the Philippines (Salazar, 2007).

Simultaneously, the government began exerting pressure on PLDT by naming six representatives to the company's 11-member board, made possible through the sequestration of Marcos-owned assets by the Philippine Commission on Good Governance (PCGG), then chaired by Magtanggol Gunigundo, an Almonte recommendee. Cojuangco, himself adept at political skirmishes, reportedly created alliances within Malacañang and pitted them against the Almonte group. In the end, a government takeover of PLDT was abandoned and Cojuangco retained his company. In return, Cojuangco supported Ramos's government and reportedly contributed to his Lakas Party (Coronel, 1998).

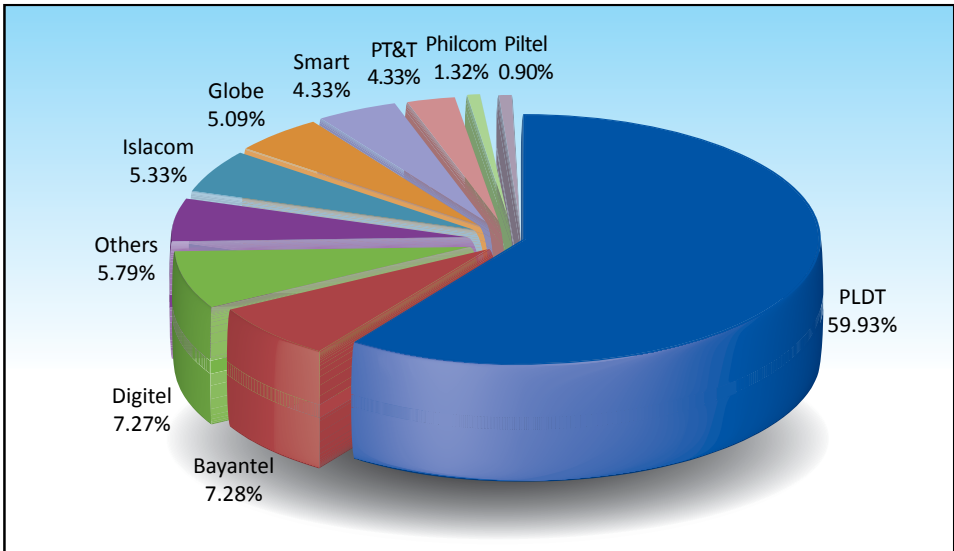
The impetus for the executive-led policy reform came in 1992, when Singapore's Senior Minister Lee Kuan Yew, during a speech in Manila, referred to a joke that, in the Philippines, "98 percent of the population are waiting for a telephone, and the other 2 percent for a dial tone."<sup>39</sup> Ramos, only a few

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<sup>38</sup> The MORE Phones coalition included: the Church-Based Consumer Movement, the Institute for Popular Democracy, the Popular Education for People Empowerment, the Education for Life Foundation, the Women's Action Network for Development, the Movement for Popular Democracy, the Institute on Church and Social Issues, the Cooperative Foundation Philippines, Inc., Pandayan Para sa Sosyalistang Pilipinas, Women's Action, the Coalition of Youth Organizations, the Asian Institute of Management, the Freedom from Debt Coalition, the Lean Alejandro Foundation, and the National Economic Protectionism Association (Philippine Graphics, July 8 1994, p. 34, cited in Salazar, 2007).

<sup>39</sup> See Lee Kuan Yew (1992).

months into the job, responded by issuing two executive orders (EOs): (1) EO 59, mandating interconnection among local telcos and lowering telephone subscription rates for consumers; and (2) EO 109, mandating the improvement of LEC service and establishing the Service Area Scheme (SAS).<sup>40</sup> Although the SAS did increase installed fixed-line teledensity—from 784,000 in 1993 to 6.6 million in 1998—(see Figure 5.1), the universal access program hurt the new telcos. It adopted a backward, technology-specific approach, forcing even CMTS operators to invest in fixed-line technology. Installed lines also did not translate into actual subscription, since low-income rural areas could not afford the service. In the end, the SAS was considered inefficient and unsound, and abandoned in 2002.<sup>41</sup>



**Figure 5.1 Philippine Fixed-line Market, 1998.**

Source: Serafica, 2001; 2002.

## RA 7925: Setting the Reform in Stone

Although the executive orders initially opened the door to liberalization, the reforms needed to be solidified through law. In Congress, allies were

<sup>40</sup> The SAS divided the country into 11 geographical service zones and required new IGF and CMTS operators to install a minimum of 300,000 and 400,000 local telephones in their respective areas within five years (later reduced to three years). The idea was for the profitable IGF and CMTS operations to subsidize the sluggish fixed-line segment, prioritizing underserved and unserved areas based on a 10:1 urban-rural ratio.

<sup>41</sup> By 2000, it was apparent that a number of operators had failed to comply with their SAS obligations: some completed roll-out, some only partially, while others were unable to start at all. The SAS was abandoned in 2002 (NTC, 2002 cited in Mirandilla, 2007).

needed to navigate the jungle of constantly realigning political and economic self-interests over a protracted period of time. The legislation process started in the Senate during Senator John “Sonny” Osmeña’s reign as chairman of the Committee on Public Services (1987–1995). In 1989, Osmeña commissioned the Economic Development Foundation (EDF) to prepare his legislative agenda for all public utilities. Cesar Sarino of EDF assembled a panel of experts into a policy center to study four sectors: transportation, telecommunications, energy, and water. After nearly a year of work, four draft bills were completed and placed in the legislative pipeline.

The legislative mill proceeded at a snail’s pace for the next six years. By 1995, only one member of the panel of experts, Rene S. Santiago,<sup>42</sup> remained to shepherd the passage of the four bills through Congress. The telecoms bill filed in the Upper House became known as Senate Bill (SB) No. 422 (or SB 422), which the telecoms industry welcomed as a better alternative to the obsolete and confining framework of Commonwealth Act No. 146 or the Public Service Act of 1936.<sup>43</sup>

What follows is a recounting of Santiago’s experience in backstopping the telecoms bill in Congress until it became law (Personal communication, January to June 2010).

### **Policy Entrepreneurship: Passage of RA 7925**

The Philippine Electronics and Telecommunications Federation (PETEF), composed of service providers, equipment suppliers, and professional groups, and the Philippine Computer Society (PCS), which perceived the eventual convergence of information and communications technology (ICT), participated actively in the finalization of SB 422. The Philippine Association of Private Telephone Companies (PAPTELCO), the association of local exchange carriers, was a silent participant. A lawyers’ group specializing in telecoms regulatory laws also got involved. Although there were public hearings, most of the discussions occurred at industry dialogues and policy debates arranged by either the PETEF or the PCS. The DOTC also wanted to influence the final mold of SB 422, based on its 20-year National Telecommunications Development Plan prepared with support from the Canadian International Development Agency (CIDA).

The bill underwent several drafts and was re-filed as SB 1353. Although ready for floor deliberations in 1992, Osmeña, a seasoned legislator, delayed

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<sup>42</sup> Rene Santiago is a civil engineer by profession who specializes in transportation and utilities.

<sup>43</sup> Prior to 1995, telecommunications was lumped with other public utilities, like transportation, ice plant, and other industries, under the Public Service Act of 1936.



the bill's second and third readings up until the session's closing month in 1995. This was done to thwart lengthy floor debates on a very technical subject that would only delay the process. The final version that came out in the committee report was also made shorter. A parallel committee at the HoR followed the Senate's move, thus making the eventual task of the bicameral committee (to reconcile the Senate and House versions) easier.

PLDT and a few other big carriers lobbied behind the scene for or against certain provisions, with help from their allies in Congress. According to one account, Islacom became instrumental, although unwittingly so, in shaping the law when it got caught in the sibling rivalry between Senator Sonny Osmeña and former Cebu Governor Lito Osmeña. Islacom's owners, the Delgados, were friends with the Osmeñas. However, Islacom's owners reportedly developed a close relationship with Lito, defeated vice-presidential candidate of Ramos in 1992, who was raising funds for the Lakas party at that time. Sonny, a known PLDT ally, also suspected that his brother controlled the heads of the NTC and the DOTC. In an interview, Sonny admitted that, to give Lito and his friends a difficult time, he inserted two provisions in the telecoms bill for (a) shortening the local exchange service roll-out period from five to three years, thereby giving new market players (such as Islacom) less time to comply with the requirement; and (b) making interconnection agreements be negotiated among concerned parties rather than facilitated by the NTC, thereby depriving the Commission of the mandate to impose interconnection and bargaining with players involving regulatory decisions (Coronel, 1998).

In March 1995, Republic Act No. 7925 (or RA 7925) was finally enacted into law as the Public Telecommunications Policy Act of the Philippines. Although peppered with provisions influenced and inserted by certain private interests, the law can be generally considered a game-changer. See Appendix 5-B for more discussion of key provisions.

The executive and congressional enactments changed the rules of the game that PLDT used to dominate and win. In the span of five years, these policy frameworks, although not sufficient by themselves, spurred the initial growth of the telecoms industry. See Table 5.1.

**Table 5.1. Number of Authorized Carriers (1992-1998)**

| Telecom Service                          | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 |
|--|------|------|------|------|------|------|------|
| Local Exchange Carrier (LEC)             | 45   | 49   | 60   | 67   | 74   | 76   | 76   |
| Cellular Mobile Telephone Service (CMTS) | 2    | 5    | 5    | 5    | 5    | 5    | 5    |
| Paging Service                           | 6    | 6    | 10   | 11   | 14   | 15   | 15   |
| Public Trunk Repeater Service            | 7    | 8    | 8    | 10   | 10   | 10   | 10   |
| International Gateway Facility           | 3    | 5    | 9    | 9    | 9    | 11   | 11   |
| Satellite Service                        | 3    | 3    | 3    | 3    | 3    | 3    | 3    |
| International Record Carrier             | 4    | 4    | 5    | 5    | 5    | 5    | 5    |
| Domestic Record Carrier                  | 6    | 6    | 6    | 6    | 6    | 6    | 6    |
| Very Small Aperture Terminal             | 4    | 4    | 3    | 3    | 3    | 4    | 4    |
| Public Coastal Station                   | 13   | 13   | 13   | 12   | 12   | 12   | 12   |
| Radiotelephone                           | 4    | 6    | 6    | 5    | 5    | 5    | 5    |
| Value-added Service                      | -    | -    | -    | 1    | 27   | 47   | 70   |

*Source:* NTC Annual Report (1997; 1998), cited in Serafica (2001; 2002).

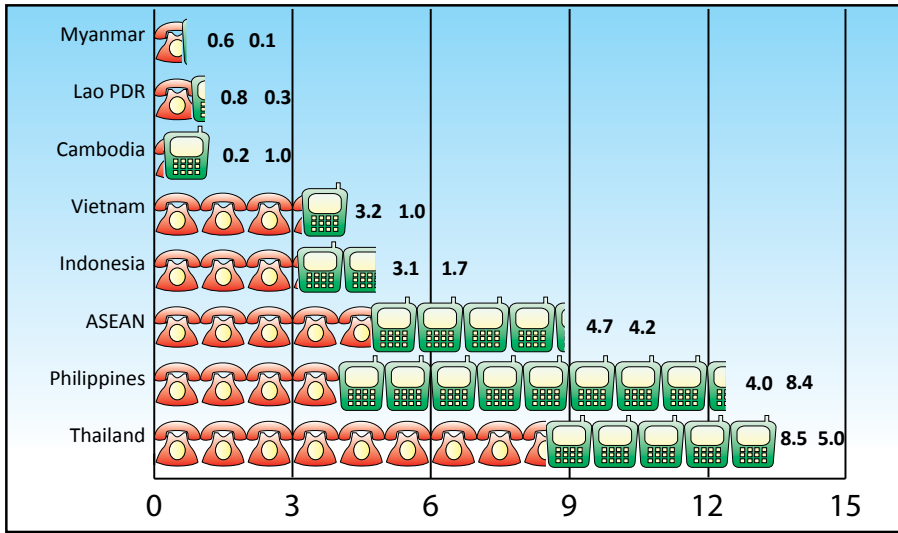
### **Mobile and Pre-paid: Shaking the Status Quo, Changing the Business Model**

Prior to telecoms liberalization, there were two default mindsets: (a) only PLDT can have a national backbone and an IGF,<sup>44</sup> therefore new players had to ride on PLDT's infrastructure; and (b) business is in Metro Manila and urban areas. This old thinking benefited the incumbent and stifled competition and universal access. Technology entrepreneur Orlando Vea said they saw things differently when they first put up Smart Communications. They built their own backbone and invested in both the cities and provinces. This defiant attitude paid off, and Smart's mobile phone business took off.<sup>45</sup>

Unlike PLDT then, new players Smart and Globe were aggressive in developing CMTS into a mass market by lowering the average revenue per unit (ARPU) to increase their subscriber base. Increased subscription lowered unit cost, which enabled Smart and Globe to offer even lower cost packages that, in turn, enticed more customers. Apart from the low unit cost, it was pre-paid services introduced in 1999 that had sales skyrocketing. By 2002, mobile had already overtaken fixed-line teledensity worldwide (ITU, 2001; 2003). Smart began offering pre-paid mobile services through top-up cards and then electronic loading service via SMS in May 2003. These "telecoms in sachets" quickly gained mass popularity and spawned new business opportunities for the common Filipino (Rimando, 2004).

<sup>44</sup> Personal communication with J. Alcuaz, March 23, 2010.

<sup>45</sup> Personal communication with Orlando Vea, April 8, 2010.



**Figure 5.2. Telephone Subscribers Per 100 Inhabitants (2000)**

Notes:



= 1 land line subscriber per 100 inhabitants



= 1 mobile phone subscriber per 100 inhabitants

Source: ITU (2001).

Interestingly, PLDT remained relatively profitable amid liberalization and the telecom bubble (see *The Economist*, 2003) in Southeast Asia that began in the late 1990s (Kelly, 2001). According to one estimate, PLDT's net income after tax more than tripled between 1987 and 1992, despite a dismal fixed-line revenue annual growth (Coronel, 1998). More notably, PLDT's performance, efficiency, and capital investment improved with competition (Cabanda & Ariff, 2002).

It became apparent, however, that PLDT had to start addressing the challenge posed by the new players. With more options, consumer demand for cheaper and better service was at its peak. PLDT was now sharing the telecoms pie with other companies, armed to compete, who wanted more than a nibble. The succeeding regulatory and court decisions would further shape and solidify the new status quo. But the subsequent changes in PLDT's ownership and management would also cause an upheaval in the company and transform its overall business strategy.

In 1999, the First Pacific Company, Ltd (FPC),<sup>46</sup> a company founded by Manuel V. Pangilinan that also served as Smart's first investor, started buying

<sup>46</sup> First Pacific Company, Ltd is a Hong Kong-based investment and management company.

into PLDT through its Philippine affiliate, Metro Pacific Corporation (MPC), by acquiring US\$749 million (27.4 percent voting interest).<sup>47</sup> In March 2000, MPC completed the infusion of its 38.3 percent ownership in Smart into PLDT in exchange for 8.0 percent or 13.4 million new shares of PLDT. The PLDT-MPC share-swap agreement eventually made Smart a 100-percent-owned subsidiary of PLDT (*AsiaPulse News*, 2000). Pangilinan took over as PLDT's president and CEO from November 1998 to February 2004, after which he was appointed chairman of the board. This buyout dislodged Cojuangco from the position he had inherited from his father. In 2007, Cojuangco quit as director, barely a month after the *Sandiganbayan*, a special anti-graft court, awarded his PLDT shares, considered as ill-gotten, to the Philippine government (De Leon, 2007). After several decades, PLDT was now owned and controlled by new blood not related to the old elites.

### **Under Pressure: The Smart-Globe, PLDT-Globe Interconnection Dispute**

The next arduous battle was interconnection among the fast-growing CMTS carriers, which served as a litmus test for the NTC's regulatory and quasi-judicial powers in a competitive environment. The courts of law began to show muscle as the final arbiter, as they could overrule the NTC. But in the end, the intervention of a powerful president served as the tipping point that finally led to the signing of an interconnection agreement between Smart and Globe, the new dominant mobile companies (Mirandilla, 2007).

The dispute began when new players started getting a good piece of the telecoms pie. Being the first to use GSM and to offer free intra-network SMS, Globe's business was propelled by the texting boom. Smart, which adopted GSM much later, attempted to negotiate for an SMS interconnection with Globe. Allegedly, Globe refused to grant Smart's request, making it impossible for Smart and Globe subscribers to communicate with each other.

On June 4, 1999, Smart filed a complaint with the NTC, requesting an order for the immediate interconnection of Smart's and Globe's GSM networks. On July 19, 1999, the NTC issued an order, noting that both Smart and Globe were equally blameworthy for their lack of cooperation and for having "unduly maneuvered the situation into the present impasse" (G.R. No. 143964, 2004). Since SMS falls within the definition of VAS or "enhanced service" under Memorandum Circular No. 8-9-95 or MC 8-9-95, the Implementing Rules and

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<sup>47</sup> Manuel V. Pangilinan, better known as Manny Pangilinan, served as FPC's managing director until 1999 and as president and CEO of PLDT from November 1998 to February 2004. See <http://www.firstpacific.com/admin/upload/media/press/ep981124.pdf>.

Regulations [IRRs] of RA 7925),<sup>48</sup> the NTC held that SMS interconnection was mandatory pursuant to EO 59.<sup>49</sup> The NTC also declared that both carriers violated MC 8-9-95, requiring PTEs to secure NTC approval before offering VAS (Section 420 [f]). Globe filed a petition with the Court of Appeals (CA), which, on August 31, 1999, issued a temporary restraining order (TRO) preventing the NTC from executing its order (Globe Telecom, Inc., 1999).

The fight became uglier by the day. PLDT accused Globe of misrepresenting calls to avoid paying correct access charges. In response, PLDT allegedly restricted Globe's interconnection with its landlines,<sup>50</sup> which resulted in frequent busy signals when Globe mobile phones called PLDT landlines. Both PLDT and Globe published full-page advertisements in local newspapers to explain their respective positions. Reports quoted PLDT officials as saying, "unstable signaling systems due to illegal traffic was (*sic*) the reason for the interconnection problems" (*Reuters*, 1999). Globe complained and asked the NTC to intervene and resolve the standoff (Reyes, 1999).

Amid public clamor, and personally irked by the interconnection problem, President Joseph Ejercito Estrada (1998-2001) played "mediator" between the two telecoms giants. On November 16, 1999, Estrada called Pangilinan of PLDT<sup>51</sup> and Jaime Augusto Zobel de Ayala of Globe to a meeting in Malacañang (Mangahas, 2002). Both Pangilinan and Ayala were reportedly caught flat-footed in the press conference-style meeting, where Estrada asked the two to resolve the interconnection impasse "as soon as possible" in front of the media (*Inquirer.net*, 1999). In the end, Globe reportedly agreed to interconnect with the SMS of PLDT's sister company, Smart. In exchange, PLDT promised "to deliver (stop blocking) more interconnection trunks to facilitate Globe traffic entry into the PLDT network" (*Inquirer.net*, 1999). Days later, the CA promulgated a decision<sup>52</sup> affirming the NTC Order and taking note of the interesting twist of events. "On the same day, Globe and Smart voluntarily agreed to interconnect their respective SMS systems" (G.R. No. 143964, 2004).

Here, the immense power of the Executive was manifested. It took only one meeting with the president to avoid the often costly, tedious, and protracted court battle.

<sup>48</sup> See NTC (1995).

<sup>49</sup> For details, see G.R. No. 143964 (July 26, 2004).

<sup>50</sup> PLDT owned 40 percent of the 6.6 million installed landlines, as of December 2000 (Serafica, 2001, 174).

<sup>51</sup> Tony Boy Cojuangco quit PLDT after losing his shares, held through PTIC, to the government (De Leon, 2007).

<sup>52</sup> Justice A. Tuquero penned the decision. See G.R. No. 143964 (July 26, 2004).

On December 21, 1999, however, Globe filed a Motion for Partial Reconsideration with the CA of the NTC's finding about Globe's lack of authority to provide SMS and the NTC's imposition of a fine. When the CA denied this motion, Globe elevated the problem to the SC. On June 26, 2004, the SC reversed the CA's decision and set aside the NTC Order, which it called "discriminatory and arbitrary" and "issued with grave abuse of discretion" (G.R. No. 143964, 2004).

This case shows that the courts can influence competition both ways—stifle it when decisions seem to be in favor of dominant parties and promote it when appropriately used by market players to police each other or an erring regulator.

The following decade saw tremendous growth in the mobile sector, led by SMS and pre-paid service. As of the end of 2010, there were 86.15 million mobile subscriptions, most of which (97-percent average) were prepaid (PLDT, 2010; Globe, 2010; Digitel, 2010). The changes brought by mobile phones were reflected in Filipinos' personal consumption expenditure. In 2003, expenditure for transportation and communication grew more than twice (11.7 percent) compared to that for food (4.2 percent), and continues to account for higher expenditure compared to clothing, utilities, and household operations.<sup>53</sup> SMS, now a paid service, is so widely used that the Philippines has earned the title of "world's texting capital" (Mendes, et al, 2007). Despite having relative low monthly ARPUs<sup>54</sup> (GSM Association, 2006), Philippine mobile operators have managed to thrive and be profitable (see Figure 5.3).

Today, mobile carriers continue to compete for the cheapest SMS and load credits, making the mobile phone the Philippines' default universal access tool.

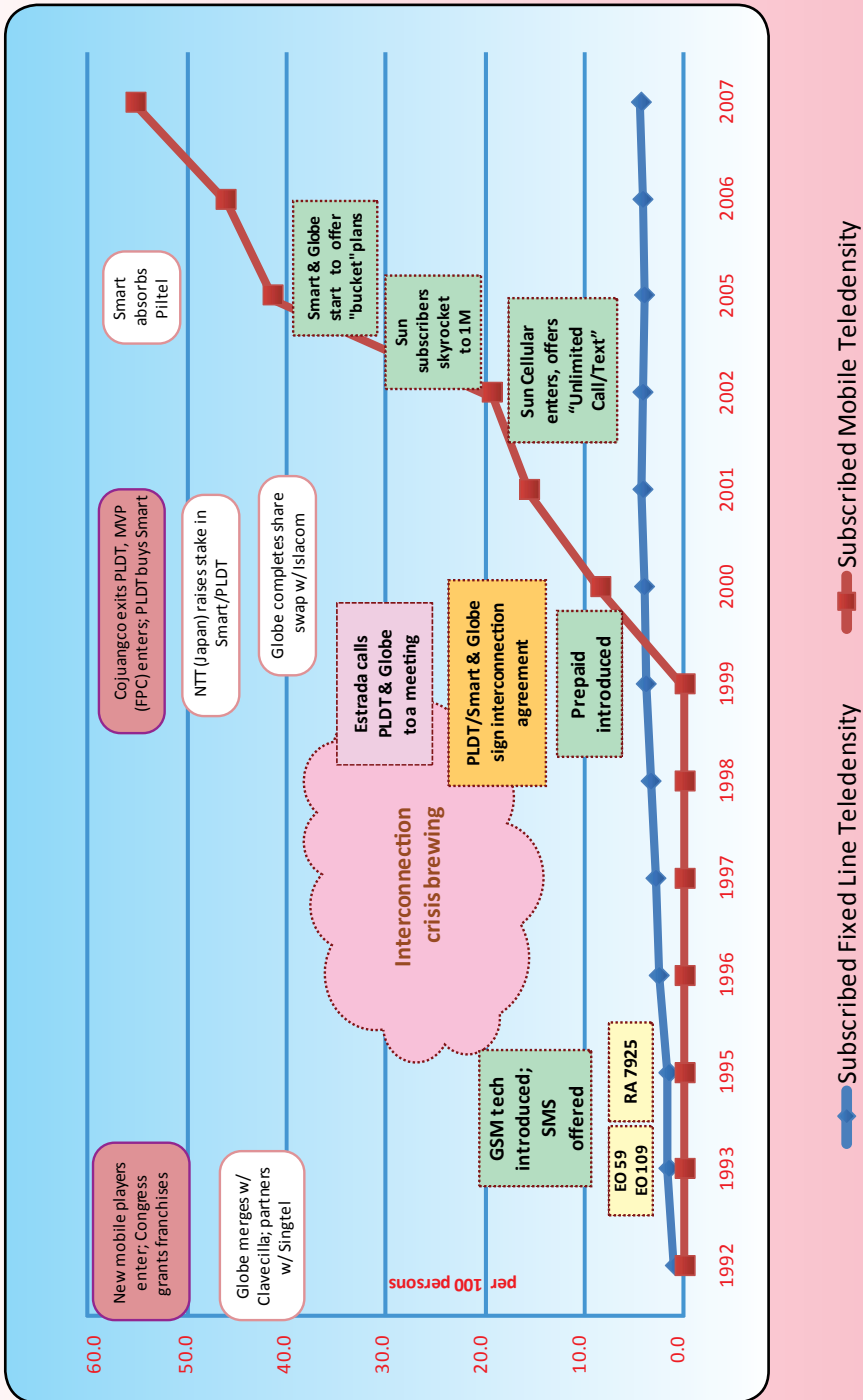
### Analysis: What Really Breached the Dam?

Not one, but a combination of several elements and developments produced the lethal blow that broke the telecoms monopoly, unleashed the power of competition, and changed the industry's business model irreversibly.

**Reform began when the Aquino administration opened the telecoms market to new players.** Although no dramatic paradigm shift, it eventually paved the way for damaging changes. Under Aquino, the old elite still managed to maintain a large part of its control through familial and political ties with

<sup>53</sup> National Statistical Coordination Board [NSCB] (2003; 2010).

<sup>54</sup> Prepaid monthly ARPU in the Philippines was at US\$5.50; it averaged US\$13 in Malaysia and US\$8.50 in Thailand.



**Figure 5.3 Timeline of Policy Issues, Market Developments, and Growth in Telecom, 1992-2007.**  
 Sources: NTC; ITU; various news sources.

government (Esfahani, 1994). Market entry and the awarding of franchises remained highly politicized and depended on negotiations with the regulator and Congress. The franchise of Smart, for example, sailed quietly through Congress because its listed owners did not belong to any political or economic elite, which might have reflected the status quo players' thinking: small players can't hurt. In contrast, Globe, identified with the Ayalas, one of the richest Filipino families, had some rough sailing, and its application languished for several years.<sup>55</sup> Nevertheless, the entry of new players introduced changes in the telecoms market structure and an opportunity to challenge the incumbent.

**Breaking the old thinking and challenging the status quo can bring reform.** The pro-reform regulator and new players went against the default mindset that telecoms relied on PLDT's infrastructure.<sup>56</sup> The NTC granted IGF licenses to two operators despite PLDT's opposition. Smart built its own network instead of relying on PLDT. Smart and Globe aggressively developed the mobile phone for the mass market, unlike PLDT, which initially saw it as a luxury market. Texting and pre-paid mobile services replaced the expensive voice calls and monthly subscription costs, effectively ending the obsession with fixed lines.

**Executive action under Ramos, backed by a vision, a supportive legislative and judiciary, and politically savvy policy entrepreneurs, made reform more entrenched.** Ramos, together with presidential troubleshooter Almonte, championed reform in the executive branch first through EOs and nurtured them through Congress and the Judiciary. Gaining support from civil society was also crucial to help demonstrate public demand for reform.

**New, appropriate technologies and business strategy were crucial factors in engendering competition.** Some companies failed to adapt to technological advancements in a timely manner. Others lacked foresight in making business strategy decisions. They retained outmoded and expensive technology believing that one's dominant position will not be toppled; that subscribers will not jump to other networks; and that no new market player, able to compete and bring in new technology, can be *that* disruptive. It was under new management that PLDT jumped to invest in GSM mobile phones.

Below is a timeline of events (Table 5.2) that highlight the political and economic setting in which developments in the telecoms sector took place (also see Figure 5.3).

<sup>55</sup> Personal communication with Rene Santiago, January to June 2010.

<sup>56</sup> Personal communication with J. Alcuaz, March 23, 2010.



**Table 5.2. Timeline of Conjunctures in Telecoms Reform (1987-2000)**

| Year | Events  |
|------|---|
| 1987 | Aquino starts reversal of Marcos policies;<br>Congress enacts new Philippine Constitution, which provides overall framework for government to regulate or prohibit monopolies in the public interest  |
| 1989 | NTC approves application of Philcom and ETPI for license to operate an IGF; Aquino fires NTC Commissioner Alcuaz.   |
| 1992 | Congress grants franchise to Islacom, Globe, and Smart;<br>Ramos is endorsed by Aquino, wins presidential election;<br>Lee Kuan Yew visits Manila, makes remarks about poor telecoms service  |
| 1993 | Ramos issues EOs 59 and 109;<br>Almonte leads plot to break up telecoms monopoly  |
| 1994 | Islacom introduces SMS-capable GSM technology   |
| 1995 | Congress passes RA 7925 or the Public Telecommunications Act  |
| 1999 | Mobile and landline interconnection disputes reach crisis level;<br>Estrada calls PLDT/Smart and Globe to a meeting;<br>Smart and Globe signs SMS interconnection agreement;<br>PLDT and Globe resolve call blockage dispute;<br>Globe introduces pre-paid mobile service |
| 2000 | Mobile phone overtakes fixed-line teledensity   |
| 2002 | Congress grants a franchise to the Digitel Telecommunications Philippines, Inc. (Digitel) to construct, install, establish, operate, and maintain telecommunications systems.   |
| 2003 | Digitel launches Sun Cellular, which offers 24/7 unlimited SMS;<br>Smart and Globe lodge complaint with NTC;<br>NTC dismisses complaint; Smart and Globe offer a similar service  |

*Source:* Compiled by author.

### **New developments: PLDT-Digitel Merger**

On March 29, 2011, JG Summit, which owns 47.4 percent of Digitel, executed a Sale and Purchase Agreement with PLDT for the sale of its investments in shares of stock in Digitel. If unquestioned, the transaction—estimated at ₱74.1 billion that accounts for 51.5 percent of shares from Digitel—is intended to be completed on June 30, 2011 (PLDT, 2011). The merger has raised fears of an impending monopoly by the old incumbent and faces opposition, led by rival Globe. After a quick probe in June 2011, the Senate indicated that the deal does not need Congressional approval and passed the ball to the NTC (Burgonio, 2011). The merger is also expected to be reviewed by the Securities and Exchange Commission (SEC). Why the need for such regulation? Because telecommunications is a public utility that provides an important service to citizens. Therefore, it is the government's mandate to look into, and guard against, any activities that may negatively affect the general welfare. And since the participation of new players has created such a huge positive impact on the telecoms sector, mergers of companies and/or the acquisition of smaller players may stunt, if not reverse, the benefits of market entry. It is, however, crucial that government exercise prudence in examining whether and how to impose regulation on what Congress already declared as a legitimate transaction. Will the merger result in more efficient service, as PLDT and Digitel share their infrastructure and expand their reach? Will the absence of a third player result in easier collusion and reversion to a duopoly? Or will the merger once again give PLDT the utmost leverage to influence the rules of the game, as it did in the past?

### **Conclusions**

The telecoms sector is proof that reforms can happen even in a country where institutions are weak, political patronage is rampant, and vested interests often overshadow the general welfare. Reform was initiated with entry deregulation that, in time, radically changed the game. Several key elements put together helped break the status quo—policy instruments that changed the market structure, a president with a vision or personal stake in the reform, alliances with influential decisionmakers in Congress and the judiciary, and entry of new market players with the muscle to invest and compete with the incumbent.

Although the political and economic crises left by the Marcos regime created public clamor to reject the old ways, it was the realigning of public and private interests, facilitated by the two successive administrations of Aquino and Ramos, which helped shape the fate of telecoms. The demand for better

service, exposed by mass media and worked by maverick and politically savvy officials, like Alcuaz and Lichauco, and advisers, like Almonte, contributed to pushing the reform forward. There were also policy entrepreneurs, like Senator Osmeña and his consultant, Santiago, who carried the ball through the labyrinth of Congress. Finally, mobilizing the disorganized public through informed consumer groups helped build a more solid, legitimate foundation for the reform advocacy.

The mobile sector is a success story of government-initiated entry deregulation and market-driven reform. A strong president, spending political capital wisely on different fronts, introduced a new policy environment that allowed new players and mandated interconnection. Meanwhile, the private sector introduced innovative new technologies and mass-market retail-pricing schemes that attracted huge demand and investment. This combination created the paradigm shift necessary to change the market structure and business model, thus making reform irreversible.

Finally, the entry of new players did not only facilitate competition in the same market; it also created new markets. The new players adopted GSM technology and offered prepaid, which gave an alternative to the costly fixed lines and refocused investments on the mobile sector. This technology and retail model shift spawned a wide range of products and services, which created a whole new set of business opportunities. The new business strategy now targets the mass population, the so-called “bottom of the pyramid,” who were shunned in the old days. With ever-growing and evolving options, the interest of the telcos now rests on their ability to satisfy the demand of their market, which comprises almost 90 million Filipinos, well aware of the limitless possibilities and constantly demanding better and cheaper telecoms services.

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The lack of secure property rights is one of the major factors that hampers Philippine peace and economic development. The Property Rights for Economic Progress project, a joint initiative between The Asia Foundation and USAID, focuses on the implementation of the Residential Free Patent Law. The pilot site is in Cebu City.

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## Chapter 6

# Property Rights Reform in the Philippines: The Residential Free Patent Act

Calixto Chikiamco and Raul V. Fabella

In 1960, Ronald Coase published his seminal paper, *Theory of Social Cost*, which became one of the cornerstones of the Public Choice School in Economics. It contained a paradigm-shifter of an idea that eventually came to be known as the Coase Theorem, which states that if the transaction cost of exchange is low enough, it does not matter for economic efficiency who holds property rights over an asset (Coase, 1960). The economic agents will bargain among themselves to give the asset to the agent who can best use it and the latter will compensate the owner for his or her share in the bargain.

Suppose Pedro, who currently occupies a hectare of rice field, can produce 40 *cavans*<sup>1</sup> of rice per year, net of cost. However, Juan, who is landless, is more industrious and knowledgeable; he can produce 100 *cavans* of rice from the same hectare of land, net of cost. At the moment, Juan produces zero *cavans*. If Juan cultivates the hectare, society is better off by 60 *cavans* and economic efficiency is served. If Juan cultivates the land, he can afford to pay Pedro 45 *cavans* (making Pedro better off:  $45 > 40$  *cavans*) and he can keep 55 *cavans* for himself (he is better off by 55 *cavans*). The Coase Theorem says that if the cost of bargaining and the enforcement of the contract between Pedro and Juan is fewer than 60 *cavans*, this arrangement (Pedro receives 45 for giving up the use of his hectare; Juan cultivates the land and claims 55) will happen. Juan and Pedro have struck a Coasean bargain! This gain, however, will not materialize if the transaction cost of the contract (contract terms have to be bargained over and enforced) is very high. Then the Coasean bargain will not happen. The transaction cost will be high, for example, if Pedro's occupancy is not secure because Pedro's claim to 45 *cavans* cannot be enforced by the courts of law. If Pedro is not sure that Juan will pay him based on the contract (enforcement is not guaranteed), Pedro will refuse to deal with Juan. The first condition for the value-creating Coasean bargain to push through is for property rights to be secure. The state can intervene by securing that property right by granting the occupant a legally binding title to the hectare of land. It turns out that perhaps billions of Coasean bargains do not occur because property rights are insecure. The loss to the economy is staggering.

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<sup>1</sup> The *cavan* is a unit of measurement for rice that is popularly used in the Philippines. One *cavan* is equivalent to approximately 50 kilograms.

The Residential Free Patent (RFP) Law is a crucial step in securing (titling) the property rights of millions of residential plot occupiers in the Philippines so as to introduce these assets to the formal financial sector. In a weak state, such an initiative had low priority and therefore was badly pursued. The extant titling process provided cost too much for the occupants. It took a team of policy entrepreneurs, headed by Calixto Chikiamco, to identify the problem and to engineer the passage of the law over the general indifference of the state. The law will eventually drastically lower the titling cost for occupiers. The journey of the team is documented below.

### **The Status Quo<sup>2</sup>**

A landowner establishes proof of ownership over a piece of land through a valid title. The title gives the owner secure property rights, which facilitates transactions in land and enables the owner to use it as collateral for loans. The courts of law protect and enforce this right. Despite the perceived benefits of a title, however, about 46 percent of the 24.2 million land parcels in the Philippines remain untitled. Of this, an estimated 70 percent, or 7.8 million land parcels, are residential. Occupiers who pay taxes on these plots get tax declaration certificates in return.

### **The Residential Titling Process**

There are two methods available to title and register a piece of land. One is judicial in nature; the other is administrative.

The judicial proceeding is a mode of acquiring residential lands by acquisitive prescription<sup>3</sup> through open, continuous, exclusive, and adverse possession of 30 years.<sup>4</sup> Judicial confirmation of an imperfect title is expensive to landowners. The process requires an average of ₱100,000<sup>5</sup> to complete. The amount includes professional fees for surveying, legal fees like lawyer acceptance and appearance fees, and other court-related costs like publication,

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<sup>2</sup> Taken from the De La Salle Institute of Governance (LSIG) kit on The Residential Free Patent. See Faustino, Tiamson, & Chikiamco (2010).

<sup>3</sup> Acquisitive prescription is a mode of acquiring ownership by a possessor through the requisite lapse of time. In order to ripen into ownership, possession must be in the concept of an owner, public, peaceful, and uninterrupted (Lubos vs. Galupo, 373 SCRA 618).

<sup>4</sup> Acquisitive prescription of real rights may be ordinary or extraordinary. Ordinary acquisitive prescription requires possession in good faith and with just title for 10 years, while in extraordinary acquisitive prescription, ownership, and other real rights over immovable property are acquired through uninterrupted adverse possession thereof for 30 years, without need of title or of good faith (Lim vs. Lim, CA-G.R. CV No. 84925).

<sup>5</sup> Foreign exchange rate was at ₱44 to US\$1, as of December 2010. See <http://www.xe.com/> for the latest rate.

postings, the procurement of witnesses, and payments of filing fees attendant to the proceedings. On top of this, under a best-case scenario, said proceedings will take at least 18 months to complete. In case of an opposition or appeal, the entire process can last for years, and in some instances, even decades.

The administrative procedure for titling residential lands is the patent application. In this procedure, the applicant buys the land through bidding, where he or she should outbid the others in order to be the successful bidder. In such a case, the occupant of the land does not have the preferential right over the property.

Under some conditions, Republic Act No. 730 (or RA 730)—through the miscellaneous sales patent application—allows the sale of public land parcels of not more than 1,000 square meters without the need for bidding. It is, however, still subject to appraisal.

Obtaining titles through the administrative procedure of sales patent is uncertain, since there is a bureaucratic process of determining the sale price, and the lot may be subject to bidding. The uncertainty of not knowing how much the land costs prevents applicants from using this process as a means of securing title to their lands.

Furthermore, some landowners feel that since they have already paid for the land by acquiring it from the previous occupants—although ownership is merely registered as an assignment of rights rather than transfer of title—they do not have to shell out money again to the government to acquire a title by sales patent.

## **The Outcome of the Titling Process**

For the past four years, only an average of 1,200 decrees of registration were issued by the Land Registration Authority (LRA) for registration of confirmed titles, and an average of 3,200 sales patents have been issued by Department of Environment and Natural Resources (DENR), which includes not only residential but other types of lands, e.g., commercial and industrial lands. On the other hand, an average of 100,000 agricultural free patents have been issued each year. Free patent—the administrative legalization of titles without the need to pay government the value of the land—are, however, only applicable to agricultural lands.

The above illustration shows that current methods of titling residential lands are not ideal modes for mass titling. Assuming that each year 1,000 titles are issued by the court and 4,000 patents are issued by DENR, it will take 1,500 years to title all the 7.8 million residential land parcels!

## Consequences

The current situation results in a number of negative impacts:

1. Land parcels, with only tax declarations as proof of ownership and not titles, are vulnerable to land grabbing and fake titling.
2. Residential homeowners are unable to borrow from banks using their residences as collateral, crimping the mortgage market.
3. Homeowners are unable to sell or even pass on ownership to their heirs except through uncertain legal assignments, increasing the likelihood of family and social conflicts.
4. Since residential land cannot be freely bought and sold, urban planning and development are hampered.
5. The supply of land in the land market is restricted, affecting land development and the like.
6. The value of these untitled lands remains low, reducing the tax take by the government from these lands.

In the Philippines, the market for land is far from efficient. There are laws, such as the nationality provisions in the ownership of land and the Comprehensive Agrarian Reform Program Extension with Reforms (CARPER), which restrict the tradability of land, and hence prevent its most efficient use. Transaction costs are also high, including a capital gains tax rate of six percent and documentary stamp tax of 1.5 percent. The lack of a reliable land information system (who owns what, who pays taxes on it, what are its boundaries, etc.) further hampers the efficiency of land markets; without it, land markets do not function properly.

There is another huge problem in the land market, which the policy reform in this case study seeks to address: of the estimated 24 million land parcels in the country, an estimated 12 million, or about half of the total, are untitled.<sup>6</sup>

This means that these land parcels, possibly valued in the trillions of pesos—especially those in the urban areas—are not and cannot be part of the formal land market. Without a formal title, ownership of these lands cannot be transferred legally, nor can these land parcels be mortgaged, since banks cannot accept mere tax declarations as secure collateral.<sup>7</sup> They can only be bought and sold in the informal market, i.e., through assignment of rights, and therefore, cannot command their true value. Without a title, these land parcels

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<sup>6</sup> Figures from DENR-LAMP (2004a) and DENR-LAMP (2004b).

<sup>7</sup> From the BSP website, <http://www.bsp.gov.ph/>, interview and email query with BSP officials.

cannot be formally divided and transferred, thus complicating the problem of generational transfer and possibly leading to family conflicts. Government cannot maximize its revenue because land parcels without titles have lower values, and since they cannot be readily sold and transferred, turnover revenue from capital gains and documentary taxes is lower than what it could be.

For occupants without titles, there is the problem of insecurity of property rights. Without a registered title, the occupants are always at risk that somebody else—through fraud or machination, given the weakness of the country’s institutions—may be able to obtain a title to the property, which they have occupied and lived on over the years. Mere tax declarations are subject to legal and illegal challenges, resulting in social conflicts that clog the courts. The occupants are always at the mercy of the government, because the legal basis for the defense of their rights to their property is weak. It was clear that a new tack towards the titling of residential plots was called for. This was the Residential Free Patent (RFP) Law. Its history is narrated next.

### **Narrative History of the Residential Free Patent Law**

The beginning of the Residential Free Patent reform may be traced to a telephone call made by then Socio-economic Planning Secretary Romulo Neri to Calixto Chikiamco sometime in 2005. At that time, Secretary Neri was visiting Mindanao and was coming out of a meeting with Victor Consunji, whose family owns the largest rural bank in Mindanao, One Network Bank.

Consunji had complained to Neri that, as rural bankers, they were finding it difficult to extend loans because many potential borrowers could not produce titles to their land properties. All they could produce were tax declarations. Since the *Bangko Sentral ng Pilipinas* (the Central Bank of the Philippines) had issued a circular prohibiting the acceptance of tax declarations as collateral, loans to borrowers against tax declarations were effectively “clean” (meaning the lender carried all the risk of default).

Neri remembered that Chikiamco had been writing about property rights. Like Neri, Chikiamco was not a professional economist, although a keen student of political economy. Although he had an undergraduate degree in economics from the De La Salle University (DLSU), Chikiamco was neither teaching economics full-time nor practicing it. He instead had a master’s degree in media management from Syracuse University. At the time Chikiamco received the call from Neri, he was engaged in business process outsourcing and internet entrepreneurship.

Contemporaneously, Chikiamco was writing a newspaper column, *Political Economy*, which he started in 1990. Over the years, his various

articles on the importance of property rights caught the attention and friendly acquaintance of Neri, who was then a professor of Finance at the Asian Institute of Management (AIM) and concurrent head of the Congressional Planning and Budget Office (CPBO).

Neri asked Chikiamco if he could study whether or how tax declarations could be made bankable, perhaps through some form of government guarantee. A study grant through the USAID-funded “Economic Modernization through Efficient Reforms and Governance Enhancement” (EMERGE) project was arranged. After thoroughly studying the matter, Chikiamco concluded that making tax declarations bankable was not feasible. Not only were there legal and regulatory hurdles, but the fact that municipal treasurers were carelessly accepting tax payments from anybody, without first verifying their ownership of the property, made tax declarations unreliable and risky as a basis for government guarantees.

In the course of his study, Chikiamco encountered Erwin Tiamson, who was then the director of the Land Management Bureau (LMB). Tiamson impressed Chikiamco with his technical knowledge of land issues. Tiamson was not a career bureaucrat, having been brought into government service in 2004 by then-Secretary of Environment and Natural Resources, Mike Defensor.

Despite the negative findings on the feasibility of making tax declarations bankable, Neri insisted that he wanted to do something on property rights reform on land. He knew—from his conversation with Consunji—that without significant reform in the titling of rural land, rural bankers would be constrained in extending loans, crimping investment, employment, and economic development in the countryside.

### **The Formation of the Advocacy Team**

Under the direction and management of Jaime Faustino of The Asia Foundation (TAF) - Philippines, a policy reform team on property rights was constituted. It was composed of Chikiamco; Antonio Jamon, Jr., a lecturer at the University of the Philippines College of Law who had worked previously as a congressional lobbyist; Victor S. Limlingan, Ph.D., a professor of Finance at the AIM and graduate of the Harvard Business School; and Gamaliel Pascual, a former investment banker and a Harvard M.B.A. graduate. Upon the recommendation of Chikiamco, Tiamson—who had resigned from government service when then-President Gloria Macapagal-Arroyo appointed Lito Atienza as the new secretary of Environment and Natural Resources—was brought into the team.

Tiamson was a key inclusion to the TAF property rights team, bringing



with him a strong technical expertise in land issues and an insider's knowledge of the bureaucracy. As was true in other successful policy reform efforts, whether in telecoms or airlines liberalization, bringing in a former insider who is committed to reform and who has an extensive knowledge of how the status quo works is a key element to getting policy reform done.

Another important hire was Katherine Farrales, who served as the resident economic researcher of the team. Farrales, who has an undergraduate degree in economics from the University of the Philippines, helped collect the data and provided the team with technical expertise.

The lesson here is that policy briefings, especially before decisionmakers, stakeholders and legislators, must be backed up by strong technical, legal, and economic studies. The team had to ensure that its policy proposal could go beyond the slide presentations and withstand legal and technical scrutiny. Moreover, to reach its intended audience, the reform proposal had to be presented clearly, without the prevalence of technical jargon, and with an emphasis on the benefits. The composition of a team and its combination of skills would prove important for the success of policy reform advocacy.

## **Exploration of Competing Approaches**

Initially, however, the team was divided on how to approach the problem. One side, composed of Limlingan and Pascual, favored a private sector solution, claiming that computerization of land records would facilitate land transactions. The other side, consisting of Chikiamco, Jamon, and Tiamson, believed that engaging government directly and working for a revision of laws was the answer.

Subsequently, under Faustino's direction, the team was split into two groups to pursue their respective strategies. One group—composed of Limlingan, Pascual, and Tiamson—was known internally as the “Ateneo team,” because the grant was given to the Ateneo Center for Economic Research and Development (ACERD) of the Ateneo De Manila University (ADMU). The other group—composed of Chikiamco, Jamon, and also Tiamson—became known as the “La Salle team,” because it worked under the auspices of the Institute of Governance of the DLSU.

Before the teams got started on the problem of the unregistered land parcels, it decided to lend its support to the World Bank and AusAID-financed “Land Administration and Management” Project (LAMP). LAMP's principal focus of reform was the legislation of the Land Administration and Reform Act (LARA), which aims to centralize all land-related agencies of the government under one department. This followed from LAMP's recommendation to

pursue the simplification of administrative processes for all land registration matters, and to prevent duplication of such activities carried out by the DENR and the LRA.

Being involved in the LAMP effort to pass the LARA bill provided important insights and lessons to the property rights team. The LARA bill, which was first introduced in the 13<sup>th</sup> Congress in 2004, repeatedly failed to get legislative approval. In the 14<sup>th</sup> Congress, although the bill passed the Lower House, it died in committee in the Senate. It encountered strong opposition from many sectors: (a) the Department of Justice (DOJ), since the LRA would be removed from its jurisdiction and transferred to the proposed Land Administration Department; (b) lawyers, principally the lawyers from the Registry of Deeds, because the bill was seen to diminish their influence compared to the geodetic engineers in the DENR; and (c) the bureaucracy, because the merged functions under the proposed Land Administration Department were perceived to result in retrenchment of government workers.

It is worth noting that, as far back as 2004, LAMP had submitted to Congress a Free Patent Amendment bill, which was a comprehensive amendment of Commonwealth Act No. 141 (known as the Public Lands Act) relating to free patent—the administrative mode of granting title to lands that does not involve sale by public bidding (in contrast to sales patent). However, its main effort was focused on getting the LARA because it considered the centralization of land administration reform functions under a single agency the principal and most important reform. This proved to be a mistake, procedurally.

### **Narrowing the Focus: Residential Lands**

Tiamson provided the principal insight on how to approach the main problem posed by the prevalence of unregistered land parcels whose owners could only present tax declarations as proof of ownership. Drawing on his experience regarding failed efforts at reform legislations in the past, Tiamson recommended that the main objective of the team be the passage of what the team came to call the Residential Free Patent Law.

According to him, confining the proposed legislation to residential lands would be less controversial than one that included agricultural and commercial lands. He worried—and later events would bear him out—that including agricultural lands could become controversial and drag down the entire bill. Although the bill would be only about titling of lands, and not distribution, given the highly charged atmosphere surrounding agricultural land, the bill's intentions could be misunderstood. In the end, the team decided that it was best to go after a politically feasible—rather than a better but politically

impractical—solution. As Neri himself had repeated to the team, quoting Voltaire, “The perfect is the enemy of the good.”

The Residential Free Patent bill was therefore crafted to increase the chances of success from a political standpoint. In addition to excluding agricultural and commercial lands, size limitations based on the classification of the municipality concerned were incorporated into the bill to overcome possible objections about the bill being intended to favor big landowners.

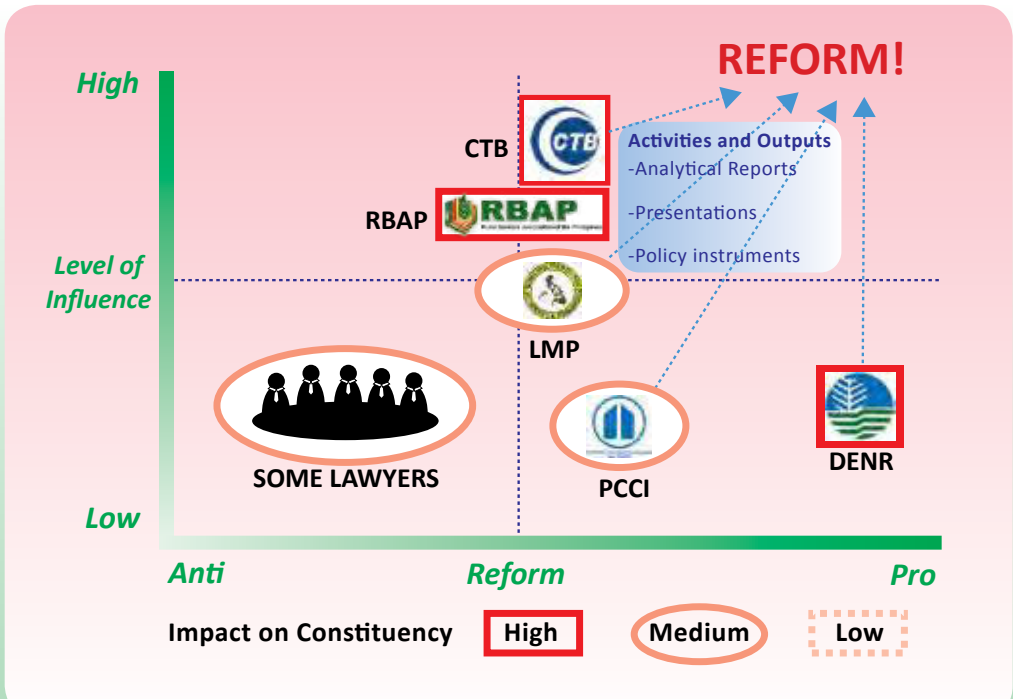
The team reasoned that of the 12 million estimated land parcels still untitled, about 70 percent was residential, and therefore, the Residential Free Patent Law would still result in most landowners having a better shot at obtaining titles, and the development benefits would still be substantial.

Furthermore, with respect to agricultural lands, unlike residential lands, there was an existing Free Patent Law. The only big weaknesses of the existing Free Patent Law for agricultural lands were the long period of occupation required (30 years) and the restrictions imposed on the beneficiaries of the agricultural free patent (prohibition to mortgage and sell the property for five years). The team concluded that to include agricultural lands on a Free Patent bill in order to remove those restrictions would complicate the bill and hamper its passage.

## **Coalition Building**

With a solution in the form of the Residential Free Patent bill on hand, the La Salle team (referred to as the “RFP team” from here on) faced the problem of forging a coalition to help push the bill. In other words, the team had to do stakeholder analysis: who cares, who can be made to care, who has the political capital, and how to get them to spend it on this reform.

The team used stakeholder mapping (See Figure 6.1) to identify and gauge the possible interests of the various stakeholders to embrace the reform efforts and their willingness to commit political capital on them. In the private sector, the team zeroed in on the Rural Bankers Association of the Philippines (RBAP) and the Chamber of Thrift Banks (CTB) as the private stakeholders who had the most interest in pursuing the reform, because the dearth of titled properties constrained secure collateral-based lending to homeowners and small businessmen.



**Figure 6.1. Stakeholder Mapping in the Residential Free Patent Reform Story**

Gaining the support of the RBAP was facilitated by Senen Glorioso, a rural banker from Quezon and former president of the association. Glorioso knew Chikiamco from the De La Salle University; he was a features editor of the school paper when the latter was editor-in-chief. Chikiamco reached out to his former schoolmate, and Glorioso agreed to help, convinced that the lack of secure land titles was an impediment to more lending in the countryside.

Chikiamco, Jamon, Tiamson, together with Francisco Magno, Ph.D., a professor at DLSU, head of the De La Salle Institute of Governance (LSIG), and graduate of the East-West Center, were invited, through the efforts of Glorioso, to make a presentation to the board of the RBAP during its annual meeting in Cebu on January 21, 2008. The Board readily embraced the position presented by the team and passed a resolution supporting the Residential Free Patent bill.

In the case of the CTB, the team made a presentation to its president, Benjamin Yambao, also president of the Manila Bank, who agreed with the intentions of the bill, but since he was an outgoing president, referred the team to the executive director, Suzanne Felix, who was able to get the board

of CTB to endorse the bill and pass a resolution adopting the bill during its conference.

Both the RBAP and the CTB became active supporters of the bill, providing crucial support at various stages during the legislative deliberations and sending representatives during committee hearings. CTB officers—among them Rogelio Florete, the politically influential owner of Bombo Radyo Philippines, a radio network—paid a visit to Senator Richard Gordon twice to express their support for the bill. At one stage, the CTB officers made an appearance at the Senate session hall when the bill was being heard on second reading, and where they were recognized by the Senate presiding officer, Senator Aquilino Pimentel, Senator “Jinggoy” Ejercito Estrada, and other senators on the floor. The CTB also invited Gordon to speak in one of their monthly meetings, where the senator promised that the bill would become law.

The participation and commitment of the RBAP in lobbying for the bill was no less than the CTB’s. Aside from passing various resolutions expressing its sentiment in writing to the senators, the RBAP provided the services of its legal counsel, Roberto Lucila, who reached out to the office of Senator Francis “Chiz” Escudero, his law school fraternity brother.

The willingness of both RBAP and CTB to spend their political capital for the passage of the bill was a reflection of how the team was able to zero in on a problem that both stakeholders recognized as adversely affecting their respective industries. In the phrase of economist Dani Rodrik, it was a perceived *binding constraint*. By providing a solution (RFP) to the problem (lack of good collateral), the team was able to generate enthusiasm and commitment on the part of the CTB and the RBAP.

### Political Champions

Another problem that the team confronted was to find sponsors for the bill. In the House, Jamon asked a friend, Congressman Rufus Rodriguez of Cagayan de Oro (2<sup>nd</sup> District), to sponsor the bill. The latter agreed, but being from the minority opposition, was merely a member representing the minority in the Committee on Natural Resources, which had jurisdiction over the bill.

The RBAP came in to help. Glorioso asked the team to present the bill to his brother-in-law, Congressman Rodolfo Valencia of Mindoro (1<sup>st</sup> District), who agreed to the objectives of the bill and signed on as a sponsor. Unlike Rodriguez, Valencia was a member of the Liberal Party that was part of the ruling administration coalition, and was therefore part of the majority in the

## Committee on Natural Resources.

Concurrently, the World Bank- and AusAID-supported LAMP, under the DENR, was pushing its version of the free patent, which differed from RFP, as it included agricultural and commercial lands, and was very liberal in area limits irrespective of the category of city or municipality. The team had concerns about the LAMP version. While it was technically and economically correct, the team believed that the LAMP version, which included agricultural lands, was vulnerable to contentious debate and delay. The team's assessment regarding the LAMP version would later prove to be correct.

In the meantime, despite repeated follow ups, the bill was not being prioritized by the Committee on Natural Resources, headed by Congressman Ignacio "Iggy" Arroyo of Negros Occidental (5<sup>th</sup> District), brother-in-law of then-President Arroyo. The committee chairman is a powerful figure in the passage of legislation: he leads the drafting and release of the committee report necessary for the bill to be scheduled for a second reading. Many a bill dies in committees this way.

Chikiamco then decided to approach Congressman Antonio Cerilles, through the help of his brother-in-law, Antonio Olizon, a friend of the congressman and president of the Wood Producers Association of the Philippines. Chikiamco also knew Cerilles from previous engagements, such as when the latter was the DENR secretary under former President Joseph Estrada. From conversations with his brother-in-law, Chikiamco learned that Cerilles had started a program in the DENR to issue usufruct<sup>8</sup> rights over logged-over (denuded) areas. Given his own interest in property rights, Chikiamco decided to write a column about Cerilles' program and, as a background, interviewed Cerilles.

A lawyer, Cerilles reasoned that by giving usufruct rights to DENR personnel to plant and harvest fruit trees in logged-over areas, the program would cause the replanting of denuded areas at no cost to government, and at the same time, augment the salaries of government personnel, reducing their incentive to engage in graft. He also reasoned that fruit trees would yield economic benefits over a long period, and the usufruct owner would have an incentive to protect those fruit trees, rather than cut them down. To Chikiamco, the program was a brilliant and innovative scheme to use property rights for environmental protection and forestry production.

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<sup>8</sup> Usufruct is the legal right of using and enjoying the fruits or profits of something belonging to another. See <http://www.merriam-webster.com/dictionary/usufruct?show=0&t=1293592055>.

However, when Estrada was deposed by a people power revolt<sup>9</sup> in January 2001, Cerilles had to vacate his post as DENR secretary. The usufruct rights program was terminated.

Post-Estrada, Cerilles got elected as congressman of the first district of Zamboanga del Sur (2004-2010), first as a member of the Nationalist People's Coalition, which joined the administration coalition supporting President Gloria Macapagal-Arroyo, then as Lakas-Kampi-CMD. Cerilles became assistant majority floor leader of the Lower House.

There were some in the non-governmental organization (NGO) community who did not want to work with Cerilles, thinking that he was a "*trapo*" (a "traditional politician" interested only in his pork barrel). However, and despite appearances, Cerilles was an unconventional politician. Already a lawyer and a congressman in his mid-50s, he undertook and finished a Master's program in urban planning at the University of the Philippines. He surrounded himself with some of his younger classmates from the School of Urban Planning of the University of the Philippines and made a few of them part of his staff. When Chikiamco presented the RFP bill to him, Cerilles promised to take a look at it. Chikiamco also presented Cerilles with two books on property rights: *The Mystery of Capital* by Hernando de Soto (2000) and *The Noblest Triumph* by Tom Bethell (1998).

While other politicians would just let the books gather dust, the unconventional Cerilles did not. On the trip to the Inter-Parliamentary Union Assembly in South Africa (April 13-18, 2008), Cerilles read the books on the plane and came out a committed believer. He agreed to sponsor the bill and wrote the introductory note himself, even citing de Soto.

Not satisfied with just filing the bill, Cerilles used his influence as assistant majority floor leader and as a friend to Speaker Prospero Nograles of the HoR to get the bill heard in his committee, the Committee on Land Use, instead of the Committee on Natural Resources, where it had been languishing. This was a key development, because without the support of the committee chairman, a bill could die for lack of hearings and an approved committee report.

Cerilles promptly scheduled hearings on the bill. There was practically no opposition during the hearings, which were attended by concerned officials from the government. The only concern expressed was by Congressman Solomon Chungalao of Ifugao Province (Lone District), who wanted to expand the RFP bill to include the rice terraces and other lands within forested areas. With his determined leadership, Cerilles was able to get his committee's

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<sup>9</sup> Dubbed EDSA 2, since it is the second time that a mass uprising on EDSA deposed what people perceived was an erring president.

approval of the bill after only two hearings. The members of his committee requested that they all be listed as co-authors of the bill, and Cerilles accommodated their request. Thereafter, the committee issued its report, and the bill was passed on second and third readings. The battle to pass the bill then shifted to the Senate.

The RFP team first had to find sponsors for the bill, which it found in Senate Majority Floor Leader Miguel Zubiri, Senators Mar Roxas, Loren Legarda, and Jinggoy Estrada. However, its efforts were complicated by the decision of LAMP to push its version of the Free Patent bill in the Senate. As observed above, the LAMP bill differed from the RFP bill in several key respects. First, it covered agricultural and commercial lands, not just residential lands, which was RFP's sole coverage. Second, while the RFP bill had area limitations based on the class of the city or municipality (initially set at 300 square meters in highly urbanized cities; 800 square meters in other cities; and 1,000 square meters in all municipalities), the LAMP version specified a more liberal area limitation of 1,000 square meters for residential, commercial, and industrial parcels. Third, with respect to agricultural lands, the LAMP bill adhered to the existing law of 25 hectares, but sought to remove all restrictions in the existing law and to reduce the period of occupation to 10 years from the previous 30 years. Finally, it sought the removal of restrictions on the sale of the titled property within five years of award and the prohibition against mortgaging the property for the same period.

The RFP team feared that the LAMP version would generate unnecessary controversy and questions, especially with respect to the coverage of agricultural lands. Because agrarian reform is a politically sensitive, emotional, and touchy issue, the team feared that the bill could be interpreted as circumventing land reform, although the bill was only about titling and not at all about distribution of land.

Its fears were soon proven to be correct, but the team had no choice because the LAMP staff—some of whom had previously worked in Congress—mounted an aggressive effort to push its version at the Upper House. The team was able to get Senator Richard Gordon, head of the Committee on Constitutional Amendments and Revision of Laws, under which the bill would be heard, to sponsor its version. Likewise, Senators Gregorio “Gringo” Honasan and Miriam Defensor Santiago agreed to co-sponsor. Ironically, Honasan would later pose objections to the bill.

Sure enough, during the very first Senate committee hearing called by Gordon, questions were raised on the agricultural section of the bill, such as on the limitation of qualified applicants and the definition of “head of the family.” Gordon had to assign a technical working group (TWG) to refine the



bill. Nonetheless, during subsequent hearings, Senator Juan Ponce Enrile repeatedly raised objections to the agricultural free patent portion of the bill, especially as to whether the DENR had the qualified personnel in the field to make a determination of who were the actual occupants and owners of the land.

In 2008, an unforeseen political event happened. As Gordon was about to issue the committee report on the LAMP bill, a Senate reorganization took place. Senator Manuel Villar was deposed as Senate president by his colleagues, and Enrile was elected in his place. A concomitant reshuffling of the committee chairmanships took place. Gordon moved to head the Blue Ribbon Committee, while Escudero assumed the chairmanship of the Committee on Constitutional Amendments and Revision of Laws, which was in charge of the LAMP bill.

With a new committee chairman in place, the committee report on the bill had to wait in line for a new approval. Since Escudero was unfamiliar with the bill and had not participated in previous hearings, the work in the Senate practically started from scratch. After many weeks, and after strong lobbying by both the RFP team and the LAMP staff, Escudero finally agreed to preside over a hearing on the LAMP version of the bill. All the stakeholders were present, including representatives from the RBAP and the CTB, who expressed their support for the bill.

After the hearing, the RFP team expected that the committee report would finally be issued. But weeks passed and still no committee report was issued. When told of the problem, the RBAP offered to help. It asked its association lawyer, who was a fraternity brother of Escudero and a member of his staff, to arrange a meeting with his legislative staff. The meeting was held, but the team could not get a commitment from Escudero's legislative aide who still had to review the bill. More weeks passed and still no report. Concerned about the long delay, the team contacted the father of Senator Escudero, Congressman Salvador Escudero, who was inclined to help, as he was a sponsor of the LAMP version of the bill in the Lower House. As luck would have it, Congressman Escudero's special concern was education. He told the team that many public schools in the countryside had no titles to the lots they were occupying, since those lots were previously donated to the government by private individuals who also did not have titles. However, these lots were never titled in favor of the government, because titling involved a long process of presidential proclamation under present law. Consequently, a number of public schools were insecure about their land property rights. When squatters would move in to occupy those lots, the Department of Education (DepEd) could not do anything about it. Other times, the heirs of the donors would move to reclaim

ownership of the lands in court and succeed.

Congressman Escudero recognized the need for a Free Patent bill with a provision for allowing special patents for lands occupied by public schools. This was important to help the public education system, according to the congressman.

Still, for some reason, no committee report was issued. It could have been that Senator Escudero was preparing for his presidential candidacy, and being new to the committee, was unfamiliar with all of the issues relevant to the bill. Instead, he decided to offload the task of issuing the committee report and defending it on the floor to the former chairman of the committee, Gordon, who gladly accepted the assignment. After the committee report was finally issued and signed by the committee members, the bill moved to the floor for deliberations.

On the floor, Enrile questioned why the bill did not specify that actual surveys be done, so an amendment was introduced prohibiting table surveys and requiring the use of actual surveys. Senator Pia Cayetano asked that gender sensitivity be incorporated into the bill. Senator Edgardo Angara introduced a special provision on special patents for public schools. Senators Miguel Zubiri and Aquilino Pimentel, both from Mindanao, mentioned that there are many former military lands in Mindanao and moved to amend the bill to include military lands that had been delisted.

However, an objection from Honasan threatened to delay the bill indefinitely. Honasan, the author of the extension of the Comprehensive Agrarian Reform Law (CARL), said that the Free Patent bill, by covering agricultural lands up to 24 hectares, would be in violation of CARPER. His chief of staff, a lawyer, expressed strong objections to the bill by stating that it would go against the agrarian reform law.

Tiamson, who knew Honasan personally, explained to him and his staff that the Free Patent bill was about titling, not redistribution. Furthermore, the limit of 24 hectares was contained in existing laws and in the constitution. Nonetheless, Honasan stuck to his objection. Finally, a compromise was struck: the Free Patent bill would contain a limitation up to five hectares, similar to the CARPER. Only when the amendment was introduced did Honasan remove his objection.

In actuality, deliberations in the Senate did not proceed so predictably or smoothly. Many unforeseen events interposed to delay deliberations on the

bill, such as the typhoon Ondoy disaster,<sup>10</sup> the privilege speeches of Senator Panfilo “Ping” Lacson on the Dacer-Corbito double murder case,<sup>11</sup> the extended debate between Senator Joker Arroyo and then-Senator Benigno Aquino III on the creation of a legislative district in Camarines Sur,<sup>12</sup> and the Maguindanao massacre and the consequent proclamation of martial law in Maguindanao.<sup>13</sup> The agenda of the Senate had to give way to these events, and deliberation on the Free Patent bill was often delayed.

As the elections were scheduled for May 2010, the bill had to be passed in 2009. The RFP team feared that the senators and congressmen would naturally be so distracted by the coming elections that they would be unable to pass the bill.

The Senate finally passed the bill on the third and final reading on October 12, 2009. The team expected the next phase—the bicameral deliberations (also, bicameral conference or bicam) to reconcile the Senate and House versions—to be a cakewalk. It was not to be.

The bill encountered a few problems. First, Senator Gordon was preparing to run for president and became very busy elsewhere. Second, Congressman Cerilles objected strongly to the Senate version, which included agricultural and commercial lands. He particularly singled out the agricultural provision, stating that it would go against the land reform law extension, CARPER.

The bicam threatened to go into a deadlock. Time was running out, with only a few days to go before the House and Senate adjourned for the Christmas break. Waiting for Congress to resume in January was a risky move, because with the elections coming, politics could shove aside the legislative agenda. (True enough, when session resumed in January, the Senate was consumed with the debate over the censure motion against Villar on the C-5

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<sup>10</sup> Typhoon Ondoy (international designation: Tropical Storm Ketsana) struck Northern Luzon, including Metro Manila, on September 26, 2009 and left 464 dead and ₱11 billion worth of damages to infrastructure and agriculture. See NDCC (2009).

<sup>11</sup> On November 24, 2000, publicist Salvador “Bubby” Dacer and his driver, Emmanuel Corbito, were abducted on Osmeña Highway in Metro Manila. Five months later, their charred remains were found in a creek in Cavite. See Dacer-Corbito double murder case timeline. (2010).

<sup>12</sup> Then-Senator Aquino filed a petition questioning the constitutionality of the law that created a new district in Camarines Sur, allegedly to suit the political interests of Representative Diosdado Ignacio Arroyo, son of President Arroyo. In April 2010, the Supreme Court ruled against Aquino’s petition (Requejo, 2010).

<sup>13</sup> On November 23, 2009, 57 unarmed civilians were massacred along an off-road hillside in Ampatuan town, Maguindanao province. Many of the victims were women, 30 of them journalists. On December 4, 2009, President Arroyo declared martial law in Maguindanao (Dalangin-Fernandez & Burgonio, 2009).

controversy.<sup>14)</sup>

Finally, Senator Gordon—recognizing that time was running out and seeing the political benefits from passage of the bill—gave way and allowed the House version to prevail. The signatures of the bicam committee members were obtained on the penultimate day of the Senate session, and the approval of the bill was made literally on the last day before the Christmas break.

The approved bill finally passed into law when President Arroyo signed the bill on March 9, 2010.

### **Lessons and Conclusions**

Policy reform consists of three phases: (a) analysis, (b) strategy, and (c) action. In the analysis phase, policy reformers must clearly understand the status quo. They must first understand how the status quo hurts social welfare. Part of the analysis involves understanding the incentives, motivations, and business models of the various players (how they make money or how they benefit from the status quo), and how the reform will affect or threaten their various business models. This will suggest the degree, strength, and intensity of their opposition to a particular reform. Identification of the entrenched vested interest is most important.

Almost all winning strategies involve forming a coalition of stakeholders because reform must confront entrenched political and economic interests. Policy entrepreneurs must undertake stakeholder mapping (See Figure 6.1) to understand where each stakeholder is coming from and their degrees of commitment and political influence. Mobilization of the pro-reform stakeholders is a must. Coalition-building should involve strong technical preparation and the marshalling of the team's social, political, and personal capital to cobble together a supportive alignment to overwhelm strong political opposition from existing vested interests.

Building a strong team to secure all the pieces together is important. The team should consist of technically prepared and reform-committed individuals whose expertise complements each other.

In this regard, taking on board a former insider as team member or consultant is clearly helpful in order to understand the sometimes Byzantine ways bureaucrats or rent-seekers operate and profit from the status quo. In the RFP case, Tiamson, former head of the LMB, was a key hire due to his mastery

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<sup>14</sup> In September 2008, Senator Lacson exposed a ₱200-million congressional insertion in the 2008 national budget for the construction of the C-5 road extension, from which the company of Senator Villar, a presidential candidate, allegedly gained ₱6.22 billion through illegal means (Legaspi, 2010).

of the technical issues and his insider's familiarity with the bureaucracy.

Strategy follows from the analysis, but it must consider situations where first-best solutions may not be politically practicable. The packaging of the reform—so that the intended beneficiaries can understand it and will spend political capital for it—is crucial. In experimental psychology, this comes under the rubric of framing.<sup>15</sup> Correct framing motivates action. The policy reform must be opportunistic, i.e., it must ride on any existing movement or event (decentralization, elections, globalization, controversy or scandal, etc.) that will improve its chances of success.

Timing and flexibility are a key part of political action, because sometimes an unforeseen confluence of events presents an opportunity to make a breakthrough. Timing involves an element of luck or unplanned opportunity. However, in almost every case, the unforeseen opportunity can go begging if not preceded by strong preparation. It is, therefore, important for policy entrepreneurs to be prepared but also to be patient, committed, and opportunistic.

The traditional approach tends to emphasize structured processes and reports, scheduled activities, and auditable participation. By contrast, the political-economic reform process is almost never linear and sequential.

Hiring and compensation practices also tend to favor academic and technical qualifications over commitment and social and political skills, which are hard to document in a résumé. We now contrast this approach revealed in the RFP with the traditional approach as instanced in the case of the LAMP.

The LAMP, funded by the World Bank and AusAID, was at best of limited success and may provide useful lessons for future developmental reform efforts. No less than the AusAID evaluation team has concluded that the program failed to improve land administration in the country, and that some of the reforms it was pushing—such as the LARA—failed to pass legislative muster despite a long and expensive effort to do so (Llanto, Riddell, & Orbeta, 2010).

LAMP's failure may be due to having a national agency (in this case, the DENR) as a partner, which may have its own agenda. The centerpiece of the LAMP reform was the centralization of land-related functions under one agency (LARA). However, the reform (LARA) was seen as centralizing authority with powers in a new line agency monopolized by DENR officers at the expense of other departments (i.e., LRA, which is under the Department

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<sup>15</sup> The psychological principles that govern the perception of decision problems and the evaluation of probabilities and outcomes produce predictable shifts of preference when the same problem is framed in different ways. See Tversky and Kahneman (1981).

of Justice). LARA also got shot down by opponents, who saw it as a means to retrench parts of the bureaucracy and enhance the power of the geodetic engineers (DENR) at the expense of lawyers in the Registry of Deeds. The issue may have been false, but opponents saw it as an issue with which to rally opposition and to get support from senators. Other options, like better coordination of land administration functions at the local government level without merging parts of the bureaucracy, were never considered.

Furthermore, the concerned national agency (DENR) was heavily politicized, and there were numerous changes in leadership, complicating the reform effort. Unlike the local government executives, who saw improved land administration as a key to increased revenues, the national agency had no real incentive to push for reform.

Still, developmental aid continues to flow largely to national government partners with the aim to effect reform, such as money being given to the Bureau of Internal Revenue (BIR) to improve revenue performance. This approach is very limiting as these government partners have their own agenda. Worse, if that “reform” will upset the business model (including the perks) of insiders, the reform will most likely be killed or diluted by insiders. For example, the computerization of BIR operations, which has been funded by foreign aid and foreign loans for decades, has failed to significantly improve revenue performance. While computerization is a technically sound solution (it promotes efficiency and transparency in tax collection and administration), the reform failed to consider that the corrupt personnel within the agency would see it as a threat to their business model, and naturally would act to subvert its effectiveness.

In contrast, the RFP team was, as it were, a guerrilla operation of sorts that worked with various government agencies and stakeholders, without the institutional constraints that LAMP had. It was free to consider a number of options and to decide how best to push a reform forward.

The factors in the success of the passage of the RFP bill may be summarized as follows: (a) use of the “team” concept with varied technical expertise that are mutually complementary; (b) inclusion of a former insider in the team, with a strong knowledge of how bureaucracy works; (c) strong technical preparation, including studies and presentations showing the objectives and impact of the bill’s passage; (d) sound political analysis, which anticipated possible objections to the bill; (e) undertaking stakeholder mapping and mobilizing the key stakeholders to spend political capital in behalf of the bill; (f) use of all types of political capital (family ties, fraternal ties, personal friendship) by a committed team to push the reform forward and to overcome obstacles; and (g) enlightened support from TAF and USAID, which involved

patient and non-traditional efforts at reform.

Pushing for a reform as political as passing a law is not a linear, sequential, and predictable process, unlike holding a seminar or conducting a study. In the case of the RFP bill, there were lengthy periods when seemingly nothing was happening. There were also instances where discussions would take place over lunches or dinners, rather than in formal settings like seminars. These activities do not fall within the traditional use of a log frame, where the metric of success is often based on the number of attendants in a seminar or the number of hours doing research. Although control points must still be established, trust and patience must underlie the relationship between the funder-managers and the team.

If development agencies want to work on policy reform involving binding constraints or high-impact reform, they may have to rethink their traditional approach because the reform process is inherently political. There are entrenched, vested interests who profit from the status quo and who will block reform. Therefore, purely technical solutions may not work because the anti-reform elements either block the reform or subvert it.

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The Batangas Port is one of the busiest in the country. Agricultural products coming from Mindoro, Visayas, and Mindanao pass through this port to get to Metro Manila.

Photo by Richard Abrina

Originally appeared in "Linking the Philippine Islands through highways of the sea," Center for Research and Communication, Manila, 2008.



Winged vans bound for Panay Island are loaded into a RO-RO vessel at Bacolod City's BREDCO Port.

Photo by Richard Abrina

Originally appeared in "Linking the Philippine Islands through highways of the sea," Center for Research and Communication, Manila, 2008.



A typical day at the arrival area of the DMIA, which now serves as a hub for budget airlines, like AirAsia, Asiana Airlines, and Cebu Pacific, among others.

Photo by the CIAC



The Ninoy Aquino International Airport (NAIA) Terminal 3 is now a hub for Airphil Express, Cebu Pacific, and other low-cost airlines. It also services Philippine Airlines.

Photo by Mithril Cloud

*Source:*

[http://en.wikipedia.org/wiki/File:NAIA\\_Terminal\\_3\\_2009\\_MC.jpg](http://en.wikipedia.org/wiki/File:NAIA_Terminal_3_2009_MC.jpg)

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RFP team gives orientation on the Residential Free Patent Act of 2010 to the Chamber of Thrift Banks, Iloilo City on May 27, 2011.

Photo by Erwin Tiamson



Erwin Tiamson (3rd from right, first row) poses with the Chamber of Thrift Banks participants at the RFP orientation, May 27, 2011.

Photo by Reynante Orceo



RFP orientation at the office of Cebu City Mayor Michael Rama. Rene Sanapo (right) is a local government reform champion.

Photo by Erwin Tiamson



Erwin Tiamson makes a presentation at an RFP seminar for the Chambers of Thrift Banks, Makati City, organized by the Foundation for Economic Freedom.

Photo by Reynante Orceo





Rice is the most important food crop and a household staple in the Philippines.

*Source:*

"Harvest" (<http://www.flickr.com/photos/ricephotos/438512752/in/pool-1416076@N23/>) by IRRI Images (link to photostream of user), from Flickr.com/CreativeCommons. Some rights reserved under the following licenses:

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# Chapter 7

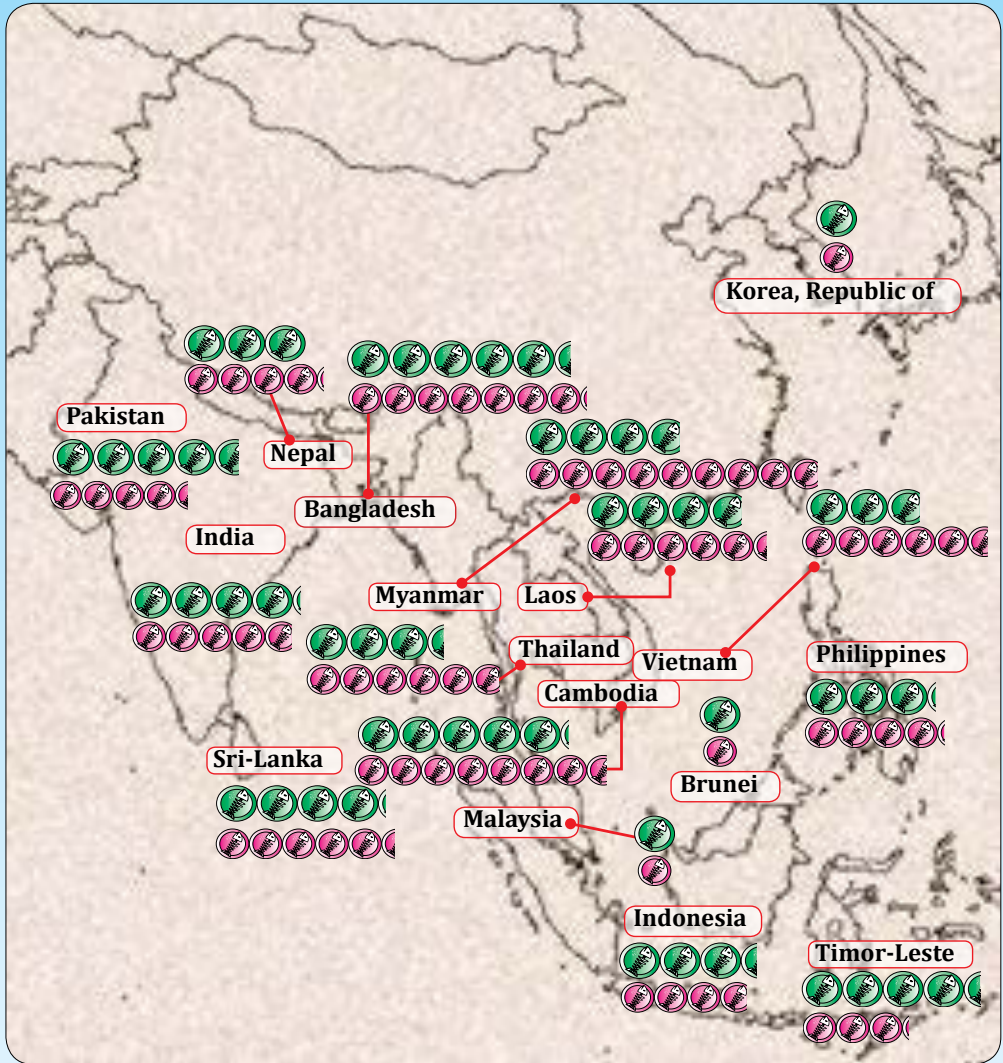
## Stymied Reforms in Rice Marketing in the Philippines, 1980-2009

V. Bruce J. Tolentino and Beulah Ma. de la Peña

Successive governments of the Republic of the Philippines have proclaimed the attainment of food security to be a primary objective of national governance and development policy. Institutions were successively created, re-created, and reformed to guide and manage the development of the rice and corn industry as a way of attaining food security. The National Rice and Corn Administration (NARIC) operated during the Philippine Commonwealth of 1935 up to 1946. In 1952, the Rice Economic Board (REB) was created “to formulate and oversee the implementation of an integrated development plan and program for rice.”

President Ramon Magsaysay (1953-1957) established the National Rice and Corn Production Program (NRCPP) and its Rice and Corn Coordinating Council (RCCC) in 1955. In 1960, the Rice and Corn Board (RCoB) was created by Republic Act No. 3018 (or RA 3018), with the purpose of “limiting the rice and corn industry to Filipinos.” Then, in 1962, the Rice and Corn Administration (RCA) was created to stabilize the price of grains. President Ferdinand Marcos (1965-1986) began his martial law administration in 1973 and issued Presidential Decree (PD) No. 4 (or PD 4), which abolished the RCA and RCoB and transferred their functions into a new, much more powerful National Grains Authority (NGA). PD 1770 (1981) expanded the scope and powers of the NGA, and renamed it the National Food Authority (NFA). However, as part of reforms in the closing years of martial law, the NFA’s scope was reduced to rice and corn by Executive Order (EO) No. 1028 (or EO 1028, s. 1985).

Despite the series of institutional rearrangements, the Philippines’ achievements in food security have been disappointing. Figure 7.1 shows the incidence of hunger in various countries from 1990 to 2005, with some 16 percent of Filipinos suffering from hunger between 2003 and 2005. Moreover, the proportion of Philippine households experiencing hunger rose from under 10 percent to over 24 percent over the period from 1998 to 2009, as tracked by Social Weather Stations (SWS) (Figure 7.2).



**Figure 7.1. Hunger Incidence in Asia Pacific, 1990-1992; 2003-2005**

Source: United Nations (UN) Economic and Social Commission on the Asia Pacific (ESCAP), 2009.

Note:



= 5% of hungry population

Legend:

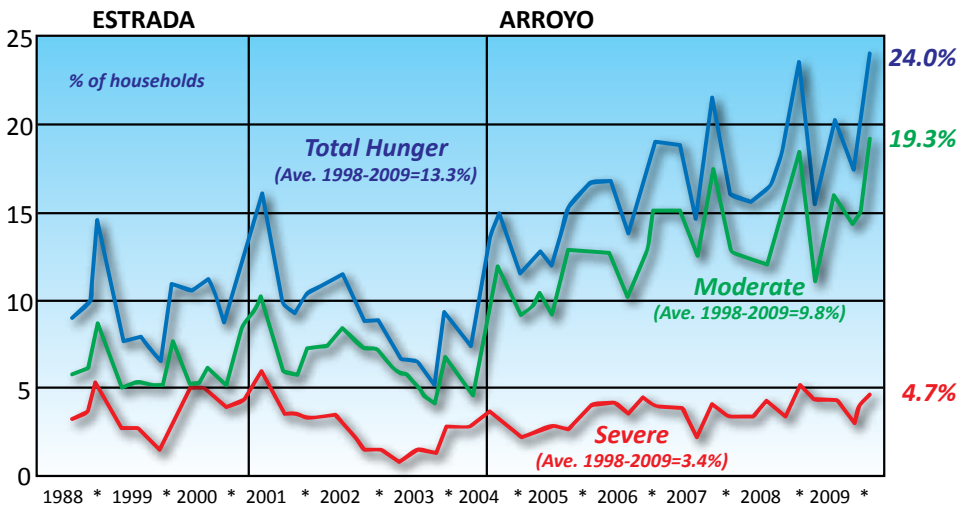


= 2003-2005

= 1990-1992

Despite the Philippine Government's continuing avowal of commitment to food security, why has hunger persisted and even worsened in the country? In particular, why are rice prices in the Philippines significantly higher than those in other countries? The policies on rice production, particularly on rice marketing, that have been adopted by the government over the country's history—and the ways in which these policies interact with other unfavorable policies, such as an overvalued exchange rate—and their impact on various stakeholders, largely explain the failure of Philippine governance to ensure food security for the population.

This case study explores the political economy of public policies on rice production and marketing in the Philippines over the past three decades, suggesting the political economy factors that have stymied efforts at reform, and perpetuated policies and arrangements that have concentrated rents in the hands of favored players. The first section of this study lays out the current status of the rice sector and the key policy issues. The second section describes various attempts toward reforms implemented over the past three decades. The last section summarizes the key constraints on rice sector reforms.



Note: Don't Know and Refused responses are not shown.

Q. Nitong nakaraang 3 buwan, nangyari po ba kahit minsan na ang inyong pamilya ay nakaranas ng gutom at wala kayong makain? KUNG OO: Nangyari po ba 'yan ng MINSAN LAMANG, MGA ILANG BESES, MADALAS, o PALAGI? (These past three months, did your family ever go hungry and you had nothing to eat? IF YES: Did it happen A FEW TIMES, HOW MANY TIMES, FREQUENTLY or REGULARLY?)

**Figure 7.2. Degree of Hunger in Households, Philippines, July 1998 to December 2009.**

Source: SWS (2010).

## Current Status of Rice Agriculture and Marketing in the Philippines

The Philippine rice sector policy is implemented through: (1) market interventions executed by the NFA, described as efforts to stabilize supply and prices, and (2) programs aimed at increasing productivity in rice—up to the attainment of national self-sufficiency in rice supply—as pursued by the Department of Agriculture (DA). These mandates are set out in key issuances, including:

1. PD 4 (1972), as amended by PDs 699 (1975) and 1485 (1978), which provides the basis for government regulation of rice trading through the NGA, and later the NFA:

It shall be the policy of the State to promote the integrated growth and development of the grains industry (rice, corn, wheat, and other grains and their substitutes such as but not limited to mongo, soybeans and cassava) (Sec. 3, PD 1485) so that it can adequately function as an institution conscious of its social responsibilities and capable of providing adequate and continuous food supply to the nation and of contributing to its proper share to national economy.

2. EO 1028 (1985) deregulated the production and trading of food grains and other agricultural inputs as earlier defined in PD 1770 (1981), which created the NFA out of the NGA. However, EO 1028 maintained the government's involvement in rice and corn trading, specifically NFA's "exclusive authority to import rice" and its procurement of *palay* (unmilled rice grain) from farmers "to stabilize the price or maintain a buffer stock."
3. RA 8435 (1997), the Agriculture and Fisheries Modernization Act (AFMA), was a major issuance, with 120 sections covering all aspects of Philippine agriculture and government support services for agriculture—research and development, financing, administrative and fiscal support for agriculture, extension and education, sectoral planning, trade and marketing. Crucially, while AFMA defined "food security" in the general senses of availability and affordability, it nonetheless decreed that the country must be self-sufficient in the production of rice and white corn, to wit:

The State shall promote food security, including sufficiency in our staple food, namely rice and white corn. The production of rice and white corn shall be optimized to meet our local consumption and shall be given adequate support by the State.

“Food Security” refers to the policy objective, plan and strategy of meeting the food requirements of the present and future generations of Filipinos in substantial quantity, ensuring the availability and affordability of food to all, either through local production or importation, or both, based on the country’s existing and potential resource endowment and related production advantages, and consistent with the overall national development objectives and policies. However, sufficiency in rice and white corn should be pursued.<sup>1</sup>

4. RA 8178 (1995), the Agriculture Tariffication Act, removed the country’s quantitative restrictions (QRs) on agricultural products in keeping with the country’s commitments under the General Agreement on Tariffs and Trade (GATT) Uruguay Round (UR) of negotiations. All quantitative import restrictions in the agriculture sector were eliminated, except in the case of rice, where the Philippines used a special provision that allowed developing countries to exempt “sensitive commodities.” The Philippines successfully negotiated to maintain its QRs on rice—and is now the last World Trade Organization (WTO) country-member maintaining such QRs. Interestingly, RA 8178 (1995) also opened the window for private sector imports of rice by amending the NFA’s powers on imports, as follows:

The Authority shall undertake direct importation of rice or it may allocate import quotas among certified and licensed importers, and the distribution thereof through cooperatives and other marketing channels, at prices to be determined by the Council regardless of existing floor prices and the subsidy thereof, if any, shall be borne by the National Government

Over the 1970s and the height of the Green Revolution,<sup>2</sup> which brought the Philippines to marginal export status, rice productivity programs dominated market interventions. This dominance has reversed since the mid-1980s, with public resources shifting away from long-term support for productivity to short-term price levers executed by NFA.<sup>3</sup>

The NFA summarizes its price and supply stabilization mandate as: buy high (from farmers), sell low (to consumers), and store long (to stabilize

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<sup>1</sup> Section 4, Agriculture and Fisheries Modernization Act of 1997.

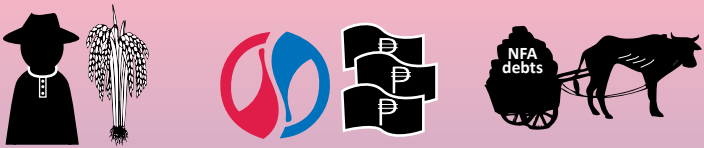
<sup>2</sup> “Green Revolution” refers to a series of research, development, and technology transfer initiatives between the 1940s and the late 1970s, which included providing grants and loans to farmers to buy additional seeds, machinery, and fertilizers to achieve increased yields and multiple cropping.

<sup>3</sup> See Tolentino (2001, December).

supplies). These are embodied in its three main programs: (a) palay or paddy procurement, (b) buffer stocking, and (c) rice distribution.

The NFA buys palay from farmers and farmer organizations at a support price, as of 2010, set at ₱17.00 per kilogram. Historically, the NFA's support price has not significantly exceeded prevailing farmgate market prices, and on the average, the NFA is able to procure only less than 3 percent of total paddy production.

**Table 7.1. NFA Palay Procurement as a Percentage of Total Production, 1990-2009**



| Year | Paddy Production<br>(Million MT) | Procurement<br>(Thousand MT) | Percent |
|------|----------------------------------|------------------------------|---------|
| 1990 | 9.32                             | 572                          | 6.14    |
| 1991 | 9.67                             | 555                          | 5.74    |
| 1992 | 9.12                             | 420                          | 4.60    |
| 1993 | 9.43                             | 155                          | 1.64    |
| 1994 | 10.54                            | 61                           | 0.58    |
| 1995 | 10.54                            | 8                            | 0.07    |
| 1996 | 11.28                            | 124                          | 1.10    |
| 1997 | 11.27                            | 101                          | 0.90    |
| 1998 | 8.55                             | 59                           | 0.69    |
| 1999 | 11.79                            | 561                          | 4.75    |
| 2000 | 12.39                            | 672                          | 5.42    |
| 2001 | 12.96                            | 474                          | 3.66    |
| 2002 | 13.27                            | 300                          | 2.26    |
| 2003 | 13.50                            | 296                          | 2.19    |
| 2004 | 14.50                            | 208                          | 1.43    |
| 2005 | 14.60                            | 76                           | 0.52    |
| 2006 | 15.33                            | 74                           | 0.48    |
| 2007 | 16.24                            | 33                           | 0.20    |
| 2008 | 16.81                            | 683                          | 4.06    |
| 2009 | 16.26                            | 464                          | 2.85    |

Note: MT = metric ton.

Source: NFA.

The NFA's official buffer stock policy is to maintain at least 30 days' supply in its hands on June 1 and at least 15 days' supply at other points of the year. The 15-day level is considered an emergency stock level. The NFA is also mandated to supply staples to calamity-stricken communities within 48 hours and to restore rice prices to pre-calamity levels within two weeks. The 30-day buffer stock on June 1 is meant to ensure the NFA's participation in the market for at least the duration of the lean production season of three months. The NFA procures relatively small amounts of paddy from farmers and has generally relied on cheaper imports to meet its buffer stock requirements.

NFA stocking and imports are meant not only to secure buffer stocks, but also to make up for perceived shortfalls between domestic production and requirements. The supply shortfalls are determined by the Inter-Agency Committee on Rice and Corn (IACRC), which meets regularly to assess the status and prospects of rice production and requirements, and to recommend imports to make up for estimated shortfalls. The assessments made by the IACRC are wholly based on physical volumes of rice demand and supply. Price is not a critical variable. Consumption is not expected to change with price changes, even with regard to changes in prices across food commodities that are good substitutes for rice in consumption.

The IACRC's import recommendation goes to the DA secretary, who endorses it to the NFA Council.<sup>4</sup> The NFA staff may also submit its own recommendation to the NFA Council, which then decides on the level of rice imports to be recommended for final decision by the President of the Philippines. The president's approval for the import is often required, because presidential approval is also required for the waiver or deferment of the import tariff on the NFA's imports, which, per the Philippines' Harmonized Customs and Tariff Code, is set at a prohibitive 50 percent ad valorem rate.<sup>5</sup>

While RA 8178 allows the private sector to import rice subject to NFA rules, the NFA maintains a virtual monopoly on rice imports. The NFA allows only a small amount of rice to be privately imported, setting the limit at equal to the minimum access volume (MAV) committed to the WTO.<sup>6</sup> The NFA distributes on a first-come-first-served basis<sup>7</sup> sub-lots of the total MAV

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<sup>4</sup> The DA secretary chairs the NFA Council.

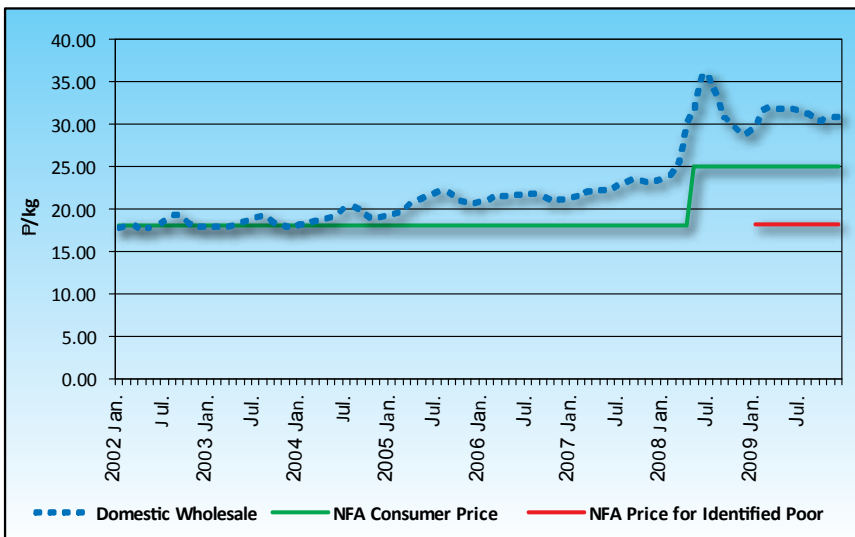
<sup>5</sup> For a brief period from 2002 to 2004 when the NFA actually paid tariffs for rice imports.

<sup>6</sup> Minimum Access Volume or MAV is that minimum amount of imports of an agricultural product that may be imported at a tariff rate lower than would be applied to volumes over and above the MAV. The MAV for rice is set at 350,000 MT per year from 2005 to 2012. Actual rice imports from 2005 to 2009 averaged at 1.9 Million MT (MMT) per year.

<sup>7</sup> Initially, "first" meant according to order of opening an import letter of credit with the Land Bank of the Philippines. This has been revised according to which applicant is able to pay a policy-determined minimum deposit, in advance, of estimated import duties.

amount, with maximum limits imposed on imports by specific importers.

On average, between 2006 and 2009, the NFA has supplied from 10 to 35 percent of total monthly consumer requirements. The NFA's legal mandate is to stabilize consumer rice prices and supplies. Operationally, the NFA's program is linked to another objective: to provide low-cost rice to the poor. Thus, NFA rice has been sold at prices lower than what prevails in the domestic market. As of 2009-2010, the rice was sold at ₱18.25<sup>8</sup> in special outlets, such as Tindahan Natin (Our Shop)—stores where only the identified poor supposedly have access, and at ₱25.00 in regular outlets to other consumers. Before the rice crisis of 2008, the NFA sold rice through all outlets at ₱18.25 per kilo. NFA also distributes rice to elementary school pupils in selected municipalities under the Department of Education's (DepEd) Food for School Program. The NFA's ₱18.25 price to consumers was lower than average domestic rice wholesale prices by about 12 percent in January 2006, with the gap increasing to about 40 percent by end-2009. Even the ₱25.00 NFA consumer price, adopted at the height of the 2008 rice crisis to move NFA prices nearer international prices, remained about 20 percent lower than average rice wholesale prices in 2009.



**Figure 7.3. Domestic Rice Price vs. NFA Consumer Price, January 2002 to July 2009.**

*Sources:* From Tolentino (2001, October), and updated by authors using data from the NFA and the Bureau of Agricultural Statistics.

<sup>8</sup> Foreign exchange rate was at ₱44 to US\$1, as of December 2010. See <http://www.xe.com/> for latest rates.



## Growing Rice Imports

The country's imports of rice as a proportion of total requirements have grown (Table 7.2). In the 1970s, this proportion was only about 1 percent. In the second half of the 1990s, some 6.75 percent of total rice requirements were imported,<sup>9</sup> while in the late 2000s imported rice comprised over 13 percent of total supplies.

**Table 7.2. Rice Imports as a Percentage of Total Domestic Supply**

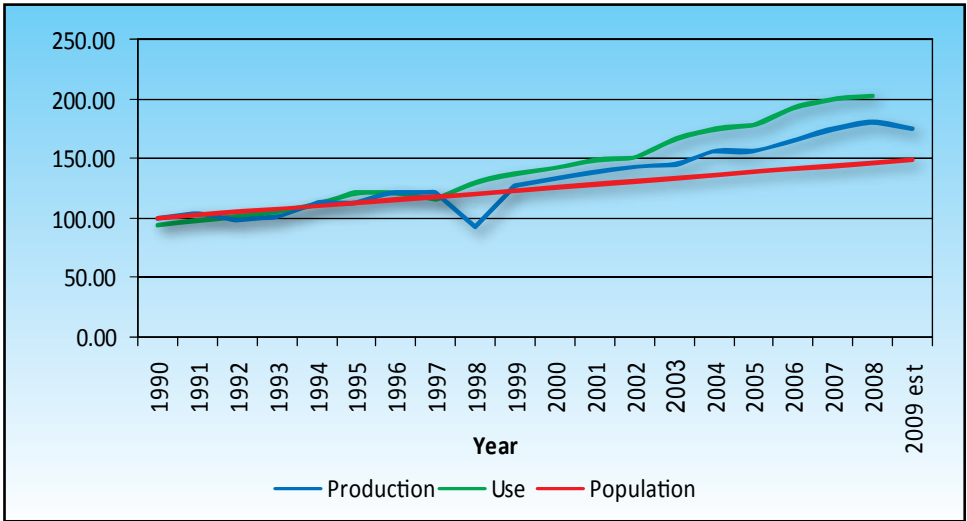
| Years   | Percent |
|---------|---------|
| 1990-9  | 41.95   |
| 1995-9  | 96.75   |
| 2000-04 | 7.55    |
| 2005-09 | 13.62   |

*Source:* Bureau of Agricultural Statistics (for raw data).

## Stagnation in Rice Productivity

Growth in the Philippines' production of rice has been quite slow. Despite the country's avowed goal of self-sufficiency, the rate of growth in rice productivity in particular, and of the agriculture sector in general, have lagged behind much of Asia. Worse, the rate of growth in the Philippines' rice production has lagged behind the rate of growth of its population and that larger population's consumption. As the population and its income have grown, its consumption of rice—not only as a staple but also as an ingredient in a host of rice-based foods, such as rice cakes, rice flour, etc.—has grown, to the extent that the country has now turned into a regular importer of rice (Figure 7.4).

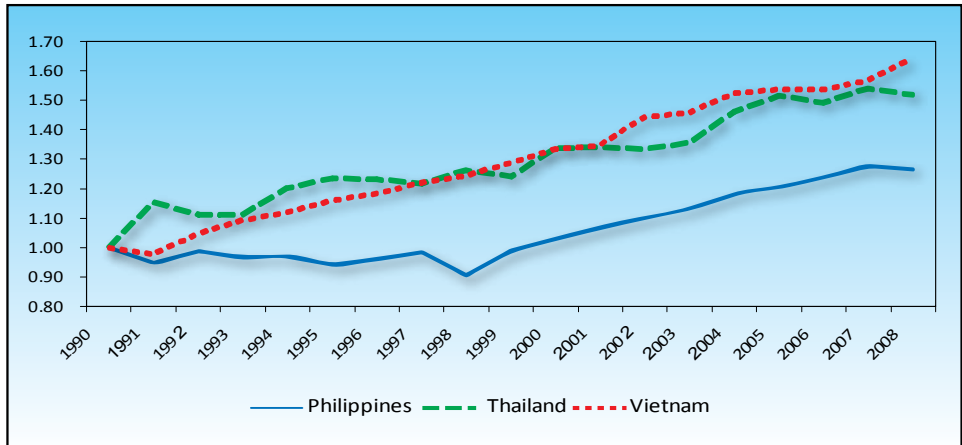
<sup>9</sup> Excluding 1998 when domestic production fell by more than 24 percent compared to the previous year, necessitating imports reaching some 22 percent of total supply.



**Figure 7.4. Rice Production, Rice Use and Population, 1990–2009.**

*Note:* 1990 = 100.

*Sources:* Bureau of Agricultural Statistics and National Statistics Office.



**Figure 7.5. Trends in Paddy Yields: Philippines, Thailand and Vietnam, 1990-2008.**

*Note:* Tons paddy per hectare; 1990 = 100.

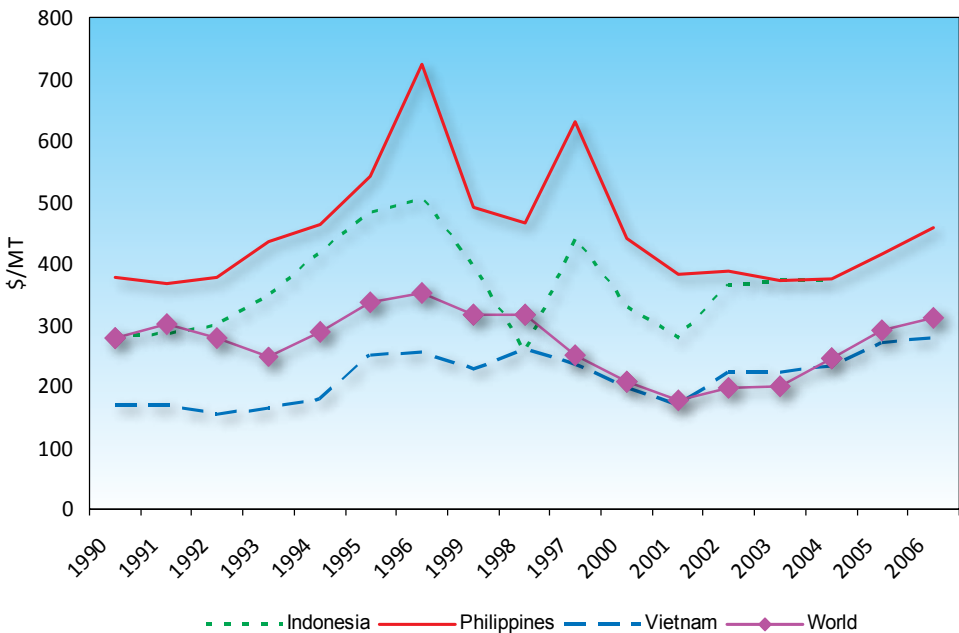
*Source:* Food and Agriculture Organization.

Relative to its major rice-producing neighbors in the Association of Southeast Asian Nations (ASEAN) region, the Philippines has been left behind in terms of productivity growth. Over the period 1990-2008, the growth of

Vietnam's rice productivity literally spurted upwards, and that of Thailand's steadily rose. In contrast, Philippine rice productivity floundered and regained upward momentum beginning only in 1999 (Figure 7.5).

### Growing Gap in Rice Costs and Prices

Equally worrisome as the lag in rice productivity is the trend in rice prices. Over the period 1990-2006, Philippine domestic consumer prices have been higher than those of Indonesia and Vietnam, and over a period were almost three times the latter, and also more volatile than world prices,<sup>10</sup> especially over the second half of the 1990s (Figure 7.6).



**Figure 7.6. Domestic Rice Prices for Philippines, Indonesia, and Vietnam, 1990-2006.**

*Note:* World Price = Class B Rice FOB (free on board) Thailand.

*Sources:* International Rice Research Institute (IRRI) for domestic prices; Food and Agriculture Organization (FAO) for world price.

<sup>10</sup> Thailand FOB price is commonly used as the world price.

## Mounting NFA Borrowings and Losses

With its buy-high-sell-low-store-long mode of operations, the NFA sustains losses for every kilo of rice sold. The NFA's buying price of ₱17.00 per kilo of palay translates to ₱26.00 per kilo in milled rice. A US\$500-per-metric-ton import FOB price<sup>11</sup> translates to ₱25.00 per kilo landed cost, excluding tariffs. Add to these milling, transport, handling, and storage costs of about ₱4.00 per kilo,<sup>12</sup> and the NFA loses some ₱13.25 to ₱14.25 per kilo of rice sold to retailers at ₱16.75 (₱18.25 to consumers) per kilo and about ₱6.50 to ₱7.50 per kilo of rice sold to retailers at ₱23.50 (₱25.00 to consumers) per kilo. If the NFA handles two million MT as it did in 2008 and 2009, losses could easily add up to more than ₱13 billion per year.

Each year, the NFA receives some ₱900 million in budget support from the government. Starting in 2005, it began receiving allocations from the Fiscal Incentives Review Board for tariffs paid on rice imports (tariffs were waived before 2002, but the NFA paid tariffs from 2003 to 2004).

To maintain its operations, the NFA borrows from commercial sources under government guarantee, for which it also sustains substantial finance charges—computed at about ₱3.30 per kilo of rice sold in 2008—contributing to even greater losses and borrowings. Trapped in a borrow-lose-borrow cycle and without substantial reform in its operations, the NFA's losses, borrowings, and cost of financing have grown rapidly from 2002 to 2009. By the end of the period, it earned the distinction of having the most borrowings among all government-owned and -controlled corporations (GOCCs).

**Table 7.3. The Financial Position of the National Food Authority (in ₱ billion)**

| Year<br>Loans | Loss from<br>Operations | Net Loss Before<br>Gov't Subsidy | Government<br>Subsidy | Net<br>Loss | Outstanding<br>Loans |
|---------------|-------------------------|----------------------------------|-----------------------|-------------|----------------------|
| 2002          |                         | 5.02                             | 0.90                  | 4.12        | 24.95                |
| 2003          | 5.5                     | 7.60                             | 0.92                  | 6.70        | 27.75                |
| 2004          | 9.0                     | 11.30                            | 4.80                  | 6.50        | 33.92                |
| 2005          | 5.4                     | 5.40                             | 0.30                  | 5.10        | 55.05                |

<sup>11</sup> The world price of rice, represented by Thailand B FOB, averaged at US\$697 per MT in 2008 and US\$583 per MT in 2009.

<sup>12</sup> Computed using 2008 NFA financial statements, with some assumptions based on more detailed 2004 statements.

| Year<br>Loans | Loss from<br>Operations | Net Loss Before<br>Gov't Subsidy | Government<br>Subsidy | Net<br>Loss | Outstanding<br>Loans |
|---------------|-------------------------|----------------------------------|-----------------------|-------------|----------------------|
| 2006          | 8.8                     | 11.40                            | 0.90                  | 10.50       | 64.08                |
| 2007          | 3.9                     | 5.00                             | 2.10                  | 2.90        | 52.40                |
| 2008          | 21.3                    | 36.80                            | 2.00                  | 34.80       | 121.80               |
| 2009          | 19.3                    | 37.20                            | 4.20                  | 33.00       | 131.50               |

*Sources:* COA Audited Financial Statements up to 2007; NFA Unaudited Statement for 2008; NFA Budget Estimate for 2009.

### Shifts in Policy Protection and Support for Rice<sup>13</sup>

International factors help explain the shifts in policy protection and support for rice in the Philippines. Throughout the 1970s, world commodity prices were relatively high, encouraging the deployment of price interventions that benefited manufacturing at the expense of agriculture. Many studies have amply demonstrated that these policies created an incentive structure significantly biased against agriculture up to the early 1980s. The bias showed in the overvaluation of the peso due to the industrial protection system and other economy-wide policies to defend large balance-of-payments (BOP) deficits. These policies included QRs on a wide range of imports—including rice—strong controls on foreign exchange, and the monopoly powers of the NFA.

World commodity prices began to fall in the late 1970s, but the policies and institutions earlier established in a regime of high commodity prices—such as the NFA—persisted. These had become a convenient revenue source for the state, a source of largesse for private interests, and a crutch for bureaucratic inefficiencies. President Corazon Aquino (1986-1992) dismantled some of the direct interventions, but neglected to eliminate the NFA's monopoly on the international trade of rice.

In 1995, the Philippines acceded to the WTO, promising to remove all quantitative restrictions and reduce tariff protection. But this promise has remained only partially implemented. Rice has been exempted from tariffication. Moreover, while the Philippines has opened up imports of rice under a MAV system, in operation the MAV is equivalent to a QR. MAV limits are much lower than estimated domestic demand at the lower in-quota tariff rate. Moreover, since the import rights on MAV are not auctioned, large rents

<sup>13</sup> Discussion in this section owes much to Cristina David (2002).

accrue to a few privileged importers.

In the early- to mid-1980s, the domestic price of rice averaged just equal to the border price converted at the official exchange rate. The Green Revolution in rice improved the Philippines' comparative advantage in rice production, enabling the country to briefly attain self-sufficiency and reduce domestic rice prices in real terms. However, since the decline in the world price of rice, the sharp fall in irrigation investments, and the stagnation of the yield potential of newer modern varieties, growth in demand for rice rose faster than production by the late 1980s, leading to the need for imports. The NFA, however, strictly limited import volumes to levels that prevented any reductions in real rice prices (Inocencio & David, 1995).

Important shifts over time are also observed in public support for agriculture. The sector's unique features—particularly its preponderance of public good elements—mean that market failures are pervasive, and that the private sector will under-invest in the key factors to accelerate or sustain agricultural growth, including modern technologies, irrigation, and market infrastructure. Moreover, many agricultural activities often generate large externalities that require regulations, market-based policy instruments, and/or public support for resource rehabilitation to protect the environment and people's health. For example, irrigation and other productivity-enhancing investments generate large positive externalities in enhanced food supplies, nutrition, and other downstream benefits. On the other hand, large piggery or poultry operations generate negative externalities in the disposal of animal wastes.

A key issue in Philippine agricultural support services has been less a matter of under-spending or under-investment, and more one of misallocation due to inefficiencies in budgetary allocations within the sector, and low economic returns or doubtful cost-effectiveness of many government projects and programs. Historically, public expenditures for the sector—in real terms and as a ratio to gross value added—and total government expenditures fluctuated widely, increasing sharply between 1973 and 1983. Since the early 1980s, the agriculture sector had bore the brunt of contractionary policies of the waning Marcos regime. The entry of President Aquino saw agriculture sector expenditures recover quickly in the late 1980s. After peaking in 1991, agricultural expenditures dropped once more, followed in 1993 by another cycle of sharply rising and declining trends after 1997. By the late 1990s, agriculture expenditures in real terms and as ratio to gross value added (GVA) were already above the high levels of the 1970s, constituting about 8 percent of total public expenditures.

The government's strategic priorities are revealed in the pattern of budgetary allocations by policy instruments, commodities, and regions. At the DA, and to some extent also at the Department of Agrarian Reform (DAR), strategic directions tend to be identified by commodities, which in turn affect regional budgetary distribution and choice of policy instrument. In the 1970s, expenditures were mainly on irrigation, accounting for half of all agricultural spending. In the late 1980s, higher public expenditure was initially allocated to the strengthening of natural resource and environmental management, and rehabilitation of forest and fishery resources. Redistributive purposes, such as the agrarian reform program and rice price stabilization, were much better supported than the productivity-enhancing investments (David, 2002). Since then, greater allocations have been made in subsidies to credit, postharvest facilities, farm machineries, seeds, and other agricultural inputs. But these have been mostly for rice in recent years. Public resources devoted to price stabilization and irrigation are significantly higher when service fees and other NFA income are accounted for.

In the case of irrigation, about ₱1 billion is generated from service fee collections, interest earnings, equipment rental, and other sources, raising total irrigation expenditures by another 20 percent. Moreover, adding the NFA's other income (₱2 billion in 2007) to the direct budgetary allocation to NFA<sup>14</sup> makes rice price stabilization the top item of public expenditures in recent years.

**Table 7.4. Agriculture Appropriations (In ₱ million, current prices)**

| Year | NFA      | Irrigation | DA Rice Program | Total for Rice | Other Agri | Agrarian Reform |
|------|----------|------------|-----------------|----------------|------------|-----------------|
| 2005 | 900.00   | 4,165.57   | 2,029.73        | 7,095.30       | 7,439.49   | 4,881.26        |
| 2007 | 1,100.00 | 7,399.14   | 2,421.86        | 10,921.00      | 8,006.34   | 5,506.28        |
| 2008 | 2,000.00 | 7,996.53   | 3,289.84        | 13,286.37      | 14,093.38  | 2,323.72        |
| 2009 | 4,000.00 | 12,610.47  | 10,038.86       | 26,649.33      | 19,349.66  | 13,173.13       |
| 2010 | 8,000.00 | 13,599.39  | 4,031.60        | 25,630.99      | 23,283.02  | 20,767.78       |

Source: Republic of the Philippines, General Appropriations Act (GAA), various years.

<sup>14</sup> Includes allocation for tariffs paid on rice imports.

## Stakeholders in Philippine Rice Policies

Over the last century, the government's direct role in rice sector production and marketing has deepened. Given that the rice produced in the Philippines is largely from open-pollinated seeds,<sup>15</sup> the significant role of government is unavoidable since rice production is heavily dependent on public goods, especially research and development, extension, irrigation, transport, and related technology and infrastructure (David, 2006).

The Philippine government's interventions in rice marketing are much more problematic. These interventions—which have been sustained since the creation of the NFA in the early 1970s—have been defended as responses to market failures, which are observed in “high” rice prices for consumers and “low” paddy prices for farmers. The monopoly and quantitative restrictions on rice trade implemented by the NFA have led to artificially high domestic rice prices (see Figure 7.6) and impose deadweight losses on the economy, not to mention other costs that arise out of inefficient operations of a public parastatal (Accelerating Growth, Investment, and Liberalization with Equity [AGILE], 2000).

In response to the spike in rice prices in 2008, the rice subsidy program budget for the NFA was expanded five-fold to 2.5 percent of gross domestic product (GDP), and now the NFA is the largest recipient of government subsidy and is also the largest loss-making government corporation (Jha & Mehta, 2008).

While the NFA's operations account for a significant and growing proportion of the Philippine government's public debt (see Table 7.3), any efforts toward reforming the NFA and the policies underlying its continued operations are met with stiff opposition from the NFA's stakeholders—especially some farmers' groups, some consumers' associations, the NFA staff, and a wide range of enterprises dependent on the NFA's continued operation.

It is important to carefully parse the stakeholders in the NFA and current rice marketing policies. Only a small proportion of farmers are served by the NFA's domestic procurement operations, since the NFA's procurement is limited to an average of less than 3 percent of total production. Moreover, the farmers who benefit from the NFA's procurement operations are those located closest to the NFA's principal warehouses and rice mills on Luzon Island near the capital—particularly in Central and Southern Luzon. The rest of the country's rice farmers deal with private sector rice traders at open

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<sup>15</sup> Open-pollinated crops allow farmers to save a proportion of their harvest for use as seed for future planting. This feature reduces private incentives to produce higher-yielding varieties, since the benefits from such improved varieties cannot be limited to innovators.



market prices.

The small subset of rice farmers who are served by the NFA's procurement operations, by virtue of their being close to NFA facilities and the capital, are also among those groups easiest to mobilize in mass actions related to NFA reform. Over the decades of the NFA's continued operations, these farmers have grown increasingly reliant on NFA procurement—and thereby value the continued existence of the NFA and the perpetuation of the set of policies that give rise to the NFA and its monopoly on rice trade. More generally, farmers are hesitant to support NFA reform because they believe that the quantitative restrictions on rice imports protect them, and the palay support price is the one remaining farm subsidy available to them, regardless that NFA palay buying has been very limited while imports have expanded.

The NFA's activities affect different groups of consumers in varying ways. Those consumers who are able to purchase rice from NFA's outlets are able to take advantage of the subsidized price (relative to domestic market) of rice. Yet these consumers are estimated to account for no more than 12 percent of all consumers (AGILE, 2000). Other consumers have to contend with the domestic market rice prices—which, due to the NFA's monopoly of rice trade, is two to three times international prices! Given that the NFA food subsidy is a very poorly targeted mechanism, there is a great deal of leakage to the non-poor—a result suggested by orthodox economic analysis (Balisacan, 1995), and substantiated in recent empirical analysis (World Bank, 2010).

Moreover, the NFA staff, union, and association of employees, fearful that their jobs and NFA-related sinecures are on the line in a reform of the NFA, constitute a lobbying power in support of the continuation of current policies.

Finally, the NFA's operations, especially imports and domestic distribution, have supported the creation and growth of a wide array of related and ancillary enterprises in shipping, cargo handling, finance, storage, transport, drying, processing, wholesale, retail, and so forth. These businesses provide goods, labor, finance, and services to the NFA, and thus the owners of and investors in these businesses are wary of any reforms that will force them to give up or even endanger their current shares and sinecures. The NFA-accredited retailers and other NFA distribution outlets, including congressmen, governors, mayors and even church groups, benefit from NFA's low release prices<sup>16</sup> and will have much to lose in NFA reform.

In short, the beneficiaries of NFA reform are the general public—taxpayers who bear the burden of fiscal subsidies to the NFA, and who bear

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<sup>16</sup> If these outlets re-label or mix NFA rice with commercial rice, then the trading spreads are much bigger than official spreads allowed by the NFA.

the opportunity losses arising from the NFA's inefficiencies; the majority of farmers (those unserved by NFA procurement); and the majority of consumers (those unable to access subsidized NFA rice). Unfortunately, these anticipated beneficiaries from NFA reform, though very large in number, are unorganized and spread out across the country. Moreover, while in the aggregate the social benefits arising from NFA reform will be large and significant, on an individual, disaggregated basis, such benefits may be quite small and do not provide significant incentive for learning and action toward reform.

In contrast, the beneficiaries of the current distorted and economically inefficient policies and arrangements in rice marketing in the Philippines are relatively concentrated and organized. Their concentration enables these beneficiaries to individually receive substantial benefits from the current policies, and thereby provides the incentive for resistance and maintenance of the current policy regime.

### **1980s-2000s:**

#### **Overview of Efforts Toward Reforms in Rice Marketing**

The government has long recognized that there are major challenges to be faced in ensuring food security in the Philippines. In fact, the government successfully met the food security challenge during the 1970s, when the Philippines emerged as a leading implementer of the Green Revolution. However, the country's gains of the 1970s were dissipated in the excesses of the dictatorship of President Marcos. By 1986, the country was again a significant importer of rice.

Over the past three decades, there have been many attempts to reform the rice marketing system in the Philippines, especially the system's largest and most visible aspect, the NFA—one of the largest state-owned and -operated corporations in the country. Table 7.5 summarizes those attempts from 1980 onwards. Except for two episodes of reform in the early- to mid-1980s, the attempts at reform were all organized as collaborations between the government of the Philippines and a wide array of international donors. The donor agencies supported the reform efforts with analyses, studies, advocacy, and investment funds.

**Table 7.5. Timeline, Philippines Rice Policy and NFA Reforms, 1980-2010**

| <b>Period</b> | <b>Reform Accomplished</b>  | <b>Key Objectives</b>  | <b>Technical Assistance</b>  | <b>Agencies Involved</b>                 | <b>Related Developments</b>   |
|---------------|---|--|--|--|---|
| 1983-1985     | Presidential EO withdraws NFA involvement in non-grains; wheat and feed trading liberalized, privatized; NFA trading limited to rice and corn | Limit support for Government corporations, including NFA; Reduce NFA involvement in food trade | Loan with Conditionalities, Structural Adjustment Program            | Office of the Prime Minister<br>IMF - WB | Debt crisis; Aquino assassination; snap elections                               |
| 1986 - 1989   | NFA issues guidelines to privatize corn trading but QR maintained; NFA trading limited to rice  | Implement NFA adjustments given reduced support to GOCCs; Improve NFA efficiency               | Analysis TA; Study   | DA<br>NFA<br>USAID<br>AAPP               | People Power; Revolutionary Aquino Government                                   |
| 1991 - 1995   | The Government of the Philippines accedes to WTO; Remaining QRs on agriculture products, including corn but except rice, tariffed.            | Improve agriculture sector productivity and support liberalization of regulated sectors        | Analysis and Advocacy TA   | DA<br>USAID<br>ASAP                      | Conclusion of GATT UR Negotiations; WTO created; Philippine rice crisis of 1995 |
| 1996 - 1997   | Selected donors prepare for rice sector reform project  | Improve food security  | Rice Sector Reforms Study (becomes basis for ADB & USAID assistance) | DA<br>ADB                                | Asian financial crisis of 1997-1998   |
| 1998          | Agriculture and Fisheries Modernization Law passed – promotes food security. Self-sufficiency in rice is made official policy                 | Agriculture and Fisheries Modernization Act  |  | Congress                                 |   |

| Period      | Reform Accomplished  | Key Objectives   | Technical Assistance                 | Agencies Involved                     | Related Developments   |
|-------------|--|--|--------------------------------------|---------------------------------------|--|
| 1996 - 2003 | Donors support projects to improve understanding of rice sector issues   | Corporate reform of NFA; Privatize trading function; Improve NFA's finances. Transfer subsidized-rice distribution to DSWD | Studies                              | NFA<br>DSWD<br>USAID<br>AGILE<br>EGTA | People Power 2 (2001)<br>AGILE project under Senate investigation for rice policy advocacy.      |
| 2002 - 2004 | NFA issues guidelines to adjust rice buying price  | Liberalize rice trade in keeping with WTO commitments (exemption of rice from tariffication lapses by 2005)                | GSDP TA component, aimed at advocacy | DA<br>NFA<br>ADB<br>GSDP              | ADB GSDP loan terminated   |
| 2002 - 2005 | President announces open participation in rice trade subject to payment of tariffs (2002). NFA begins paying tariffs on rice imports using, initially, loan proceeds and, later, FIRB subsidies. | NFA begins allocating volume for private sector imports  |                                      |                                       | Philippines successfully negotiates at WTO for extension of exemption of rice from tariffication |
| 2006 - 2007 | With donor support, NFA designs and implements some improvements in NFA administration and management  | Enhance efficiency of NFA corporate operations; Improve governance of GOCCs  | Study Advocacy TA                    | NFA<br>DA<br>DOF<br>AusAID<br>PEGR    |  |
| 2007 - 2008 | Philippine institutions undertake additional studies on rice policy  | Enhance grains productivity and marketing efficiency   | Study on Food Security               | PhilRice<br>SEARCA                    |  |

| Period      | Reform Accomplished   | Key Objectives  | Technical Assistance      | Agencies Involved                | Related Developments   |
|-------------|---|---|---------------------------|----------------------------------|--|
| 2008 - 2009 | <p>NFA issues guideline to adjust <i>palay</i> support price upward.</p> <p>DSWD and NFA implement program to distribution of low-priced NFA rice to poor families identified by Access Cards; NFA issues guideline to adjust rice retail price of NFA rice upwards.</p> <p>NFA implements reorganization program pursuant to EO on "Government Rationalization."</p> | Adjustments to food price crisis; Improvements in targeting of beneficiaries of subsidized rice. Improved efficiency of NFA | Study Advocacy TA         | OP<br>DA<br>NFA<br>DSWD<br>DBM   | International food price crisis (2008); US and international financial crisis (2009) |
| 2009 - 2010 | Donors support projects to push improved understanding of rice sector issues among key stakeholders and public.   | Enable recovery from food price crisis, enhance grains productivity and marketing efficiency                                | TA<br>Emergency Food Loan | DA<br>USAID<br>FAO<br>World Bank |  |

*Notes:* AAPP = Accelerated Agriculture Productivity Program; ASAP = Accelerated Systems Agribusiness Program; AusAID = Australian Agency for International Development; DBM = Department of Budget and Management; DSWD = Department of Social Welfare and Development; EGTA = Economic Governance Technical Assistance; Fiscal Incentives Review Board (FIRB); GS DP = Grains Sector Development Program; IMF = International Monetary Fund; OP = Office of the President; PEGR = Partnership for Economic Governance Reforms; PhilRice = Philippine Rice Research Institute; SEARCA = South East Asian Regional Center for Graduate Study and Research in Agriculture; USAID = U.S. Agency for International Development.

*Source:* Matrix developed and assembled by authors from various sources.

Several observations may be made regarding the reform programs listed above. In hindsight, the reform efforts and interventions supported by donors generally did not achieve their objectives, whereas those reforms implemented largely on their own by the Philippine Government from 1983

to 1989 achieved significant positive change.

Technical assistance that was provided as part of the reform activity was generally limited to analytical support, and usually to a specified government agency. Little attention was given to identifying, educating, and building constituencies for reform outside of government. This is a crucial gap in programming, because the constituencies for maintaining the status quo in Philippine rice marketing policy are strong, based on their incentives to protect their rents arising from current policies, programs, and the general public's misconceptions of NFA's role in food security.

An early reform effort executed by the Philippine Government began in the early 1980s and culminated in 1985, ending the NFA's involvement in the marketing of all food products except rice and corn. The context for the change was the closing years of the failing administration of President Marcos, highlighted by a serious fiscal crisis in the wake of the global oil price shocks of the early 1980s. In this instance, the Philippine government had little choice but to implement reforms, which included drastic reductions in budget support to government parastatals, including the NFA. This was an action that had already been strongly recommended by the IMF, which the government had approached for assistance.

The 1980s were also an era marked by the implementation of "structural adjustment reforms" established as conditionalities to the provision of assistance by the international monetary institutions, principally the IMF and the World Bank. Thus, with the mere stroke of a pen, President Marcos, acting in his capacity as virtual dictator, issued a set of presidential decrees that vastly reduced the scope and scale of the NFA's role in food marketing. Again, these policy measures had been required as conditionalities in IMF assistance to the Philippines.

Throughout its tenure from 1986 to 1992, the Aquino government was acutely aware of the need for more effective food security policy, and in fact instituted major reforms in food price and buffer stocking during the euphoric but brief honeymoon period just following Aquino's entry into power—a context characterized by fiscal crisis, domestic unity, and generous international goodwill. Between 1986 and 1988, given the Freedom Constitution and the absence of a legislature, President Aquino governed by issuing executive orders. A key EO privatized the importation of corn within set quantitative restrictions. This change was consistent with the earlier Marcos-era presidential decrees that reduced the NFA's involvement in food products and was widely supported by the business sector and the population eager to remove any vestiges of Marcos-era economic regulations.

The reforms instituted by President Aquino were also in keeping with

conditionalities that mandated greater privatization and liberalization—the basic elements of the IMF financing program which the Aquino administration inherited. In implementing the reforms, the Ministry of Agriculture and Food (later called the Department of Agriculture or DA) set the volume limits or QRs on corn imports at levels generally accommodating the stated feed requirements of the fast-growing livestock and poultry industry. The NFA allocated the resulting import volumes among the various livestock and poultry raisers, and also continued to buy corn from farmers at support prices set higher than domestic farmgate prices.

Further changes in the rice sector were instituted between 1987 and 1990. These tweaks, labeled part of the Rice Productivity Enhancement Program (RPEP), aimed at increasing farmers' incomes while maintaining the NFA's involvement in grains trade. The tweaks focused on correcting distortions in rice economics created by past reliance on input and credit subsidies for promoting production.

A study supported by USAID did examine the NFA's operations, particularly the efficiency and impacts of its buy-high-sell-low involvement in rice trade. But recommendations for adjusting selling prices upwards to fully account for longer storage costs during the lean season did not prosper, with actions held back by the government's assessment that any reforms would lack popular and political support. Popular will was interpreted to focus on protection for both producers and consumers while squeezing trader profits, which were deemed excessive.

The mid-1990s saw renewed enthusiasm among reform-minded analysts and government officials for the reform of the NFA and rice marketing. First, the UR of multilateral negotiations under the GATT was finally concluded, with the countries represented in negotiating parties agreeing to reform programs that called for an immediate replacement of import QRs with tariff quotas, and the reduction of tariffs over a 10-year period.

In the WTO request and offer processes, the Philippines offered the removal of its agricultural QRs—tariffication and the binding and reduction of agricultural tariffs. However, the country also sought to exempt rice in these policy changes. Through several cycles of WTO negotiations over the last two decades, the Philippines has successfully negotiated extensions on the exemption of rice from tariffication. This success has resulted in little or no serious consideration by the government of moves to reduce tariffs or remove import QRs.

Advocacy by the DA and the executive branch, with assistance by USAID, paved the way for the Philippine Senate's ratification of Philippine accession to the WTO.

In keeping with UR agreements, RA 8178, or the Agricultural Tariffication Act, was enacted in 1995, mandating the tariffication of remaining import QRs on agriculture products, including corn. Rice was excluded from tariffication, but RA 8178 addressed the possible need for rice imports by providing that “The (National Food) Authority shall undertake direct importation of rice or it may allocate import quotas among certified and licensed importers.” Thus, while rice import QRs were maintained, the legal basis for the NFA’s monopoly on rice imports was at least diluted.

Another impetus for change was a rice crisis in 1995, which in hindsight manifested in perceived rice supply shortages and an accompanying rice price bubble caused by several policy mistakes. First, severely limiting rice imports to assuage farmers after the passage of RA 8178 resulted in tight supplies and saw prices rise to unprecedented levels, hurting the consuming public and causing outrage and panic. Second, the imposition by the Department of Trade and Industry (DTI) of price controls on rice resulted in less rice being made available in the open market. Finally, continued selling by the NFA at prices much lower than market spawned long queues of people wanting to buy rice from the NFA and a much faster drawdown of NFA buffer stocks.

From 1992 to 1993, the International Food Policy Research Institute (IFPRI) supported a study on food security in the Philippines (Balisacan, Clarete, & Cortez, 1992). The study is significant because the results became the basis for subsequent loan-cum-technical assistance to the Philippines from ADB and USAID on rice sector reforms. This was buttressed in 1998 when the promotion of food security, “including sufficiency in rice and corn,” became official policy when the AFMA of 1997 was passed into law.

From 1998 to 2003, USAID and ADB supported the reform agenda proposed in the ADB study, but with little success. USAID worked with the NFA on restructuring the latter’s corporate operations and financial management. Some advocacy work aimed at legislation—as well as executive action—was also initiated with the Office of the Presidential Assistant on Food Security. The NFA rank and file resisted these moves strongly, as these appeared to threaten the NFA’s status.

Later, USAID supported work with the Department of Social Welfare and Development (DSWD) to introduce a means test-based, targeted food subsidy program. This program was, however, cut short when USAID support was aborted following the Senate’s scrutiny of the USAID’s role and possible intrusion into matters of Philippine sovereignty, as organized under its AGILE project. Meanwhile, ADB worked with the Departments of Finance and Agriculture on a loan-cum-policy reform program for rice and corn—the Grains Sector Development Program (GSDP).



President Gloria Arroyo (2001-2010) came into power in 2001 following the departure of President Estrada. On advice from her presidential assistant for food security, she announced in her 2002 State of the Nation Address (SONA) that the private sector would be allowed to import rice as long as tariffs, set at 50 percent, were paid. The NFA then began to allocate import quotas for the private sector, initially limited to farmers groups and later expanded to traders. At the same time, the government withdrew the NFA's tariff-free import privilege. These moves were meant to signal that government was prepared to level the playing field between the private sector and the NFA.

However, these measures did not translate to significant private sector involvement in imports because: (a) the total quota on rice imports allowed to the private sector was—and remains—small relative to total imports, and (b) in combination, the world price, domestic price, and 50-percent tariff have made rice imports by the private sector unprofitable. Tariffs on the NFA's imports were, in effect, waived by the government. Moreover, private sector imports were restricted to be executed within some specified period during the country's rice lean season, a period when the NFA also imports in large volumes, which are released to the market at subsidized prices or at a loss.

World rice prices slowly but steadily rose through the decade of the 2000s, resulting in the worsening trading losses for the NFA. In 2006-2007, the Australian Agency for International Development (AusAID) worked with the Departments of Finance (DOF), Agriculture (DA), and the NFA on a study to restructure NFA operations and make it more efficient. Per agreement between AusAID and the government, the study focused on operational issues that the NFA could control, but in the end, the study acknowledged that policy issues—pricing, tariffs, and private sector imports—had to be tackled to address the larger part of NFA's losses. The NFA, with AusAID assistance, prepared a program to reform these policy elements for submission to the Cabinet and the President, only to await action on the recommendations in vain.

The 2008-2009 global food price crisis again underlined the need for reforms in Philippine rice marketing. Philippine stocks were low in 2007-2008, and as supplies tightened and prices rose in 2008, the government resorted to panic procurement. Responding to price signals that had been driven up by the Philippines' panicked behavior, other countries adopted export control measures. As a result, the Philippines had to import at prices more than double those of the previous year, further multiplying the NFA's trading losses. With domestic prices soaring at the height of the crisis, the NFA was forced to increase its price to consumers from ₱18.25 to ₱25.00 per kilo in an attempt to quell the rapid drawdown of its stocks. This higher price

regime was later maintained for regular outlets, but the lower ₱18.25 per kilo rice was again made available to holders of access cards—the “poor” families identified by local government units (LGU) and the DSWD.

The food price crisis also heightened the imperative to increase domestic rice productivity. President Arroyo launched the F.I.E.L.D.S. Program covering subsidies for F—Fertilizer; I—Irrigation and Infrastructure; E—Extension and Education; L—Loans and Insurance; D—Dryers and other post-harvest facilities; and S—Seeds, financed partly by an emergency food security loan from the World Bank. The provision of the loan opened up some space for donor-government dialogue on the role of the NFA in food security. As the Arroyo administration came to a close in 2009-2010, officials of the DA reported a growing consensus in government that the NFA would need to adjust its prices to account for costs, reduce its share of imports to the buffer stock requirements, and allow the private sector to import the rest. The NFA's social function, i.e. selling subsidized rice to the poor, will be transferred to the DSWD, possibly merged with the latter's Conditional Cash Transfer Program (CCTP). The new administration under President Benigno Aquino III (June 2010-present) is now supporting the transfer of budgetary appropriations from the NFA to the DSWD's CCTP.

### **The Grains Sector Development Program and GSDP Loans**

In this section, we take a close look at the GSDP and the associated GSDP loans as a specific reform effort. The GSDP was launched in 1990 under President Cory Aquino. Further reformulation and development continued through the term of President Fidel Ramos (1992-1998), but it was not until 2000 that the government and ADB finally reached agreement on the terms. The loan became effective in August 2000 under President Joseph Estrada (1998-2001) and Agriculture Secretary Edgardo Angara. From project identification to effectivity, the GSDP program covered 10 years, three presidents and five secretaries of agriculture!

The GSDP loan program was designed to finance important components of the Philippines' programs in grains productivity, food security, and poverty alleviation. The GSDP was expected to help overcome the policy, institutional, and investment constraints resulting in low grains productivity and food insecurity, in a manner consistent with the Medium-term Philippine Development Plan (MTPDP), the sectoral agriculture development plan, and AFMA. These programs include those for rice and corn, and the support for key agriculture agencies such as the DA and its component agencies, such as the Philippine Rice Research Institute (PhilRice), the Agriculture Training Institute (ATI), the Bureau of Agricultural Statistics (BAS), the Bureau of

Agricultural Research (BAR), the Bureau of Plant Industry (BPI), the Bureau of Soils and Water Management (BSWM), the National Irrigation Administration (NIA), and the DA's Policy and Planning Group (PPG).

The GSDP was an integrated package of five components of policy and institutional reforms, sector investments, and advisory technical assistance (TA) projects aimed at making the grains sector more productive and internationally competitive, while helping the country meet its food security objectives. The five components were: (1) policy and institutional reforms to ensure increased private sector investments; (2) irrigation facilities and farm-to-market roads in key grains areas; (3) activities to strengthen the generation and dissemination of grains technology; (4) improvement of the government's capacity in grains statistics for policy analysis; and (5) efficient GSDP management.

The GSDP package included two loans totaling US\$175 million to be disbursed from 2000 to 2005. The first loan of US\$75 million was to finance investments in irrigation, advanced rice and corn production technology, and improved capacity in policy and planning. The GSDP policy loan worth US\$100 million was designed to push the policy matrix agreed upon between the government and ADB consisting of: (a) liberalized, more cost-effective grains pricing and trade; (b) improved grains buffer stock administration; (c) a restructured NFA to focus on grains trading, with policymaking and regulation assigned to a separate line agency; and (d) design and implementation of a targeted food subsidy safety net for the poor. The GSDP policy matrix was consistent with the Philippines' commitments under the WTO Agriculture Agreement and the ASEAN Free Trade Agreement (AFTA).

The GSDP loans were complemented by four advisory technical assistance projects in support of program implementation: (a) the "Grains Policy and Institutional Reforms" project, which provided advocacy and policy analysis assistance to the DA and the NFA in carrying out the reform agenda; (b) an assessment of the financial health of the NFA; (c) options for the restructuring of the NFA; and (d) design of a food subsidy program targeting the poor. The second and third projects were financed by the USAID and completed in 2000 under the AGILE project.

The GSDP included a policy advocacy component, signaling recognition of the politically controversial nature of the reforms included in the GSDP policy matrix. These reforms were intensively advocated to the full extent enabled by the technical assistance component of the GSDP, and over a relatively short period, grains sector issues, facts, and information relevant to decision-making were put on the table for dialogue and decision. Yet, by the end of 2003, it became clear that the grains sector reforms would not be achieved,

given the combined effect of three factors: (1) the outlook and strategy on grains sector reforms at the DA had changed, as political and populist pressures waxed and waned; (2) the time and resources required for the advocacy for, and completion of, the envisioned reforms in the face of the sheer size and diversity of the stakeholders had been underestimated; and (3) resistance to the reforms mounted by selected stakeholder groups—notably those farmer-leaders and grains entrepreneurs who have directly received benefits from the NFA's operations, and the NFA Employees Association—was intense.

In late 2003, given the non-implementation of the agreed-upon policy matrix, the GSDP loans were cancelled by mutual agreement between the Philippine Government and ADB. The key reason given for the cancellation was the change in thinking on the government's side with regard to key aspects of the policy matrix, due to changes in officials accountable for the grains sector reforms. The new officials came in when Estrada was replaced by Arroyo as president in January 2001. President Arroyo appointed Leonardo Montemayor, a farmer-leader, as agriculture secretary. Montemayor immediately disowned the policy initiatives of his predecessor, which included the moves toward rice sector reform.

### **The Institutions of Rice Sector Governance in the Philippines**

Over the last two decades, while there has been relative stagnation in Philippine agriculture, there have been many and frequent changes in the institutional structures of governance, as well as in the officials of government responsible for the sector's governance. To what extent can such frequent changes in the agricultural bureaucracy and bureaucrats explain the poor performance of the sector?

Through the years, the DA has undergone several episodes of reorganization: (a) 1983–1984 under Secretaries Tanco and Escudero; (b) 1986–1987 under Secretaries Mitra and Dominguez; (c) 1992–1994 under Secretaries Bacani and Sebastian; (d) 1998–2001 under Secretaries Angara, Panganiban and Montemayor; and (e) 2002–2010 under Secretaries Lorenzo, Panganiban and Yap. Virtually, all senior-level officials of the Philippine government—from the level of assistant director upwards to secretaries—are political appointees hand-picked by the President. Assistant directors are at the fifth level of the Philippine bureaucracy, with secretaries at the first level below the president. At the DA, at least 200 posts are to be filled by presidential appointments. Thus, when presidents change, the appointees to the top levels of government also change. Since there have been five presidents since the departure of Marcos in 1986, there have been at least five sets of changes of all political appointees.

There are ongoing efforts to create a permanent civil service through the Career Executive Service Officer (CESO) system. However, the process of institutionalizing the CESO system has been slow due to its nature as a system of accreditation and qualification. In order to be recognized as a CESO, and thereby protected from capricious removal from office, individual civil servants have to gain the qualities required for appointment to a permanent or tenured post through examination and experience. However, despite the existence of the CESO system, appointing authorities have chosen to override the system or ignore its controls.

Since 1971, 14 men have served as secretary of Agriculture. Since the EDSA 1<sup>17</sup> revolution of 1986, and the average service period of the agriculture secretary has been about 19 months (Table 7.6). However, there is great variability in the length of service among the secretaries. Arturo Tanco served for 162 months, while Domingo Panganiban served for barely a month. Tanco was secretary from 1971 to 1984. Thus, it can be observed that, prior to 1986, the top leadership of the DA was quite stable, with the secretary and his team being in place for at least five and a half years. In contrast, the periods of service of the agriculture secretaries from 1986 up to the present have been quite short. Since 1986, 10 men have served as agriculture secretary, each serving an average of only about 19 months. Moreover, since 1986, *none* of the agriculture secretaries have been able to serve their full six-year term.

**Table 7.6. Department of Agriculture Leadership, 1971–2010**

| From-To                    | Secretary of Agriculture | Months of Service |
|----------------------------|--------------------------|-------------------|
| January 1971 - June 1984   | Arturo M. Tanco*         | 162               |
| July 1984 - February 1986  | Salvador H. Escudero III | 20                |
| March 1986 - February 1987 | Ramon V. Mitra           | 12                |
| March 1987 - December 1989 | Carlos G. Dominguez      | 34                |
| January 1990 - June 1992   | Senen C. Bacani          | 30                |
| July 1992 - February 1996  | Roberto S. Sebastian     | 44                |
| March 1996 - June 1998     | Salvador H. Escudero III | 25                |

<sup>17</sup> EDSA stands for Epifanio delos Santos Avenue, where a mass uprising in 1986 toppled Marcos after 14 years of rule and catapulted Cory Aquino, widow of assassinated Marcos oppositionist Benigno Aquino, Jr., to power.

| <b>From-To</b>                  | <b>Secretary of Agriculture</b> | <b>Months of Service</b> |
|---------------------------------|---------------------------------|--------------------------|
| July 1998 - April 1999          | William D. Dar**                | 9                        |
| May 1999 - December 2000        | Edgardo J. Angara               | 19                       |
| January 6 – February 15, 2001   | Domingo F. Panganiban           | 1                        |
| February 16 – November 30, 2002 | Leonardo Q. Montemayor          | 22                       |
| December 1, 2002 - August 2004  | Luis Lorenzo Jr.                | 31                       |
| August 2004 - July 2005         | Arthur C. Yap                   | 11                       |
| July 2005 - October 2006        | Domingo F. Panganiban           | 15                       |
| October 2006 - March 2010       | Arthur C. Yap                   | 40                       |
| March - June 2010               | Bernie G. Fondevilla            | 4                        |
| July 2010 – present             | Proceso Alcala                  | 6                        |

*Notes:* \*Including Environment and Natural Resources, and Agrarian Reform;

\*\*William Dar was acting secretary.

With each changing of the guard at the departments came changes in sectoral and departmental goals, objectives, strategies, timetables, programs, projects, and activities. Such changes were unavoidable, first because there were new people in top positions in each of the departments, and new people, at the very least, meant changes in leadership styles and work arrangements. The changes instituted immediately after the Marcos regime in 1986 were truly substantial. In the first place, there was a new openness and a return to democratic institutions, a clear differentiation between the very strong presidency—or in some views, dictatorship—of President Marcos, and that of President Cory Aquino, which was much more consultative and balanced by a re-empowered legislature and judiciary.

The combination of frequent changes in officials, new initiatives, and people new to government service means that some time was necessary to learn the job. The task of learning the job is also complicated by the need for visibility and impact as soon as possible after taking office. This pressure results in two major initial preoccupations upon entry: (a) the need to erase the programs of the previous appointee and (b) the need to announce programs labeled as one's own. The series of reinvented programs for rice production and food security announced and implemented by successive administrations since 1972 reflects this behavior (Table 7.7).

**Table 7.7. Rice Production and Food Security Programs, 1972–2010**

| From-To     | Program Name/Title   | Secretaries of Agriculture                                      | Duration (Years) |
|-------------|--|---|------------------|
| 1972 -1986  | <b>Masagana 99</b> (M99)   | Arturo R. Tanco/<br>Salvador H. Escudero III                    | 15.0             |
| 1987 - 1989 | <b>Rice Productivity Enhancement Program</b> (RPEP)  | Carlos G. Dominguez   | 2.5              |
| 1990 - 1992 | <b>Rice Action Program</b> (RAP)   | Senen C. Bacani   | 2.5              |
| 1993 - 1995 | <b>Key Production Areas</b><br>(for rice and other priority commodities) Grain Production Enhancement Program                            | Roberto S. Sebastian  | 3.0              |
| 1996 - 1998 | <b>Gintong Ani Programs</b> (for rice, corn, livestock, fisheries, high-value crops and marginal areas)                                  | Salvador H. Escudero III  | 2.5              |
| 1998 - 2000 | <b>President Erap's MakaMASA Programs</b> (for rice, corn, livestock, fisheries, coconut, sugar, tobacco and high-value crops)           | William D. Dar*/<br>Edgardo J. Angara/<br>Domingo F. Panganiban | 2.5              |
| 2001 - 2002 | <b>GMA CARES</b> (for credit, "rolling stores", rice, corn, irrigation, livestock, fisheries, coconut, sugar, tobacco, high-value crops) | Leonardo Q. Montemayor  | 1.5              |
| 2003        | <b>GMA CARES</b> , with an emphasis on hybrid rice   | Luis Lorenzo, Jr  | 1.0              |

| From-To     | Program Name/Title                                      | Secretaries of Agriculture     | Duration (Years) |
|-------------|---|--------------------------------|------------------|
| 2004 - 2010 | <b>GMA Cares</b> , with emphasis on lowering wage goods | Arthur Yap, Domingo Panganiban | 3.0              |
| 2008 - 2010 | <b>F.I.E.L.D.S.</b>                                     | Arthur C. Yap                  | 3.0              |

*Note:* \*William Dar was acting secretary, awaiting the expiration of the ban on candidates who lost in the most recent elections from being appointed into office.

The landmark program Masagana 99 (Bountiful 99) implemented during the tenure of President Marcos and Agriculture Secretaries Tanco and Escudero, is credited with bringing the country from the brink of starvation in the early 1970s to self-sufficiency and some exports by 1979. The M99 program ran for 15 years and at least 14 phases, with refinements made with each phase. The initial phases were wracked with design errors and inefficiencies. Given that the country was under martial law, the implementers of M99 were allowed room to learn from their mistakes and improve the program with each succeeding cycle.

All the rice and food security programs since 1986 have been short-lived, at least in name. In 1986, the key features of the M99 program were abandoned in favor of a much more market-oriented approach based less on irrigation infrastructure and directed credit support, and more on seed and fertilizer distribution—the RPEP, which lasted for two-and-a-half years, through the administration of Carlos Dominguez. Since 1989, the RPEP has been revived and relabeled at least five times through the administrations of at least five replacement secretaries of agriculture. The replacement of Roberto Sebastian in 1996 can be directly traced to the performance of the rice sector, where his “key production areas” approach was perceived as unsuccessful given the jump in rice prices during the so-called “1995 rice crisis.” Analysis has determined that the volatile rice prices in 1995 were due to the effects of rice trade policies, not production support.

Finally, the designs of the rice production and food security programs in the post-1986 period differed only in labeling but not in substance. Each focused on priority production areas, usually irrigated areas. Each was highlighted by programs for access to, and subsidies for, seeds and fertilizers. Each was, in the end, dependent on the NFA for procurement support. Given the frequent changes in leadership, there were many changes in timing and



implementation calendars, and learning and relearning of the management and administration of the programs.

Each new secretary usually initiated his term with restructuring and reorganization. Usually explained as part of “streamlining the bloated bureaucracy,” offices were moved around, abolished, created, or recreated. However, because legislation is required to make any substantial changes permanent, many of these actions ended up as uncompleted initiatives. Of course, successive administrations had different ideas about institutional structure. An action under the president’s executive authority is the attachment of agencies to the supervision of ministries. An example of the successive changes in attachment is the NFA, which, since the 1970s, has been shifted back and forth from the DA to the Office of the President.

With the change in president also came changes in other key officials, as summarized in Table 7.8. These changes further delayed any action on rice sector reforms, since there is an unavoidable need for officials to study and understand the complex issues. Worse, since 1986, the successive agriculture secretaries have tended toward populist positions on rice sector reforms. Most were propelled into office by populist “people-powered” agendas, and the coalitions that have supported their entry into government have been fragile, often held together only by visions of immediate reward.

**Table 7.8. Key Agriculture Sector Officials, Pre- and Post-Arroyo**

| Post                     | Pre-January 2001   | Post-2001  |
|--------------------------|--|--|
| Secretary of Agriculture | <b>Edgardo Angara</b> (up to December 2000)                | <b>Luis Lorenzo</b> (December 2002 - August 2004)    |
|                          | <b>Domingo Panganiban</b> (December 2000 - January 2001)   | <b>Arthur C. Yap</b> (August 2004 - July 2005)       |
|                          | <b>Leonardo Montemayor</b> (February 2001 - November 2002) | <b>Domingo Panganiban</b> (July 2005 - October 2006) |
|                          |  | <b>Arthur C. Yap</b> (October 2006 - March 2010)     |
|                          |  | <b>Bernie G. Fondevilla</b> (March - June 2010)      |
|                          |  | <b>Proceso Alcala</b> (Since July 2010)              |

| Post                 | Pre-January 2001   | Post-2001  |
|----------------------|--|--|
| Secretary of Finance | <b>Jose Pardo</b> (Jan 2000 - Jan 2001)<br><b>Alberto Romulo</b> (Jan 2001 - Jun 2001) | <b>Jose Isidro Camacho</b> (June 2001 - November 2003)<br><b>Juanita Amatong</b> (December 2003 - February 2005)<br><b>Cesar Purisima</b> (February 2005 - July 2005)<br><b>Margarito Teves</b> (July 2005 - June 2010)<br><b>Cesar Purisima</b> (Since July 2010) |
| NFA administrator    | <b>Domingo Panganiban</b> (acting administrator up to January 2001)                    | <b>Antonio Abad</b> (February 2001- December 2002)<br><b>Arthur Yap</b> (January 2003 - July 2004)<br><b>Gregorio Tan</b> (August 2004 - December 2008)<br><b>Jessup Navarro</b> (January 2008 - June 2010)<br><b>Lito Banayo</b> (Since July 2010)                |

### Constraints to Reforms in Philippine Rice Marketing<sup>18</sup>

Why is it that close to three decades of efforts to reform rice marketing in the Philippines have largely failed? The series of reform efforts enumerated in the second part of this paper seems to indicate that insignificant progress in rice sector reform has not been for lack of effort. Many of the reform programs have been financed by international aid and designed to link reforms with fiscal rewards, such as program loans and public budget support. Yet, as of this writing, the policy regime determining rice marketing in the Philippines has not changed in any significant way since the early 1980s.

<sup>18</sup> This section draws from learning gained from Bruce Tolentino's over three decades of involvement in rice sector issues, including his roles as: (a) community organizer among rice farmers in Lanao del Sur province in Central Mindanao; (b) Manager, Food Sector Program of the Philippine Business for Social Progress (PBSP) Foundation; (c) academic doing research on agricultural development; (d) Undersecretary for Policy, Planning and Trade of the Department of Agriculture, Philippines; (e) policy adviser on agricultural, rural and economic development in various Asian countries, including Cambodia, Indonesia, Maldives, Myanmar, Philippines, Timor Leste, and Vietnam; and (f) a senior officer of the Department of Agriculture's Policy Analysis Division (PAD).

The reform efforts have largely failed due to a combination of the following aspects of Philippine rice sector governance:

- a. the competing objectives of NFA operations;
- b. the combination of a short-term governance horizon and a complex, long-term issue;
- c. pervasive food security myths and fears;
- d. NFA-dependent enterprises and livelihoods;
- e. patronage and corruption; and
- f. the failure to deal with the root cause of the rice sector's problems: the NFA's monopoly of international trade of rice.

### **Competing Objectives**

The mission of the NFA has often been summarized as, “Buy high, store long, sell low.” Clearly, this is an impossible mission. The NFA cannot guarantee that all rice farmers can sell their paddy at “high” prices, that consumers—particularly the poor—are supplied with “low”-priced milled rice, and that the price of rice remains stable in the gaps between production seasons.

The impossibility of the NFA's mission has worsened over time, since the understanding by farmers and consumers of the meaning of “high” and “low” prices of paddy and milled rice have been conditioned by their long-running experience with a regime of prices distorted by policies that have kept these prices artificially high, relative to the world market. Philippine rice policies have generally constrained imports, while preventing—or at least muting—the transmission of international price movements to the domestic market. The result has been generally higher but more volatile domestic prices, both at the retail consumer and paddy farmgate levels. With open markets and liberal trade, the appropriate benchmark for domestic prices are border prices, and any differences can be attributed to tariffs and transport costs.

As seen in Figure 7.6, domestic rice prices, however, have consistently been much higher than world prices. As a result, the few farmers who have long benefited from the NFA's domestic procurement and buying operations have come to expect the NFA's purchase price for paddy to be kept “high” relative to their experience of domestic prices, which have long been significantly above border prices. The majority of rice farmers—those who are not directly reached by the NFA's domestic procurement operations—nevertheless benefit from the policy-induced higher prices. Unfortunately, consumers have long suffered domestic rice prices that are multiples of border prices, while remaining unaware of the gap between.

## **Short-Term Governance Horizon**

The very brief tenures of senior officials help explain the short-sightedness of governance. As presidents came and went, and as cabinet secretaries were frequently replaced, the premium on political connections as currency for bureaucratic survival has been growing in value. It is no surprise that most of the appointees to the Departments of Agriculture, Agrarian Reform, and Environment and Natural Resources have increasingly been politicians rather than sector experts. Each of the administrations since 1986 has had so much to do, so little time, and not much experience in how to get the job done. This combination, in a context with a hungry political opposition anxious to capitalize on weaknesses and errors, has helped foster an atmosphere where cabinet members are replaced at the first mistake—however unavoidable—whether in perception or in actuality. A culture of “cabinet revamps” and replacements of one official or another has emerged, where one of the first reactions to a perceived inadequacy in leadership, capacity or political skill is the replacement of the erring or inadequate cabinet member. In turn, such an atmosphere has emphasized political expediency and a focus on short-term gains, often at the expense of sustainable, long-term effectiveness.

Food security and agricultural development issues are long-term in nature and thereby require governance horizons that see beyond relatively brief electoral cycles and terms in office. Effective agriculture sector management is implemented in tune with agricultural seasons. Crops cannot be hurried through their growth cycles. Moreover, the world grows all the more complex with rapid population growth, increased food requirements, intensified domestic resource scarcity, and global openness.

The misplaced focus on short-term survival has encouraged the reliance on measures with immediate impacts on food supply and prices, regardless of their fiscal sustainability and implications for long-term food security. This explains the observed shift in government fiscal support for agriculture—from productivity-improving measures, largely the province of the DA to price-support and control measures implemented by the NFA (David, 2002).

## **Enterprises and Livelihoods Dependent on the NFA**

The NFA’s long existence, large size, and dominant role in the Philippine rice market have spawned the establishment and growth of a large multitude of enterprises, jobs, and livelihoods highly dependent on the continuation of current rice market policies and operations of the NFA.

The NFA contracts a large array of support enterprises to carry out various aspects of its operations. It directly operates and also rents grains

warehouses and mills throughout the country. It operates and rents fleets of trucks and containers. It hires ships and boats to transport rice throughout the archipelago. The NFA's operations keep many mills and related businesses going. It procures supplies and equipment for its operations—sacks and other containers, scales, trolleys, coolers, dryers, fumigators, vehicles, office equipment, and generators, among others. All of these NFA-related suppliers and businesses, directly and indirectly, generate jobs for many thousands. Most of these enterprises and jobs exist because the NFA exists, and their health depends on the size and extent of the NFA's operations.

The NFA borrows from the private banking system to finance its procurement operations and imports. The NFA is rated highly creditworthy by the banking system since its borrowings are covered by the sovereign guarantee of the Republic of the Philippines, as certified by the DOF. Moreover, bank lending to the NFA is accepted by the Central Bank of the Philippines as fulfillment of the legally mandated requirement that at least 25 percent of the total loanable funds of banks must be lent to agriculture sector projects. It is no surprise that the banks prefer to lend to the NFA, given that making large loans to a single, creditworthy borrower is much easier, cheaper, and more secure than making many loans to very many small farmers and entrepreneurs spread out in the rural areas.

Finally, there is the NFA Employees Association, with about 5,000 members, most of whom are naturally fearful that they will lose their jobs as a result of reform.

### **Patronage and Corruption**

The NFA has emerged as an increasingly important instrument and source of political patronage and corruption in the Philippines.

The NFA is simultaneously the regulator and most important player in the Philippine rice market. It holds licensing authority over all enterprises and entrepreneurs wishing to engage in the grains (rice, corn, and wheat) industries. These enterprises include millers, dryers, warehouses, transport, retail, wholesale, shipping, packaging, and handling of grains, trade, import, and export. Note that the NFA requires entrepreneurs to apply for separate licenses for various aspects of the grains business, and thus, retailers are issued one type of license while wholesalers are issued another category of license. The NFA imposes fees on the licenses, and also sets the criteria for approval of applications for, and periodic renewals of, licenses. By itself, this power held by the NFA already poses considerable opportunity for corruption and control of the grains market.

Rice is a favored patronage good that is appreciated by recipients—often highly concentrated, large communities of voters. The NFA often works with politicians to distribute rice, particularly in areas that have been hit by calamities or other natural disasters.

The NFA selectively provides access to a favored few to its stock of imported rice, which is likely to have been imported at the low border price, and which may be sold in the domestic market at the relatively high domestic retail price. Many of those favored with access are the local political elites.

Because of the NFA's nationwide network of warehouses, it is often engaged to participate in other mass distribution programs. A recent, prominent example is the NFA's role in nationwide distribution of subsidized fertilizer to farmers, supposedly as part of the country's farmer support program. This case is now under litigation due to various allegations of corrupt conduct, including the distribution of substandard-quality fertilizer, overpricing, irregularities in procurement, use of proceeds for electoral finance, and distribution to non-deserving beneficiaries, among others.

### **Failure to Deal with the Root Cause: The NFA Monopoly**

The key factor that has led to the NFA's pervasive and distorting role in the Philippines' grains sector is that it has a monopoly of international trade of grains, particularly rice. There have been some limited steps taken in recent years to open up rice trade to private traders, but these have been incomplete, and therefore ineffective. For example, RA 8178 (1995) opened the door for private sector traders to import rice, but under severe constraints imposed by the NFA, including licensing subject to unnecessarily restrictive criteria, and having all trade terms approved by the NFA and subjected to full import tariffs.<sup>19</sup> The NFA continues to license all grains players, sets the rules for all trade, and has advantageous access to financing. Finally, private importers have to contend with prohibitively high tariff barriers,<sup>20</sup> while the NFA is allowed to import on a tariff-free—or tariff-deferred—basis.

The NFA's monopoly and resulting long dominance in the Philippines' grains sector has prevented the entry and growth of private players. This has lent false credence to the notion— which the NFA and vested interests encourage—that only the NFA has the capability and experience to engage

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<sup>19</sup> Another example of limited openings for private trade is the farmers-as-importers program launched by the NFA in 2000, wherein farmers' groups were allocated import privileges, and further allowed to outsource the import transaction to the NFA, for a fee.

<sup>20</sup> Importers are allowed to import in the NFA's name to secure duty-free privilege but they have to pay an "equalization" or "service" fee to the NFA.

in rice trade. This is patently false beyond the very short run. The positive experiences of many other countries, including Malaysia, Indonesia, Egypt, and South Korea, that have allowed the participation of private companies in food trade, show that new entrants learn and adjust very rapidly to trade conditions, particularly if the entrants are experienced traders in food and other commodities. There are many such companies in the country, including the San Miguel Corporation, Purefoods, Republic Flour Mills, VitaRich, Rustan's, SM Hypermart, S&R, Robina Corporation, and Robinson's, to name just a few of the largest, Philippine-based firms. Moreover, as the country opens up retail trade and allows the entry of the large multinational hypermarket firms such as Carrefour, TesCo, Harrod's, Price Club, and CostCo, there ought to be no question regarding the capability of such firms to substantively engage in international trade in rice.<sup>21</sup>

## Conclusion

This case study explores the political economy of public policies on rice production and marketing in the Philippines over the past three decades, focusing on the failure of a series of reform efforts. Clearly, a combination of various components contributing to weak governance explains the ineffectual reform efforts, starting with the failure to resolve the root cause of the country's food security problems—the NFA's monopoly of international trade in rice. Over its long history of operation, many interests have come to be vested in the continuation of current rice policies, and these interests have had the incentive to resist reform efforts. In short, the balance of forces in the political economy of rice market policies in the Philippines has favored the status quo.

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<sup>21</sup> In September 2010, the Philippines' Supreme Court ruled that Republic Act 8762 or the "Retail Trade Liberalization Law of 2000," is constitutional, thus opening the way for the entry of the large multinational marketing firms.

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For the past 30 years, the Bureau of Internal Revenue has undertaken several donor-funded reform efforts, most of which have failed. Until reforms are successfully put in place, taxpayers will continue to distrust, and likely work their way around, the system.

Photo by Mary Grace Mirandilla-Santos

# Chapter 8

## BIR Reform Initiatives: Why Is Success So Elusive?

Raul V. Fabella and Karl Kendrick T. Chua

Economic and social progress require a modicum of basic public goods that not only protect basic human rights but also make the lives of citizens progressively better. The provision of these public goods is the *raison d'être* of the entity we know as *the state*. The state's power to tax, i.e., to collect revenues from its citizens, forcibly if need be, springs from the moral duty to provide those public goods. How well the state fulfills this function depends partly on the revenues generated by its revenue collection system. A well-functioning revenue collection system is a *sine-qua-non* for a well-functioning state.

The state's moral right to resources privately owned by its citizens depends on how well these resources are deployed for the public interest. In economic efficiency terms, the resources collected by the revenue agencies are deployed by the state so that they collectively generate benefits in excess of the maximum that could be generated when such resources are deployed by their individual owners. That is the case, for example, of a public good such as a bridge or a roadway. The celebrated Samuelson theorem (1954) says that such public goods will be underprovided (i.e., fall below the Pareto optimum level) by voluntary contribution due to the self-regarding citizens' disregard for the collective good. Indeed, if the Olsonian *free riding* (Olson, 1965) is taken into account, the situation becomes worse. Samuelson's solution is a benevolent central planner armed with the power to tax who will adequately procure such goods. The biggest objection to the Samuelson theorem is the assumption of a *benevolent* central planner who is at once programmed to pursue the greatest good for the greatest number and is adequately *competent* to do so. Such a happy marriage of competence and benevolence seldom, if ever, exists in many less-developed countries (LDCs), where governments are more likely to be either (a) malevolent, if competent; (b) incompetent if benevolent; or (c) malevolent and incompetent. These combinations of qualities impact precisely the capacity of the state to turn tax revenues into public goods. Indeed, when the state is neither benevolent nor competent, the Samuelson under-provision thesis may reverse, i.e., private provision may do better (Fabella, 2009).

Whenever the public goods provided by the state consistently fall below the expected minimum, citizens can collectively resist the tax imposition,

(e.g., a tax revolt). That path being futile and being subject to collective action failure, latent individual resistance will surface as tax evasion. Once the state loses the moral right to collect taxes, it loses the *first-party enforcement* aspect of tax enforcement (that force of the law coming from the citizens' sense of duty) and must raise its third party enforcement (involving detection and punishment) effort and budget for the same tax collection level. This is a scenario rife with the corruption of the revenue organs and agents. A self-perpetuating downward spiral of low revenues and more corruption is not far behind, unless the issues are quickly addressed.

The Bureau of Internal Revenue (BIR) of the Philippines has been facing the same self-feeding downward spiral. Collectors are traditionally paid very low wages relative to their responsibilities, from very low budgets, and are expected to collect from a very cynical public fully aware of government waste and graft. Collecting agents are therefore expected to be on the take, and honesty is not always a rational response. Thus develops a "lemons market"<sup>1</sup> for talent in tax enforcement, where the bad commodities chase out the good ones. Meanwhile, taxpayers who collude with erring tax collectors end up paying less; and if in competitive business markets, they drive out rival and upright businessmen, creating another lemons market in the business sector. This collusive network forms the primary constituency of the internal revenue status quo. A system of favors and side-payments scales up the radius of this constituency to include strategic decision centers.

Once the feedback mechanism is in place, it is very difficult for well-meaning authorities to reverse it. The system will deploy any number of defensive maneuvers to preserve its privileges. Stemming the negative spiral has been the principal challenge of BIR reform initiatives over the years.

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<sup>1</sup> In Akerlof's (1970) seminal paper, he used the automobiles market to illustrate how quality relates to uncertainty. In his example, Akerlof described how individuals buy a new automobile without knowing whether the car they buy will be good or bad (known in the US as lemons). Thus, "there is more incentive for sellers to market poor quality merchandise" and "there tends to be a reduction in the quality of goods and also in the size of the market". For a detailed discussion, see Akerlof (1970).

## BIR Reform Initiatives<sup>2</sup>

In the last three decades, several reform efforts have been undertaken by the BIR, often with significant donor support.<sup>3</sup> Some of these reforms have been outright failures. Even those that had some initial success have typically proven unsustainable. The following are nine major reform efforts that have been attempted in the last three decades:

1. Plana reform (1975-1980)
2. Comprehensive Tax Reform Program of 1986 and related tax administrative reforms (1986-1992)
3. Tax Computerization Project (1993-1999)
4. The Comprehensive Tax Reform Program (1997)
5. Establishment of the Large Taxpayer Service (1999)
6. Bañez reform (2001-2002)
7. Parayno reform (2003-2005)
8. VAT and related policy reforms (2004-2005)
9. Various donor-supported tax administration reforms (2006-2012)

There are two general types of tax administrative reform initiatives: process and accountability. Many reforms focused on the procedures and systems, as well as training staff on reform management and on the various aspects of the tax process. The harvests from these reforms range from mixed to nil. Accountability reforms include reduced discretion of tax officials and increased accountability and transparency in the BIR (e.g., reforms in the audit process, performance management, and human resource management). These have failed outright, due to strong and overt opposition from BIR personnel, and at times, tacit opposition from top management.<sup>4</sup> BIR tax effort performance in the last four decades is shown in Figure 1. Two episodes stand

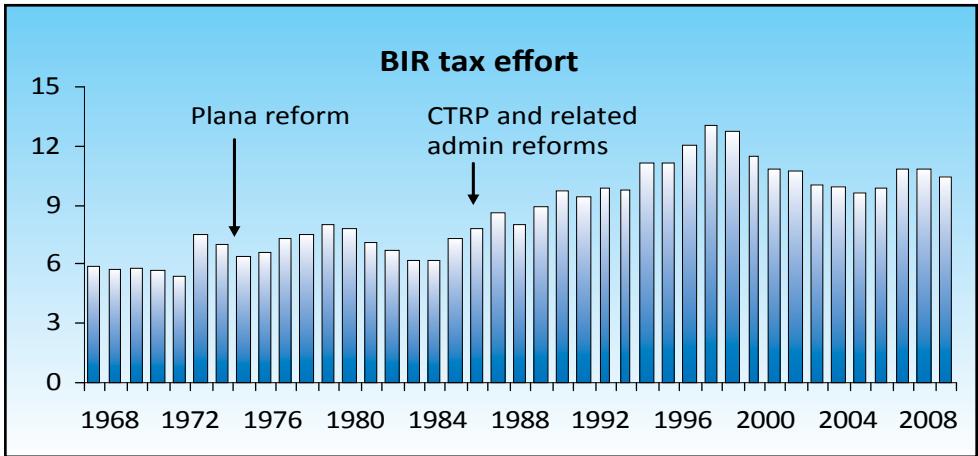
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<sup>2</sup> This section draws a great deal from an unpublished monograph by Karl Kendrick T. Chua (2008).

<sup>3</sup> As enumerated by Chua (2008), these include the World Bank-funded Tax Computerization Project (1993-1999) and the National Program Support for Tax Administration Reform Project (2007-2012), two Institutional Development Fund (IDF) grants from the World Bank (2002-2005 and 2006-2009); several IMF technical assistances; several USAID-funded projects (AGILE, EMERGE, EPRA, LINC-EG); Strengthening of the RATE Program, development of an HRIS, and roll-out of the integrated tax system (ITS) to non-computerized RDOs supported by MCC; the VAT information system (VATIS) and strengthening of BIR's enforcement capacity supported by ADB; the establishment of the BIR contact center supported by CIDA; SIDA technical assistance for improving tax statistics and audit; and AusAID assistance for capacity building and HR development, among others.

<sup>4</sup> A remark in an interview by a former high official of the BIR in the Estrada administration that "the bigger damage is if tax collections are misspent and not so much the potential losses from tax examiners who collude with or extort from taxpayers" is a case in point (Bacalla, 2000).

out as exceptions and are indicated by arrows representing the first two in the list, which will be discussed in depth.



**Figure 8.1. BIR Tax Effort (1968-2008).**

*Source:* Chua (2008).

At the outset, it is safe to observe that lack of sustained effort is partly to blame for the failures. A number of important reforms advocated by a new leadership were discarded or left to wither by the next leadership. Three examples of good reforms that have not been sustained in the past are: (1) the RATE Program of Commissioner Guillermo Parayno, which was, however, not given the same priority by his four immediate successors in the Arroyo administration; (2) the Revalida Program (or internal audit of tax examiners' performance) of Commissioner Liwayway Vinzons-Chato, which was discontinued by her successors; and (3) Executive Order No. 114 (or EO 114), signed by President Arroyo but not implemented after the departure of Commissioner Rene Bañez. More recently, the faster turnover of BIR commissioners<sup>5</sup> and BIR officials assigned to the reform program has exacerbated this problem, giving rise to a large number of discontinued or failed reforms. Lack of high-level support and commitment appears to have been the main driver of the short-term nature of many reforms.

In the next sections we will focus on reform initiatives that have been relatively successful (the Plana reform and the 1986 Comprehensive Tax Reform and related tax administrative reforms), and instances where they have not succeeded as envisioned (the Tax Computerization Program, Large

<sup>5</sup> The nine BIR commissioners between 1998 and 2010 served an average of less than two years in office.

Taxpayer Service, the 1997 Comprehensive Tax Reform Program [CTRP], and the Bañez reforms).

### **Cases of Relatives Success: Surge and Retreat**

In the history of administrative reforms of the BIR, two episodes stand out as cases of relative success—relative, that is, to other BIR reform episodes, and successful in the sense that they led to sustained increase in tax revenues for at least five years. One was a series of accountability-enhancing measures adopted during Marcos’s martial law period. The BIR commissioner—with strong political backing from the martial law president and an astute reform management strategy—managed to oversee substantial improvements in revenue collection while making significant inroads into the web of corruption in the BIR. The other is a series of administrative reforms that accompanied a major overhaul of the tax system under the newly elected revolutionary government of Corazon Aquino.

#### **Plana Reform (1975-1980)<sup>6</sup>**

The reforms under former BIR Commissioner Efren Plana are considered by observers to be the most successful administrative reforms in the history of the BIR. Appointed by President Marcos in September 1975, Commissioner Plana came into the BIR with an anti-corruption platform.<sup>7</sup> Plana’s success in reforming the BIR was rooted in the unwavering support and the vast autonomy given to him by the former dictator to run the BIR with little political interference. Moreover, his reforms benefited from a public sector-wide anti-corruption drive that gave his reforms credibility. When he assumed office, Marcos had just conducted a public sector-wide performance audit and dismissed 2,000 government officials who failed it—including the minister of Public Works, the Customs commissioner, and the acting commissioner of

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<sup>6</sup> Robert Klitgaard (1988 and 2004) and Briones (1979) largely form the sources of this section. Also forming the basis were an interview with former Commissioner Plana and several interviews with former BIR officials under Plana. Klitgaard (2004) introduced Justice Plana as “the one who famously cleaned up the BIR more than two decades ago.”

<sup>7</sup> Prior to his sudden appointment as BIR commissioner, Plana was associate justice of the Court of Appeals (1973-75). His other positions: deputy minister of Justice (1972-73), deputy minister of National Defense (1970-72), and a director and chief legal counsel of the Board of Investments (BOI) (1968-70). While a complete outsider to BIR, Plana was well connected to the highest office and was fully supported by the most important members of the cabinet, namely, Finance Minister Cesar Virata and his former classmate, Defense Minister Juan Ponce Enrile.

the Commission on Audit.<sup>8</sup> The BIR commissioner was also replaced.<sup>9</sup> Plana's spotless and distinguished record of public service made him highly credible. To combat corruption, Plana brought in third parties to the BIR, hired new blood, and deployed the media to publicize cases of BIR corruption.

Plana came into the BIR as the economy was recovering from previous crises. In 1975, the internal revenue tax effort had fallen to less than 6.4 percent of gross domestic product (GDP), more than one percentage point below the average of the previous two years, owing to a combination of a weak tax administration and slower economic growth, thanks to the 1973 oil price shock. Economic growth, which began to pick up in 1975, averaging six percent in the next five years, gave Plana room to collect more taxes. More importantly, the fiscal deficit was confined to less than two percent of GDP, relieving him of the pressure to collect. The importance of this cannot be overlooked.

Corruption was then already a serious problem in the BIR, and knowledgeable estimates put the amount of corruption at 10 to 20 percent of tax revenues (Briones, 1979). Taxpayer audits were riddled with extortion and bribe-taking. Grease money was the way to fast-track services in the BIR. Many sensitive positions were allegedly auctioned off to corrupt officials seeking lucrative rent-seeking opportunities. Corruption was systemic and payoffs reached top BIR officials and even the internal audit office. Public perception of the bureau was negative and staff morale was low (Klitgaard, 1988). BIR personnel were divided into the ins and the outs, or those who belonged to the "family," and those who did not.

While Plana's reform was carefully planned, Plana's style also mattered. When he assumed office, he took time to learn the internal workings and dynamics of the BIR, consulting extensively with his senior staff and various stakeholders, such as field officials, rank-and-file staff, businessmen, other taxpayers, and officials of other government agencies.<sup>10</sup> In order to gain their cooperation, he avoided the usual pitfall of assuming guilt *a priori* among the BIR veterans. Instead, he learned progressively who were possibly corrupt by asking bureau personnel who they believed were clean. More tellingly, he employed the services of investigators from the Department of Defense (DOD)

<sup>8</sup> Marcos fired the acting commissioner on Audit, believing that rampant corruption in government could not have happened without the connivance of the Commission on Audit.

<sup>9</sup> Marcos' own motive for the purge of the public sector of corrupt officials and his special attention on the BIR was understandable. Three years into the declaration of martial law, corruption was still rampant, his "new society" movement had not accomplished all it promised, and was thus losing credibility. Moreover, he needed to borrow from the World Bank and IMF to fund his massive infrastructure projects, one precondition for which was ensuring adequate revenues. Thus, BIR reform was an especially important initiative.

<sup>10</sup> Civil society as a countervailing voice hardly existed during martial law.



to document the lifestyles of the top 125 employees of the BIR.<sup>11</sup> He also used the media to publicize cases of BIR corruption, creating a highly effective form of non-judicial punishment (Klitgaard 1988). The press was then totally controlled.

To fight corruption, Plana limited discretion and increased transparency in the BIR. Old hands at the BIR had to adjust to his no-nonsense, professional, and strict manner of running the bureau.<sup>12</sup> After ascertaining whom he could trust, he assigned these “clean” officials to special assignments, such as internal audits. He hired newly minted certified public accountants and had them work with “senior heroes” to review the work of tax examiners (Klitgaard, 2004). By doing so, he sent a strong signal to corrupt examiners that their work could be audited anytime. At the same time, he brought in the Commission on Audit (COA) to supplement the work of the internal audit office. To further limit the discretion of BIR employees and make the Tax Code simpler for taxpayers and tax examiners alike, he pushed for the simplification of the Tax Code, which led to the various amendments to the National Internal Revenue Code, all enacted by presidential decrees.

The reforms led to the longest sustained increase in internal revenue tax effort in decades. Tax effort rose from 6.4 percent of GDP during his first year in office in 1975 to 8.0 percent by the time he left the bureau in 1979. Growth in tax collection averaged 22 percent between 1976 and 1980 (with the highest collection growth recorded in 1978 at 30 percent, following amendments to the Tax Code in 1977).

The success of his reforms, however, depended so much on Plana’s leadership and the political support he personally enjoyed from both the president and some of the most influential members of the Cabinet. He fell short of engendering the institutionalization of his system, which began to sputter after five years of positive accomplishments. With Plana leaving the BIR in May 1980 to assume his post as deputy minister and acting minister of Finance, tax effort began to flag anew, along with the global slowdown in 1982. From eight percent of GDP in 1979, internal revenue tax effort fell to 7.7 percent the following year and reached 6.1 percent of GDP in 1983-1984 (the lowest since 1972). Tax compliance and administration also weakened—especially between 1983 and 1985—when the economy was in deep recession and the

<sup>11</sup> According to Briones (1979), bureau personnel would refrain from naming corrupt officials (since members of the family were bound by loyalty) but were more open to naming who they thought were clean.

<sup>12</sup> It was reported that Plana did not hesitate to publicly reprimand even the most senior officials in the bureau for poor performance. In one incident, an official suffered an apparent heart attack in his office allegedly after getting a serious scolding.

country became rife with rumors of corruption and waste in the highest level of political leadership. At the same time, President Marcos appeared to be shifting to using the BIR for extraneous ends. The BIR lost its moral stature.

### **Comprehensive Tax Reform Program of 1986 and Related Tax Administrative Reforms<sup>13</sup>**

In the wake of the fall of the Marcos dictatorship and of the worst recession in the country's history, the newly inaugurated Aquino administration launched a comprehensive tax reform program. The reform was necessary, given the fall in the tax effort from 12.8 percent of GDP in 1979 to 10.7 percent of GDP in 1985 and the consolidated public sector deficit above six percent of GDP. Moreover, the debt crisis in the early 1980s had closed the international credit market to the Philippines. This left the new government with no recourse but to embark on a full reform of its tax system to be able to access concessional finance. It was primarily a tax policy reform and only secondarily a tax administration one.

Among the salient features of the reform were: (1) the shift from the dual personal income tax schedule system (one for compensation earners and another for business and professionals) to a unified schedule for personal income taxation; (2) the introduction of ceilings on allowable deductions (which, unfortunately, was not implemented due to the strong lobby from various professional groups); (3) the shift from a dual-rate system of 25 and 35 percent applicable to taxable income of corporations to a single rate of 35 percent; and (4) the introduction of the VAT.<sup>14</sup> These sweeping tax policy reforms were enacted through executive orders, thanks to the fact that during this revolutionary period, the president enjoyed the power to issue executive orders with full force of legislation.

Administrative reforms—mostly piecemeal but high-impact in nature—followed to enable the BIR to implement the new policies and to prepare it for eventual modernization. In 1987, the Department of Finance (DOF) and its attached agencies, including the BIR, were restructured under EO 127. The BIR's restructuring aimed to make its organization more responsive to the new tax system, improve taxpayer service, and increase efficiency. Tax collection was enhanced via (a) a credible one-time amnesty covering the years 1981 to 1985 (when compliance was the weakest), which resulted in ₱1 bil-

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<sup>13</sup> This section draws partly from Diokno (2005).

<sup>14</sup> The VAT replaced the previous sales tax system. All in all, the VAT replaced 66 various types of sales taxes. The adopted VAT was based on the consumption and destination principle with three effective rates: 10 percent, exempt, and zero-rated (primarily for exporters).

lion (0.2 percent of GDP) in additional tax collection in 1986, and (b) improvements in arrears management, which raised an additional ₱4.2 billion<sup>15</sup> (0.6 percent of GDP) in 1987. The perception of reduced corruption (relative to the latter part of the martial law years) helped increase trust and tax compliance. Moreover, in the succeeding years, the bureau rationalized its audit process, significantly expanded the withholding tax system, and moved towards in-house computerization.<sup>16</sup> Resistance was limited, as the reforms did not directly curtail the discretion and power of tax officials.

BIR's administration reforms in the mid-eighties also benefited from the higher compensation of BIR staff. BIR staff remuneration had been increased in 1985 to about double the pay of other government agencies.<sup>17,18</sup>

These reforms, together with the improving economic environment and a period of high growth in the mid-1990s, resulted in an unprecedented growth in the internal revenue tax effort from 7.3 percent of GDP in 1986 to 9.9 percent of GDP in 1992, and later, to a historic high of 13 percent of GDP in 1997—the total tax effort reached 17 percent of GDP in 1997. General tax compliance also improved. The number of tax filers doubled between 1986 and 1992 and continued to increase between 1992 and 1997 with the implementation of the tax identification number (TIN). Public perception of corruption also improved.

The successes of the tax reform of 1986 and complementary reforms by the administration were primarily driven by the imperative to put its fiscal house in order. President Aquino fully supported the reform, and a well-coordinated and highly competent economic team crafted the policies with little political and business interference. In tax administration, reform efforts, riding on the initial high credibility of the new government and the public perception of improving governance, were successful for a number of additional reasons, such as continuity of leadership at the BIR and the appointment of competent outsiders to head the bureau: Plana stayed for five years;

<sup>15</sup> Foreign exchange rate was at ₱44 to US\$ 1, as of December 2010. See <http://www.xe.com/> for latest rates.

<sup>16</sup> The information system of the BIR prior to 1991 was outsourced to the Revenue Information Systems Services, Inc. (RISSI). EO 468 abolished the RISSI and authorized BIR to establish an efficient computer and communications network system.

<sup>17</sup> To incentivize the BIR to collect during the 1984-1985 recession, President Marcos granted all BIR personnel a package of benefits and incentives to improve professionalism and create a career system in the BIR (EO 1042). In particular, the BIR salary scale was upgraded to rectify the inequities in salaries and raise them to levels comparable with government financial institutions. This salary advantage, however, was removed with the passage of the Salary Standardization Law in 1988.

<sup>18</sup> Commissioner Ruben Ancheta (1980-86) was well known (and well loved) in the BIR, not for his reforms, but for pushing for salary increase for BIR staff.

Commissioners Bienvenido Tan, Jr. (1986-1988) and Jose Ong (1989-1993) stayed in their posts long enough to personally oversee the reforms in the BIR. Moreover, there was also continuity in the second tier. Deputy Commissioners Victor Deoferio, Jr. and Eufracio Santos both served uninterrupted for almost eight years during the terms of the two commissioners.

### **Why the Relative Success?**

The reasons why these initiatives made headway are important. Firstly, one cannot ignore the fact that they occurred under the watch of presidents with decree-making powers and who demonstrated the willingness to use those powers: President Marcos removed outright 2,000 officials who failed the government audit, while President Aquino replaced local officials en masse soon after assuming emergency powers. The Marcos regime also brought in freshly minted military officers into the BIR and other agencies and formed an investigative, monitoring body backed up by decree powers. These demonstrated—in no uncertain terms—the higher powers’ resolve, and it was not lost on anybody. The support of a higher power that was deemed ready and willing to deploy effective force to see its programs through was central.

The strength of the support and commitment of the higher authorities was manifested in the length of tenure of the commissioners appointed. In the case of Plana, there was an additional boost to the effort: the controlled press was used extensively in support of the reform effort.

Another favorable tailwind was that neither the political leadership nor its appointees were tainted by corruption. This gave the agency a moral ascendancy to collect taxes (in 1975, the Marcos regime had not yet shown its dark side, or at least, still enjoyed the benefit of the public’s doubt). When the leadership began to falter in the credibility dimension, these reforms also faltered.

The sad common observation is that these reform initiatives—while initially successful—were not sustained, and revenue performance began to retreat after peaking. The change in focal personnel and/or the change in the priorities and credibility of the higher leadership led to the erosion and eventual reversal of early gains.

### **Cases of Partial and Outright Failure**

Other reforms have had less success or failed outright. In the period after the Marcos dictatorship and the Aquino revolutionary government, reforms that were carried out did not benefit from high levels of political will and posi-

tive circumstantial factors that made reforms easier to implement. In particular, the more frequent changes in leadership limited the sustainability of most reforms. As a result, most recent reforms have had little or no impact on tax effort.

### **Tax Computerization Project (TCP) (1993-1999)**

In the 1990s, a major reform effort focused on computerizing the various tax processes and linking the regional and district offices to the national office via a network. In 1993, the Philippines, with funding from the World Bank, embarked on an ambitious US\$63-million tax and customs computerization project—the largest agency modernization effort attempted by the government—after three years of preparation (World Bank, 2000). According to the project’s implementation completion report (ICR), “The project entailed changing manual, paper-based tax administration to computerized, paperless ones (*sic*), and training around 8,500 staff on the new systems.” The output, an integrated tax system (ITS), was judged by the IMF (1999) to be a “world-class tax system which many developed countries would benefit from.” A total of 14 modules representing the various tax processes were developed. Implementation, however, was limited to only a handful of modules, while other modules, which limited the discretion and power of tax officials, stalled and were apparently opposed. In addition, a network was set up to link 41 district offices, 19 regional offices, and three data centers with the main computers in the national office.

In many ways, the timing of the project was right. Tax effort had been on a general uptrend since 1986, aided by better tax policy and improved tax administration. From 10.8 percent of GDP in 1986, tax effort reached 15.6 percent of GDP in 1993 and continued to be responsive to growth.

The growing economy and high confidence in the new administration of President Ramos further fueled economic activity resulting in rapid growth of income and formal sector jobs, further increasing tax collection. A fiscal surplus (gross of privatization) was achieved in 1994—for the first time in history—and was maintained for the next three years. As such, there were no strong pressures to collect and meet revenue targets. Moreover, basic, fundamental reforms—such as the shift to the TIN and the expansion of the withholding tax system—were underway, ensuring an adequate revenue base. At the same time, the president appointed a competent new commissioner, Liwayway Chato, who would stay on as head of the BIR for the next five years. Prior to her appointment as commissioner, Chato, a private tax lawyer, headed a high-level team commissioned by Ramos to conduct a management and performance audit of the BIR.

The TCP moved smoothly, in general, throughout its implementation. In the BIR, continuity of leadership at the top and the second tier provided focus and adequate guidance. Although there were three deputy commissioners for information systems in succession, all three coordinated with one another, and the last deputy commissioner was with the project from its inception and had full ownership of the project. At the DOF level, Ramos's second secretary of Finance, Roberto de Ocampo, stayed in office for four years, longer than any former Finance secretary since the time of Cesar Virata. After de Ocampo, three secretaries took office in succession, but this did not pose a problem, as the undersecretary for the Domestic Finance Group, Milwida Guevara, took the role as overseer of the project. However, the change in administration in 1998 threw in a change in leadership style and priorities; project momentum slowed, and some priorities were replaced.

Despite the favorable environment and commitment to the reform, project results were mixed. The ICR rated the project *satisfactory* in most aspects, such as development of the ITS, the setup of the Large Taxpayer Service (see discussion below), increasing the number of registered taxpayers, and improvements in the efficiency of tax administration in general. However, it was rated unsatisfactory in some aspects, such as audit and the inability to clearly demonstrate that computerization did indeed increase collections. Although all 14 modules were developed, only four "non-threatening" modules were institutionalized, while the rest were piloted but were eventually shelved. The ICR reported that, as of June 2000 (six months after the project closed), "Computerization has not yet had a significant impact on revenues. We expect the latter to happen once the ITS's auditing capacities are fully used."

However, the audit functions were never used after initial pilots due to resistance. According to the BIR's version of the ICR:

ITS bases the selection of audit candidates principally on the completion of tax returns and the details of the account information form (AIF), a new tax form required from taxpayers. The poor taxpayer compliance on both returns and AIF made it impossible to use information from these forms as basis for audit selection. Because of this, the entire audit functionality was not implemented. On hindsight, it would still have been possible to implement at least the case monitoring, document tracking, and assessment issuance, which were also audit functionalities available from ITS.

What the BIR and World Bank ICRs did not say, however, was that several facets of the TCP were facing opposition, especially from field officials who feared that computerization was taking away too much of their power and discretion. As a result, field officials did not have the incentive to guide tax-

payers in filling out the forms properly and completely and in ensuring compliance with timely filing of forms. In addition, neither the BIR nor the DOF enforced the implementation of the Financial Link (FINLINK) functionality, which would have connected the BIR to other agencies to allow the collection of third-party data to feed into the audit system instead of relying on taxpayers' returns.

Moreover, a very important management tool developed in the TCP—the National Office Management Information System (NOMIS)—was shelved after initial runs. The NOMIS intended to provide top management with quick summary and up-to-date tax statistics for planning and analysis, as well as a basis for allocation of collection goals and evaluating tax programs against agreed performance indicators. This system was equipped to provide management with taxpayer and industry profiles to aid the selection of taxpayers for audit or investigation. Chato's successor, Beethoven Rualo, the second commissioner to have risen from the ranks, apparently had no interest in such a tool, which would curtail even the commissioner's power of discretion.

Out of an ambitious system design, only a small subset of modules was fully implemented. Since the close of the project, only the front-end applications on bank interface, registration, transaction processing, and some back-end applications such as the returns compliance (stop-filer) application were implemented and institutionalized. The rest of the back-end modules, such as case monitoring, tax reconciliation, accountable forms, legal information, and audit, were not implemented. The technically sound reform foundered in the implementation stage, where it was rendered pro forma by opponents.

The impact of the TCP on revenue collection remains vague to this day. Towards the end of the project, many exogenous shocks entered the picture and significantly affected revenue collection. These factors were the Asian financial crisis, the 1997 CTRP (discussed below), and the 1998 and 2001 changes in administration. The DOF pushed several measures in taxation for personal income, value-added, and excise to offset the decline in revenues from import duties and fiscal incentives. Thus, the direct contribution of the TCP is hard to isolate.

## **The Comprehensive Tax Reform Program of 1997**

In 1994, the government began work on a second comprehensive tax reform program, which became effective in 1997. The overarching goal of reform was to protect the tax effort from its imminent decline given falling import duties due to the trade liberalization, the large number of fiscal incentives that were enacted and approved between 1992 and 1996 to promote investments, and higher personal and additional exemptions for

individual taxpayers.

In particular, the reform aimed to (a) make the tax system broad-based, simple, and with reasonable tax rates; (b) minimize tax avoidance allowed by existing flaws and loopholes in the system; (c) encourage payment by increasing the exemption levels, lowering the tax rate, and simplifying procedures; and (d) rationalize the granting of tax incentives, which reached ₪32 billion in 1994 (Diokno, 2005).

Although desirable, there was no urgency to reform the Tax Code. While there was scope to improve the tax system—especially in the areas of corporate taxation and fiscal incentives—the rest of the tax system, though not perfect, was not in bad shape (as evidenced by the increase in tax effort, albeit slower). The tax system suffered more from administration problems than design problems. The economy was doing very well. Growth in 1996 reached 5.8 percent and was projected at 6 percent in 1997 (the start of financial crisis pushed down growth to 5.2 percent instead). The fiscal surplus was maintained between 1995 and 1997, and government debt stock was falling in real terms from over 70 to 55 percent of GDP between 1993 and 1997. In fact, the country was close to exiting the IMF program, and fixing remaining issues in the tax system was seen as one of the important requirements for that exit (Diokno, 2005).

The reforms to rationalize fiscal incentives were completely ignored by Congress. In fact, Congress passed 12 more laws granting fiscal incentives and higher exemptions. This, together with the non-indexation of excise taxes, contributed to the steady decline in the tax effort in the following decade. The result of the reform was the passage of 10 new tax measures having the effect of raising revenues and 28 tax measures having the opposite effect of giving away revenues through granting incentives and higher exemption (Diokno, 2005).

Unlike the 1986 reforms, revenue laws had to pass through Congress. As the proposals of the executive<sup>19</sup> had to be approved by Congress, the passage of reform measures suffered significant delays, and many good provisions were watered down. Some laws even proved to be inferior to the laws they replaced. Congressmen, who were preparing for the 1998 general elections, had little interest in improving the tax system and were afraid to earn the ire

<sup>19</sup> In the cabinet, Secretaries Roberto de Ocampo, Cielito Habito, and Salvador Enriquez were major proponents of the reform. Finance Undersecretary Milwida Guevara led the technical panel. In addition, a presidential task force on tax and tariff reforms, chaired by the secretary of Finance and multi-sectoral in composition with representatives from the government, the private sector, and the academe, was created in 1994 (Diokno 2005).



of big businesses, which generously contributed to their campaigns. In the Senate, Senator Juan Ponce Enrile, a foremost tax expert, was the champion.

The 1997 CTRP weakened, rather than strengthened, the Philippine tax system. In the years following the implementation of the CTRP, tax effort progressively fell in 2004 from a peak of 17 percent to 12.4 percent of GDP, the lowest since 1986 (BIR tax effort likewise fell from 13.1 to 9.8 percent of GDP). Tax effort was also pulled down by the twin Asian financial and El Niño crises in 1998.

Opposition also grew bolder after Chato's departure. As a case in point, some features of the CTRP, such as the tax on fringe benefits and the minimum corporate income tax (MCIT), were not implemented by the BIR due to strong opposition by businesses. Moreover, the VAT on banks was also not implemented and "when finally implemented, was recalled, and then subsequently repealed." (Diokno, 2005). The 1997 CTRP experience shows that tax policy reformers underestimated the power of bureaucratic and business opposition.

### **Establishment of the Large Taxpayer Office (LTO)**

A sister reform to the TCP was the establishment of a Large Taxpayer Office in the BIR.<sup>20</sup> To secure revenues coming from the largest taxpayers of the country, the BIR established the Large Taxpayer Service (LTS) in 1999. The LTS is a third-level office in the BIR headed by an assistant commissioner who reports directly to the commissioner. The LTS has its roots in the Large Taxpayer (LT) division (headed by a division chief), which existed between 1993 and 1999, and was limited to monitoring and receiving payments from large taxpayers. Other core functions (registration, assessment, and collection) were carried out by the respective revenue district offices having jurisdiction over the large taxpayers. The establishment of the LT division was one of the preconditions before the tax computerization loan could be approved in 1990. By contrast, the LTS is a one-stop shop.

The LTS was originally set up as an elite office composed of the best personnel in the BIR. To carry this out, LTS staff—examiners, in particular—were selected via a stringent recruitment process, which involved an interview with top management, a written exam, and a psychological exam. Successful applicants were then required to take core training (both formal and on-the-job) on the end-to-end audit process, including industry profiling and bench-

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<sup>20</sup> The country's largest taxpayers normally contribute 50 to 80 percent of total tax revenues. The rationale for an LTO is to increase control over the largest part of the revenue flow. Countries that have successfully implemented LTOs have experienced improving tax compliance and higher tax revenues.

marking, international financial reporting standards, and the audit of complex industries such as banking and insurance. In the succeeding years, training in computerized audit tools became a standard requirement. Bonuses were given to both the office and to individual staff whenever the LTS exceeded its target.

Despite being a sterling idea, the LTS reform was not sustained in succeeding years. The increase in the number of large taxpayers under its purview, especially in the latter years, was not matched by a commensurate increase in the number, caliber, and capacity of LTS staff—in particular, examiners. Moreover, the original recruitment method was discontinued after the initial implementation, and the LTS training program lost steam following the budget cuts.

While the elite group of BIR examiners that was carefully selected in 1999 was given advanced and specialized training, the current roster of LTS examiners is undertrained and inadequate in number. Less than a quarter of the original high-caliber examiners have remained in the LTS.<sup>21</sup> In mid-2007, a major reassignment of personnel led to the transfer of a significant number of original LTS examiners to the field and their replacement by examiners from the field with little or no LTS experience. At present, the auditing of more complex industries, such as banking and insurance, is a problem for the LTS.

Originally, the LTS covered 630 of the country's largest taxpayers and accounted for 32 percent of the BIR's tax collection. This was increased in 2000 to 938 taxpayers, when the excise tax service was merged with the LTS; to 1,306 taxpayers in 2002, covering more than 50 percent of total revenues; and finally to 1,587 taxpayers in 2006, accounting for about 65 percent of total revenues.<sup>22</sup>

The transfer of large taxpayers to LTS has always been a sensitive issue. Regional directors and revenue district officers oppose the transfer, primarily because it significantly decreases their respective tax base, and hence collection, and in turn, opportunities for rent-seeking. This tussle between regional offices and the LTS intensified in 2007, when an additional 279 taxpayers were transferred from the regional offices to the LTS, raising the share of LTS collection to 65 percent. Something had got to give.

In 2007, Commissioner Lilian Hefti delisted almost 500 large taxpayers from the LTS, many of which were among the most compliant taxpayers. The delisting violated existing BIR policy to gradually increase the size of the LTS

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<sup>21</sup> Some of those who resigned found employment among large taxpayers.

<sup>22</sup> The criteria for enlisting and delisting large taxpayers were not applied automatically and consistently.

(RMO 98-01). The official reason for the transfer was to balance tax collection equally between the LTS and the regional offices (the regional offices were clearly unhappy with their small tax base).<sup>23</sup> Among those delisted were the largest banks and insurance companies, which, by virtue of the complexity of their businesses should be placed in the LTS, and multinational companies, which were among the most highly compliant group of taxpayers. The delisting backfired as the BIR's collection fell in the months after the delisting. The commissioner, realizing that her move could jeopardize collections further, declared her intention to return the delisted taxpayers if the fall in collection could be attributed to the delisting. She was soon replaced, however.

The new commissioner, Sixto Esquivias, declared at the start of his term his intention to return the delisted taxpayers and embark on a plan to strengthen the large taxpayer office. A plan was worked out on how to strengthen the LTS over the medium-term, with a timeline to gradually increase the capacity of the LTS and the number of taxpayers falling under it. The goal was to eventually increase the LTS's share of collection from 50 percent after the delisting to 80 percent in three years. To improve the competence and integrity of staff in the LTS, the original selection process would be revived, and selected staff would be placed at higher salary grades and be given adequate training.

The LTS started as a good idea. However, it had to be implemented by a system that still has to overcome the opposition from within its own ranks, and so was neutralized to a large extent. This is a common fate of programs intended to reform an agency, but which have to be implemented by that very same agency. The story of the LTS continues.

### **The Bañez Reform Saga<sup>24</sup>**

Rene Banez's appointment as BIR commissioner came at a time when the anti-corruption momentum was high, and there was pressure from the people to run a clean government. Succeeding Estrada, who had been removed from office extra-constitutionally on account of corruption, President Arroyo publicly emphasized her personal interest in cleaning up the revenue agencies and proclaimed during her first state of the nation address (SONA) to Congress her intent to "make the BIR and Customs showcases in this fight against graft and corruption." Upon assuming office, the president removed BIR Commissioner Dakila Fonacier, an appointee of Estrada who had just stayed for

<sup>23</sup> The reasons for delisting were varied. One informant said the real reason was to "teach the taxpayers a lesson because they were 'hard headed.'"

<sup>24</sup> This section draws heavily from de Dios's (2003) excellent account of the political economy of the Bañez reform.

a year in office, and put in his place former BIR Deputy Commissioner Rene Bañez.<sup>25</sup>

Bañez assumed the Office of the BIR Commissioner in February 2001. He pushed for a three-pronged program of reform: (1) the reorganization of the BIR operations group into four taxpayer segments—large, non-large, government, and tax-exempt (embodied in EO 114). He also proposed the separation of the excise tax group from the large taxpayers; (2) outsourcing of non-core BIR activities; and, finally, (3) corporatization, the establishment of new accountability rules and performance contracting through the establishment of a new collection agency by an act of Congress (Internal Revenue Management Authority [IRMA]). He brought with him all the right ideas.

In May 2001, Bañez ordered the reshuffling of 10 revenue officials as part of the re-organization effort. This whipped up a storm of protest. Full-page ads began to appear in the dailies calling for the ouster of Bañez. A temporary restraining order (TRO) was secured, stopping the implementation of travel orders of revenue officials. The Philippine Association of Revenue District Officers (PARDO) filed a plunder case against Bañez before the Office of the Ombudsman. Twelve congressmen lent their voices to the opposition to the BIR commissioner. More tellingly, the revenue collection was reported to have fallen short by ₱6 billion. The squeeze had begun, but the real blow was still to come.

### **The IRMA Bill**

Despite the ruckus caused by the reshuffle, Bañez persisted in pursuing the corporatization agenda. The IRMA bill was filed in August 2002. Explains Bañez (2009):

Under the IRMA, the tax agency would be supervised by a Revenue Board that would function like the independent policy-making Monetary Board of the Bangko Sentral ng Pilipinas (BSP). The Board would be chaired by the Finance secretary, and would have as members the budget and management and socioeconomic planning secretaries, the Securities and Exchange Commission (SEC) chief, and three private sector representatives.

The IRMA's CEO would have a performance contract with the board, upon which his compensation would be based... a "new

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<sup>25</sup> Bañez, considered an outsider by the BIR family, was a member of the high-level team commissioned by Ramos to conduct a management and performance audit of BIR in 1992. He was appointed deputy commissioner in 1993. In 1995, Bañez left the BIR for private practice.

BIR” that would have external accountability to the executive and legislative arms of government, as well as managerial flexibility.

IRMA was meant to replace the old BIR. IRMA would have had budget independence, greater autonomy, and would not have been hamstrung by civil service rules in the hiring and firing of front-line revenue officers. But all personnel of the BIR had to resign, or would have been considered to have done so, and had to reapply for positions in the new agency. This was the killer provision. EO 114, which was forged in an agreement with insiders, promised no de-hiring. As Bañez observed:

In the second week of August 2002, the workforce at the BIR denounced the proposed creation of the IRMA, particularly the provision that threatened the employees’ security of tenure. The said provision required that they apply anew for their positions, their acceptance or non-acceptance contingent on their qualifications.

The BIR Employees Association (BIREA) thereafter declared that the proposed abolition of the agency and its replacement by the IRMA was unconstitutional and violated civil service laws. BIREA referred to the measure, which was then pending in the House of Representatives, as “class legislation” because it singled out BIR employees for exclusion from civil service coverage.

The IRMA recruited the BIR rank-and-file to the anti-Bañez cause. It also gave the antis foot soldiers with which to mount protest marches. The BIREA was mobilized and held daily demonstrations. Members from the provinces were bused to the national office to reinforce the demonstrators from NCR offices. At one time, the “mob”—as described by onlookers and the press—went wild, banged the gates of the BIR, and pushed their way through the BIR’s heavily guarded doors in an attempt to literally kick Bañez out of office.

Meanwhile, the revenue collection shortfall of ₱39 billion for the first half of 2002 put an even more negative light on the Bañez-BIR war. Bañez reported that this was a deliberate effort: “I strongly believe there are perpetrators who are out to sabotage the reforms by deliberately cutting back on collections during the first half of the year.”

In the weeks prior to Bañez’s resignation in August 2002, the BIR had come to a virtual standstill as many BIR officials refused to do their job. President Arroyo, who initially gave her full support to Bañez, wavered after seeing negative tax collection growth through the first half of 2002, and the national

government deficit exceeded five percent of GDP, the highest in decades. As de Dios (2003) explains the president's attitude, "The need for a short-term solution to the deficit problem then appeared to overtake the longer-term strategy of placing revenue collection on a new footing, and a reversal was in the offing." Other supporters in Congress and in the BIR also deserted Bañez.

Bañez resigned on August 19, 2002. IRMA languished and died in Congress. Even the EO 114 was opposed and fell victim to neglect. President Arroyo offered only token support, and the private sector was not eager to fight. Bañez, reflecting on the lack of private sector support, said, "I was actually waiting for signs, a show of support from other stakeholders, from the private sector, who, since time immemorial, had been asking for reforms." In the end, Bañez was left to fend for himself. He became the latest victim of the powerful anti-reform network and a warning to others. The political hurdle proved too high for this well-meaning crusader.

### **Reasons for Failure**

So why did the Bañez reform initiatives come to a different end than the Plana reforms? First, Plana was supported by a president with decree-making powers, i.e., effectively the EO was the law. Plana's principal had demonstrated the will to use such power in other areas. Bañez was appointed and initially supported by a president who had to work with Congress. Plana had no such restrictions.

Secondly, their styles also differed. In his first speech as commissioner, Bañez told the BIR audience that he would "destroy the BIR and build a new one," a remark that immediately earned the ire of many BIR officials. In sharp contrast, Plana avoided such incendiary language, and thus, slowly won the cooperation of BIR officials.

Thirdly, the macro-fiscal environment was very different. Between 1975 and 1980, during the term of Commissioner Plana, the country was growing at an average of 6 percent per year, and pressures to collect additional revenues were not as high. Bañez, on the other hand, was operating in a much weaker post-Asian Crisis economy and a weaker fiscal position. As such, it was imperative to meet collection targets to prevent the fiscal deficits from ballooning. This made support for radical reforms, which would have adverse short-term impact, more tenuous.

Fourth, the Bañez corporatization initiative embodied in the IRMA was far more radical than the Plana reforms. It exceeded the EO space and required an act of Congress. The decision to submit the IRMA to Congress after the strident

saber-rattling by PARDO stood the divide-and-conquer rule on its head: it recruited the BIR rank-and-file represented by BIREA into the opposition ranks. It also added a breach of trust dimension into the controversy, since IRMA controverted the no-dehiring promise of the original covenant EO 114. Suddenly, the advocates were fighting on more fronts than they could handle.

Some objective lessons can be learned from the Bañez experience. The first lesson is to exhaust the potential of the EOs and the powers of the chief executive. When the depth of the proposal extends beyond the purview of the EOs, the nature of the game radically changes, since the president has to play quid pro quo with Congress. When this is the case, the game must be played primarily by Malacañang (seat of power) not by the BIR commissioner. The second lesson is to deploy the divide-and-conquer rule: never make more enemies than necessary. Alienating the BIREA with IRMA, and threatening rank-and-file jobs even before the revenue officers reshuffle issue was settled, were tactical errors. Finally, the chief executive must realize that a proposal for meaningful reform of the BIR will run into the headwind of falling tax revenue as revenue collectors fight back. This latter must be part of the equation *ab initio*. As de Dios (2003) put it:

It was ultimately a naïve belief that one could make a determined attempt to break the corruption cycle in the tax agencies, and at the same time, that one collected extraordinary revenues. It should instead have been expected that resistance to reform within the agency, particularly from insiders, but also from outside beneficiaries, would be put up, one of which might take the form of deliberate underperformance.

The Bañez reform program was rejected because it *misread the political environment and the limits it sets on the doable*. It advocated correct ideas of transparency and accountability, but its vehicle was overly radical for the political soil. The balance of forces permitted only evolutionary rather than revolutionary steps.

## Summary

The story of the administrative reform initiatives in the BIR in the democratic era is a virtual litany of failures. These failed initiatives, nonetheless, are valuable sources of lessons for future advocacies. Since we cannot return to the era of the decree-making executive, reform advocates must become as politically savvy as their opponents. Internal resistance deploying a clever and well-funded use of the press and Congress, the use of the rank-and-file, the blocking moves using the courts of law, and most

importantly, the tax revenue squeeze have managed to cow higher authorities into largely letting the administrative status quo be. It is much easier to tweak the tax rates whenever a fiscal crisis looms. This is an interesting version of the *Olson effect*: a well-organized minority lords it over a diffuse majority. The minority here is represented by tax reform oppositors forcing government to raise assessments on the taxpaying majority to remedy fiscal imbalances. It is clear that future reform initiatives must carefully map the political terrain to avoid the tactical mistakes of past efforts. It seems clear that reform efforts must be planned and directed by and in Malacañang, outside the walls of the BIR itself.

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A shanty, which fisher folks built by hand, stands proud in the middle of Laguna de Bay, dwarfing the skyscrapers behind it.

Photo by Erwin Tiamson

This photo was taken on February 24, 2011 in Barangay San Vicente, Angono, Province of Rizal.

# Chapter 9

## Development Thinking and the Rise of Human Agency

Raul V. Fabella

Human agency has not had a prominent seat in the table of development ideas of the post-World War II (WWII) era. The emergence of the role of institutions in the development landscape and of the all-important question of how to induce institutional change has opened the door for human agency in the first decade of the 21<sup>st</sup> century. In this chapter, we summarize the evolution of development thinking in the second half of the 20<sup>th</sup> century and suggest that the human agency is a logical corollary. We argue that one form that human agency takes in institutional change is *developmental entrepreneurship* acting through the instrumentality of collective action.

Mechanical engineering models of development, which dominated the post-WWII era, made the capital and financing gap the compelling issue of development. In the process, they buried the role of institutions and human agency in the inert constants of its equations. The burial was made plausible with the deployment of some fundamental simplifying assumptions: (a) the unlimited supply of labor, which rendered the supplier of labor services a pure wage-taker; and (b) the benevolent central planner, which banished diversity and political conflict from the development discourse. The pivotal role of development agencies was highlighted by the belief in pure altruism among development agencies. These meant that resources made available are always the right ones, and the recipient always deployed them to maximize public welfare. As events and development outcomes would reveal, institutions and human agency cannot be so cavalierly treated in the long-run trajectory. The so-called parameters do not stay put, and the predicted positive growth vanishes or reverses in sign. Governments are seldom benevolent or competent, and often privilege private interests over the public interest. Capital made available by aid or loans only gets frittered away when the extant institutions are not right and wobble under political pressure. Non-altruism and/or hubris among aid agencies push capital of the wrong kind and costly equipment rusts in the warehouses.

The “Policy First” paradigm dominated the last quarter of the 20<sup>th</sup> century. Development failures, which were manifested by periodic crises, meant the package of policies that were largely anti-market was wrong and must hence be made to conform to a set of policies that appeared to

be effective in delivering stability and growth in some countries. This set of policies came to be called the *Washington Consensus*. But how do you induce the dismantling of wrong policies, which are nonetheless products of political bargaining and negotiation—in other words, political settlements among internal players? The answer was pressure from the outside, embodied in the conditionalities attached to aid. A number of problems stood in the way. One was the “Samaritan’s Dilemma” where donees find it advantageous to evade difficult reforms in favor of pro-forma ones, which however manage to continue the aid flow. A law may be passed without the requisite enforcement mechanism. More importantly, even when some conditioned policy reforms are implemented, the requisite regulatory mechanism may not be in place. For example, a state monopoly may be privatized by virtue of the World Bank condition, but the resulting private monopoly’s abuse—its market power in the absence of adequate regulation—reduces or erases the welfare gain. Reforms that are not accompanied by changes in the beliefs and perceptions of the domestic players are considered temporary and reversible, so that investments do not confirm the reform. New market ventures that are not guaranteed from expropriation or policy reversals will not be entered. If third-party enforcement of contracts is weak, contracting will likely evolve towards the less productive spot contracts.

Policy reforms need to be hung on additional embedded scaffoldings to perform their magic. These scaffoldings, which we call *institutions*, are at the heart of the emerging development paradigm as the 21<sup>st</sup> century began. Good institutions and good economic performance appear to correlate strongly. But how does a polity acquire good institutions? Institutions can be viewed as carefully crafted *political settlements*, which result from bargaining among various interests and groups in society. They can subvert the public good. Indeed, in weak governance environments, they tend to be predatory. The ascendance of institutions in the development narrative puts human agency squarely at the center of the inquiry. Institutional change is an artifact of human agency. Institutional changes that enhance greater inclusiveness are public goods that seem to require a special trait. For lack of a better label, we call this *development entrepreneurship*. This chapter, distilling the lessons of the cases here documented, explores how development entrepreneurship may be engendered. In the following, we detail these ideas starting with the mechanistic thinking.

### **Mechanistic Models in Developing Thinking**

The decades from 1950 to 1980 were dominated by a mechanistic view of development, one which relegated institutions and human agency

as background constants of the growth equation. The central idea was the capital gap.

## The Capital Gap View in Development Theory

Mechanistic development models are economic-engineering formulae that deliver growth automatically once the identified gap is filled. The first was the *capital gap* (see, e.g., Fabella & Gunatilake, 2007; Thorbecke, 2000). The event that shaped the development thinking in the second half of the 20<sup>th</sup> century was no doubt the *Marshall Plan* that underpinned the post-WWII reconstruction of Western Europe. The Marshall Plan financed the massive physical infrastructure reconstruction of Europe, which laid the cornerstone of the “30 Glorious Years.” Postwar Europe had a massive *financing gap* (to be discussed further in succeeding paragraphs) for which the Marshall Plan was the perfect response. From originally financing imports and balance-of-payments (BOP) support, it embraced project (infrastructure) aid as the dominant delivery modality (Tarp, 2006).

The postwar era also saw many former colonies attaining political independence from their colonial masters. They were at once destitute, in great haste, and facing huge capital gaps. They were increasingly being reminded of how Soviet Russia had moved rapidly from the backwaters to—arguably for many and decisively for some—the leading edge of development. It was argued that replicating mini-Marshall Plans in the Third World would produce an anti-communist phalanx. These were the formative events that shaped subsequent aid attitude in the West. These events, however, had support from, and in turn, supported prevailing developmental paradigms.

The Marshall Plan received intellectual support from Rosenstein-Rodan’s (1943; 1961) *Big Push* idea. Rosenstein-Rodan argued that indivisibilities and market failures abound in Third World economies and give rise to increasing returns and external economies. To leapfrog these, one needed very large outlays of capital. Since this will not be provided by the market, it is imperative that the state step in and provide for the “social overhead capital.” But the modicum requisite investment may be so large that it cannot be afforded by the economy, especially one just coming out of the war. Thus, to finance the capital requirement of Eastern and South-Eastern Europe when the war ended, Rosenstein-Rodan proposed in 1943 the *Eastern European Industrial Trust*.

Corroborations and articulations of the Rosenstein-Rodan idea proliferated. To Ragnar Nurkse (1953), the clarion call was for a “balanced growth” or “a frontal attack—a wave of capital investments in a number of different industries.” For Leibenstein (1957), it was the “critical minimum

effort” idea. The concept of the low-level equilibrium trap, which motivated the “critical minimum effort” and the “critical ground speed” viewpoints, was suggested by Nelson (1956). Hirschman (1958) proposed the idea of “backward and forward linkages.” W.W. Rostow (1959) hit on the stages of economic growth emphasizing the “take-off” stage “when the scale of productive economic activity reaches a critical level and produces changes, which lead to massive and progressive structural transformation...” Rostow’s influence was to shape US foreign policy toward aiding least-developed countries (LDCs) attain take-off, so as to form a bulwark against the Soviet sphere expansion. The *Great Spurt* was Gerschenkron’s (1962) characterization of the drive toward high growth in large manufacturing and the relative neglect of agriculture. All had one thing in common: they pointed to “capital deficit” as the central bottleneck.

While this paradigm receded to the background in the waning decades of the 20<sup>th</sup> century, the associated economic ideas would resurface time and again. The modern reincarnation of the Big Push idea is perhaps Jeffrey Sachs’s much-discussed and criticized book, *The End of Poverty* (2005), to end poverty in sub-Saharan Africa via the ramping up of aid to committed levels.

### Financing Gap in Growth Theory

A parallel development, this time in the Theory of Economic Growth, tried to understand the experience of Western economies and especially the growth of Soviet Russia. Evsey Domar (1946) proposed a framework that showed the growth of gross domestic product (GDP) as a fixed proportion of the share of investment in GDP. This came to be known as the *Harrod-Domar Model*. The fixed-proportion technology employed the idea of “surplus labor” with zero marginal product. In the aftermath of WWII, the surplus labor came from decommissioned military personnel. It also echoed the current understanding of the Soviet economic strides (Domar was, after all, a Russian émigré).

The Harrod-Domar Model had one magical aspect that the previous genre lacked—it gave the profession an idea of the financing gap. In very simple terms, the financing gap is the difference in the rate of investment that a country can finance by itself and the rate of investment that it needs to attain its desired growth rate. This further strengthened the claim of the financing gap as a central concept in the praxis of growth promotion and aid level determination.

A version of the Harrod-Domar Model customized for Third World countries was introduced by Arthur Lewis (1954). The starting point was the existence of “rural surplus labor” that made capital to be the only

binding constraint, allowing fixed-proportion technology. Again, the Soviet Russian economy, as in Rostow, was the archetypal explicandum. “Capital accumulation is economic development” may well be the principal mantra of that development era. The Lewis dualistic labor-surplus economy was formalized by Ranis and Fei (1964) in their dualistic model that came to be known as the *Ranis-Fei-Lewis Model*.

It is no surprise that aid-allocating agencies find comfort in capital deficit models of growth (Ranaweera, 2003). In this reckoning, aid agencies hold the key to growth as they hold the wherewithal to close the financing gap.

By the early 1970s, it was clear that while economic growth was becoming a sustained reality in East Asia, it was not the rule. Another widespread observation was that growth was not readily translating into poverty reduction; the benefits of growth were not being shared. Not enough of the so-called trickle-down effect was happening (Chenery, Ahluwalia, Bell, Dully, & Jolly, 1974). By current understanding (the *Kuznets Inverted U Hypothesis*), income distribution should first worsen before it improves in the process of growth. The consensus of the 1970s, therefore, was that aid and development agencies redirect aid towards more income equality and inclusive growth. The departure was, however, more nuanced rather than substantive.

### **The Invisible Human Factor**

This mechanical engineering view had nothing at all to do with the people. Human actors were invisible, compressed into black boxes called “constants” or “parameters” (as in the *incremental capital-output ratio*). Their freedom and power to decide are of no consequence. How about the governments of nations? The underlying assumption was that the state was a benevolent central planner, another product of the 1950s (Samuelson, 1954). Without fail, this state would apply any additional capital to the best possible use. Moreover, labor was rendered completely passive by its unlimited abundance (as in the Ranis-Fei labor surplus economy). Economic agents, both kings and peasants, did not matter through this array of deft assumptions. This turned out to be very naïve, but at that time, it was not yet known. As it became revealed later, growth had, in fact, little to do with resource or capital constraint but everything to do with policies, institutions, governance, and even cultural factors—all emanations and artifacts of human actors. These issues still lay outside the purview of the orthodox economics of that period (Landes, 1998). These ideas, together with the corroborating Prebisch-Singer export pessimism (Singer, 1965), shaped policy certainties that spawned the import substitution era of the 1950s.

## **The Policy Deficit View: Intimations of Human Agency**

The 1970s saw unprecedented turmoil in the world oil market. The oil-exporting countries jacked up oil prices by manipulating supply and amassed huge petrodollar revenues, which it then tried to recycle through the large banks. The LDCs facing oil import-driven trade deficits saw a window of opportunity for closing its financing gaps by foreign borrowing at very low—sometimes negative real—interest rates. These created unsustainable BOP and fiscal deficits when the world interest rate started to shoot upwards. These triggered the crisis decade of the 1980s, marked by severe macroeconomic instability.

Stabilization programs now hogged the development thinking. The structural adjustment lending became the logical adjunct of stabilization programs following a BOP or other crises. The occurrence themselves of BOP and other unsustainable imbalances suggested that some structural bottlenecks are to blame. The phalanx of economic policies was out of synchrony with economic realities and needed to be corrected if the imbalances were to be prevented from recurring. There was, in other words, a policy gap. The policy prescriptions eventually crystallized into a roadmap known as the Washington Consensus. It was recognition that domestic political settlements were out-of-tune with economic realities, as evidenced by the crises. Domestic forces by themselves cannot change these settlements, which can be modeled as stable equilibria of interest group games. But outside forces can change the political game and its equilibrium. The belief was that changes in these political settlements can be induced by a promise of financial flow from the outside. If nothing else, it re-introduced the human factor into the discourse. Policies, after all, are artifacts of human agency.

The answer in the 1980s and 1990s was the Structural Adjustment Loans (SALs) of the World Bank and the conditionalities of the International Monetary Fund (IMF). They became the workhorse of policy conditionality or policy-based lending in the 1980s. They were designed to ease the way for reforms largely involving domestic market policies, e.g., liberalization, privatization and deregulation. The whole concept was to “push” or “buy” reforms (Radelet, 2005; Easterly, 2003). It made good sense from the air at that time.

The performance record of the conditionality approach to policy reform, however, fell very short of expectations. This called for a re-examination of the aid delivery systems (Easterly, 2001; 2003; OECD DAC, 2005).

Not only was conditionality under question; the effectiveness of aid, in general, came under renewed scrutiny. New empirical results by Boone (1994;



1996) and White (1992) seemed to favor the null hypothesis of “no effect of aid on growth” over the judgment of just inconclusive evidence of the 1980s (e.g., Mosley, Hudson, & Horrell, 1987; Michalopoulos & Sukhatme, 1989). Finally, the Burnside and Dollar (1997; 2000) result pointing toward aid by itself having a negative effect on economic performance and being effective only if conditioned on a good macroeconomic and institutional environment, provided a window for how to improve outcomes. These gave renewed impetus to engendering good institutions that enhance aid effectiveness (see also Rajan & Subramanian, 2005; Easterly, Levine & Roodman, 2003).

The World Bank (1998) analysis of its own past conditionality-based projects concluded that “...donor financing with strong conditionality but without strong domestic leadership and political support has generally failed to produce lasting change.”

### Institutional Gaps

Coincident with the growing disenchantment with conditionalities was the emergence of a development paradigm that put “institutions” and “rule of law” at the center stage of development thinking (Bardhan, 1989; North, 1990; Keefer & Shirley, 2000). The view sprung from the now-widely accepted empirical observation that the development of Western Europe closely dovetailed the emergence of market-enhancing institutions, whether state-based or market-engendered, that made exchange, long-distance trade, and time-mediated exchange less risky and more predictable (North & Weingast, 1989; North & Thomas, 1973). These institutions provided protection for property rights and enforcement of contracts. For examples of such, there are the Maghribi and the Bank of England (Greif, 1989; North & Thomas, 1973).

It was a short leap from here to the observation that development failures are close correlates of institutional failures. Sensible economic policies, such as deregulation or privatization, cannot engender enough new private investments where there is an overhang of considerable regulatory uncertainty. The empirical support from cross-country studies came fast and furious with the availability of governance quality indices (e.g., Kaufman-Kraay, Freedom House, and The World Bank Institute) that proved very statistically robust. The “institutions matter” view reached its height in the “deep determinants” debate where the consensus seemed to be “policies don’t matter as much as institutions” (Rodrik, 1999; Rodrik, Subramanian, & Trebbi, 2002; Easterly & Levine, 2003; Knack & Keefer, 1997; La Porta, Lopez-de-Silanes, Shleifer & Vishny, R., 1999). This, as we shall see, would generate new development mantras, *institutional deficit* and *governance matters*, which would guide aid-giving and development policy in the new century. Although the cross-country

econometric results have well-known weaknesses—especially when applied to policy-making in individual countries—taken as a whole, they shaped conviction in a new and meaningful direction. More importantly, individual country case studies and experiences tended to be corroborative.

The still-unfolding economic miracle called the People's Republic of China (PRC) is *prima facie* evidence of the strong link between rapid growth and growth-enhancing institutions. PRC, starting in the 1980s, experienced a massive transformation in institutions: the massive retreat from purely state to market provision of goods and services, the use of prices to allocate goods and capital, the embrace of direct foreign investment, the determination to unlock the potential of the global export market, and the celebration of private wealth accumulation, among others. These institutions induced massive investments (investment rate is around 35 percent per year), which engineered a transformation never before witnessed in history. Already about 400 million people have crossed the poverty line. The PRC is now the second-biggest economy in the world with a trillion dollars in foreign exchange (forex) reserve. It is pulling along the growth of the global economy. The story of post-Mao PRC is the story of good institutions enabling human actors to engender rapid and inclusive growth. Vietnam's emergence also confirms these new beliefs. These two cases are particularly pronounced because the institutional changes were brought about by internal forces rather than by external inducements, thus confirming the 2005 Paris Declaration's principle of local ownership.

There is hardly any question now about the importance of institutions in economic growth. But that knowledge is less compelling if institutions are fixed and static entities not subject to human influence. Geography is also important to economic outcomes, but we cannot change geography. We also know that institutions change, but the process of change may itself be just random. The emerging consensus is that institutional change can be induced and guided. But how?

### **Institutions as Artifacts of Human Agency**

To address the question of how institutional change comes about, one must first address the question, "What are institutions?" Parks and Cole (2010), following Khan (2009), adopt the constructive label "political settlements" to describe the wherewithal of institutions:

Institutions are... the product of ongoing conflict, negotiation, and compromise among powerful groups, with the ruling coalition shaping and controlling this process. In most cases, power relations are fluid and dynamic, and political settlements are constantly

adapting and subject to renegotiation and contestation. As a result, political settlements should not be interpreted as one-time events, but rather as rolling agreements between powerful actors.

In other words, institutions are no-conflict zones made possible and enduring by the threat of costly conflicts among contending groups. Mutually assured destruction made the institution of limited confrontation the lasting arena of contestation during the Cold War. Institutions are by analogous description the stable equilibria of the coalitional games played by various groups in pursuit of their own interests in society (Greif & Laitin, 2004; North, Wallis, & Weingast, 2009). A comprehensive review of how these political settlements are reached, maintained, and undermined is given by Parks and Cole (2010). The older development orthodoxies did not worry about the messy tug-of-war between contending parties in developing countries. Tried-and-tested formulae can be imported from the developed world by governments that are monolithic, conflict free, and benevolent.

The problem is that in the real world of politics and vested interests, political settlements are sensitive to bargaining power lodged among the elites, and thus, can be used to serve their interests. They can, therefore, be non-inclusive and even predatory. Beneficiaries will fight tooth and nail to preserve their privileges. How does a status quo that benefits a few get replaced by another which benefits the many? In other words, how does an old iniquitous political settlement get undermined? This is the development challenge of our time. Anyone who cracks the code will have an inside track on the Nobel Prize in Economics.

Aid and development agencies are naturally the most ardent consumers of these ideas. Aid agencies are themselves repositories of first-hand experiences of trying to introduce reforms. The meager state of knowledge on institutional change based on aid agency experience is summarized by Shirley (2008):

- (i) Most institutional change takes much longer to germinate and render permanent than the timeframe of aid projects;
- (ii) Sustained institutional change requires changes in norms and beliefs, which outsiders, even with their superior resources, cannot easily influence;
- (iii) Among instances of successful institutional shifts, the role of insiders and local agents proved all important, and their views may not always jibe with the best practice championed by the donors;
- (iv) Absent complementary institutional scaffoldings, aid may just

create perverse incentives for, if not prop up, the very opponents of reform.

The toughest condition seems to us to be second on change in beliefs and norms that underlie sustainability. Time is of the essence here and quick fixes are the potential pitfalls. These lessons serve as the caveats to political advocacy, especially for aid agencies seeking to force open political settlements by superior inducements. One track is via conditionality. Since we have already observed the poor record of the conditionality approach to policy change, we dwell now a little on why.

### **Conditionality as Institution Changer**

The conditionality approach is an externally induced modality toward institutional change. Azam and Laffont (2003) showed that given donee choice in an aid-contracting game, unconditioned aid results in the enrichment of the elite and the exclusion of the poor in the recipient country. By contrast, the attachment of conditions for aid biases the political process in favor of the poor. But theory can be very misleading here. It is assumed that the donor can enforce the contract (punish the donee for non-compliance), which is seldom true. As a result, the conditionality approach to institutional change is also subject to the Samaritan's dilemma. The Samaritan's dilemma (Buchanan, 1977) describes the situation where the donee deliberately chooses to remain poor by avoiding acts that lift him out of his or her poverty, since continued poverty induces continued aid flow from the donor. The donors (if indeed they are Samaritans) are only too eager to interpret some (however pro forma) performance as adequate to warrant continuation of the aid relationship. To put it differently, the donee, equipped with fishing gear, refuses to fish in order to induce continued donation of fish. Thus, conditionality as institution changer has a poor record. But this has not stopped experimentation with externality-induced changes.

Conditional aid relations are contractual relations, and real contracts can cover only some—but not all—the required deliverables. This is known as incomplete contracting (Williamson, 1985). There is a lot of room for reneging, especially where the deliverables are not easily observable. The ruling elite of the recipient country signs that contract, receives aid, but cherry picks and delivers only the least costly and least binding items, leaving intact the more costly and binding constraints. The former are what Shirley (2008) calls “pro forma reforms,” which are often associated with the Samaritan's dilemma. In Shirley's words:

Ruling elites often prefer pro forma changes so they can obtain funds without politically costly changes in deep-seated

constitutional rules, norms and beliefs—the Samaritan’s dilemma... conditionality will be met by passing laws without mechanisms for their enforcement; creating agencies without adequate staffing, budget or mandate... etc.

## Conditionality Tournaments

Are there ways out of the Samaritan’s dilemma? Running the aid game as a tournament is the new and ongoing experiment to improving aid effectiveness. There is a limited aid fund to be disbursed to an unspecified number of countries. Reform hurdles are set and agreed to by a country applying for a share in this fund. The diverse domestic human agents and groups within its borders bargain among themselves to clear the hurdles in view of the promised future aid flow. Those who clear the committed hurdles receive a share; those that don’t will have to try harder next time. This is the concept behind the *Millennium Challenge Account* of the United States.<sup>1</sup> In theory, while this appears to solve the problems of contemporaneous or ex-ante conditionality, it still has peculiar problems. Those who are able to clear the hurdle are usually also the least needy (they can afford the financing and political cost of reform on their own). In fact, these do not need the aid flow because private loan providers know their capacity, and thus, flock to their doorstep. The result is that aid flows inversely to need.

Genuine desire to clear the reform hurdles on the part of the donee can also coexist with a real inability to finance the cost of transit to a new regime. The donor may not be there by design to lend a hand. And when this rule is relaxed (as when financing for reform is made available before the hurdles are cleared), the Samaritan’s dilemma again rears its head. Likewise, since the hurdles are many and diverse, and cherry picking is possible, even poor performance relative to hurdles may be interpreted as adequate, due again to the Samaritan’s dilemma. Effectiveness will be sacrificed. However, the main drawback of conditionality as an institution changer is that it lacks local ownership.

## Institutional Change and Indigenous Collective Action

Why do some polities succeed in providing institutions that speed up economic growth while others don’t? One pathway that has attracted intense contemporary curiosity and interest is the polity’s capacity for collective

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<sup>1</sup> The Millennium Challenge Account was created by the U.S. Congress in January 2004 to promote good governance, country ownership, and results in the country recipients. Read more at <http://www.mcc.gov/>.

action (see, e.g., Keefer, 2010). Collective action occurs when members of the same community work together to attain a collective goal that benefits all. This is not so easy, since individual agents would rather get a free ride on others' contributions to a public project. This insight was introduced by Mancur Olson (1965) in that seminal work *The Logic of Collective Action*. A collective goal may be a physical asset (such as an expressway) that serves everyone, or a policy change that makes commerce easier and cheaper for all. Collective action capacity describes how well and how readily members of the same community work together to meet some collective action challenges, e.g., providing a footbridge or a *ronda* (night watchmen) in crime-ridden communities, or providing and enforcing a cooperative rule of behavior or a conflict resolution agency. A strong collective action capacity means that the community can mount ambitious scale-economic projects at a lower cost. A weak one means that only inconsequential projects get undertaken and completed. Institutional change towards more inclusive outcomes is a collective action challenge.

Again, the PRC is a good example of an immensely strong collective action capacity (evidenced by the building of the iconic Three Gorges Dam). The Philippines is an example of a state with weak collective action capacity (iconic examples are the San Roque Multi-Purpose Dam, whose irrigation segment—with the capacity to irrigate up to 70,000 hectares—has been lying idle for a decade, and the new state-of-the-art Ninoy Aquino International Airport [NAIA] Terminal 3, unused for six years after its completion in 2002). But a strong collective action capacity is a double-edged sword. It can be marshaled for weal or ill. Japan used its strong capacity for collective action to develop rapidly in the post-Meiji Revolution era (1868-1900). It also used this capacity for collective action in the 1930s and 1940s to wage aggressive and eventually self-destructive wars. Germany under Hitler rode the same remarkable capacity to rapid recovery in the 1930s and destruction in WWII.

But since collective action capacity is a double-edged sword, how does a polity shape collective action capacity to favor inclusive outcomes? Democracy has been suggested as one such facilitating institution. Rodrik (1999) has proposed that an *electoral democracy* is a *meta-institution* that spawns other good institutions. This has to do with facilitating accountability and the power of recall vested on the majority. But democracy understood as universal suffrage performs weakly at delivering public goods and economic growth (see, e.g., Barro and Sala-i-Martin, 1998; Keefer, 2011). Non-democracies have done better economically than democracies in East Asia, for one. There are many ways by which the accountability feature of majoritarian rule can be vitiated. One such is called the “tyranny of the minority.”

Mancur Olson (1965) introduced the differential difficulty for collective action among groups as an explanation for the tyranny of the minority: a cohesive minority can lord it over a diffuse majority in the policy market. Groups that command higher capacities should do better than others in a social contest, say, in the allocation of the budget or in electoral contests. This explains the persistence of institutions that fail to serve the welfare of the majority (the old PLDT monopoly and the NFA, among the cases documented in this volume) even as they erode that of the more numerous non-elites.

This has a resonance in the differential performance of countries in the development landscape. Countries with strong collective action capacity tend to provide better public infrastructure (because they can readily mobilize resources and bargain around obstacles), better legal protection, and more credible policy covenants for investment (say, for non-expropriation of private economic surpluses). Strong collective action capacity has surfaced in different guises in the literature: as “trust” in Fukuyama (1995) or as “social capital” in Coleman (1988) and Knack and Keefer (1997).

There is now a growing body of evidence to show that more primitive institutions, even in pre-democratic societies, may facilitate collective action and explain growth and growth-enhancing outcomes in those polities. Keefer (2011) shows evidence that long-lived institutionalized political parties, especially in non-democracies, do well in delivering public goods in poor countries while competitive elections do not. This helps to explain what is known as the “East Asian exceptionalism”: rapid growth without the scaffoldings of formal electoral democracy. The key concept in this view is the collective action capacity of the polity. This type of political party facilitates the capacity of the memberships to discipline the leadership and redirects decisions towards greater inclusiveness. Their longevity also induces them to morph from what Olson called “roving bandits” into “stationary bandits” with a stake on future revenue flows.

### **Some Essential Features of Collective Action Capacity**

For collective action capacity to decisively push inclusive growth, it must be endowed with two crucial features. It must be *strong* and it must be *properly directed*. Strong collective action capacity means that the decisions by the mandated center are not vetoed or undermined by other decision centers or attenuated by organs of enforcement. Some would call this “executive autonomy.” Some states, by accidents of their histories, already have strong inherited collective action capacities. The central authority already enjoys autonomy in resource mobilization, budget allocation, and project choice. This history may include dark episodes involving the complete purging of

potential and actual opposition (many countries used ideology to physically annihilate class enemies or send them into exile). The result is a period of strong collective capacity. Strength may also have been forged on the anvil of a long militaristic tradition. It may come from the terror in a police state.

Spells of collective action muscle, by themselves, may not deliver public benefits because they can just as likely be wrongly directed. As previously observed, collective capacity can cut both ways. North Korea is iconic for strong collective capacity with utter disdain for public welfare. It manages to wield absolute power despite consistently starving its own people. The PRC post-1949 enjoyed strong capacity for collective action (going to war in the Korean peninsula and almost winning showed that), but sputtered economically in pursuit of wrong goals under the Great Leap Forward of Mao Zedong. Cuba has a strong collective action capacity partly because all the potential oppositors are in exile in Florida. The training of such a collective action capacity for socialist goals has muted its benefits. The imperative in these countries is *correct direction*. Once the ship of state embraces the proper direction, it moves quickly. Witness the PRC after the ascendance and tutelage of Deng Xiaoping in 1978; witness Vietnam in the first decade of the 21<sup>st</sup> century. Provided that an about-face of their respective leaderships occurs, North Korea and Cuba can exhibit the genome of economic miracles for the next two decades. Getting collective action capacity to serve inclusive growth is a collective action challenge itself.

Other countries do not have the right histories to draw from for strong collective action capacity. Post-colonial democracies have the worst record. In many of these already largely fissured countries, democracy may have widened—rather than healed—ethnic, religious, and cultural divides. Witness the collapse of stable political settlements after Josip Bros Tito of Yugoslavia and after Saddam Hussein of Iraq.

When collective action capacity is weak as it is in many countries, the political settlements it is able to support are generally rent-extractive, a view inherent in North, Wallis, and Weingast's (2009) idea of "limited access order." For example, the incapacity of the Philippine state to enforce its sovereignty over Maguindanao Province led to an implicit political settlement, which gave the Ampatuan clan a monopoly of violence and rent-extraction powers over the area in return for opposing the Moro Islamic Liberation Front (MILF). The weak political center also buys the military's loyalty by increasing its share in the state budget and looking away from how it is used. Thus, in these countries, the imperative is for collective action capacity to be at once *strengthened and redirected*. This is an even bigger collective action challenge. The case studies in this volume suggest the role of committed reform agents.



## Development Entrepreneurship and Collective Action

The new institutions that undergird the modern economic miracle in PRC were fought for and ushered in by the pragmatists, led by Deng Xiaoping, after a long political struggle. These institutions redirected the strong collective action capacity in China from ideological goals towards the public good. The pragmatists were also quintessential insiders. Indeed, had outsiders held sway, the history of modern China would be very different. Likewise, the new institutions that supported the Japanese economic miracle in the post-Meiji period were engendered by the conscious embrace by the Japanese modernizers who won the right to redirect the nation by winning a civil war. In South Korea, the institutions that nurtured an export orientation, which proved inclusive, were set in place by President Park Chung Hee. These were true-blue insiders who identified the institutional and policy problems, found the alternatives, and used collective action capacity to undermine the prevailing political settlements, and install the solutions. These are iconic examples of “local ownership” championed by the 2005 Paris Declaration and affirmed by the New Institutional Economics.

The cases documented here confirm the importance of local ownership in the change process. This localness emerges first and foremost in the role played by indigenous actors navigating their local political jungles to engender locally conceived reforms. This we call development entrepreneurship, a mindset displayed by indigenous individuals or organizations that commit themselves to making their ambient socio-political institutions work for the greater social good. Development entrepreneurship entails the undertaking two genres of activities: *(a) identifying the binding constraints* on the one hand, and *(b) reshaping the social and political circumstances* on the other, which lead to the adoption of good institutions. What, in particular, do these consist of? From the case studies, this means the following series of actions:

- (1) Identifying the social problem: a binding constraint in the form of some law, agency, program, or practice within the status quo that exacts a large net cost on society at large, even as it often benefits only a privileged few;
- (2) Understanding how the binding constraint emerges as a political settlement among various self-seeking stakeholders;
- (3) Identifying or formulating an alternative to the binding constraint and carefully evidencing its superior potential benefits;
- (4) Bringing the alternative and its superior benefits to the consciousness of the leadership and/or of the public;
- (5) Identifying the vested interests expected to oppose its replacement

because they benefit from the status quo; uncovering how financially or ideologically they are benefited;

- (6) Identifying and building coalitions among the victims of the status quo and the potential friends and beneficiaries of reform, thus amplifying their political voice empowered with requisite intellectual armory and evidence-based arguments and studies;
- (7) Identifying potential allies within the governmental decision structure and nurturing support with conviction by equipping them with requisite intellectual armory and evidence-based arguments and studies.

Items (1) to (3) constitute the “identifying the binding constraint” layer of development entrepreneurship; (4) to (7) constitute the “reshaping the social and political circumstances;” this corresponds to the economic entrepreneur seeking the buy-in of venture capitalists. This set of actions corresponds to the “introduction of new combinations” by a Schumpeterian entrepreneur. Development entrepreneurship thus embodies the two imperatives of an inclusiveness-leaning collective action capacity: the *strengthening of the penalized majority’s collective capacity* to extract institutional change, which when successful, effectively redirects the collective action capacity of the polity to serve the public good. Taken together, this is a gargantuan task undertaken normally only by very rare individuals or groups of individuals.

Development entrepreneurship may be displayed by a government actor, say, the president, a cabinet secretary, or a lawmaker (the president in the case of water privatization and telecoms deregulation), or it may be displayed by private persons or by organizations outside the government who pursue buy-ins by insiders (the case of aviation deregulation and the Residential Free Patent Law). It may be displayed by non-governmental organizations (NGOs) or civil society organizations (CSOs) (Schumpeter [1949] also included organizations among possible entrepreneurs). Whether by insiders or outsiders, the process of inducing change is long, messy, and unpredictable. As the failure cases show, nothing is guaranteed but aggravation. Rene Bañez, who led the ill-fated reform initiative in the BIR in 2001, still has to contend with lawsuits a decade after he was let go.

To observe that development entrepreneurship played crucial roles in the reform initiatives documented is not to say that development entrepreneurship is a sufficient—or even the most binding—ingredient in the change process. A development entrepreneur (DE) seems, however, to be a necessary—perhaps one among many—condition for the process to pull through. It is difficult to narrate of the cases without the doggedness displayed by specific groups of actors. While a crisis may occur or a favorable conjuncture may rear its head,

there is still a need for an actor or a group of actors to transform a problem into an opportunity—that is, to craft or divine the alternative, to get crucial decisionmakers to coalesce around this lodestone, and decide the best investment of their political capital. Banerjee and Duflo (2011) also narrate cases of exceptional individuals who made the difference in bringing about institutional changes that markedly improved people's lives.

## The Emergence of Development Entrepreneurship

Why the DE emerges is a difficult question to address. One problem is that good institutions are public goods and orthodox theory—whether going through Paul Samuelson or Mancur Olson—says these will be underprovided among selfish agents. For some, development entrepreneurship appears to require a non-selfish gene. It is increasingly fashionable to say that in each person's make-up is a social gene that deeply cares for the social good of the community. Evidence for the need to belong to and to do well by one's group has been mounting from evolutionary biology to brain studies (for a comprehensive review, see e.g., Rifkin's *The Emphatic Civilization*, 2009). Mainstream economics remains discomfited by such a concept. More comfortable for the profession is the default hypothesis: development entrepreneurship—if at all—is a random mutation generated by, say, a Poisson process. We have no power to influence it so we don't dwell on it. It is like the equatorial paradox in Growth Economics. You cannot rule it out; but as it does not help policymaking we turn to other more tractable factors.

Perhaps it is time to interrogate this default hypothesis of pure randomness and exogeneity. After all, the history and growth of the economics discipline is a litany of once-exogenous variables rendered endogenous to ample harvest (e.g., total factor productivity [TFP], innovations, institutions). Perhaps there are regularities here—not yet in the caliber of laws—that can be exploited.

It must be noted that a non-selfish gene need not be involved in development entrepreneurship. There could be two phenotypes of the same genotypic selfish gene. One views its individual well-being as divorced from that of the polity and the other sees its individual well-being as coursed through its social group. The differentiated expression is generated by circumstances which can allow manipulation. An example of the first type is Olson's *roving bandit*; an example of the second is his *stationary bandit*. Both are selfish, but the latter finds it more profitable to become Hobbes's *Leviathan* with a stake in his subjects' well-being and productivity. Machiavelli's enlightened *Prince*, who refrains from expropriating his subjects' properties and their women, does so, not so much from altruistic motives but from the imperative to survive in an environment of contestable sovereignty. The Prince needs

the loyalty and the industry of his people. President Ramos—who played a prominent role in water and telecoms reforms—was acutely discomfited by cross-country comparisons showing the Philippines lagging far behind. He thus operated as a legacy executive, one who finds inspiration in the fond remembrance of progressive future generations. Schneider and Teske (1992) also show that competition among different political jurisdictions leads to institutional change. The fact that inter-group competition can engender group-phenotype was already the message of Darwin’s other volume *The Descent of Man* (1871).

The stories documented here suggest other possible enablers. Two types of people can be identified: those within government and those outside government. The non-government people who got involved (Hederer [2007] calls them “propagators”) were either connected with academic institutions which did not discourage policy engagement or people of independent means. The government people who figured prominently had mandates from the electorates to mind the problems of the polity and were compensated to do so. Both types had the *time and space flexibility* to pursue activities not directly contributive to their financial well-being. Both types also exhibit *relative financial security*. But even then, meaningful reforms are risky and could be costly for those who advocate them. It can cost one’s job or a lawsuit. The default state of players is important in case of failure. Government people—whose default state is uncomfortable—often decide to play it safe, pursue non-controversial, pro-forma reforms, if at all, and still get re-elected. Those whose default state is comfortable (i.e., who do not need the position) take the plunge. Having space-time flexibility and relative financial security seems necessary—but not sufficient—to indulge one’s group-phenotype. This phenotype will remain unexpressed if unaccompanied by these two enablers.

### **Development Entrepreneurs, Lobbyists, and Revolutionaries: The Hierarchy of Political Settlements**

DEs, lobbyists, and revolutionaries have one thing in common: they all work to change the status quo. They are all political entrepreneurs (PE) (Hederer, 2007). How does a development entrepreneur differ from the other two types?

Consider the status quo as a hierarchy of nested political settlements. An “overarching political settlement” (OPS) sits atop and nests all other political settlements. This overarching political settlement corresponds to a fundamental document many times identified with—but need not necessarily be — a constitution. The OPS embodies the (i) goals that the social covenant

is designed to pursue (say, the summum bonum as seen by the polity); (ii) the fundamental principles guiding and limiting the pursuit (such as the separation of church and state, private ownership, and one-man-one-vote); and (iii) the instrumental bodies (such as the government branches in a tripartite system of government). We use the shorthand *G* to delineate (i) and (ii). An example of *G* is “‘the greatest good for the greatest number’ under private ownership and ‘one-man-one-vote.’” The OPS is many times ratified as a political settlement via a national referendum.

Under the OPS are a bevy of “subordinate political settlements” (SPS) in the form of laws, executive orders, etc., each designed in theory to implement *G* set down in the OPS. An EO is an SPS issued by the executive branch. Laws are SPSs passed by the legislative branch. There is no guarantee of the effectiveness with which each SPS serves *G*. Some SPS may, indeed, subvert *G*—either deliberately or as unintended consequence. Some SPS may transfer resources from one pocket to another such as high tariff protection. The contents of *G* may allow multiple interpretations and the judicial branch is the final arbiter among these.

A revolutionary is a political entrepreneur out to undermine and replace the OPS; a development entrepreneur is a political entrepreneur who accepts the OPS but is out to replace an SPS that serves the interest of a minority with one that serves the interest of the majority. The lobbyist is a political entrepreneur who accepts the OPS and is out to replace an SPS with another SPS that serves the interest of the particular group that remunerates the lobbyist. The lobbyist is re-distributive PE. The DE is a value-adding PE. The lobbyist is a self-phenotype while the DE is a group-phenotype.

The Deng Xiaoping who—as part of the communist movement—toppled the overarching political settlement lorded over by Chiang Kai Shek in 1949, was a revolutionary. The Deng Xiaoping who rejected a gamut of SPSs under Mao (collective farming, the Great Leap Forward, the state monopoly of the delivery of goods and services) and offered, instead, a gamut of replacements under the banner of “Socialism with Chinese characteristics” under the same OPS, was a development entrepreneur (Deng Xiaoping, 1984). The revolutionary goes to battle with bombs, bullets, and a knowledge of the lay of the land; the development entrepreneur goes to war with technical and political analyses, and the detailed lay of the political landscape supporting the target SPS.

DEs, lobbyists, and revolutionaries have other similarities. None of them is a permanent state, like the priesthood or being male or female. A DE in one arena may be a lobbyist in another. Many revolutionaries first started as DEs but switched after being disillusioned. A lobbyist may switch to development entrepreneurship after a “Saul of Tarsus moment.” They face a fundamental

uncertainty about the success of their enterprise. A development entrepreneur marches to a different drummer than the general run of people. His pursuit being the collective good, his motivation cannot be the financial returns to the enterprise. Development entrepreneurship is a kind of insanity. That is why it is difficult for economics to digest it. But development entrepreneurship as the embodiment of human agency seems most in keeping with the Paris Declaration (Organization of Economic Co-operation and Development – Development Assistance Committee [OECD DAC], 2005) imperative of “local ownership” and the NIE caveat of “change in belief systems and norms.”

### Summary

In the previous parts, we summarized the evolution of development thinking leading to the emergence of institutions and human agency. We started with the mechanical models of the post-WW II era, where human agency is effectively abstracted by clever assumptions—a benevolent government and economic agents rendered powerless by abundance. They also succinctly rendered the development problem in understandable gaps. The most famous of these, the financing gap, made external aid agencies the central player in development. But it proved wanting.

The policy gap view of the 1980s—culminating in the Washington Consensus with its emphasis on conditionality and externally driven change—also proved disappointing as it ran into the Samaritan’s dilemma, agency problems, strategic behavior by donees, and even donors with ulterior motives. In other words, they lacked local ownership.

The new century saw the gradual ascendancy and eventual embrace of institutions as central. Cross-country evidence, however deficient and scattershot, corroborated country case studies to confirm that good institutions spell the difference. If this new view was to engage our attention, institutions must be rendered endogenous. Since institutions are artifacts of human agency, this puts human agency at the center of the development process. How does a polity acquire good institutions remains the development challenge of our time.

Is there a master narrative that governs institutional change? In this paper we propose that if there indeed is one, collective action capacity should be an ingredient in this narrative. We propose that institutional change is—like building a public infrastructure—a collective action challenge. As such, it quickly runs into the “Olsonian *free riding*,” and into the murky waters of politics and political settlements. Thus, it requires a strong collective action capacity to bring about. Development failures and collective action failures

are many times fellow travelers in development annals. Collective action capacity may fail to enhance the public good either because it is *weak* and/or because it is *wrongly directed*.

In some countries, history has begotten a strong collective action capacity; in these cases, collective action has to be *redirected* to the right ends. This, we argue, is what happened in the PRC in the last two decades of the 20<sup>th</sup> century, thanks to the exertions of Deng Xiaoping. In many more countries, the capacity for collective action is weak. And precisely because of weakness, it was generally trained towards rent extraction from the most powerless to support tenuous political settlements. For example, the incapacity of the Philippine state to enforce its sovereignty over Maguindanao led to an implicit political settlement, which gave the Ampatuan clan a monopoly of violence and rent-extraction powers over the area. The members of the press and of the opposing clan that entered—and were believed to be subsequently massacred by the Ampatuans on their own sacred ground—were defying this political settlement. In these polities, collective action capacity must be at the same time *strengthened* and *redirected*.

Guided by the cases documented here, we suggest that an important sub-narrative of institutional change is the role of development entrepreneurship displayed by indigenous actors or organizations. Depending on the polities, development entrepreneurship either redirects or strengthens and redirects collective action capacity toward more inclusive outcomes. The actors displaying development entrepreneurship identify binding constraints toward more inclusion and organize the coalitions and networks that work to lift those binding constraints. The members of the press and of the opposing clan who defied the political settlement with, and were subsequently massacred by, the Ampatuans, were following the dictates of development entrepreneurship. To replace the old political settlement, they paid with their lives.

It is clear that development entrepreneurship comes under the general rubric of political entrepreneurship, of which much has been written. We differentiate DEs from other agents of social change—such as lobbyists and revolutionaries—by mapping their change targets against the hierarchy of nested political settlements. This starts with OPS, under which exists a collection of SPS. Revolutionaries work to replace the OPS; DEs and lobbyists work to replace an existing SPS—DEs by an SPS that serves greater social inclusion; lobbyists by an SPS that serves or preserves social exclusion.

We also suggest some factors that may render DEs tractable and endogenous. We classify agents as either self-phenotype or group-phenotype of the selfish genome. One is a selfish agent who views his private well-being as divorced from that of the polity's and the other views his private well-being

as unbreakably wedded to the well-being of the polity. Group competition may make the group-phenotype more likely. Likewise, space-time flexibility and relative financial security may help engender more group-phenotypes, and thus, development entrepreneurs in the population.

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The skyscrapers of Makati City, the country's prime commercial district, have long symbolized modern infrastructure, entrepreneurship, and economic progress.

Photo by Erwin Tiamson

This photo was taken on February 24, 2011 in Barangay San Vicente, Angono, Province of Rizal.

# Chapter 10

## Development Entrepreneurship

Jaime Faustino and Raul V. Fabella<sup>1</sup>

Over the past 50 years, the understanding of what promotes development has evolved considerably. From gap identification and the provision of technical solutions, development agencies and practitioners are now more aware of the importance of institutions. While most now accept the definition of institutions as “the rules of the game in a society—and the nature of political and power struggles that lie behind them” (Rodrik & Rosenzweig, 2009), *which* institutions are right for a particular development environment remains a challenging question. In a review article, Booth (2011) notes that “institutions rule, but what are the right institutions is context- and time period-specific, and institutional change is not self-generating.” Since the right institutions do not emerge by themselves, an even bigger challenge is how to engender the right institutions if we knew them. North’s (1990; 2003) observation is still valid: “We know institutions matter, we just don’t know how to change them.” Partly to address this problem, human agency has recently emerged as a possible determining factor in engendering institutional change (Leftwich, 2011). Very much along this path are two recent books by Banerjee and Duflo (2011), and by Karlan and Appel (2011), which offer compelling instances of incremental changes realized by human agents, changes that build on themselves and together promise to amount to a quiet revolution in welfare improvement.

Drawing on the case studies in this volume, this chapter proposes an approach for development agencies and practitioners to integrate political and technical dimensions to more effectively engender institutional reform. Referred to as *development entrepreneurship*, the operational approach is designed to help donors navigate the conceptual chasm between the traditional role of being principal providers of technical assistance and the less familiar role of supporting change advanced by local actors. (Unsworth & Moore, 2010).

The *development entrepreneurship approach* consists of three dimensions to achieve institutional change:

1. **Reform elements.** Premised on the assumption that *politics matters*, the approach integrates technical analysis, political economy analysis,

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and political action. These are integrated in an iterative process with the goal of determining technically sound and politically possible reforms.

2. **Human agency.** Built on the consensus that *human agency matters*, the approach highlights the importance of the principal actors who actively manage the reform elements with a single-minded focus on taking advantage of reform conjunctures that foster institutional change. These actors are what we call *development entrepreneurs*.
3. **Project structure.** Recognizing that incorporating the political dimension remains a challenge for development agencies, the approach outlines a working project structure that reduces the reputational risks of a more political approach to development and improves aid effectiveness.

### The Traditional Pathway to Institutional Change

The *traditional development agency model* neatly divides the political and technical responsibilities. Development agencies and their consultants supply the technical analysis and, more recently and increasingly, political economy analysis. *Political action* is the exclusive realm of government partners. This thinking is embedded in the charters of development agencies. The charters of the World Bank and the Asian Development Bank (ADB) contain explicit prohibitions on political activities. For example, Article 36 of the ADB Charter (1966), entitled *Prohibition of Political Activity: The International Charter of the Bank*, states that:

The Bank, its president, vice-president(s), officers, and staff shall not interfere in the political affairs of any member, nor shall they be influenced in their decisions by the political character of the member concerned. Only economic considerations shall be relevant to their decisions. Such considerations shall be weighed impartially to achieve and carry out the purpose and functions of the Bank.

The traditional approach works extremely well when the interests of public interest-seeking development agencies and government partners are congruent. The water privatization case study is a good example. The principal impetus for change came from reform champions within the Philippine government who maneuvered it through the political maze. But technical advice proffered in a timely fashion by development agencies—in this case, the World Bank and International Finance Corporation (IFC)—proved important.

That the development agencies and host governments have aligned



interests is, however, a statistical outlier. In an overwhelming majority of cases, they do not match. And where they do not match, it remains an accepted tenet that the government can be induced to improve through various incentives or conditions. Unfortunately, conditionalities have been found better at effecting nominal, rather than real, reform. In the case of the National Food Authority (NFA), the interests of the host government and development agencies were never genuinely similar. The 2005 Paris Declaration has signaled the need to revisit this assumption. Given the centrality of politics in institutional change, and of the latter in economic development, the separation of technical analysis from political action in the traditional approach is increasingly the subject of major debate and criticism.

### Development Entrepreneurship

The development entrepreneurship approach integrates the technical and political dimensions of reform. This integration involves, first and foremost, recognition of the iterative process in the search for a breakthrough. It is quintessentially learning by doing. There is no single point in time when full understanding and control are achieved, as relationships, networks, and ideas are constantly being discovered and discarded to respond to random shocks. It is based on the view that social and political realities are self-organizing systems characterized by non-linearity and unpredictability (Ramalingam & Jones, 2008).

The cases highlight precisely that reform is an iterative search process. Successful institutional reform calls for a series of decisions that are taken in response to the rapidly changing terrain. Williams, Duncan, Landell-Mills, and Unsworth (2010) propose a similar process that links politics and growth. Some of these steps are strategic retreats reminiscent of Lenin's "one step forward, two steps back." A natural corollary of the iterative process is unpredictability and protraction. How protracted some of these processes can be—at times taking decades to bear fruit—is highlighted in the case studies.

The highly iterative search process that attends reform is significant, because its trajectory can hardly be predicted by *ex ante* political economy analysis and supplied from the outside. It can only be discerned by individuals involved and immersed in the process. The sea transport case study illuminates this point. In the 1990s, several donors, such as the United States Agency for International Development (USAID) and the Japan International Cooperation Agency (JICA), provided technical assistance to the port regulator, the Philippine Ports Authority (PPA), recommending the implementation of the alternative Roll On/Roll Off (RO-RO) shipping mode. Meaningful steps in that direction did not follow. The interests of the government partners diverged

from those of the donors. The key actors—the regulated shipping companies, cargo-handling companies, port terminal operators and their labor unions, and the government regulator—manifested convergent interests, which conspired to thwart reform and maintain an inefficient cargo-handling system. Higher tariffs by the shipping companies contributed to the income of the regulator. How could consumer sovereignty be served?

One way was to overhaul the regulatory agency enough to give more weight to consumer welfare. While this tack appeared first-best, this proved a dead end, as the power of the allied incumbents, trained precisely in stopping this, proved too strong. Recognizing the futility of working within the agency, the reform advocates, working mostly outside the government with the help of USAID, adopted an alternative and more concrete reform pathway, which turned out to be more politically feasible. This was the RO-RO policy previously shelved by the regulator. Reformers built a coalition of users and other stakeholders affected by, or deeply concerned with the high cost of sea transport. In the government, these included the Development Bank of the Philippines (DBP), the National Economic Development Authority (NEDA), and the Department of Agriculture (DA). In the private sector, committed supporters included the Mindanao Business Council (MinBC), the Supply Chain Management Association of the Philippines (SCMAP), and the Philippine Chamber of Commerce and Industry (PCCI), among others. A favorable political conjuncture helped push the new initiative over the top.

### Unpacking the Development Entrepreneur's Challenge

Three essential elements are especially helpful in the unpacking of the development entrepreneur's challenge: (a) *technical analysis*, which reveals a binding constraint and possible correct solutions; (b) *political economy analysis*, which reveals the political settlement underlying the binding constraint; and (c) *political action*, which seeks to alter the political settlement through an iterative process that discerns a *technically sound* and *politically possible* reform. We elucidate each in turn.

*Technical analysis* is the identification and evidence-based evaluation of a binding constraint, indicating its opportunity cost to society, and specifying a plausible alternative.

*Political economy analysis* involves the identification of the major groups supporting the political settlement underlying the institutional status quo, and the pro-reform interests—usually the disadvantaged groups and the fence-sitters who could be transformed into supporters of the reform by appropriate *quid pro quo*. Inherent in political economy analysis is the appreciation of

*political capital*, the ability of individuals, groups, associations, families, and informal networks to influence the outcome of political events.

In their survey article, Duncan and Williams (2010) note that there are common strands in the various political economy analysis efforts, such as the UK's Department for International Development's (DFID) *Drivers of Change* studies, the Sweden International Development Cooperation Agency's (SIDA) *Power Analysis*, and the World Bank's *Problem-Driven Governance and Political Economy Analysis*. These include: a recognition of the centrality of politics; a greater emphasis on specific country realities and less on ready-made normative judgments; the identification of underlying factors, such as a country's history, society, and geography, that shape the political process; a balanced focus on institutions and leadership; and a recognition that development agencies as resource providers, consciously or otherwise, privilege one faction over another, and so are *ab initio* political actors.

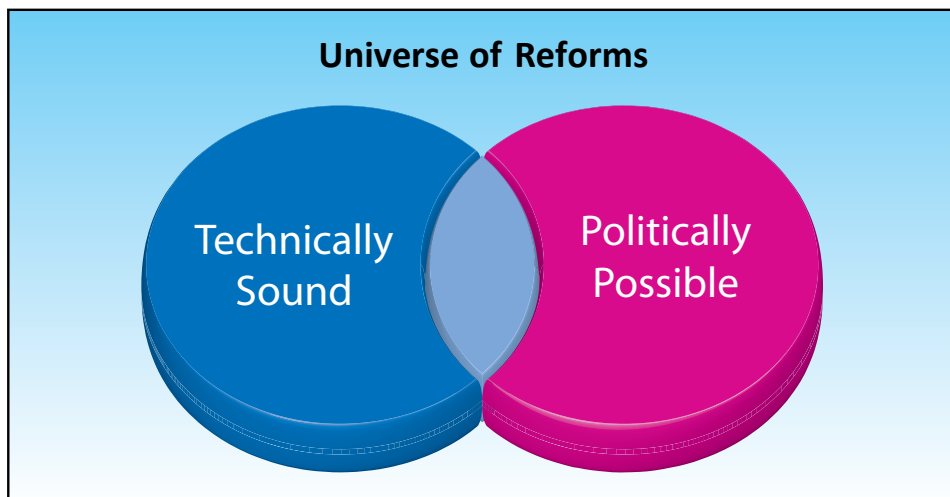
An important outcome of the political economy analysis is an understanding of the business model, a covenant among elements of the elite showing how the surplus or rent is generated, by what rule—formal or informal—and how that surplus is shared by the various vested interests. This can be legally mandated or autonomous. In a pure market setting, a cartel is a business model to maximize rents extracted from the consumers. A monopoly sanctioned by the state whose organs receive emoluments from the monopolist is another business model. In political science, the business model is viewed as a stable political settlement struck among elites (Parks & Cole, 2010; Di John & Putzel, 2009). When such a political settlement is inimical to the collective welfare, then proper institutional change can benefit the majority.

Because the business model is a product of human agency, it is contingent on decisions of critical actors in society. An important element of the business model, therefore, is the role of elites who dominate social decisions (see, e.g., Amsden, DiCaprio, & Robinson, 2009). The primary goal in understanding the business model is to concretely identify the forces, interests, and incentives that sustain poor development outcomes.

*Political action* refers to strategies and activities, such as coalition building, to get actors to spend their own limited political capital to make reform politically possible. This is the substantive element of the reform process and the exclusive domain of local partners. It involves a painstaking iterative process in search of that replacement institution which the local context can absorb as its own. This then involves, at the same time, an ongoing *in situ* political economy analysis and simultaneous indigenization and modification of the institutional target. Crucial actor decisionmaking in the

strategic, technical, and political dimensions is integral to this process.

The outcome of the process is technically sound and politically possible reform options, as seen in Figure 10.1 as the non-empty intersection of two sets of reforms. If the intersection is empty, then it is futile to get busy at reform. We will elaborate on these two sets below.



**Figure 10.1. Technically Sound, Politically Possible Reform**

**Technically sound reform.** A technically sound reform is one that, if implemented, will either reduce the social cost to, or raise the collective good of, society. It implies a correctly identified binding constraint (a genuine government or market failure). The now well-known “growth diagnostic” procedure (Hausmann, Rodrik, & Velasco, 2005) is one way to ferret out the binding constraint.<sup>2</sup> It is our contention that the set of possible replacements of a welfare-reducing institutional status quo is non-unique. There are many possibilities. In a long chain of causation, there may be many binding constraints, the remedy of each being necessary for the benefits to flow. The development entrepreneur has to make a decision which to attack first, given the political capital of the various members of the coalition.

Technically correct and politically possible reforms stand in contrast to ready-made menus, such as the Washington Consensus and “best practices,” that adopt a “one-size-fits-all” approach. Instead, more open-ended views, such as “good-enough governance” by Grindle (2007), “building on the status

<sup>2</sup> See Dani Rodrik’s webpages at <http://www.hks.harvard.edu/fs/drodrik/GrowthDiag.html> and [http://rodrik.typepad.com/dani\\_rodriks\\_weblog/2008/09/a-manual-for-growth-diagnostics.html](http://rodrik.typepad.com/dani_rodriks_weblog/2008/09/a-manual-for-growth-diagnostics.html). Also see Hausmann, Rodrik, & Velasco (2005).

quo” by Moore and Unsworth (2006), and “best-fit” by Williams et al. (2010) become the order of the day.

**Politically possible reform.** Even assuming the binding constraint is correctly identified, there remains the problem of how to introduce the identified reform. In the traditional model, country ownership of the reform is served by partnering with the host government. The partnership comes with various forms of conditionality (ex-ante, ex-post, and process). Process conditionality, for example, underlies the Poverty Reduction Strategy Papers (PRSPs) of the World Bank. Azam and Laffont (2003) provide the theory underpinning this conditionality view. Many now recognize that sticking with the external pull or push for reform strategy is misplaced. Host governments often do not have the autonomy and strength to deliver what they promise, even when they do want the reform. The political settlements that support the status quo are not dissolved merely because of the promise of aid contingent on reform. Formal rules may change, but the underlying binding informal rules may persist.

“Politically possible” refers to the likelihood—given the local political context, including the efforts and the resources deployed by advocates and oppositors—that the reform will be implemented (see, e.g., Fabella & Fabella, 2011). The first-best (one with the highest welfare benefit) reform may have zero political feasibility. If so, which of the second, third, or fourth best has the best chance of surviving? The development entrepreneur discerns the right balance between the welfare benefit of a reform and its feasibility. It is this role that cannot be easily undertaken by external agencies. Strategic retreats from the original target are unexceptional. This was evident in the cases of RO-RO and the Residential Free Patent Law.

In the case of aviation, the highest authority of the land, towards the end of its tenure, decided on a compromise. The dominant carrier was able to keep flights to Manila limited, so the reform advocates did not get the original target of open skies. But the latter got pocket open skies for the Diosdado Macapagal International Airport (DMIA), which still translated into enormous increases in air traffic rights and seat access. This allowed greater consumer sovereignty. Politics intervened, but development entrepreneurship was able to engineer a settlement, which was still a strong positive. By contrast, the BIR case illustrates how a technically sound reform (the switch to performance contracting for tax collectors) got routed by the adverse political wind when a less-ambitious reform might have worked.

## **Reform Conjunctures**

Reform conjunctures are the combination of unforeseen events or circumstances that render the reform target, or some variant of it, politically feasible. Here we have the environment anointing the best-fit reform, in a sense. The political feasibility of a reform is not set in stone. It fluctuates with unforeseen political and economic shocks, rediscovered personal networks, and other factors. An economic or fiscal crisis can undermine or strengthen the status quo. For example, the looming fiscal crisis in 2002 weakened presidential support for Bañez's effort to reform tax administration. The nuclear plant explosions in Japan in the wake of the March 2011 earthquake-tsunami disaster have drastically changed the landscape for nuclear power development. If the reform elements are not in place when the favorable conjuncture occurs, the change embraced may not take the path to improve welfare.

The policy change toward the RO-RO option is another example. The RO-RO strategy for engendering competition in the shipping industry was identified a decade before as a technically sound remedy to the government's failure to make sea transport cheaper and more efficient. But the reform was given only lip service by the authorities. The RO-RO reformers originally targeted a first-best solution to high sea transport: an overhaul of the regulatory agency to stand up to the shipping cartels. However, this turned out to be a non-starter. The shipping cartels had managed the appointment of their allies to the regulatory agency, with the purpose of maintaining the inefficient business model and thwarting any reform effort. It was an unrelated event—the upcoming 2004 presidential elections—and the importance of the Mindanao vote to the incumbent that made the RO-RO initiative compelling and raised its political feasibility. The reformers recognized the strategic opportunity, shifted tactics, and identified a new set of powerful Mindanao-based stakeholders, who demanded that the RO-RO policy be included in the presidential agenda. Thus, more voices lined up behind the policy. Over the opposition of the agency regulating sea transport and the shipping cartel, and primarily in order to court the Mindanao vote, President Arroyo signed the RO-RO policy.

## **Human Agency and Development Entrepreneurs**

There is a plethora of concepts in the development and political science literature going back to the 1980s that come under the rubric of human agency. Concepts such as reform champions, change agents, policy entrepreneurs, and of course, revolutionaries, are all human agency phenotypes that ply more or less similar pathways (Kingdon, 2011; Pierson, 2004). Development

entrepreneurs also come under this rubric, but with a difference.

Development entrepreneurs are human actors who have the cognitive and emotional make-up—engendered either by nature or nurture—that leads them to pursue the greater social good through institutional change. For a range of reasons, some people take personal responsibility for bringing about institutional change that enhances the public good. Whether in government, civil society, or the private sector, development entrepreneurs navigate complex socioeconomic and political terrains, build coalitions, and align various interests toward the desired institutional reform. This is embryonic in Leftwich and Hogg (2010) who note that “local leaders, elites, and coalitions are the critical necessary agents that are required to contest, negotiate, and devise legitimate, effective, and durable institutions.”

Development entrepreneurs are willing to strategically engage himself in the murky world of political networking and bargaining, all in pursuit of the public good. Their efforts—if successful—will benefit the whole community, but not necessarily themselves directly. In other words, they are crusaders for the social good. Herein lies the difficulty with the idea of development entrepreneurship.

Development entrepreneurs march to a different drummer than Economics’ *Homo economicus*, since their pursuit is precisely a public good. In this, they are unlike the classical Schumpeterian entrepreneurs, who may realize enormous financial rewards at the end of the day, though this is hardly their principal motivator. But like the Schumpeterian entrepreneurs, development entrepreneurs take great risk, since the outcome they commit to may never materialize. Deng Xiaoping’s two-decade odyssey to save Chinese Socialism from forever “redistributing poverty” is development entrepreneurship at its best.

The cognitive and motivational make-up of the development entrepreneur is interesting, and evidence on these issues is only beginning to emerge. Saras Sarasvathy (see Sarasvathy, 2001; Sarasvathy et al., 2010) documented hundreds of individual case studies in an attempt to determine the traits and characteristics of entrepreneurs in the business setting. She concludes that entrepreneurs rely on a process that “allows goals to emerge contingently over time from the varied imagination and diverse aspirations of the founders and the people they interact with.” This she calls “effectual reasoning.” By contrast, Sarasvathy avers that corporate managers use “causal thinking,” defined as starting with a pre-determined goal and a given set of analytical means that identify the optimal alternative to achieve the goal.

There is also growing field and laboratory evidence that *Homo economicus*, as simply rational and self-interested utility-maximizing actors, is off the

mark (Ostrom, 2000; 2005; Ariely, 2010). Daniel Pink (2010) cites research evidence pointing to non-monetary factors that motivate people to perform better. Called “intrinsic motivation,” Pink argues that for tasks requiring cognitive and creative skills, optimal performance occurs when people are given (a) autonomy, or the ability to decide what they do; (b) mastery, or the ability to get better at what they do; and (c) purpose, or the ability to give meaning to what they do.

This runs counter to superior-subordinate management structures, and as we explain below, the development agency-contractor model. Instead, it supports the proposition that grant structures that allow for autonomy may be useful. The case studies in this volume seem to corroborate Pink’s view that money is not the main driver. Given the enormous trouble and difficulty that individual development entrepreneurs experience and continue to encounter, such as harassment, lawsuits, and character assassination, it is clear that money is not the main motivator.

Indeed, in some of the cases, such as in aviation and in water service privatization, we recognize autonomous development entrepreneurship at work, that is, actors within government who, on their own—seemingly unconnected to and unsupported by outside allies or donors—pursue reform in the name of public interest. They could have opted for the comfortable caretaker role but decided to challenge the status quo. One has to add, however, that what we call below the “double coincidence of power and righteousness” is rare.

It is our belief that there is in each person’s make-up a social gene that deeply cares for the social good of the community. Evidence for the need to belong to and to do well by one’s group has been mounting from evolutionary biology to brain studies (for a comprehensive review, see Rifkin’s *Empathic Civilization*, 2009). Whether that gene gets expressed is another matter altogether. The gene will remain in the shadows if the environment is severely unfavorable.

### **Circumstantial Drivers**

From our limited experience, academic and non-governmental organizations (NGOs) are hotbeds for development entrepreneurs, especially where these provide the financial wherewithal relatively independent of, and the space and time flexibility to pursue, such a calling. Public intellectuals with independent means also figure prominently, since they have both financial independence and time and space flexibility. The two operative conditions that seem to enable development entrepreneurs are relative financial



independence and flexibility. Needless to point out, they are necessary but not sufficient conditions for a development entrepreneur to be engendered. When these individuals are in the government, they are the ones who can say, “I don’t need this job,” since their outside financial default positions are, in fact, better. These people are also in the best position to appreciate a problem, imagine solutions, and act on them.

Here, there is a window for development agencies to act as facilitators. While financial return is not the motive, still there is a modicum of financial space that must be attained to liberate time and attention from day-to-day needs for provenance. How such facilitation gets implemented remains a challenge and is the subject of the next section.

### **A Workable Project Structure for Facilitating Locally Driven Change**

We have argued that institutional change is achieved through an iterative and protracted search process, punctuated by reform conjunctures, and facilitated by development entrepreneurs. The implications of these findings for development agencies are significant. At the policy level, we argue that it is best for development agencies to concede the role of “principal drivers of reform” to indigenous individuals. Development agencies should consider a less direct approach and instead play a more supportive role that facilitates the work of local development entrepreneurs.

The approach poses a number of difficult challenges for development agencies. We have previously noted the dilemma facing development agencies (Tolentino, 2010): being politically inert avoids institutional risk but also heightens the risk of aid ineffectiveness. In the following section, we explore some solutions to the major challenges of crafting appropriate programs and project modalities that address institutional risk and aid effectiveness.

### **Project Modalities: Contracts and Grants**

The traditional approach to development contracting is to write a straight quid-pro-quo contract with a consulting firm or an individual consultant. This is viable when the deliverables are unambiguous, say, a study of an industry policy environment. The problem with utilizing contracts to promote development entrepreneurship lies precisely with the deliverables. Firstly, a project intended to pursue change in a policy or an institution may not yield appreciable, favorable outcomes over extended periods—a caveat from New Institutional Economics and the experience of development entrepreneurs, such as Deng Xiaoping and his reform odyssey. The process of change is highly non-linear; there could be nothing substantive happening for a long time

despite the exertion, followed by rapid change. Thus, the deliverable output is difficult to measure in the meantime.

Secondly, there are no generally acceptable metrics for background spadework done. Effort tends to be sporadic, idiosyncratic, and difficult to observe. The goal cannot be chopped down into doable bits. The passage of a law, for example, may take years, and even then, many times passage alone does not suffice to bring about real change (i.e., only pro forma change). It may be marred by the deliberate lack of enforcement or inadequate budgets. The steps toward substantive change are numerous, and unless enough of all the steps are completed, no appreciable outcome will occur. Thus, both the effort and the output here are difficult to measure.

Standard agency contract theory dictates that where agent effort is non-observable, contracts should be performance-based, that is, payment comes after the outcome is observed. Where the outcome (change in policy or institution) is also unobserved until it actually happens, there is no natural basis for payment, and therefore, no objective basis for a contract. This *double moral hazard problem* (Ostrom, Gibson, Shivakumar, & Andersson, 2002; Martens, Mummert, Murrell, & Seabright, 2002; Shirley, 2005) induces the familiar solution to this dilemma among donors: risk-avoidance surfacing as neglect of internal political action. Instead, the arms-length conditionality approach is adopted. Incorporating political action can entail much greater risk-taking on the part of the development agency. The fundamental risk-reward trade-off holds here, as in every standard entrepreneurial endeavor: greater return for greater risk.

Overcoming this problem is not easy. Contract theory has struggled with this issue, and glimpses of the possible solution take the form of (a) careful screening and signaling, and (b) relational contracting and partnerships.

Careful screening and signaling is the process whereby agents are chosen on the basis of a proven and verifiable track record of performance predating the engagement with the aid agency. Prior performance reveals the type of the development entrepreneurs. Such signals of credible commitment mean that the aid agency is rewarding past efforts to incentivize future ones. The first problem this faces is that the past record may itself be difficult to interpret as to authorship and attribution. The second problem is that agents with such records are very scarce; if they were plentiful, the recipient country would not be in need of aid. The third is that it has a success bias because success is easier to verify, but this can be very unfair. A development worker can pour his life into a reform project and never see his holy grail. Deng Xiaoping, in the late 1960s, was a pathetic and quixotic figure. None would have bet that this aging tractor factory worker would eventually engineer the greatest

institutional and economic turnaround of the century! Fortunately for China, Deng wagered on himself.

Relational contracting and partnerships, as in contract theory with moral hazard hurdles, is another way to go. This is built on shared values between the donor and the agent. The relation now occurs as a longer-term and more diffuse social exchange rather than as a more rigid market exchange of goods and services. The terms of the relational contract are not black and white, but fuzzy and flexible. Relational contracting is really a form of a repeated game where the temptation to shirk decreases the longer the relationship lasts. Agency slides into partnership. Is this foolproof? No. It's just that the likelihood of betrayals can be rendered tolerably small. What is known in most of East Asia as *guanxi* is a quintessential relational contract. Needless to add, it is a very effective and successful device (see, e.g., Fabella, 2007).

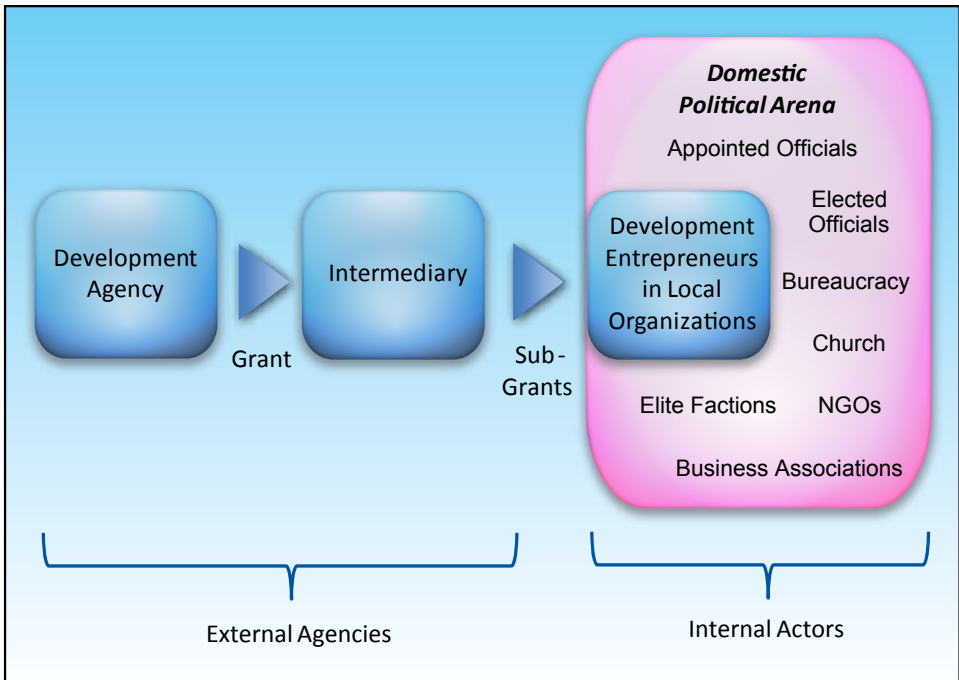
Given the experience of The Asia Foundation, grants of financial resources in pursuit of agreed-upon shared goals are most likely better than contracts aimed at delivering support to development entrepreneurs, given the nature of the tasks. Contracts specify the deliverables, the time and place of delivery, and the sanctions contingent to violations. Grants allow *a flexible project structure that provides an environment more congenial to development entrepreneurs*. By flexible, we mean that while the broad final goal is established (such as lowering sea transport costs), most other aspects of the project (intermediate objectives, activities, outputs, personnel, and work plan) are viewed instrumentally and are allowed to morph, based on changing conditions, new information, and unforeseen reform conjunctures. In essence, grants harness Daniel Pink's essential elements for better performance through "intrinsic motivation": autonomy, mastery, and purpose. It is easier to foster longer-term relational contracts with grants.

### **The Indirect Approach: Using Intermediaries**

Development agencies inclined to work politically confront two main issues. The first is the problem of discerning the politically feasible reform. This is addressed by the political action of development entrepreneurs, but with whom contracting is a problem. The other is the challenge of identifying and distinguishing genuine from bogus reformers. Drawing on the case studies, there emerges recognition that intermediaries can play an important role in addressing both issues.

An intermediary is an agency with a long-term presence in the locality that can play the role of a *developmental venture capitalist*. Its role is multi-faceted: (a) it helps development agencies identify, nurture, and foster lasting

relationships with development entrepreneurs; (b) it serves as a buffer between development agencies and the domestic political processes (see Figure 10.2 below); and (c) it ensures proper narrative reporting and financial compliance.



**Figure 10.2. Development Entrepreneurship Grant Structure**

The long-term presence of intermediaries in the locality means that its information—about binding constraints, political realities, potential development entrepreneurs, and the need for support—is richer than the development agency's. The intermediary thus performs the role of channeling aid to development entrepreneurs while information asymmetry is inherent in this relational partnership. This mimics the role of the ordinary venture capital firms, which parlay the capital of their limited partners to fund startups.

The downside of this indirect approach is obvious: it involves resorting to another layer in the aid delivery system. This, however, appears to be an unavoidable cost to gain sufficient understanding of, and inroads into, the murky depths of local politics.

In developing countries, activities by development agencies in the political arena can raise sovereignty infringement issues. And given politically engaged development entrepreneurship, development agencies may be

reluctant to pursue this approach directly. To address this, the development agency and internationally based intermediary organizations can best partner with local entities: civil society organizations, local think tanks, NGOs, and business associations. One advantage of these intermediaries is their right to legitimately engage and participate in domestic political processes. Another advantage is that these organizations are autonomous and multilaterally supported. Unlike development consulting companies and consultants, local partner organizations are not implementers of development agency programs; instead, their board and staff independently develop and determine their reform programs.

### **Conclusion and Recommendations**

The case studies have identified two distinct approaches to institutional change. The first involves the provision of technical assistance to government counterparts. In some cases, such as water privatization, this traditional approach successfully introduced reform. However, it is highly dependent on the presence of genuine reformers already in positions of power who pursue reform in accord with the perception of development agencies. Thus, there has to be a rare double-coincidence of power and righteousness. The ongoing global aid effectiveness discussion underscores that this assumption is rarely operative. Instead, because of regulatory capture and elite rent-seeking, government counterparts are unable to impose their will on dominant elites, even if they wanted to. In those situations, which constitute the majority of instances in developing countries, an alternative approach is called for.

The second approach, development entrepreneurship, is what we propose. It is an approach that banks on three pillars to achieve institutional change: (a) a recognition of the iterative process of change that calls for a combination of technical analysis, political economy analysis, and political action; (b) local leadership, referred to as development entrepreneurs, who take personal responsibility for achieving development outcomes; and (c) a project structure for development agencies to support local partners through intermediaries.

Recognizing the difficulties of identifying and discerning development entrepreneurs, we posit a role for intermediaries, which we call development venture capitalists. These are organizations that have a long-term presence in the country, have a deep understanding of local political and economic dynamics, and have established a network of reform-minded individuals and organizations. They provide development agencies with additional information to make informed choices to improve aid effectiveness.

While the approach looks promising, there is much that is still unknown. The notion of development entrepreneurship proposed here is based on a limited number of Philippine case studies. We hypothesize that development entrepreneurship played an even more important role in other more successful countries (say, Deng Xiaoping in the PRC). Clearly, more research work needs to be done. Though we now have some suggestive indicators of how development entrepreneurs work to engender institutional reform in the Philippines, how development entrepreneurship can effect change in other countries is of interest. In addition, the Philippine cases were limited to economic reform issues involving largely government failures. There is a need to explore development entrepreneurship in other areas, such as education, local governance, and environmental issues, to name a few. There is also a need to explore further the traits and characteristics of development entrepreneurs, and which of these can be purposively nurtured.

In terms of programs for development agencies, a number of ongoing initiatives follow the same pathway. The Asia Foundation, in partnership with the Developmental Leadership Program, held workshops for the Australian Agency for International Development (AusAID) central and field staff on working politically. The Research and Policy in Development (RAPID) program<sup>3</sup> at the UK-based Overseas Development Institute (ODI) has developed a research and training program for policy entrepreneurs. Working with many partners, the ODI has developed a broad range of tools and training models to translate knowledge into action. The Asia Foundation developed a training and mentoring program on development entrepreneurship for Philippine NGOs, think tanks, and civil society organizations.

In an era when institutional weakness is a recognized binding constraint, and institutional change is the main breakthrough channel, working with development entrepreneurs and development venture capitalists is an important modality that development agencies can ignore at the risk of being ineffective. Development entrepreneurship is a compelling mechanism for incorporating the technical and political dimensions necessary for institutional change. As the cases in this volume illustrate, transformative institutional change starts with the dreams of specific individuals. Transforming those dreams into development realities hinges on their commitment and creative ability to maneuver through political and economic realities. In some instances, development agencies and intermediaries play pivotal roles.

We hope this volume helps to transform development dreams into reality.

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<sup>3</sup> See the RAPID programme website: <http://www.odi.org.uk/work/programmes/rapid/default.asp>.

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## **List of Acronyms**

|        |  |
|--------|--|
| ACERD  | Ateneo Center for Economic Research and Development                  |
| ADB    | Asian Development Bank   |
| AFMA   | Agriculture and Fisheries Modernization Act                          |
| AFTA   | ASEAN Free Trade Agreement   |
| AGILE  | Accelerating Growth, Investment, and Liberalization with Equity      |
| AIM    | Asian Institute of Management  |
| ARMM   | Autonomous Region in Muslim Mindanao                                 |
| ARPU   | Average Revenue Per Unit   |
| ASA    | Air Service Agreement  |
| aSEA   | Archipelagic Southeast Asia  |
| ASEAN  | Association of Southeast Asian Nations                               |
| ASK    | Available Seat Kilometers  |
| AT&T   | American Telephone and Telegraph                                     |
| AusAID | Australian Agency for International Development                      |
| ATI    | Agriculture Training Institute                                       |
| ATO    | Air Transportation Office  |
| BAR    | Bureau of Agricultural Research                                      |
| BAS    | Bureau of Agricultural Statistics                                    |
| BCDA   | Bases Conversion Development Authority                               |
| Bicam  | Bicameral conference committee (Senate and House of Representatives) |
| BIR    | Bureau of Internal Revenue   |
| BIREA  | Bureau of Internal Revenue Employees Association                     |
| BOT    | Build-Operate-Transfer   |
| BPI    | Bureau of Plant Industry   |
| BSP    | Banko Sentral ng Pilipinas (Central Bank of the Philippines)         |
| BSWM   | Bureau of Soils and Water Management                                 |
| CA     | Concession Agreement (Chapter 4 only)                                |
| CA     | Court of Appeals (all chapters, except Chapter 4)                    |
| CAAC   | Civil Aviation Consultative Council                                  |
| CAB    | Civil Aeronautics Board  |
| CARL   | Comprehensive Agrarian Reform Law                                    |
| CARPER | Comprehensive Agrarian Reform Program Extension with Reforms         |
| CCTP   | Conditional Cash Transfer Program                                    |
| CDMA   | Code Digital Multiple Access   |
| CDC    | Clark Development Corporation  |
| CEO    | Chief Executive Officer  |
| CESO   | Career Executive Service Officer                                     |

|         |   |
|---------|---|
| CEZA    | Cagayan Economic Zone   |
| CHA-RO  | Chassis RO-RO   |
| CIAC    | Clark International Airport Corporation                                     |
| CIDA    | Canadian International Development Agency                                   |
| CMTS    | Cellular Mobile Telephone Service   |
| COA     | Commission on Audit   |
| CPA     | Cebu Port Authority   |
| CPBO    | Congressional Planning and Budget Office                                    |
| CPCN    | Certificate of Public Convenience and Necessity                             |
| CTB     | Chamber of Thrift Banks   |
| CTRP    | Comprehensive Tax Reform Program  |
| DA      | Department of Agriculture   |
| DAR     | Department of Agrarian Reform   |
| DBP     | Development Bank of the Philippines   |
| DENR    | Department of Environment and Natural Resources                             |
| DepEd   | Department of Education   |
| DFI     | Direct Foreign Investment   |
| DILG    | Department of Internal and Local Government                                 |
| DMAP    | Distribution Management Association of the Philippines                      |
| DMIA    | Diosdado Macapagal International Airport                                    |
| DOD     | Department of Defense   |
| DOF     | Department of Finance   |
| DOJ     | Department of Justice   |
| DOT     | Department of Tourism   |
| DOTC    | Department of Transportation and Communications                             |
| DPWH    | Department of Public Works and Highways                                     |
| DSWD    | Department of Social Welfare and Development                                |
| DTI     | Department of Trade and Industry  |
| ECC     | Environmental Compliance Certificate  |
| EDC     | Export Development Council  |
| EDF     | Economic Development Foundation   |
| EGTA    | Economic Governance Technical Assistance                                    |
| EMERGE  | Economic Modernization through Efficient Reforms and Governance Enhancement |
| EO      | Executive Order   |
| EPA     | Emergency Price Adjustment  |
| ETCI    | Express Telecommunications Company, Inc.                                    |
| ETPI    | Eastern Telecommunications Philippines                                      |
| FCC     | Federal Communications Commission   |
| FCDA    | Foreign Currency Devaluation Adjustment                                     |
| FINLINK | Financial Link  |
| FLA     | Foreshore Lease Agreement   |

|        |   |
|--------|---|
| FPC    | First Pacific Company, Ltd.                 |
| FPI    | Federation of Philippine Industries         |
| GATT   | General Agreement on Tariff and Trade       |
| GDP    | Gross Domestic Product                      |
| GOCC   | Government-Owned and Controlled Corporation |
| GSDP   | Grains Sector Development Programs          |
| GSM    | Global System for Mobile Communications     |
| GTE    | General Telephone and Electrics             |
| GVA    | Gross Value Added                           |
| HB     | House Bill                                  |
| HOR    | House of Representatives                    |
| IACRC  | Inter-Agency Committee on Rice and Corn     |
| ICR    | Implementation Completion Report            |
| ICT    | Information and Communications Technology   |
| IFC    | International Finance Corporation           |
| IGF    | International Gateway Facility              |
| IMF    | International Monetary Fund                 |
| IPPG   | Improving Institutions for Pro-Poor Growth  |
| IRMA   | Internal Revenue Management Authority       |
| IRRs   | Implementing Rules and Regulations          |
| ITS    | Integrated Tax System                       |
| ITU    | International Telecommunication Union       |
| IXC    | Inter-Exchange Carrier                      |
| JICA   | Japan International Cooperation Agency      |
| LAMP   | Land Administration and Management Project  |
| LARA   | Land Administration and Reform Act          |
| LMB    | Land Management Bureau                      |
| LDC    | Least Developed Country                     |
| LEC    | Local Exchange Carrier                      |
| LGU    | Local Government Unit                       |
| LMB    | Land Management Bureau                      |
| LOI    | Letters of Instruction                      |
| LO-LO  | Load-On/Load-Off                            |
| LRA    | Land Registration Authority                 |
| LSIG   | De La Salle Institute of Governance         |
| LT     | Large Taxpayer                              |
| LTO    | Large Taxpayer Office                       |
| LTS    | Large Taxpayer Service                      |
| MARINA | Maritime Industry Authority                 |
| MAV    | Minimum Access Volume                       |
| MBC    | Makati Business Club                        |
| MCC    | Millennium Challenge Corporation            |

|             |  |
|-------------|--|
| MCIA        | Mactan-Cebu International Airport                        |
| MECO        | Manila Economic and Cultural Office                      |
| MinBc       | Mindanao Business Council                                |
| MORE Phones | Movement for Reliable and Efficient Phone Service        |
| MPC         | Metro Pacific Corporation                                |
| MTPDP       | Medium-Term Philippine Development Plan                  |
| MWCI        | Manila Water Company, Inc.                               |
| MWSI        | Maynilad Water Services, Inc.                            |
| MWSS        | Metropolitan Waterworks and Sewerage System              |
| NAIA        | Ninoy Aquino International Airport                       |
| NARIC       | National Rice and Corn Administration                    |
| NEDA        | National Economic Development Authority                  |
| NFA         | National Food Authority                                  |
| NGA         | National Grains Authority                                |
| NGO         | Non-Governmental Organization                            |
| NIA         | National Irrigation Administration                       |
| NOMIS       | National Office Management Information System            |
| NORMINSA    | Northern Mindanao Shippers Association                   |
| NRCPP       | National Rice and Corn Production Program                |
| NRW         | Non-Revenue Water  |
| NTC         | National Telecommunications Commission                   |
| ODA         | Official Development Assistance                          |
| ODI         | Overseas Development Institute                           |
| OECD        | Organization for Economic Co-operation and Development   |
| OFW         | Overseas Filipino Worker                                 |
| PA          | Provisional Authority                                    |
| PAL         | Philippine Airlines                                      |
| PAPTELCO    | Philippine Association of Private Telephone Companies    |
| PARDO       | Philippine Association of Revenue District Officers      |
| PCCI        | Philippine Chamber of Commerce and Industry              |
| PCGG        | Philippine Commission on Good Governance                 |
| PCS         | Philippine Computer Society                              |
| PD          | Presidential Decree                                      |
| PETEF       | Philippine Electronics and Telecommunications Federation |
| PHI         | Prime Holdings, Inc.                                     |
| Philcom     | Philippine Global Communications, Inc.                   |
| PHILEXPORT  | Philippine Exporters Confederation                       |
| PhilRice    | Philippine Rice Research Institute                       |
| PIDS        | Philippine Institute for Development Studies             |
| Piltel      | Pilipino Telephone Corporation                           |
| PLDT        | Philippine Long Distance Telephone                       |
| PNSDW       | Philippine National Standards for Drinking Water         |

|       |  |
|-------|--|
| PPA   | Philippine Ports Authority                         |
| PPP   | Public-Private Partnership                         |
| PTIC  | Philippine Telecommunications Investment Group     |
| QR    | Quantitative Restriction                           |
| RA    | Republic Act                                       |
| RAPID | Research and Policy in Development                 |
| RATE  | Run After Tax Evaders                              |
| RBAP  | Rural Bankers Association of the Philippines       |
| RCA   | Rice and Corn Administration                       |
| RCCC  | Rice and Corn Coordinating Council                 |
| REB   | Rice Economic Board                                |
| RFP   | Residential Free Patent                            |
| RiCoB | Rice and Corn Board                                |
| RO    | Regulatory Office                                  |
| ROI   | Return on Investment                               |
| RO-RO | Roll-On/Roll-Off                                   |
| RP    | Republic of the Philippines                        |
| RPEP  | Rice Productivity Enhancement Program              |
| RRTS  | Road-RORO Terminal System                          |
| SB    | Senate Bill  |
| SBIA  | Subic Bay International Airport                    |
| SC    | Supreme Court                                      |
| SCADC | Subic-Clark Alliance for Development Council       |
| SEC   | Securities and Exchange Commission                 |
| SIP   | Subscribers Investment Plan                        |
| SLDP  | Sustainable Logistics Development Program          |
| SMS   | Short Messaging Service                            |
| SONA  | State of the Nation Address                        |
| SRNH  | Strong Republic Nautical Highways                  |
| SWS   | Social Weather Stations                            |
| TA    | Technical Assistance                               |
| TAF   | The Asia Foundation                                |
| TCP   | Tax Computerization Project                        |
| TIN   | Tax Identification Number                          |
| TOP   | Temporary Operating Permit                         |
| TRO   | Temporary Restraining Order                        |
| TWG   | Technical Working Group                            |
| UR    | Uruguay Round                                      |
| USAID | United States Agency for International Development |
| VAT   | Value-Added Tax                                    |
| VATIS | Value-Added Tax Information System                 |
| WTO   | World Trade Organization                           |

## **Appendix 2-A**

### **Executive Order No. 170 – The RO-RO Policy Promoting Private Sector Participation and Investment in the Development and Operation of the Road Roll-On/Roll-Off Terminal System**

WHEREAS, it is the policy of the Government to reduce the cost of inter-island transportation through the establishment of an efficient and cost-effective Road Roll-on/Roll-off Terminal System (RRTS);

WHEREAS, the RRTS is a vital component of the Government's agri-fisheries modernization and food security programs the objectives of which are to raise the income of farmers and fisherfolk;

WHEREAS, the RRTS will also serve to enhance tourism, transportation and commerce throughout the country;

WHEREAS, there is a need to encourage the participation of the private sector in the establishment, construction and operation of RRTS facilities;

WHEREAS, the Philippine Ports Authority, the Cebu Ports Authority and the Maritime Industry Authority are the proper Government agencies mandated to reduce transport costs and improve the quality and efficiency of transport from the countryside to the urban markets;

WHEREAS, the Department of Environment and Natural Resources is responsible for the issuance of Environmental Compliance Certificates;

WHEREAS, the RRTS is a component of the Sustainable Logistics Development Program of the Development Bank of the Philippines;

WHEREAS, there is a need to establish a new policy that will promote the development of the RRTS.

NOW, THEREFORE, I, GLORIA MACAPAGAL-ARROYO, President of the Republic of the Philippines, upon the recommendation of the Department of Transportation and Communications and the Development Bank of the Philippines and by virtue of the powers vested in me by law, do hereby order:



Section 1. Definition of Terms. — As used in this Executive Order:

- a. Roll-on/Roll-off or Ro-Ro Operations shall refer to the method of loading and discharging of self-powered vehicles, such as cars, and trucks, on their own wheels by their owners or drivers between vessel and shore via a ramp;
- b. Ro-Ro vessel shall refer to a ship type or design duly approved for Ro-Ro operations;
- c. Road Ro-Ro Terminal System (RRTS) shall refer to the network of terminals all over the country, separated by a distance of not more than fifty (50) nautical miles and linked by Ro-Ro vessels; and
- d. Lane-meter shall refer to one (1) meter of deck with a width of 2.5 to 3.0 meters.

Section 2. Integration of the RRTS with the National Highway System. — To the extent permitted by law, the RRTS shall be considered as part of the national highways. Accordingly, vehicles that can be moved by their own power and passing through such links shall not be burdened by transport procedures and costs, unless otherwise provided by law. A Certificate of Public Convenience shall however be required for the operation of Ro-Ro vessels in accordance with law.

Section 3. RRTS Toll. — The RRTS toll shall consist of the following:

- a. A terminal fee levied by the Ro-Ro terminal operator on vehicles and passengers for the use of the terminal;
- b. A passage fee levied by the Ro-Ro vessel operator on self-powered vehicles based on lane-meter;
- c. A passage fee levied by the Ro-Ro vessel operator on passengers; and
- d. A berthing fee levied by the Ro-Ro terminal operator on the Ro-Ro vessel for mooring or berthing at the Ro-Ro terminal.

Section 4. RRTS Documentary Requirements. — To the extent permitted by law, the Maritime Industry Authority (MARINA), Philippine Ports Authority (PPA), Cebu Ports Authority (CPA) and other concerned Government agencies shall ensure that the RRTS shall be covered by reduced and simplified

documentary requirements. No clearance shall be required of motor vehicles using the RRTS: Provided, however, That the owners or operators of Ro-Ro vessels shall comply with the reporting requirements under Section 11 of the Anti-Carnapping Act of 1972 (Republic Act No. 6539).

Section 5. Private Commercial Terminals. — The PPA and the CPA shall ensure that Ro-Ro terminals established and constructed through private investments shall be operated as private commercial terminals. The PPA and CPA shall likewise take concrete steps to privatize state-owned Ro-Ro terminals to attract investments in the RRTS.

Section 6. Environment and Business-Related Requirements of the RRTS. — Where all the legal requirements have been complied with, relative to the construction and operation of RRTS facilities, the Department of Environment and Natural Resources shall issue Environmental Compliance Certificates within a period of forty-five (45) days therefrom, and the proper Government agency shall enter into foreshore lease agreements within a period of ninety (90) days therefrom. Local government units are strongly encouraged to issue the necessary permits for the operation of RRTS facilities within three (3) days from date of application. Likewise, the PPA, CPA and MARINA shall issue the permits necessary for the construction and/or operation of RRTS facilities within thirty (30) days from date of application.

Section 7. Private Sector Financing for the RRTS. — The Development Bank of the Philippines shall make available long-term loan/financing to eligible projects and qualified borrowers under its Sustainable Logistics Development Program.

Section 8. Implementing Rules and Regulations. — Within thirty (30) days from the effectivity of this Executive Order, the Department of Transportation and Communications shall formulate and, after public hearing and consultation, issue the Implementing Rules and Regulations for this Executive Order.

Section 9. Effectivity. — This Executive Order shall take effect immediately upon approval.

*City of Manila, January 22, 2003.*

## Appendix 5-A

### Profile of Philippine Mobile Carriers

***Pilipino Telephone Corporation (Piltel)*** was incorporated in 1968 and initially operated LEC services. The company was bought by PLDT in 1980 (Salazar, 2007) and granted provisional authority by NTC in 1989 to operate a CMTS in Metro Manila. Piltel began offering analog mobile services in March 1991 under the *Mobiline* brand<sup>1</sup> and, on March 27, 1992, was given a congressional franchise<sup>2</sup>, amending its original franchise, to allow it to provide various types of telecommunications services. On August 18, 1997, Piltel was awarded a license—CMTS CPCN.<sup>3</sup> Around this time, the Asian financial crisis had struck, cellular fraud or cloning became rampant, and Piltel was investing heavily in its rollout in southern and western Mindanao. The combination of these factors resulted in huge losses for the company. In November 1999, Piltel stopped investing in its AMPS/CDMA networks and signed a facilities-sharing agreement to use the GSM network of competitor, Smart. Piltel embarked on various manpower reduction programs from 1999 to 2001, and outsourced most of its business operations to Smart, PLDT and other members of the PLDT Group. In April 2000, Piltel launched its digital prepaid mobile service, under the *Talk 'N Text* brand, which targeted customers at the bottom of the pyramid (BOP). In 2004-2005, Piltel was absorbed into Smart. In June 2008, NTC approved the transfer of Piltel's fixed-line business to PLDT. In August 2009, Piltel transferred its GSM business and assets to Smart, which owned 99.5 percent of Piltel, as of December 31, 2009.<sup>4</sup>

***Smart Communications, Inc. (Smart)*** was established in 1991 and received its franchise for “*integrated telecommunications, computer, and electronic services*” on March 27, 1992.<sup>5</sup> In January 1993, Smart started its mobile operations as a means for mass-market communications that can

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<sup>1</sup> Read more from Piltel's official website, <http://www.piltel.com.ph/About/History.htm>.

<sup>2</sup> Piltel's franchise was originally granted under RA 6030, which was subsequently amended by RA 6531 and RA 7293. [http://www.congress.gov.ph/download/ra\\_08/Ra07293.pdf](http://www.congress.gov.ph/download/ra_08/Ra07293.pdf). Piltel's franchise expires in 2019.

<sup>3</sup> Pilipino Telephone Corporation. 2009. Annual Report. Securities and Exchange Commission (SEC) Form 17-A (as of December 31, 2009). [http://www.pse.org.ph/html/ListedCompanies/pdf/2010/PLTL\\_17A\\_Dec2009.pdf](http://www.pse.org.ph/html/ListedCompanies/pdf/2010/PLTL_17A_Dec2009.pdf).

<sup>4</sup> See Piltel Notice and Agenda and Information Sheet 2010 Annual Meeting of Stockholders, 7 May 2010. <http://www.piltel.com.ph/NR/rdonlyres/E23E4B67-980D-4C0C-8019-F385A97DE447/0/DISfinal32410.pdf>.

<sup>5</sup> See RA 7294 (March 27, 1992), *Smart Information Technologies, Inc. (SMART) Franchise*. Retrieved from [http://www.congress.gov.ph/download/ra\\_08/Ra07294.pdf](http://www.congress.gov.ph/download/ra_08/Ra07294.pdf). Smart's franchise expires in 2017.

leapfrog the PLDT-dominated fixed lines.<sup>6</sup> *First Pacific Company, Ltd. (FPC)*,<sup>7</sup> through its Philippine affiliate, *Metro Pacific Corporation (MPC)*, was the first investor of Smart. In 1999, First Pacific, the owner of Smart, bought into PLDT through a US\$749 million acquisition (27.4 percent voting interest).<sup>8</sup> Subsequently, in March 2000, MPC completed the infusion of its 38.3 percent ownership in Smart into PLDT in exchange for eight percent or 13.4 million new shares of PLDT valued. The PLDT-MPC share-swap made Smart a 100-percent-owned PLDT subsidiary (Smart Communications, Inc., 2007). In March 1995, *Nippon Telegraph and Telephone Corporation (NTT)* of Japan provided a 15 percent initial equity investment in Smart. In March 1999, NTT raised its investment in Smart, from 15 percent to 37 percent, through the purchase of Smart shares from FPC. In September 1999, NTT Communications exchanged all of its shares in Smart for newly issued common shares of PLDT. In March 2006, NTT Communications sold half of its PLDT shares to NTT DoCoMo.<sup>9</sup>

***Globe Telecom, Inc.*** began as the Robert Dollar Company, which was awarded a congressional franchise in 1928 to operate wireless long-distance message services in the Philippines. It was incorporated in 1935 as *Globe Wireless Ltd.*, which was later renamed *Globe-Mackay Cable and Radio Corporation* ('Globe-Mackay'). In 1965, its franchise was further expanded to allow it to operate international communications systems. In 1974, Globe-Mackay sold 60 percent of its stock to The Ayala Corporation, local investors and its employees. In 1992, Globe-Mackay merged with the Clavecilla Radio Corporation, a domestic telecommunications company, to form *GMCR, Inc.* ('GMCR'). The merger allowed the transfer of Clavecilla's congressional franchise to GMCR on 19 March 1992.<sup>10</sup> In 1993, the Ayala-owned GMCR welcomed a foreign partner, *Singapore Telecom, Inc. (STI)*, a wholly-owned subsidiary of *Singapore Telecommunications Limited* ('SingTel') (Globe Telecom, Inc., 2009).<sup>11</sup> In August 1998, GMCR changed its name to Globe

<sup>6</sup> Personal communication with Orlando Vea, Smart founder and current chief wireless advisor, and Mon Isberto, Smart's head of public affairs, 8 April 2010, Makati City, Philippines.

<sup>7</sup> First Pacific Company, Ltd. is a Hong Kong based investment and management company.

<sup>8</sup> First Pacific Company Ltd was founded by Manuel V. Pangilinan and served as its managing director until 1999. Pangilinan served as president and CEO of PLDT from November 1998 to February 2004. See <http://www.firstpacific.com/admin/upload/media/press/ep981124.pdf>.

<sup>9</sup> See [http://www.ntt.co.jp/ir/library/20f/pdf/20-F\\_0603.pdf](http://www.ntt.co.jp/ir/library/20f/pdf/20-F_0603.pdf).

<sup>10</sup> See RA 7229 (March 19, 1992). *Approving the Merger Between Globe Mackay Cable and Radio Corporation (GMCR) and Clavecilla Radio System and the Consequent Transfer of Clavecilla's Franchise to GMCR*. Retrieved from [http://www.congress.gov.ph/download/ra\\_08/Ra07229.pdf](http://www.congress.gov.ph/download/ra_08/Ra07229.pdf).

<sup>11</sup> Globe Telecom, Inc. (2009). Annual Report. SEC Form 17-A (as of December 31, 2009). [http://www.pse.org.ph/html/ListedCompanies/pdf/2010/GLO\\_17A\\_Dec2009.pdf](http://www.pse.org.ph/html/ListedCompanies/pdf/2010/GLO_17A_Dec2009.pdf).

Telecom, Inc.<sup>12</sup> and in 2001, acquired *Islacom* as its wholly-owned subsidiary<sup>13</sup>.

***Isla Communications Inc. (Islacom)*** was incorporated in 1990 and awarded a franchise for ‘mobile telecommunications’ on April 10, 1992.<sup>14</sup> It was the first to launch a digital mobile communication service in the country using Europe-based GSM (Global System for Mobile Communications)<sup>15</sup> in 1994. It was jointly owned by the Delgado family and *Shinawatra*, a Thai telco, until it was bought by Globe. In February 2000, Globe Telecom, Inc. completed a share-swap agreement with *Islacom*, making the latter a consolidated subsidiary of Globe, effective June 27, 2001 (See Globe Telecom, Inc., 2002).

***Express Telecommunications Company, Inc. (ETPI)*** or ***Extelcom Express Telecommunications Company, Inc. (ETPI)*** or ***Extelcom*** was granted its first franchise in 1958 as Felix Alberto and Company, Inc. to establish radio stations for domestic and transoceanic communications.<sup>16</sup> Its franchise was amended in 2009 to include wire and wireless telecoms systems.<sup>17</sup> *Extelcom* was established in December 1988 and used to be owned by the Lopez family telco, *Bayan Telecommunications, Inc. (BayanTel)*, which has a 42 percent stake in the company through *Marifil Holdings*. In 1989, *Extelcom* was granted provisional authority by NTC to **install, operate and maintain a CMTS in Metro Manila. PLDT challenged this in court and successfully got a temporary restraining order (TRO) in 1990 for NTC and ETCI. The case was eventually revisited by the SC and TRO lifted,<sup>18</sup> but not without PLDT’s efforts to block the entry of a competitor, yet again. ETCI launched its cellular service in 1991 and was later on granted a CPCN in October 1992.<sup>19</sup> The early granting of its franchise spelled doom for ETCI at a time when PLDT strongest. ETCI had no choice but to ride on the incumbent’s backbone infrastructure—**

<sup>12</sup> See Lallana, E.L. (2004). *SMS, business and government in the Philippines*. In ICT4D.ph (a project of the Department of Science and Technology and IDRC). Retrieved from <http://unpan1.un.org/intradoc/groups/public/documents/Other/UNPAN024834.pdf>.

<sup>13</sup> Globe Telecom, Inc. (2009).

<sup>14</sup> See RA 7372 (April 10, 1992). *Isla Communications Co. Franchise*. Retrieved from [http://www.congress.gov.ph/download/ra\\_08/Ra07372.pdf](http://www.congress.gov.ph/download/ra_08/Ra07372.pdf). *Isla Comm’s franchise expires in 2017*.

<sup>15</sup> See definition at <http://www.mobilecomms-technology.com/projects/gsm/>.

<sup>16</sup> RA 2090, Felix Alberto and Company, Incorporated Franchise. Retrieved from [http://www.lawphil.net/statutes/repacts/ra1958/ra\\_2090\\_1958.html](http://www.lawphil.net/statutes/repacts/ra1958/ra_2090_1958.html).

<sup>17</sup> RA 9714 (May 25, 2009), Amending the Franchise of Express Telecommunications Co. Inc., (Formerly ‘Felix Alberto and Company, Incorporated’) Granted Under RA 2090. Retrieved from [http://www.congress.gov.ph/download/ra\\_14/RA09714.pdf](http://www.congress.gov.ph/download/ra_14/RA09714.pdf).

<sup>18</sup> G.R. No. 88404 (1990, October 18). *PLDT vs. NTC and Cellcom, Inc.* (Express Telecommunications Co., Inc. [ETCI]). [http://www.lawphil.net/judjuris/juri1990/oct1990/gr\\_88404\\_1990.html](http://www.lawphil.net/judjuris/juri1990/oct1990/gr_88404_1990.html).

<sup>19</sup> Taken from *Extelcom’s website* <http://www.extelcom.com/aboutUs.html>.

effectively giving PLDT control over the connection of its cell sites.<sup>20</sup>

## Appendix 5-B

### RA 7925 Key Provisions as Game-changers<sup>21</sup>

**Value Added Services (VAS).**<sup>22</sup> Definition of VAS under RA 7925 became a central issue when Voice-over Internet Protocol (VoIP)—an application that allows voice calls through the internet—was introduced in 2005. When small and independent ISPs began offering VoIP, franchised carriers challenged this at NTC, saying that voice calls, by any means, require a congressional franchise. In the end, NTC ruled that VoIP was VAS<sup>23</sup> and allowed non-telcos to provide various VoIP services.<sup>24</sup> This exerted downward pressure on the cost of international telephony. Today, VAS is a ₱5 billion sunrise industry offered by nearly 500 providers<sup>25</sup> and big businesses, like San Miguel Corporation,<sup>26</sup> are gearing up to enter the VAS market.

**Public offerings.** This provision requires franchised carriers to open their shareholdings to the public. Since PLDT was already listed in the stock exchange, it did not object. Legislators saw this provision as a democratization of wealth that enables the public to invest and participate in the profits of regulated carriers. Its inclusion, however, had a practical basis—an additional layer of regulation outside of NTC, which was deemed too weak. Transparency in corporate matters became a requirement without direct imposition.

***Ipsa Facto* clause.** The provision on equality of treatment<sup>27</sup> guarantees that no carrier can be more equal than others. Surprisingly, PLDT suggested this, probably because it wanted to take advantage of beneficial provisions in

<sup>20</sup> Personal communication with J. Alcuaz, 23 March 2010.

<sup>21</sup> Based on an analysis by Rene Santiago.

<sup>22</sup> VAS is enhanced services beyond those ordinarily provided for by telecoms carriers, which can be offered by entities without a telecoms franchise, as long as they do not put up their own network (Section 11 of RA 7925).

<sup>23</sup> See NTC. (March 29, 2005). Explanatory Memorandum and Memorandum Circular for Voice Over Internet Protocol (VoIP). Retrieved from [http://portal.ntc.gov.ph:9081/wps/\\_mc/MC2005/MC-05-08-05-EXPLANATION.pdf](http://portal.ntc.gov.ph:9081/wps/_mc/MC2005/MC-05-08-05-EXPLANATION.pdf).

<sup>24</sup> PC-to-PC, PC-to-fixed line, and PC-to-mobile.

<sup>25</sup> By end 2007, 488 VAS providers were registered with the NTC. See NTC website, <http://portal.ntc.gov.ph>.

<sup>26</sup> SMC, one of the largest food and beverage conglomerates in Southeast Asia, has been trying to acquire Extelcom, which has been down by legal problems. SMC has since shifted focus on Bell Telecommunications (Belltel). See [http://www.pse.com.ph/html/disclosure/pdf/2009/pdf/dc2009-8161\\_SMC.pdf](http://www.pse.com.ph/html/disclosure/pdf/2009/pdf/dc2009-8161_SMC.pdf).

<sup>27</sup> Section 23, Article VIII of RA 7925.

any new franchise, such as tax exemptions.<sup>28</sup> This unintentionally spawned a 2006 proposal from NTC on imposing to a carrier with significant market power (SMP)<sup>29</sup> obligations related to transparency, non-discrimination, accounting separation, access obligations, price control and cost accounting, which in effect, would prevent a carrier from becoming too dominant.

**Consumer protection.** Grants NTC the mandate to censure misbehaving carriers<sup>30</sup> and gives relief to telecoms users against the misuse of a telco's monopoly powers.<sup>31</sup> There was no objection from the industry to this provision, which can be considered as nice to have; can only be enforced given a strong regulator.

**Privatization of government facilities.** Meant to prevent a repeat of the failed ventures of government in telecoms, as well as signal to the private sector that competition from government will not recur.<sup>32</sup>

<sup>28</sup> Personal communication with R. Santiago, January to June 2010.

<sup>29</sup> The European Commission (EC) introduced the concept of *significant market power*—the ability of a firm to act independently of competitors and customers—as *an ex ante* (or anticipatory) regulation in telecommunications. See <http://www.ictregulationtoolkit.org/en/Section.1711.html>.

<sup>30</sup> See Section 5, Article III, RA 7925.

<sup>31</sup> See Section 20, Article VII, RA 7925.

<sup>32</sup> The government used to operate its own telephone service in Manila and several urban areas, with atrocious levels of service. The investments program of DOTC in Regions 1 and 2 in the 1980s was the equivalent of government going into direct competition with PDLT and PAPTELCO.

## Appendix 6-A

Free Patent Bill Timeline<sup>33</sup>**Table 6.1. House and Senate Bills, 13th Congress (June 2004 to May 2007)**

| Date              | 13 <sup>th</sup> Congress Bills   |
|-------------------|---|
| September 7, 2004 | Congressman Jose G. Solis files HB 2729 (Natural Resources Committee)   |
| August 24, 2005   | Senator Miriam Defensor Santiago files SB 2100 (Committee on Constitutional Amendments, Revision of Codes and Laws) |

The proposed legislation removes the restrictions and encumbrances of titles granted through free patent. Moreover, it seeks to extend free patent to residential, commercial and industrial lands.

However, for almost three years from the filing of the bills, there had been no committee actions and endorsements.

**14<sup>th</sup> Congress—Bills and Supporters**

During the 14<sup>th</sup> Congress, LSIG (La Salle team) proposed to legislators its recommended policy reform and promoted it to stakeholders. Meanwhile, the LAMP continued to promote the comprehensive free patent amendment of the *Public Land Act*.

In the House of Representatives, three representatives adopted the draft as proposed by LSIG while four patterned their bills after LAMP's proposal. In the Senate, LSIG got the support of four senators to sponsor its proposed policy, and three sponsored LAMP's proposal.

**Table 6.2. House Bills, 14<sup>th</sup> Congress (June 2007 to May 2010)**

| Date            | House Bills  |
|-----------------|--|
| July 10, 2007   | Congressman Jose G. Solis files HB 0973 (Justice Committee)                |
| August 21, 2007 | Congressman Rufus B. Rodriguez files HB 2123 (Natural Resources Committee) |

<sup>33</sup> Taken from Faustino, Tiamson, & Chikiamco. (2010). *The residential free patent*. Unpublished manuscript, USAID, Manila.



| Date              | House Bills  |
|-------------------|--|
| October 9, 2007   | Congressman Salvador H. Escudero III files HB 2861 (Natural Resources Committee)                     |
| December 13, 2007 | Congressman Rufus B. Rodriguez files HB 3298 (Justice Committee)                                     |
| January 24, 2008  | Congressman Rodolfo G. Valencia files HB 3401 (Natural Resources Committee and Justice Committee)    |
| January 24, 2008  | Congressman Narciso D. Navarro III files HB 3402 (Natural Resources Committee and Justice Committee) |
| May 5, 2008       | Congressman Antonio H. Cerilles files HB 4039 (Special Committee on Land Use)                        |

**Table 6.3. Senate Bills, 14<sup>th</sup> Congress**

| Date              | Senate Bills*                                  |
|-------------------|--|
| November 12, 2007 | Senator Miriam Defensor Santiago files SB 1849 |
| November 29, 2007 | Senator Gregorio Honasan II files SB 1931      |
| January 16, 2008  | Senator Richard Gordon files SB 2003           |
| May 5, 2008       | Senator Miguel Zubiri files SB 2239            |
| May 22, 2008      | Senator Jinggoy Estrada files SB 2318          |
| June 10, 2008     | Senator Loren Legarda files SB 2382            |
| June 11, 2008     | Senator Mar Roxas files SB 2401                |

*Note:* \*All Senate bills were referred primarily to the Committee on Constitutional Amendments, Revision of Codes and Laws and secondarily to the Committee on Environment and Natural Resources.

More than getting legislators to sponsor the bill, the LSIG was able to get the support of different organizations to push for the immediate passage of the bill. From the private sector, the RBAP and the CTB became staunch advocates of the *RFP Bill*. From the local government, the league of municipalities and the league of provinces also released resolutions supporting the policy reform initiative.

**Table 6.4. Stakeholders' Resolutions**

| Date              | Resolution  |
|-------------------|---|
| January 20, 2008  | Rural Bankers Association of the Philippines Board of Directors Resolution                |
| February 26, 2008 | Chamber of Thrift Banks press statement supporting RFP                                    |
| March 5, 2008     | League of Municipalities of the Philippines resolution                                    |
| March 7, 2008     | Chamber of Thrift Banks annual convention, with RFP as a key concern/priority legislation |
| April 15, 2008    | League of Provinces of the Philippines resolution   |

These stakeholders became committed to the reform initiative and attended every committee hearing to show their support. LSIG continued to provide them with technical assistance whenever needed.

### **Committee Actions**

In just about a year from the initial filing of the bills, a committee report is now ready to be issued from both Houses of the Congress.

**Table 6.5. Committee Actions, Senate and House of Representatives**

| Date            | Committee Action   |
|-----------------|--|
| June 3, 2008    | House of Representatives Committees on Natural Resources and Justice hearing on free patent amendment                |
| June 11, 2008   | House of Representatives Special Committee on Land Use first hearing on <i>Residential Free Patent</i>               |
| June 11, 2008   | Senate Committee on Constitutional Amendments, Revision of Codes and Laws first hearing on free patent amendment     |
| July 7-9, 2008  | Joint Senate and House of Representatives Technical Working Group (TWG)  |
| August 12, 2008 | Resolution of the referral issue: All Free Patent Amendment Bills were referred to the Special Committee on Land Use |
| August 26, 2008 | Senate Committee on Constitutional Amendments, Revision of Codes and Laws second hearing                             |
| August 29, 2008 | Senate Committee on Constitutional Amendments, Revision of Codes and Laws second TWG                                 |

| Date               | Committee Action   |
|--------------------|--|
| September 9, 2008  | House of Representatives Special Committee on Land Use second hearing on <i>Residential Free Patent</i>          |
| September 23, 2008 | Senate Committee on Constitutional Amendments, Revision of Codes and Laws third hearing on free patent amendment |

On June 3, 2008, the House of Representatives Committee on Natural Resources held a joint public hearing with the Committee on Justice on free patent amendment. Only House Bill (HB) Nos. 3401 and 3402, which were both referred jointly to the abovementioned committees, were included in the agenda. The other bills were either referred solely to the Natural Resources Committee or the Justice Committee, while HB 4039 was referred to the Special Committee on Land Use. Nevertheless, a TWG was formed for all the bills as they awaited the resolution of the Rules Committee for the mix-up.

With the referral issue pending, the Special Committee on Land Use held its own public hearing on *Residential Free Patent* on June 11, 2008.

The Senate Committee on Constitutional Amendments, Revision of Codes and Laws meanwhile conducted a hearing on free patent amendment on June 11, 2008, where a TWG was also formed.

On July 7-9, 2008, the Senate Committee on Constitutional Amendments and House of Representatives Committees on Natural Resources and Justice held a joint TWG meeting in Clark, Pampanga to fast-track the drafting of the substitute bill and committee report. However, on August 12, 2008, the Rules Committee decided to refer all the free patent bills to the Special Committee on Land Use.

The House of Representatives Special Committee on Land Use drafted its own committee report separately, with the assistance from the LSIG. On September 9, 2008, the committee held another hearing on *Residential Free Patent* and approved the bill, with the members present signing as co-authors. The official committee report and substitute bill, which basically tackled only HB No. 4039, was yet to be submitted.

On August 26, 2008, the Senate Committee on Constitutional Amendments held another hearing to finalize the report. However, concerns were raised regarding the substitute bill and another TWG was formed to answer the issues. On August 29, 2008, the TWG meeting was held. Finally, on September 23, 2008, the substitute bill that was finalized in the previous TWG meeting was approved. The official committee report was yet to be released.

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