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Beyond the remittances-driven economy

Notes as if the long run mattered

by

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Monograph originally prepared in August 2007 for the
Center for National Policy and Strategy (CNaPS).

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Abstract

This paper discusses the causes and consequences of the current trend in which a principal driver of growth is inward remittances by workers deployed overseas. The main benefit of the phenomenon is an easing of the fiscal burden arising from the effectively large transfer from workers to the government. On the other hand, the "Dutch Disease" it causes takes a long-term toll on the tradables sector. The paper concludes that the fiscal payoffs from the phenomenon are best used by reinvesting these in the foundations of domestic competitiveness—particularly education and focused infrastructure—to offset the worst effects of the trend and prepare prudently for the time it ends or reverses.

Key Words: Philippine economy, labour migration, migrant remittances, remittances-driven economy, services sector, exchange rate, Dutch Disease, "divide-by- N" syndrome, transport infrastructure, political infrastructure cycle, political institutions

JEL Codes: B52, F22, F240, O240, O530, R42

Beyond the remittances-driven economy
Notes as if the long run mattered*

1. On recent growth

1. The Philippines passed a significant milestone when it managed to avert a threatening fiscal and financial crisis in 2005 and 2006. When it did so, the foundations for fiscal consolidation were laid. And while revenue effort still has significant room to improve, the country now at least has the opportunity to sustain current levels of low-to-moderate growth over the next 3-5 years without expecting major disruption from the fiscal side or the external sector.

2. Officially and in business circles, however, there seems to be a fundamental misreading of the economy's actual condition. This is to be seen in the uncritical euphoria that greeted the report that the economy had expanded 6.9 percent in GDP during the first quarter. As a result, the economy's growth possibilities are overblown, while the magnitude of adjustment that still needs to occur and the problems to be confronted are dangerously underestimated.

3. There are strong reasons to believe that the actual rate of economic expansion is overstated [Medalla 2007]. Objective macroeconomic indicators are more consistent with a picture of continuing weak (though still positive) growth since the end of the Asian financial crisis. Among these continuing indicators are (a) persistently weak or negative growth in capital spending; (b) low inflation; (c) a strengthening peso; (d) low domestic interest rates; (e) sluggish bank lending; and (f) a declining share of imports. By contrast, it would need a big stretch of the imagination to reconcile the trend in these indicators with a rapidly growing economy. (Back-of-the-envelope

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suggest that GDP growth figures relative to pre-Asian-crisis levels may be systematically overstated by about 1-1.5 percentage points. This means that, even with the acceleration of the first quarter, what we are really still witnessing is the equivalent of 5.0-5.5 percent GDP growth in pre-crisis times.)

The remittances-driven economy

4. Philippine growth since the Asian financial crisis has increasingly deviated from the typical "East Asian" pattern of high growth with high investment and high exports. Instead it is now a process *driven largely by the phenomenon of overseas remittances*[1], which sets in motion the following processes:

(a) exogenous inward remittances are converted into domestic currency largely to finance the consumption of overseas workers' families;

(b) the resulting real currency appreciation erodes manufacturing and export competitiveness, causing investment in and output by these sectors to weaken (incipient "Dutch disease" [2]);

(c) accelerating foreign-exchange inflows are nonetheless enough to support the import-replacement of domestic output;

(d) a portion of the remittances not devoted to consumption finds its way into real-estate investments;

(e) but large investments are generally not needed, in any case, where no large demands are made on the production sector.

This process largely explains the sectoral patterns in the present "SM economy": advancing consumption, retail and wholesale trade, and real estate, on the one hand; and generally anemic manufacturing and investment, on the other.

5. The performance of the *services sector* (showing the fastest growth on the production side), however, can stand further elaboration. Clearly, the domestically oriented parts of this sector have also benefited from the growth of consumption spending (e.g., retail

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[1] Estimates of the stock of overseas workers (i.e., excluding permanent migrants) vary from 4.5 million (Commission on Filipinos Overseas) to 3.5 million (World Bank), to a low of of one million (National Statistical Office). The last estimate however includes only those who departed in the last five years (as cited in Ducanes and Abella [2007].)

[2] "Dutch disease" refers to the negative impact on the Dutch manufacturing industry of the discovery of North Sea oil in the 1970s. The resulting large foreign-exchange revenues from oil mining caused a real appreciation of the currency and a fall in competitiveness of the exportables industry.

and wholesale trade, financial services, real estate, as well as transport and communications). In addition, however, certain parts of it continue to ride the wave of large changes in information and communications technology that have sustained their export competitiveness (hence, e.g., the emergence of numerous forms of cross-border trade in services, notably BPO). Technological change in services has therefore partly offset the disadvantage of real currency appreciation; this is in contrast to domestic manufacturing, which has been more vulnerable to the "Dutch disease" entailed by a remittances-driven economy.

6. But, although the growth it has engendred has been limited, the remittances-driven economy has nonetheless produced a significant amount of social benefits. It has been an effective safety net and a means to social mobility and for some poorer families to pull themselves out of poverty. It is estimated that owing to the presence of an overseas worker, a hitherto poor family gains a 70-percent chance of crossing over to being nonpoor [Ducanes and Abella 2007]. The downstream effects of the remittances-economy on family incomes is likely to have been a primary reason that despite mediocre GDP per capita growth in the Philippines, poverty reduction and inequality did not significantly worsen over the period 1997-2003: headcount poverty-incidence, defined on a dollar-a-day basis, was barely changed from 13.6 to 13.5 percent, while inequality, as measured by the Gini coefficient, also fell from 46.2 percent to 44.5 percent.[3]

7. The benefits of remittances extend not only to the level of the family but to the country and economy at large. As already noted, it has resulted in stable prices during the period of high world petroleum prices reduced the government's fiscal burden. Moreover, the remittances-driven economy has in many ways even allowed government to abdicate many difficult and urgent tasks without putting economic stability at risk. Public investment, for example, has perversely become less necessary, since the production sector makes fewer demands on infrastructure in any case. Private efforts have sufficed in any case to accomplish a degree of poverty alleviation and inequality reduction, again without too much government intervention.

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[3] Figures from the World Bank's *povcal.net*.

8. Nonetheless the inherently *limited and self-undermining nature* of a remittances-based economy cannot be denied. More specifically, the entire process lacks a *self-sustaining dynamic*, since its driving force (i.e., the most important exogenous variable in the system) is a continuing acceleration in inward remittances. In other words, for growth from this source to be maintained over several years, not only must remittance flows remain high, *they must grow at an increasing rate*.

9. While in terms of magnitudes, there are currently no signs that remittance flows are about to cease or even decline, it is improbable that they can indefinitely sustain the annual growth of 10-12 percent observed in the past few years. This assessment is relates partly to the number of qualified workers of certain skills the country can realistically hope to train and deploy, and also partly to the degree to which other countries will continue to require them. It should also be noted that a part of remittances most likely consists of repatriations of accumulated savings or borrowings (e.g., part of the stream that is underwriting real-estate investments). In this aspect they partake more of the character of one-time capital inflows than continuous flows of current income.

10. It is instructive to contrast growth that is primarily reliant on spending (a species of which is remittance-based growth) with the kind that can be sustained over the long term. Unlike the former, the latter typically calls up deep sources of productivity, such as those involving scale-economies from the diffusion and cross-fertilisation of skills, useful knowledge, and access to intermediate inputs from producers working in close proximity with one another [see, e.g., Gill and Kharas 2007:9].

13. Almost by definition, however, such dynamic advantages are just those which a remittances-based economy cannot afford, at least not directly. The skills demanded in overseas employment are idiosyncratically fitted to external markets and therefore difficult to acquire and almost impossible to deepen domestically (that is, except for industries and sectors for which the country possesses an intrinsic demand, e.g., health care, about which more below). As an example, the huge global demand for skilled construction workers able to operate heavy lorries, cranes, and other heavy-engineering and heavy handling equipment is bound to remain underfilled. This is largely due to the fact that the local construction and engineering industries are themselves fairly

unsophisticated by world standards. As a result, the workers it produces are unable to gain any deep experience in operating the equipment actually used in foreign contracts, much of which has to be learned on the job. Partly for this reason, most jobs Filipino workers in such sectors are mostly in entry-level categories.

14. Moreover, owing to the physical dispersion of skilled workers and the consequent lack of productive interaction among them, the dynamic feedback and cross-fertilisation among acquired competencies, as well as the scale-economies typical of classic industrialisation processes, inevitably fail to materialise. Although individual Filipino workers may acquire superior on-the-job experience on foreign assignments, these contribute only minimally, if at all, to the pool of locally useful knowledge: for the firms and entrepreneurs that would have required those skills are themselves not present domestically, while the complementary assets required to operate those skills (e.g., the machinery and related skills) are not ready to hand. This is why returning workers are rarely able to make use of their skills domestically and, for the most part, are compelled to accept being "deskilled" when they decide to stay home.

15. The remittances-driven economy ultimately becomes self-undermining to the extent that the brain-and skills-drain it causes makes it *more difficult* to deepen the domestic economy's production structure that is the source of such skills. The gap in technology and skills between the country and the rest of the world implies that (a) recruits to overseas jobs will on average be selected only among the country's best and most experienced; (b) where knowledge-acquisition is tacit, many of these will nonetheless be wanting in actual experience relative to the idiosyncratic demands of foreign jobs; (c) and yet crucial sectors of the economy relying on such manpower will therefore tend to suffer from skills shortages. This is already evident in some sectors, such as the airline industry, which is suffering from the outmigration of pilots, or even of the shortage of nurses in the medical sector.

16. The most evident and palpable manifestation of the self-limiting nature of remittances-driven growth is, of course, macroeconomic. Over the past three years (2004-2007), the peso has appreciated by more than 20 percent[4], from P56 to P46 to

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[4] In terms of dollars per peso, on the other hand, the appreciation has been about 18 percent.

the dollar. While this phenomenon is partly due to other factors – including the dollar's global weakness and the dissipation of macroeconomic uncertainty and the revival of interest among portfolio foreign investors particularly after fiscal reforms took hold – by far the weightiest factor making for stability has been the large inflows of overseas workers' remittances. Ironically, therefore, the flows of foreign exchange spawned by out-migration have caused a peso appreciation that diminishes the attractiveness and undermines the very purpose of that out-migration itself. The appreciation of the peso in since 2004 will already have cost the overseas workers and their families a rough equivalent of more than 188 billion pesos in purchasing power.

17. The peso appreciation has also eroded the competitiveness of *all* tradables (i.e., both export and import-competing sectors). For such sectors, a stronger peso means lower (peso) revenues relative to that of nontradables, with the losses being larger for firms that use higher domestic content. (By contrast, firms that produce nothing domestically but import all their merchandise actually gain.) Hence, remittances-driven growth not only undermines the earnings of the overseas workers themselves; not only does it *directly* affect a number of sectors through the loss of skilled personnel to outside deployment; but carried on too far and too long, it also affects the economy as a whole *indirectly* through "Dutch Disease" or "booming-sector" effects.

18. The departure of a significant part of the labour force plus the growing unattractiveness of tradables directly reduces the need for investment generally. This fact is evident in the precipitous decline in investment from 24 percent of GDP in 2000 to less than 18 percent in 2006. The investment slump in turn implies below-normal import demand, hence a below-normal demand for foreign currency, therefore feeding back into the strong-peso regime.

19. It is hardly possible to make a prognosis *when* the current remittances-driven episode will end. The only certainty is that the process is self-undermining and cannot last indefinitely. At some point, the forces for a slow implosion can result in a situation where the increasing outward exodus of workers creates only as many jobs and incomes

abroad as it destroys at home, leaving the economy as a whole unimproved or even worse off.[5] Long before that, however, growth will have sputtered.

A guided transition

20. For all that, conditions while they last imply an unprecedented macroeconomic stability. The current challenge is how to make the most of a remittances-driven economy so that its deleterious consequences are minimised while the domestic economy is guided onto a path of more sustainable growth. The skills-exodus and the Dutch Disease to which its gives rise may be viewed by some as if they were a typhoon carrying all before it. All that can be done is to hunker down until it passes and seek to preserve what one can of domestic productive activities. That metaphor may be too negative, however. More appropriate perhaps is the need for a ship to trim its sails in a strong squall, i.e., adjust its rigging to suit the winds. Indeed, accomplished properly, such a measure, rather than resulting in a shipwreack, may actually bring a ship quite a way forward.

Exactly what does "trimming the sails" involve in this context, however? Since the economy now floats in largely uncharted waters, the prudent national strategy – i.e., one that preserves the country's options and marshals its limited resources – must have the following components:

Mitigating upward pressure on the peso

21. First, *macroeconomic and financial measures must be taken to relieve further upward exchange-rate pressure*. Without having to commit itself to any irreversible industrial policy, the government can and must take action to prevent further damage to the tradables sector (not to mention the overseas workers themselves) by steming any further unwarranted rise in the peso. The situation has reached the point of national urgency that coalitions of overseas workers and exporters have broached the idea of dual exchange rates. There are good reasons not to support such moves. The best one is the availability of a simpler measure. Namely, the government can and should

[5] This can happen if the exchange rate is sufficiently influenced by the number of workers deployed overseas.

radically shift its borrowing and repayment mix by paying down foreign debt through domestic borrowing.

22. While it is true the share of domestic debt in new government borrowing by government has risen substantially, foreign debt has largely fallen only in relative terms, i.e., the foreign-debt stock is kept constant even as the economy grows. The Department of Finance has still basically adhered to the policy of using *new foreign debt to retire old foreign debt*. To cause a real dent on currency appreciation, however, the government should instead seriously consider paying down a larger portion of its foreign debt by borrowing domestically and using the peso proceeds to buy foreign exchange on the open market. This measure by itself should add substantially to the demand for dollars and remove some of the sting of the peso appreciation.

Investing in infrastructure and education

23. Second, *there needs to be a concerted effort to invest in common facilities*, *particularly physical infrastructure and education*. While the nature and extent of industries in a post-remittances world cannot be precisely known, these must inevitably draw upon the nation's common stock of physical infrastructure and skilled labour. Hence the it is a prudent course to expand in those areas that may represent current or future hindrances to growth.

24. The degree of underinvestment in physical infrastructure in the country is well-known and even officially recognised. The country has been a perennial laggard in league tables that rank the quality of various forms of phyiscal infrastructure (e.g., in the World Competitiveness Rankings of 2006, the Philippines ranked 51st among 55 countries in terms of infrastructure).

25. The recovery of investment-spending (both public and private) in infrastructure would achieve either or both of the following:

> *First*, it would contribute to a rise in import-demand and therefore open another channel to drain the excess-dollar problem and curb currency appreciation (The commissioning of a single new power-plant, for example, would add a one-time one billion to foreign-exchange demand.)

Second, it would facilitate lower costs of domestic production all round, providing an added incentive for investors to locate domestically and promote home employment. (The power plant whose construction was referred to above also helps to re1duce energy costs. The same is true for investments in high-speed roads, seaports and airports.)

26. The peculiar challenges associated with the scale, design, and selection of physical infrastructure projects in the Philippines are discussed further below. Here it suffices to point out that the types of infrastructure urgently required in the country are those in: (a) power, from generation to distribution; (b) water supply, irrigation, and distribution; (c) national roads and expressways; (d) international airports and seaports; and (e) mass-transit systems in the country's major urban and industrial areas.

27. The crisis in education is also public knowledge. It is masked, however, by the fact that the country is living off stocks of previously-educated manpower, as well as the illusion created by inflated formal credentials, which conceals deep-seated problems of quality in the education system. This is why the country seems to score well in gross measures of literacy and educational attainment[6] yet invariably does poorly in bedrock tests of education content and quality. Undeniable examples of these are the country's low ranking in international measures of mathematics and science proficiency among school children (e.g., the IMSS) and the high rejection rates among college applicants in the business-process outsourcing industry.

28. Education is important because the skilled or trainable labour it produces is a resource shared by both the domestic economy and the exodus-industry. In this sense, education transcends the home-versus-abroad dilemma. While it is true, for example, that the bulk of the nurse-output is oriented to migration or working abroad therefore contributing to the skills-drain, there is nothing to be done about it but to turn out even more nurses, in order ensure that a sufficient (if transient) number remains to minister to the domestic population.[7] Short of direct government interference in people's career

[6] This includes the successes in international competitions of small groups of exceptional Filipino pupils from atypical private or science high schoools.

[7] Refer also to the next footnote.

choices, the only way to "keep home" globally marketable and footloose skills is to provide the complementary assets that their domestic employment requires, as the example of the business-process outsourcing industries has shown.

Intermediate industries during the transition

29. No one knows or understands fully what new industries and sectors will survive or emerge beyond the episode of remittances-led growth. This is why infrastructure spending and education – owing to their wide use and applicability – are safe bets to focus on. Beyond these, however, a number of domestic economic sectors and industries possess reasonably goo1d prospects notwithstanding, namely:

(a) Activities where the country possesses absolute or unique locational advantages. Such advantages will sometimes suffice to offset the price- and infrastructure penalty on domestic production. Location-based *tourism* is an example, to the extent the country's unique attractions and locales lend it a differentiated advantage (albeit in the context of an industry that is monopolistically competitive). Given the limited global distribution of many mineral resources, *mining* is also promising for the same reason. A number of *high value-added agricultural crops* (or the reprocessing of traditional crops into higher value-added products) may also fall in this category.

(b) Activities that are themselves by-products or consequences of the skills-exodus. *Medical tourism* and the *retirement* businesses are cases in point. The production of nurses and care-givers is undoubtedly oriented to employment abroad. Nonetheless the process of producing outbound workers will inevitably give rise to a surplus of such workers domestically.[8] To the extent and during the time that they do remain based in the country, such

[8] This can be demonstrated simply. Suppose W and w are the respective foreign and domestic wages for a skill with $W > w$, and there are a fixed number n of foreign jobs (i.e., a quota) available. Then with unrestricted occupational choice, a total number of entrants N will willingly incur the cost of training c until the expected foreign wage less the cost of training equals the certain domestic wage, i.e., until $(n/N)W - c = w$. Since $(n/N) = (w + c)/W$, clearly $N > n$ as long as the foreign wage is sufficiently high relative to the full cost of training (namely the foregone domestic wage plus the training cost), i.e., $W > w + c$. This condition is almost always fulfilled in the Philippine context.

workers can represent a distinct advantage and can be mobilised for such industries.

(c) Activities riding global waves of technological change. The most obvious among are those linked to information and communications technology, where large productivity growth has been sufficient to offset the ravages of the Dutch Disease. The remarkable growth in the scale and scope of the *services-outsourcing* sector (BPO being the most prominent) notwithstanding the exchange-rate and skills-penalty is testimony to this fact. The continuing presence of Japanese and Taiwanese *electronics* manufacturers in the country is also significant and at least partly attributable to the importance of easy communication (in English) in a sector where the frenetic pace of technological change needs to be urgently implemented at the level of the shop-floor.

Other such niches may exist, since technological changes are also taking place globally in biotechnology, new materials, aeronautics, and possibly alternative-energy sources[9]. It remains an open question, however, whether the conditions that led to success in the services-outsourcing can be replicated in these other technological areas. Biotechnology would seem the most proximate field to latch on to[10]. But even here it is doubful whether the country's current corps of trained scientists constitutes a critical mass to catch global attention.

30. All the activities mentioned face reasonable to excellent prospects, even in a remittances-driven economy. Still, it is important to note that realising these prospects will depend on whether complementary assets can be provided. Many of them suffer – to varying degrees – from the same general erosion of advantage caused by the deterioration or absence of physical infrastructure and eroding educational quality, and this could prevent their sufficient "deepening" to make a huge employment impact. Even BPOs, for example, are plagued by the deterioration of education quality, particularly by

[9] The location in the country of the second-largest solar panel manufacturer in the world is significant in this respect.

[10] This, especially in the light of the country's acknowledged high level of biodiversity.

declining standards of spoken English. Again, the development of all kinds of tourism depends at a minimum on the availability of reliable power and efficient transport links, areas in which the country has under-invested. The production of engineers, biologists, and technicians that could attract the presence of global biotechnological and engineering industries in the country will depend on how well and how quickly the education system shapes up. And so on.

2. Bridging the infrastructure gap

31. Whether for its favourable macroeconomic consequences or its impact on competitiveness, a recovery of infrastructure-investment has now become imperative. A number of factors, however, prevent this from happening. Until recently, the most important hindrance has been the government's problem with keeping its deficits under control. With fiscal consolidation occurring, however, this is no longer as important a reason as it was only a year ago, although it may still be an issue in the medium- or long-term. Instead the reality of fiscal consolidation has revealed the deeper malaise responsible for the infrastructure failure: *ineffective political markets*, which result in (a) perennial underprovision of infrastructure and (b) provision of a frequently inferior or inappropriate character.

33. Public infrastructure is, of course, a political issue even in other jurisdications because of the "public-good" problem it involves. Pure public goods are those whose benefits are nonexclusive and nonrival, so that it is both infeasible and inefficient to restrict the number of their beneficiaries. (It would be difficult and counterproductive, for example, to monitor and charge people for the use of uncongested city roads[11].) Since fees are difficult to impose, there will be little private-sector interest to provide such goods, and the only way to underwrite them is out of general taxation. Taxation however hits specific people, while the benefits from public goods are indiscriminately enjoyed by the many. Hence there is little incentive to pay taxes (even as there is every incentive to complain about the level of public-goods provision). This is the well-known "free-rider" problem of public goods.

[11] That is, of course, until the point of congestion is reached.

34. For infrastructure the problem is worsened by the inherent myopia of present generations with respect to the future. Benefits from long-gestation projects – typical of infrastructure – will after all be enjoyed only well into the future, while taxes are collected here and now. (This problem may be mitigated by borrowing instead – about which more later.) In the event, this phenomenon is partly manifested in the fact that in every budget crunch, it is always infrastructure budgets that are cut first rather than personnel costs and maintenance and operations.

35. In this country such generic factors are compounded by *poverty, inequality, and one-sided access to political power*. The free-rider problem is worsened by the fact that the poor majority have even less of an ability to pay taxes, even as they feel entitled to public goods, extending beyond the minimal set (i.e., beyond Smith's peace-keeping, administration of justice, and public works and infrastructure) to include welfare and subsidy programmes and direct redistribution (viz.,"Those who have less in life should have more in the law"). The funds to support such social demands, on the other hand, are nowhere forthcoming, since those who do have the ability to pay are able to escape the burden either by influencing legislation through lobbying, or buying off those who would impllement the law. Infrastructure myopia, is also worsened by the fact that the poor will typically have short horizons, placing a higher premium on consumption than investment; as a result infrastructure ranks low ih the order of political priorities even where popular preferences were genuinely registered. Between the continual demand for government intervention and provision – beyond even what may be considered prudent – and the perennial shortage of means to fulfill even the minimum of such expectations, political frustration is heightened and the credibility of institutions undermined.

36. In more successful countries, political leadership emerges to bridge the gap between the high expectations of the poor and self-absorption of the rich, between the myopia of the present generation and the welfare of future ones. In the Philippines, however, an important reason this has not happened is the absence of any national programme-based organisations – i.e., either political movements or parties – that might link the actions of politicians to a specific national agenda and hold them *collectively responsible* for specific mixes of taxation-cum-spending. As will be discussed below, the main result is that the question of revenues falls between chairs and is even more neglected than

usual. A failure to deliver revenues reliably, however, effectively means a neglect of public-goods provision, including infrastructure.

The "divide-by-*N*" syndrome

37. A peculiar offshoot of the Philippine political process is the *"divide-by-N" syndrome* (first described by R. Fabella), that is, the mechanical and feckless dissipation of government funds across localities instead of their rational allocation to where these might have the most impact. The phenomenon is apparent in the fragmentation of many projects both in space and time, as typified by the pork-barrel allocation of legislators (e.g., bridges that lead nowhere, dirt roads interrupted occasionally by concrete paving; half-roofed schoolhouses, etc.). Similarly, there is an unnecessary duplication of projects without regard for scale economies, as seen for instance in the proliferation of provincial airports and seaports, special economic zones, and even state universities.

38. The divide-by-*N* syndrome is the result of a system where the bulk of revenues is collected nationally and only subsequently redistributed (mechanically) to the local levels. Indeed the Local Government Code largely enshrines fragmentation, to the extent it applies rigid formulas for dividing local government shares in revenue by administrative units (*barangays*, municipalities, cities, and provinces) and within each administrative level using another formula based on population, area, and equal sharing.

39. Since the problem of raising sufficient revenues is thus effectively passed on to the national government – primarily to the executive branch – while the distribution of part of it (the LGU share) is mechanical, politicians will regard their mandate principally as that of hauling down and channelling as much *additional* national resources as possible to their client-district, -city, or -province from the remaining common-revenue pool, in fulfilment of their expected patronage role. For this reason, political merit and reward become based primarily on a politician's prowess in parlaying connections and alliances (whether by currying favour with, or by threatening obstruction of the administration and national agencies) to obtain a larger share of national revenues in the form of projects for favoured constituencies. In terms of size, however, districts, cities, and even provinces are unable in finance and unequipped in skills to undertake large-scale overarching projects; hence the resulting fragmentation and dissipation.

Short horizons and term-limits

40. Another aspect of the current system that has proven inimical to sustained and sound public investment is the built-in *short-term horizons* of national office-holders. The deeper reason for this is the concentration of in the presidency and the absence of political parties that can internalise political gains through time. As a result, there are no means of ensuring policy-continuity at the national level. The incentive to avidly pursue and complement any past administration's projects is weak at best, since: (a) little or no political credit can be claimed, and (b) only minimal new corruption rents can be derived from projects already in the pipeline. The more powerful incentive is to initiate new projects rather than complete ones that have been begun. In the worst case, of course, not only are pipeline projects delayed, they can also be saddled with corruption rents many times over across successive administrations, as has apparently occurred with the CBK (IMPSA) power project and the NAIA Terminal 3. Even in such cases, however, the bias is created is still for a delay in implementation, an even higher overprice.

41. Short horizons and the desire to accumulate personal political credit explain, among other things, the piece-meal pattern and the glacial rate of completion of what should have been an all-Luzon expressway. The 75.8-km. South Expressway, which joins Paco in Manila and Calamba, Laguna, dates from the Marcos-era. It has been separated by a ridiculous 8 km from the Ramos-built STAR (Southern Tagalog Arterial Road, a 22-km. long road connecting Santo Tomas to Lipa. Work to connect the two began only in 2006. And of course it is too much to ask that the highway thus built should extend all the way to where by all rights it should: the port of Batangas. In the meantime, the North Expressway (NLEX), stretching 88 km. from Balintawak, Quezon City to to San Fernando, was also built during the Marcos period and is not connected by any high-speed road to the South expressway. The work to connect the two expressways is only now beginning.

42. The length of time this has been decided and implemented is remarkable: it has taken all of *three decades* (since the first of these toll roads were inaugurated) to construct a total of less than 200 km. of largely disconnected expressways. Yet internationally speaking, the scale of these projects is decidedly minor. By comparison, Malaysia's E1 expressway is almost five times as long, stretching 966 km. from the

country's border with Thailand to the Singapore Causeway – yet it took only 13 years to build (1981-1994).

43. It is a minor paradox that not more infrastructure spending is being done at the local level where, for good or ill, a modicum of continuity is made possible by political dynasties that perpetuate their members in office over decades, effectively circumventing term limits through revolving-door and bench-warming tactics. It is a question then why a good deal of local discretionary spending appears to be for contractual personnel. A tentative answer must lie in the extremely small subdivision of the country's political units, which are tailour-fit to the requirements of clan-dominance but ill-suited to the requirements of large-scale infrastructure planning. Hence, although municipal roads may sufficiently merit the attention of a local mayor to have them cemented, neither the funds, nor the incentives, nor the visioning capacities exist for local officials to cooperate across municipalities to build arterial roads and highways. There are, of course, exceptions: the extended terms of the Fernandos in Marikina or the Binays in Makati have permitted significant infrastructure to be put in place in those areas.[12]

Financing via ODA and BOT

44. With the budgetary process being prone to cutbacks and the "divide-by-*N*" syndrome, substantial infrastructure projects have largely been forthcoming only when financed through foreign borrowing or build-operate-and-transfer (BOT) schemes: these are where legislative oversight is least, executive discretion is greatest, and the leeway for grand corruption also the widest.

45. Each has advantages on paper. Financing infrastructure through either ODA or BOT relaxes the government's liquidity constraints: the first, to the extent foreign aid is available under concessional terms; the second, because it is the private sector rather than the government that puts up the investment. BOT projects affford the additional advantage of relieving government of the problem of running enterprises (with their attendant problems of ensuring personnel quality, customer responsiveness, cost

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[12] A typology of local leaders is given by de Dios [2007].

control, and equipment maintenance). Indeed, when properly implemented, some ODA and BOT projects may even be regarded as exemplary. A number of smaller road and bridge projects in the Visayas, or even the MRT II line (Santolan-Divisoria) are fairly good examples of ODA-financed infrastructure; meanwhile, the North Expressway concession and the privatisation of Metro Manila's water concessions must be counted as successful BOT projects.[13]

46. In practice, howeever, BOT schemes have given rise to their own spate of problems, stemming largely to various guarantees given to winning bidders to incentivize such projects. Among such guarantees [14]are those: (a) to repay loans incurred by the builder-operator in case the latter should default (so-called "sovereign guarantees"); (b) to ensure against foreign-exchange fluctuations; (c) to pay the builder-operator a minimum return regardless of the extent of the public's use of the facility (or so-called "take-or-pay" or "minimum off-take" provisions); or (d) to compensate the operator for government's failure to deliver on certain promises (e.g. so-called "performance undertakings"). In practice, such guarantees have tied down the government and led to large losses and "contingent liabilities", as seen from the experience of Napocor, the purchase-power agreements (PPAs) of independent power-producers, LRTs 1 and III, and Metro Manila's western water concession. Learning painfully from these lessons, the government has since adopted policies in principle that proscribe terms that involve (a)-(c), although not before it had accumulated huge losses and obligations.

47. The dilemma, of course, is that such guarantees or subsidies cannot be ruled out in principle. Indeed a compelling case can be made for subsidising infrastructure with positive nonmonetisable externalities. Running such ventures purely on a for-profit, cost-recovery basis is likely to lead to higher pricing and lower usage than a social optimum requires. Urban rail transport is an example: absent subsidies, such a facility is likely to charge high prices to recover costs, thereby discouraging some passengers. A partial public subsidy to encourage more people to use urban trains would be justified to the

[13] The failure and successful replacement of the first western-side water concessionaire in fact showed the robustness and viability of the scheme, including its dispute-settlement and exit mechanisms.

[14] See Llanto [2006] for a more complete discussion.

extent its cost was exceeded by the incremental benefits to public health and the environment. The difficult choice in such projects is often not *whether* some form of public support is required, but rather the more technical issue of the *extent* of such subsidies and *the manner* in which these are to be given. This technical indeterminacy, however, can provide sufficient leeway for discretion and a corruption of priorities and processes. Finally, BOT bidding rules may also be rigged to accommodate inefficient contractors and costly facilities. And although no government funds become implicated in BOTs, the public could nonetheless be saddled with the burden of long construction delays, inferior services, and unreasonable charges.

48. The superlative example of all these ills is the NAIA terminal 3 project, an "unsolicited" BOT project, where the government nonetheless became committed to an overpriced, corruption-ridden (and apparently imperfectly constructed) facility that would have overcharged its users if the original terms of the proponents had been implemented. A deeper tragedy – less emphasised in the media coverage – is that the entire idea of building a new terminal in Pasay was flawed and short-sighted to begin with: the airport there has only one main runway, rather than two parallel ones, which is the minimum standard for modern airports. Indeed the terminal has become outmoded even before it has begun to operate. It would be unable to accommodate anticipated air traffic, particularly the new generation of wide-bodied aircraft. It would have made eminently better sense to undertake the larger effort of transferring the entire Manila airport to Clark, which does possess parallel runways that can accommodate the new generation of wide-bodied aircraft (the Airbus 380, for example). Such strategic mistakes must be put down to the political impotence and weak technical capacities of the bureaucracy relative to the confluent interests of rent-seeking politicians and BOT brokers.

49. In the case of ODA, apart from the problem of ensuring the integrity of project-selection, additional issues have to do with the selection of suppliers or contracters to implement the project. (Note this problem does not exist in BOTs, in principle, since the problem of cost overruns is internalised by the winning private-sector bidder.) While there is an increasing global movement to "untie" aid and allow access to competitive

international bidding in ODA projects, not all donor countries have complied[15]. The controversies generated by some of China's ODA (e.g., the North Rail project and the national-broadband network and cyber-education projects), which countenances the hand-picking of its contractors, are only the most obvious examples.[16] Even where aid from donor-countries is ostensibly untied, however, the bidding process can in practice still be saddled by unreasonable pre-qualification and other requirements that narrow the effective pool of bidders. A recent study of Japan-financed road projects in the Philippines, for example, finds that the packaging of contracts into large chunks can limit competitive bidding and create "a potential environment for collusion among the few participating bidders" [C. Virata and Associates 2006:4] that can result in unwarranted high costs.

50. At bottom, therefore, the problem common to both ODA and the BOT processes is their vulnerability to manipulation by ODA merchants and pushers of various BOT schemes, which can distort the selection of projects. This is largely the outcome of the government bureaucracy's poor or unsupported technical capabilities, combined with the bias of vested interests seeking to benefit from a particular project through corruption rents or the capture of a privileged monopolistic position.

The political infrastructure cycle

51. The infrastructure dilemma, therefore, is as follows: the division of powers, political incentives, and the inequitable socio-economic structure prevent any meaningful effort at revenue generation; much of the revenue generated and allocated through the legislated budgetary process is, in any case, dissipated by political hyperdivision (the divide-by-*N* syndrome), short government horizons, and weak planning capacities. The institutional adaptation has instead been to rely on foreign assistance and BOT schemes to implement large infrastructure projects. These, however, are plagued with their own problems, namely, flawed and biased project-selection, excessive government guarantees, overpriced services, and regulatory capture in general.

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[15] The Development Assistance Committee, a subgroup of the OECD that monitors ODA, estimated that 42 percent of all aid in 2006 was untied according to its standards, implying that more than half of ODA remained tied.

52. When these micropolitical-economic problems play out, they produce the larger phenomenon of a *political infrastructure-cycle* that is characterised by two regimes: (a) *perennial shortage* and rationing punctuated by (b) years of prodigality, a condition not unlike that of a person on a forced diet with a periodic urge to binge. The crucial variable in determining these two alternating regimes is the country's changing ability to access foreign financing. For it is foreign finance, whether accessed by government or the private sector, which determines whether and to what extent the economy gets out of its tight budget constraints. We already discussed, for example, how ODA and private-sector BOTs became the way out of the budgetary impasse – it is no accident both these modes are dependent on foreign finance.

53. Regimes of plenty have been relatively few and brief in recent history and typically coincide with periods of easy foreign borrowing. The longest episode was probably the period of easy loans during the Marcos period[17]. Relative to subequent events, the late years of Ramos (1995-1997) when the country began its return to international capital markets, and the early years of Arroyo (2000-2002) may also fall under this category. By contrast, the Aquino administration, when the country was in debt arrears, and the Estrada administration, which overlapped the Asian financial crisis, were years of rationing. The current post-RVAT (from 2006) period of Arroyo, as we argue further below, may also qualify. Evidence of this periodisation is partly reflected in the roads contributed by each administration. Reckoned as annual averages[18], the Marcos and Ramos administrations registered the highest kilometres of road built (i.e., 5,166 and 6,518 km. respectively), while the Aquino and Estrada administrations had the lowest (391 and 119, respectively). The first two years of Arroyo registered 824 km of roads built annually [Llanto 2002:7].

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[16] On the national broadband network controversy, see Fabella and de Dios [2007].

[17] Strictly speaking, however, the easy-loans period under Marcos probably ended in 1982, although the regime survived until ealry 1986. This can also have affected the averages reported in paragraph 53.

[18] Llanto [2002: 7, Table II.2] provides the following details:

	Marcos	*Aquino*	*Ramos*	*Estrada*	*Arroyo*
Years in office	20	6	6	2	2
Ave. km. of roads built	5,166	391	6,518	119	829
Total km. built	103,321	2,344	39,107	237	1,647

54. The net result however is that to this day a good deal of large and major infrastructure still dates largely from the Marcos period (e.g., the Luzon expressways, the pan-Philippine highway, even the existing Manila international airport). Of some 148,000 km. of road built between 1965 and 2000, almost 70 percent was constructed under the Marcos period (which accounts for only 56 percent of the entire period). Part of this may simply relate to the length of time involved and planning indivisibilities. Another part however may relate to (a) the fact that the authoritarian regime was more politically secure relative to local interests, which vitiated the divide-by-*N* syndrome; and (b) the fact that the regime possessed a longer time-horizon. (On the other hand, the corruption was probably on a grander scale.)

55. The expected end of the easy-spending period is reached when the debt and contingent liabilities build-up catches up with the budget process itself. From being the means to evade the strictures of the budget, ODA and BOT obligations become constraints to the budget itself, as debt-service and contingent liabilities pre-empt increasing shares of obligatory government spending. This has largely been the story of the 2003-2006 period.

56. Only the threat of a general financial meltdown typically makes government deviate from the above pattern and muster enough political will to fix chronically large deficits. The "method" is also entirely predictable: across-the-board cuts in spending, with infrastructure spending being the first to go; only if that does not work – meaning either the IMF or credit-ratings agencies are unimpressed – will raising revenues be considered. In all this it should be noted that revenues are never generally raised in order to finance a well-conceived plan of spending: rather it is to stave off a crisis. The Arroyo years since 2003 have largely been years of severe rationing, characterised by scrimping on infrastructure, education, and other social services.

57. In the event, the passage and implementation of the RVAT legislation in 2005-2006 marked a point when the economy entered the second regime. How long remains to be seen. Sensing this, members of the political elite have served notice they will no longer have their appetites restrained. If previous patterns are repeated, irresistible political demands for spending will predictably multiply and rise through time, once more breaching the limits set by established revenues; then primary deficits will predictably

reappear and the cycle will be repeated. Periods such as the present, therefore, when a crisis has just been averted and the budget constraint is temporarily relaxed, contain a false promise of deliverance – that is, unless the pattern is broken

58. But this can obviously occur only if several things occur. *First*, fiscal consolidation must be sustained to finally end the roller-coaster of cost-cutting and rationing on the one hand, and reckless borrowing and spending on the other. But this in turn implies that implies that revenues must be reliably and efficiently mobilised over the long term. *Second* there needs to be a sharper focus of government spending to where it is indispensable, which means a strategic delineation of priorities in lieu of the short-horizons and hyperdivision of projects that currently rule. *Third*, and as a corollary, there needs to ba sharper definition of where and how the private sector can actually substitute for the government in infrastructure provision, and credible rules must be in place for this to occur. *Fourth* and finally, there needs to be a quantum increase in transparency, competitiveness, and competence in the award of public contracts. Each of these broad topics is discussed in turn below.

3. A pressing agenda

Sustaining fiscal consolidation

59. Higher spending on infrastructure will depend on whether sustained revenues are forthcoming. While the government made fiscal headway with the passage of new-tax legislation in past two years, as a result of which the fiscal deficit has been tamed, there are no iron-clad guarantees this will persist beyond the short- to medium-term. As things stand, the government is having difficulty meeting the (to our mind unnecessarily stringent) target of closing the national government budget gap by 2009. This year it has failed to meet its own revenue targets and has met second-quarter 2007 targets only through window-dressing and one-time privatisation proceeds. The remaining agenda under this rubric demand are in two major areas: (a) rationalization of fiscal incentives and (b) reforms in tax administration.

60. The *reform of the government's system of fiscal incentives* (i.e., its tax-giveaways) is needed to close the last major loophole in the tax system, as legislated. The proliferation of tax exemptions and tax holidays for various entities (e.g., preferred

industries and entities, special economic zones, including buildings in the central business districts, in addition to exporters, etc.) is now the major reason that the growth of tax revenues has lagged behind growth in incomes.[19]

61. A clear policy must be enunciated to curb the grant of further incentives once the current ones lapse. In principle, only incentives to exporting firms should be given, although the definition ought to be widened to include service-exporters, with particular attention to the potential and emerging service-industries discussed earlier. The

62. A further measure to consider in this connection is a moratorium on the designation of further *special economic zones*, together with a thorough study to consider the consolidation and reduction of existing ones. The proliferation of special zones and ports, particularly in far-flung areas, is seldom viable and – if not the result of an exaggerated estimate of the province's prospects – is more often merely used as a conduit for smuggling by local politicians.

63. Thus far the government has sustained the momentum of fiscal consolidation by passing new tax laws, notably the RVAT; in the medium-term, government will do better when it plugs the incentives loopholes and supplements this by one-time gains from privatisation. The long-standing problem, however, is not the passage of new tax laws but the enforcement of existing ones – tax administration. At the moment, however, there is no innovation that yields a permanent improvement is in sight. The legislation the government passed ostensibly to deal with this matter – the Lateral Attrition Law – has proven such an imposition, as impractical as it is naïve and mechanical, that government's commitment to it has not proved credible. Tax administration remains an area over which looms a huge question mark.

Focusing infrastructure priorities

64. The most significant but also the most difficult reform that must be undertaken is the *focusing and concentration of government infrastructure spending*. In the short- to medium-term, resources must be mustered and directed at only a few strategic projects

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[19] Prior to this, the other major reason was the narrow scope of coverage of the VAT and the fact that commodity taxes levied on major products such as alcohol and tobacco were specified in unchanging nominal amounts.

that will "catalyse" aggregate investment. This should imply a radical reorientation away from current policies, which are motivated by the political placation and tokenist levelling that produce the "divide-by-*N*" syndrome.

65. First and foremost, government must take the frank and pragmatic decision to *reconcentrate its infrastructure efforts in the country's core growth-areas*. These cores will obviously include the national capital region; the central-southern Luzon growth corridor; the metropolitan Cebu area; and the metropolitan Davao area. Such a policy is both pragmatic and anchored on sound principle. These areas account for a large and growing share of national output, with the national capital region and the Calabarzon area alone producing almost half (48.4 percent) of GDP[20]. Any incremental infrastructure investment to relieve the binding constraints to production in such areas is bound to yield higher gains in terms of productivity than the same amounts invested in peripheral areas.

66. This proposal fully recognises the nature of modern industries and services, which tend to concentrate geographically – i.e., to co-locate, especially in cities – in order to take advantage of economies of scale and of the proximity to both markets and suppliers. (See, e.g., the recent work by Gill and Kharas [2007], which makes just this point.) Such *agglomeration economies* make such areas of concentration many times more productive than their surrounding areas, so that for the same reason, it becomes somewhat futile to expect an even distribution of firms and economic activity across the entire archipelago. The corollary, of course, is that the purely economic demand for infrastructure will also be unlikely to be evenly spread out, but will be most intense in regions of concentrated economic activity.

67. Since infrastructure often partakes of the character of a network, it is more productive if developed most where activity is densest and most intensive. A phone line becomes more useful, the more of other telephones it can call. Hence the expansion of that network is most needed where there are the most users. For the same reason, a power plant is better located where power shortages are in fact already occurring,

[20] Figures used were in current prices of 2005. The figure for 2005 shows a rising trend from the comparable 47.4 percent in 2002.

rather than in areas where there is as yet no power demand. The expansion of a road network contributes more to output if it radiates outwards from a central place, since the new localities that join to it are always certain of connecting to larger and richer markets. By contrast, even the best concrete road will barely serve a poor barangay if it is merely connected it to an equally poor barangay. Such arguments can be repeated for different types of infrastructure.

68. It should be pointed out that in the game of global competitiveness, it is ultimately not countries but more narrowly-defined regions that compete as locations of firms and entrepreneurship, technology, and capital. Ultimately, it is not a question of the Philippines competing versus Thailand or China or Vietnam, but rather how conditions in Manila or Cebu compare to those in Hanoi, Bangkok, or Thailand's eastern seaboard, Shanghai, or Shenzhen. The upshot is that to the extent infrastructure-spending fails to improve the conditions in the major growth areas, it does little or nothing for the country's competitiveness as a whole and is almost as good as wasted.

69. A change in paradigm is bound to ruffle the feathers of both local politicians interested primarily in hauling down fiscal resources to maintain their power, as well as well-meaning people who sincerely believe in an equitable distribution of national spending. It will be objected, for example, that this proposal ignores the welfare of the regions. At best however this will only be partly true. First, notwithstanding the concentration of population in Metro Manila, the Philippines still ranks below many countries in terms of the share of the urban population living in a primate city[21]. This indicates that the urban population is actually more disperse here than in other countries, partly a consequence of the country's island character. The presence of a number of growth centres in the country means that pursuing the policy will in practice means being set aside for regional growth centres, allaying the fears this will be another scheme of "imperial Manila/Luzon". Second, the expansion of growth centres will typically encompass and middle- and smaller settlements and fill up the spaces between

[21] The Manila megacity area accounts for 21 percent of the country's urban population. Comparable figures are 32 percent for Bangkok and Taipei; Seoul 32 percent;; Tokyo 42 percent; Phnom Penh 44 percent; Ulaanbataar 54 percent; and Vientiane 65 percent. The primacy index for Jakarta (12 percent) and Kuala Lumpur (14 percent) are lower, while Chinese cities show the lowest values [Gill and Kharas 2007: 237, Table 5.2].

them (which is what Metro Manila's development is), so that infrastructural development naturally ripples outward from the centre to heretofore less-developed areas (though admittedly *not* in the patchwork manner now observed). Finally, however, it should be pointed out that the "welfare of regions" is ultimately nothing if not the welfare of people. Given the reality of labour mobility, on the one hand, and the cumultaive processes inherent in growth, it may be easier at this time to facilitate people's transfer to more promising regions than to interrupt technological progress and the growth of mass markets.

70. In practice, implementing such a policy-shift entails drawing up a short-list of catalytic projects that are most likely and obviously to support growth in the core areas. Such a list is necessarily short, first, because it limits itself to the most essential infrastructure in a few growth areas; second, fiscal consolidation (particular tax administration reforms) is presumed to take time to complete, during which the government would be prudent to select only the most vital projects.

71. In terms of major physical infrastructure in Luzon alone, as illustration, the following list (albeit partial) appear compelling:

(a) completion of a high speed link from SLEX to the port of Batangas, providing an alternative offloading point for cargo coming from and destined for the metropolis;

(b) work on a high-speed road linking North and South Luzon expressways, facilitating the rapid movement of goods from north to south (and vice versa) without the penalty of wading through Metro Manila's urban congestion;

(c) completion of the road connecting Clark to Subic, linking two major concentrations of firms and creating a synergy between the two;

(d) urgent start of construction to complete and interconnect the light-rail systems for Metro Manila, helping in reduce congestion of roads in the metropolis, which is estimated to cost some billions[22] annually;

(e) operation of the terminal 3 at the existing airport and a definite schedule for the future transfer of the international airport to Clark (assuming the current airport cannot be retrofitted to accommodate later-generation aircraft).

[22] A 2000 paper (Sigua and Tiglao) from the National Center for Transport Studies of UP placed the costs at P100 billion annually.

72. Such a list is meant as no more than an illustration of the scale required to qualify as a core project. To be sure, the administration has identified almost all of these as "priorities". The issue, however, has never been including more projects in a priority list, but rather pruning it. It is not that someone's pet project is missing from Malacañang's list – the real problem is that *everyone's* pet project is apparently on that list, which completely undermines the meaning of the word "priority", anyway. It is debatable, for example, to what extent an international airport is necessary for Bohol when Cebu's is so proximate. The matter smacks entirely of political payback. In terms of future needs, the raising Cebu's single-runway international airport to the *minimal* global standard of having two parallel runways – in tandem with more frequent short flights and efficient sea links to Bohol – may do more for the tourism and commerce for both islands than for each to have an international airport, neither of which is globally up to snuff. The same forward-looking upgrading may actually be warranted for Davao's international airport and leads one to question the wisdom of government caving in to demands to designate Zamboanga, Cagayan de Oro, Gen. Santos, Iloilo, Legazpi, Bacolod, etc. also as "international" airports. The extent of the airport-frenzy will be appreciated by considering how Indonesia – a country of 17,508 islands, measuring 1.9 million km^2, and with a population of 234 million – has not more than 60 airports, of which only nine are international. The Philippines, on the other hand – with less than half the number of islands, only 16 percent the area, and only slightly more than a third of the population – has 97 airports, with 13 claiming to be international and the list still growing. Resource-dissipation, pure and simple.

Laying down rules to mobilise private financing and initiative

73. In other parts of the economy, promoting investment in infrastructure requires no more than for government to leave the field in good order and lay down the rules for the private sector to take over. Such is the case for such sectors as power-generation and -transmission, water-supply and irrigation, and telecommunications, and toll highways, among others. Common to these infrastructure facilities is the fact that they all "club goods": like pure public goods, they can be used jointly; unlike pure public goods, however, their use has the exclusion property, i.e., people can be feasibly barred from availing themselves of it. It is therefore possible to charge for the use of such

facilities, making it is feasible in principle for the private sector to provide them on a cost-recovery, for-profit basis (though sometimes with a subsidy).

74. From this viewpoint, it is a wonder that not more of such facilities have been constructed with private-sector money – and more expeditiously. More often than not, the real obstacle has been the government's failure to define consistent and credible rules for private-sector participation. Processes have frequently failed to: (a) select the most efficient, cost-effective, or investment-ready operator; (b) choose the most appropriate plan and design; (c) install an regime that encourages the optimal number of entrants and investors, i.e., instead discouraging new entrants or encouraging too many. The long-drawn-out effort to implement the power-sector reforms – particularly the sale of NPC and Transco assets – is a paradigmatic example of a disorderly retreat of government from a vital sector. It has been a witches' brew with all the lethal ingredients: government corporate suits unwilling to surrender positions of influence and subsidised at the public's expence; entrenched private-sector interests anxious to protect their lucrative power contracts with government or their self-dealing with allied downstream industries; politically connected carpet-baggers and deal makers on the lookout for a bargain and a quick turnaround; and finally, politicians willing to tailour-make the rules in exchange for a lucrative side-deal. The regime fulfils its own specifications: plant a jungle and only predators will thrive. *Bona fide* investors, whether domestic or foreign, are bound to stay away or at least to bide their time until things become clearer. Privatisations fail several times, mired in mistrust and charges of bid-rigging. In the meantime, of course, time passes and the reality of an energy shortage looms larger.

75. While the power-sector illustrates the case where government failed to induce enough entry, it has also failed in the opposite direction – i.e., allowing too many entrants. This is seen in government's the inability to rationalise the overcrowding in Metro Manila's public-transport system. A glaring disparity in a comparison between Manila and other countries in the region is the abnormally large number of public transport vehicles in the city. Manila has 13,375 public transport vehicles per million[23]

[23] Figures from Gill and Kharas [2007:252, Table 5.7].

persons (compared to only 2,044 for Jakarta, 1,890 for Bangkok, and 1,807 for Hong Kong). More effective regulation, the reduction of vehicles among private operators, and the encouragement of more efficient modes of transport would cause an increase in productivity in the metropolis. A radical change in ownership structure for urban public transport is called for mitigate the problem of vehicle over-deployment (and the resulting congestion) caused by excessive competition among disperse owners. A superior arrangement would be a monopoly or duopoly arrangement – beginning with the EDSA route – with franchise rights auctioned off by government (with the proceeds used partially to buy off incumbent operators).

76. Three well-known (because rare) examples show how credible government rules do work to encourage substantial private investment in infrastructure: the privatisation of the metropolitan water concessions; the deregulation of telecommunications; and the refurbishing of the North Expressway. These instances have been recounted often enough to warrant retelling. Some significant lessons to be learnt from them, however, are the following:

(a) the need for transparent criteria in selecting winners and qualified entrants;
(b) an unequivocal measure for delineating failure and conditions for exit, as well as a procedure to reassign rights once incumbents fail;
(c) the need to commit to a credible process of price-adjustments, triggered by certain observable events; and finally,
(d) the need for an impartial arbiter to resolve disputes or to make determinations regarding states of the world.[24]

77. In all these – credibility, impartiality, transparency, etc. – reputation plays a major role. A good reputation, however, is in short supply for government just now. One solution, as some of the above examples suggest, is instead to "borrow" reputation in the meantime from third parties and outside institutions. Just how effective this is most evident in the award of the water concessions: bidding was designed and sanctioned by the World Bank subsidiary, the IFC; an intricate third-party dispute-settlement mechanism was provided for under the contract itself and paid for by the contractors

[24] This is nothing unique: the introduction of an impartial arbiter or honest broker was the same approach taken in resolving the long-standing and thorny controversy in Philippine basketball.

themselves. Until the time it gains the requisite reputation, government might do well in major infrastructure projects involving the private sector to deliberately tie its hands by *explicitly committing to abide by the judgement of outside parties* such as multilateral agencies, agreed and contractually-stipulated arbitration panels, or even standing bodies, such as the International Court for the Settlement of International Disputes[25] or the International Court of Arbitration. Indeed, government would enhance its credibility by committing *ex ante* to refrain from resorting to its own courts[26]. Apart from reservations about the abdication of sovereignty, the pragmatic objection to such an approach is the potentially high costs involved. This objection is however met by pointing to the restricted and transitory nature of the measure: restricted since it is a recommendation meant to apply only to major infrastructure projects involving the private sector – which we have determined ought to be a short list to begin with – and transitory because it is meant to last only to the extent the government is unable to mobilise investment based on its own reputation. At any rate, there will be cases where high investment, even at a high cost to government, may trump a regime of zero costs and zero investment.

78. Finally, a special problem is thrown up by the government's desire to divest itself of some major infrastructure and utility assets, where it currently cohabits with strategic private sector partners. This typically occurs in unreformed sectors where government implicitly tolerated private monopolies when it wittingly or unwittingly found itself a co-owner (e.g. sequestered Marcos assets). In such instances, inertia and the desire to earn quick privatisation revenues may induce government simply to sell to its "strategic partner". Where its partners are efficient and investment-ready, no harm is done. At times, however, government's cozy strategic partners have self-selected so that they are neither. In such cases, government would do better to hand off its shares to new owners that are more solvent and readier to invest in the utility or facilities. In this manner, mere changes in ownership can result in real increases in capital spending.

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[25] From which the Philippine government recently won a favourable ruling versus Fraport on the NAIA terminal 3 case.

[26] As an aside, the intractability of local courts is an important reason that international arbitration has not made great headway.

Strengthening government's regulatory and planning capacity

79. Under a regime where private sector is to play a major role in implementing infrastructure investment, it is government's role to vet alternative plans and designs, screen contractors, monitor progress and regulate operations. These require skills that differ markedly from those that were required in the era when government itself was directly involved in implementing projects and operating enterprises.

80. The susceptibility of government to manipulation by vested interests, acting either through unsolicited BOT proposals or ODA-financed projects, is partly due to the bureacracy's lack of an independent capacity for long-range planning and for the conduct of detailed pre-feasiblity and feasibility studies. This capacity has eroded through time, partly because the extended budgetary restrictions on infrastructure made such efforts gratuitous, partly because of the loss personnel skilled enough to undertake such exercises, and partly because ODA and BOT schemes purport to build in and conduct such studies in their own proposals at their own cost.

81. Clearly, however, for the quality of infrastructure spending to improve, government must learn to say no when it needs to, and this can come about only if the bureaucracy is equipped with the wherewithal to objectively examine and compare competing alternatives. *In practical terms, the government needs to reorient priorities so that it is prepared to allocate significant amounts to the conduct of detailed pre- and actual feasibility studies on its own account*. The sub-optimal location of the third-terminal project in the current NAIA is an example of planning failure and the bureaucracy's inability to push through with its actual priorities over those of a private proponent. For another, the overpriced and oversold national broadband network, a proposal slated to be financed by ODA, would have had no leg to stand on if bureaucracy had first devoted sufficient efforts to quantifying its costs and benefits in detail. The second half of saying no, of course, is not simply the bureaucracy possessing the right information but also their having the autonomy to resist improper political pressures.

82. This last consideration suggests that the failure or success of an infrastructure catch-up really reflects upon the nature of the country's politics and the way it mediates social interests. All that has been said thus far *presumes* the country's political institutions and political system can accommodate change. The reforms presupposes

that leadership – whether individual or collective – will arise to resolve the collective-action problems that have prevented the country from making headway and marshalling its meagre resources effectively. Yet the impeccable logic of myopia, of subdivision, of dispersion, of social levelling, the quick fix, and the sweetheart deal may be too compelling to overcome. So that decades hence, landing in some overbuilt but dilapidated and deserted "international" airport in a desolate region, a foreign tourist might marvel at the monumental dissipation that characterised the Philippines' self-delusional attempt at development in the early 21st century.

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