

GTZ Philippines

Private Sector Development Program Report

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Philippine-German Development Cooperation Program

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1. Executive Summary

Background

In 2001 the Department of Trade and Industry (DTI) has forwarded a request for Technical Assistance (TA) to the bi-lateral negotiations between the Governments of the Philippines and the Federal Republic of Germany. The goal of the requested TA was to promote the development of a strong private sector to support industries to become locally and/or globally competitive. The idea of the proposal was in principle accepted by the German side for further consideration, but a series of concerns were raised with regard to conceptual and technical issues. In view of the agreed geographical focus of the Philippine-German development cooperation program in the Visayas, it was decided to focus future projects in the Visayas (regions 6, 7, 8).

To address these open issues, an appraisal mission team was fielded to the Philippines from April 15 to 29, 2002 under specified Terms of Reference (**see Annex 1**). The mission team consisted of Mr. Joachim Prey (Team Leader), Dr. Peter Hartig, Mr. Udo Gaertner, Mr. Prashant Rana and Ms. Ulla Toernroos.

The mission members would like to express their gratitude to the GTZ office Manila for the perfect organization of the mission. Likewise, the mission would like to thank all visited institutions and persons for sharing their time and valuable knowledge on private sector and SME related topics and issues.

Framework Conditions

Philippine **economic performance** has been constrained by a combination of external and domestic factors. The regional financial crises in 1998, the worldwide recession in the electronic industry and the general downturn in the world economy were external factors influencing the performance of the Philippine economy. Domestic political and economic factors have also contributed to the modest performance in recent years. These include the crises of political leadership in 2000 culminating in impeachment proceeding against then president Estrada, the unstable law and order situation, and governance problems in the country. On the economic side, the fiscal deficit, deficiencies in infrastructure and the insufficient framework for private sector development are the main issues responsible for a weaker long-term economic performance than elsewhere in the region.

The **incidence of poverty** in the Philippines fell sharply in the first half of the 1990s. Since then, however, poverty reduction has stagnated with poverty incidence rising to 26% in 2000 or above the level of 1997. The differences in incidence of poverty and other social development indicators across the regions mainly reflect the disparities in their access to economic resources. A large proportion of the Philippine's economic activities and population is concentrated in the National Capital Region (NCR), which accounts for almost 31% of the GDP between 1997 and 2000.

Regions 6-8 in the **Visayas** showed economic growth between 1995 and 2000 above the national average. Regarding the poverty incidence Region VI and VIII have the highest figure with 43.0%, while Region VII is below 39.0%. All 3 regions are well above the national average of 34.2% in 2000. Likewise, the HDI index for the 3 regions is well below the national average of 0.625 in 1997.

The **Medium-Term Philippine Development Plan (MTPDP) 2001-2004** lays down the strategies of the new administration for poverty reduction and formulates the development framework for the Government. One of the focal areas will be the accelerated development of SME.

Private Sector and Socio-Economic Development

Poverty and **unemployment** remain the Philippines' most serious economic and social problems. If the government is to "win the war against poverty" at the end of the decade, the economy must grow on a sustained basis and across all sectors, in order to cope with the still high growth of population. Special government or donor financed projects or programs will by far not be sufficient to generate the jobs and income required for a more equitable socio-economic development. The fight against poverty will not be won without a stronger **private sector**.

The **philosophy of a market economy** and free enterprise requires a fundamental change of paradigm in the Philippine economic policies. To support a flourishing private sector the government has to set framework conditions that are conducive to free entrepreneurship but at the same time will also secure faire competition. Thus, in future, the role of the government will increasingly be to make markets work and to a lesser extent to directly intervene in market processes or even substitute private sector activities.

Importance of SME and Major Development Constraints

SME are crucial for the generation of **employment** and **income** and for the **reduction of poverty**. They disperse economic activities to the countryside, and thus contribute to a more equitable distribution of benefits from economic growth. Likewise, this segment provides a strong domestic supply base for globally-competitive industries; and last, but not least, a strong SME sectors can contribute to the development of a strong middle-income class in the Philippines, thus leading to a more stable and domestic driven growth process.

The SME sub-sector is largely **lacking competitiveness**. This is mainly the result of inadequate production facilities, low production productivity, insufficient product quality and a lack of market information. There are several reasons for this:

- The **business environment** is not conducive to a dynamic development of a SME sector with high cost of formalizing and operating small businesses;
- **Business services**, e.g. in the areas of product development and quality, market development, eco labeling, etc. are still mainly provided for by government agencies, special programs or NGOs; variety and quality of business services are insufficient, are not market driven; and, because of subsidization, not sustainable;
- The **financial sector** is not offering adequate and sufficient (medium- to long-term) financing facilities to SME; while there are banks catering to the SME market segment, they have institutional deficiencies, limiting their contribution to SME financing;

- Another obstacle for SME which want to improve their competitiveness is the lack of adequately trained personnel, in particular if they want to upgrade their technology or introduce new product lines.

The Business Environment for SME

The Philippine Government has established special institutions for SME promotion and has implemented various SME programs; their impact seems to be not sufficient to compensate for existing **unfavorable rules, regulations and practices**. These include restrictions on access to markets, regulations and fees that add to the fixed costs of doing business, and laws governing commercial transactions and property rights. In addition to biasing the size distribution of firms, some of these constraints can create incentives for firms to operate in informal rather than formal markets;

Generally, SME wouldn't describe their environment as an enabling one. The more formalized they are the more they feel the burden of administrative and regulative requirements. Thus many SME prefer staying informal and neglecting the laws. Because of the still ineffective enforcement structures both at national and local level this appears to be the most convenient and cost effective way of coping with a failing environment.

Policies and Initiatives to Improve the Business Climate for SME

DTI and in particular its Bureau of Small and Medium Enterprise Development (BSMED) of DTI has started to address this problem and is now in the process of developing a **comprehensive and integrated policy**. DTI is assisting the SMED Council in conducting a comprehensive review of all laws, policies and programs affecting SME. Among the provisions that will be reviewed is the mandatory credit allocation for SME and the Charter of the SBCFG. DTI will propose an amendment to the National Internal Revenue Code to give SME an option to compute their income tax as a fixed percentage of either gross revenue or gross income. Various other laws are under review.

A very interesting initiative is the "Philippine Cities Competitiveness Ranking Project", developed by DTI and the Asian Institute of Management (AIM).

Most businesses and in particular the SME feel the impact of a positive or negative business climate mainly on the local level. In addition, the devolution process in the Philippines has significantly strengthened the mandate of the **Local Government Units** (LGU) to improve the business environment and attract new firms.

Creating an enabling environment is not a one time job of formulating a new law but a continuous effort of trial and error from both public and private sector to identify bottlenecks, elaborate proposals, follow-up their approval and implementation. Crucial for success is the combination of initiatives at national and at local level. Ultimately it is at the local level where the impact and success of such initiatives becomes visible.

Business Services

An initial **Rapid Market Appraisal** (RMA) for 13 selected BS in the Visayas region was conducted in March-April, 2002. The study indicates that, together with other constraints, the malfunctioning of BS markets in the Philippines is hindering the development of SME. There are a number of problems which are limiting the growth and effectiveness of BS markets in the Visayas. These **key problems** can be summarized as follows:

Demand-Side:

- Some SME are unaware of the value of business services.
- Some SME are unaware of the availability of some services.
- SME lack information about business services.

Supply-Side:

- Some services are unavailable.
- Many services are poor quality, inaccessible or inappropriate for SME.
- There is a lack of competition in many BS markets.
- Private providers and BMOs do not perceive SME as a good market.
- Providers lack information about SME demand for services.

Addressing these issues would stimulate the growth of BS markets, enabling more SME to get the services they want to develop their businesses. There are indications that the necessary pre-conditions for effective BS market development exist in the Philippines.

The analysis of the rapid market appraisal results suggests three high potential entry points for the PSDP: Business service market analysis, business information and service development.

Financial Sector

The **financial sector framework** conditions in the Philippines have been considerably improved over the last decade. The basic prudential regulations are in place. Further action is needed to improve the enforcement of existing laws and regulations, especially regarding prudential norms and disclosure requirements. The insufficient protection of creditor rights seems to be one major impediment to a more efficient functioning of the Philippine financial system.

The **banking sector** in the Philippines is still highly segmented. Small and medium sized businesses are mainly financed by private development banks, larger rural banks and only a few small commercial banks, which could be grouped as SME banks. Efforts to down-scale commercial bank lending are insignificant and not very successful.

SME credit access problems are mainly caused by three interrelated issues:

- The information problem;
- The cost problem; and
- The collateral problem.

SME banks could be supported in developing new or improved special SME credit technologies to mitigate these basic constraints; and there is an additional need in enhancing the overall institutional capacities of SME banks to ensure their long-term viability.

Natural partners for a SME financing component are the private development banks, the larger rural banks and a few small commercial banks. Thus, the main criteria for PSDP partner selection is not the type of banking institution but the main target market of the respective bank.

Existing **training facilities** and **concepts** in the Philippines are not adequate or sufficient to improve both the credit technologies and the institutional viability of SME banks. In particular, formal class-room-type trainings or a “bank academy” approach are not catering to the specific needs of individual banks. Assessment of the individual needs of the bank, a strong commitment (in the form of resources) of the bank management and intensive on-the-job consultancy are some of the necessary requirements for a more suitable training approach.

Activities of Other Donors

There are other donors supporting private sector development and promoting SME in the Philippines, e.g. the ADB, CIDA, JICA and USAID. So far, there is no donor agency concentrating its efforts on the SME sector as a cross-cutting intervention area for development. No donor has a comprehensive support strategy for the SME sector in the Philippines as of now.

One consequence for the general PSDP approach is to provide for a comprehensive intervention concept for SME development. With limited resources, the PSDP has also to ensure an approach providing sufficient room for cooperation and networking with other donors and agencies.

The Proposed Private Sector Development Program (PSDP)

The mission identified three **major development constraints** of SME in the Philippines:

- The lack of a business environment at national and local level conducive to the development of a dynamic SME sector;
- The lack of adequate business services for SME;
- The financial sector is not offering adequate and sufficient (medium- to long-term) financing facilities to SME;
- Another obstacle for SME is the lack of adequately trained personnel, in particular if they want to upgrade their technology or introduce new product lines.

The PSDP should focus its interventions on the first 3 areas. The area skills development is not elaborated further, because it is already included in the Project “Expansion of Dual Education and Training (EDET) with TESDA, which will be part of the wider program approach.

The findings of the mission are in line with the recommendations in the sector strategy paper for the Focal area “Economic Reform and Development of the Market System”. Likewise, the proposed intervention areas are principally confirming the program proposal discussed during the last bi-lateral negotiations.

The program’s **overall goal** should be:

To contribute to the generation of employment and income for the poorer strata of the Philippine society.

Program objective is:

To promote the development of a strong and competitive private sector.

Final **beneficiaries** will be SME and micro enterprises with growth potential, their workforce and people looking for work with a specific consideration of female entrepreneurs and workers; small artisans with development potential in rural areas; school graduates and young employees as potential founder of SME.

Intermediate organizations are all SME relevant organizations such as management and technical staff of DTI at national and regional level; management and concerned staff of banks and private business service providers; bank associations and representatives of the private business sector; LGU representatives; and NGOs. Specifically, it is assumed that private SME banks and providers of business services will be the “core group” of intermediary institutions of the PSDP. The Program will establish Public Private Partnership schemes with private enterprises and banks.

Program Approach

Each component will have interventions on national and local levels. This will allow a better cooperation between the different projects and programs and create opportunities for mutually beneficial **synergies**.

Therefore, the Program will introduce innovative and replicable models in the Visayas region and use them as an input for training and capacity building in the concerned institutions, both at regional and national levels (**elevator principle**).

The interaction between the components is guided by the following principles:

- Principle of mobilizing already existing local resources to avoid duplications and over-lapping (principle of subsidiarity).
- Principle of synchronizing different, compatible business-related services (e.g. business- and financial services)
- Principle of sharing resources between components (advisory personnel, data banks etc).

Special emphasis will be put on the willingness of interested public and private institutions to contribute with their own financial and human resources.

In the case of private sector led components, the objective is to develop or improve markets for financial and business services: Thus, sustainability will be ensured by the profitability of the service provided.

Interfaces with Other Projects

The complexity of necessary interventions in support of a more dynamic SME sector requires the use of the whole range of German DC instruments; in addition, close cooperation and coordination with other donors is demanded. Coordination and cooperation with other projects should take into account the specific competencies and experiences of donors and projects, thus saving resources of the PSDP and avoiding duplications and inconsistencies of interventions.

There are several projects of German DC with potential linkages to the proposed program.

Projects of **Technical Assistance** (TA) with cooperation potentials are the “Expansion of Dual Education and Training (EDET)” with TESDA, the upcoming Project “Support of Decentralized Structures in the Visayan Region” with NEDA, the “Coastal and Fisheries Resources Management in the Visayan Sea Project”; and the Leyte Island Program (Sustainable Resource Management Leyte).

Potential synergies are promising between the proposed PSDP and the ongoing **TESDA/GTZ Project**, in particular in the skills and staff development area.

Financial Cooperation (FC) projects with the potential of synergies are the “Promotion of Small Enterprises Project II” and the “Pollution Control Project, Phase II”.

The planned and ongoing projects of **IFC** seem to offer the best potentials for close co-operation with the planned PSDP. As IFC is providing financial assistance in the form of long-term loans and equity, the PSDP could zero in with strategic inputs in the field of technical assistance. Both the Planters Development Bank projects and the planned Bank Holding Company project of IFC could offer the PSDP high impact leverage.

In addition, **interfaces** could be developed between the PSDP and activities of **CIDA, ADB, JICA, Swisscontact** and USAID.

Partnerships with Private Banks and Private Enterprises

The Program actively seeks to involve private enterprises and banks as partners for implementation and to establish Public Private Partnerships. While in the case of private enterprises or business service providers possible partners still have to be identified, the mission had already the opportunity to discuss possible forms of cooperation with **Planters Development Bank**.

Program Implementation

The development of the private sector cannot be the responsibility of one public or private sector institution alone. Various government departments and authorities at national as well as at local levels are involved. In addition the various private sector organizations like chambers and associations, but also the corporations and enterprises themselves play an important role.

However, the **Department of Trade and Industry (DTI)** has a specific mandate for promoting private sector development and coordinating initiatives of other government institutions. DTI faces the challenge of improving its outreach by adopting a clearly defined "facilitator"-role and outsourcing activities to the private sector in future. In the program implementation DTI should focus on those areas of the Program, which concerns its regulatory and coordinating functions both at national and at regional levels.

Implementation Structure at National Level

A **tripartite steering committee** shall be established. The public sector is to be represented by DTI, the private sector by one representative from the Philippine Chamber of Commerce and Industry (PCCI) and one from the bank associations, the civil society by PBSP and as an additional member GTZ.DTI, represented by an Undersecretary, should chair the steering committee. The Steering Committee will be responsible for defining the strategic and conceptual framework, and for monitoring the implementation and the impact of the program. The Secretariat of the Steering Committee shall be set up within the program structure.

Implementation at national level will be carried out by a program office within DTI, but open for **cooperation with private sector institutions**.

- Implementation of Component 1, enabling environment, is carried out by and with the concerned bureaux of DTI.
- Implementation of Component 2 and 3, financial services and business services will be private sector led.
- Skills development and TVET is an important concern of the Program in particular in the regions, where immediate synergies can be seen between the development of business service and the qualification of labor. As there is already a Philippine – German project with TESDA in place, close cooperation with this project will be established both on a regional and national level.

DTI should nominate a fulltime Philippine program coordinator, who reports directly to the Undersecretary responsible for the overall program. The GTZ program adviser will be the main counterpart for the Philippine program coordinator.

Implementation Arrangements at Regional Level

It is suggested to set-up a **Project Implementation Unit (PIU)** in the Visayas to implement the program at regional level. This PIU will implement the TA-component with regard to the 3 identified sub-components. The PIU operates as an independent entity to ensure equidistance with all related project partners that would primarily come from the private sector. These partners could be suppliers of BS, regional

SME-banks or facilitators like DTI and the SMED Councils. They will be selected along a set of criteria in line with the programme objectives.

The autonomy of the PIU is also important to portray a more business like approach to PSDP interventions. This is especially important in an environment where public development activities have taken on a more donor-client relationship even in the sphere of private sector development. One of the novel approaches in the program would be to increasingly use business indicators to monitor and evaluate project activities.

The PIU will be guided by PSDP policies and strategies. These are formulated and discussed by a steering committee consisting of selected stakeholders. The PIU will also provide field level inputs to and coordinate the various program components as well as the GTZ / TESDA project. The PIU will network with various stakeholders at the provincial and regional levels, in consultation with PSDP management.

The PIU will be staffed with qualified international and national professionals in the area of business promotion and financial services. The role of the PIU is to act as a catalyst and not as a service provider in the business services market and financial services market. Hence the PIU infrastructure shall be kept to a minimum.

Next Steps

Beginning of June: The mission suggests to establish a task force on the Philippine side consisting of the potential members of the future steering committee, and NEDA as coordinating body during program preparation.

June and July: Internal discussion of the report on both sides. The task force should prepare a joint position paper of all stakeholders presenting the major issues for the planning workshop.

August: Planning workshop with German and Philippine authorities plus the relevant stakeholders. Final decisions should be made during the workshop.

August onwards: Planning and program preparation according to administrative procedures on both sides.

By mid 2003: Tentative start of the program subject to approval by German and Philippine Government.

2. Introduction and Background

In 2001 the Department of Trade and Industry (DTI) has forwarded a request for Technical Assistance (TA) to the bi-lateral negotiations between the Governments of the Philippines and the Federal Republic of Germany. The goal of the requested TA was to promote the development of a strong private sector to support industries to become locally and/or globally competitive. The idea of the proposal was in principle accepted by the German side for further consideration, but a series of concerns were raised with regard to conceptual and technical issues. In view of the agreed geographical focus of the Philippine-German development cooperation program in the Visayas, it was decided to focus future projects in the Visayas (regions 6, 7, 8).

To address these open issues, an appraisal mission team was fielded to the Philippines from April 15 to 29, 2002 under specified Terms of Reference (see Annex 1). The mission team consisted of Mr. Joachim Prey (Team Leader), Dr. Peter Hartig, Mr. Udo Gaertner, Mr. Prashant Rana and Ms. Ulla Toernroos.

At the outset of the mission, the TOR were discussed and agreed upon firstly between GTZ Country-Director, Mr. Müller and secondly in two meetings with the concerned Philippine agencies, NEDA and DTI. These meetings took place on 15th of April 2002. It was understood that the TORs of the mission reflected adequately the concerns of the German and the Philippine side and that the Mission should go on as planned. DTI and NEDA seconded personnel to accompany the mission in Manila as well as in the regions.

A further concern from the German side was to ensure close exchange of information and coordination with a Project Review and Revision Mission in the Project "Expansion of Dual Education and Training (EDET) with TESDA, starting on the same day.

The mission members would like to express their gratitude to the GTZ office Manila for the perfect organization of the mission. Likewise, the mission would like to thank all visited institutions and persons for sharing their time and valuable knowledge on private sector and SME related topics and issues.

The report starts with an extensive status-quo assessment comprising the macroeconomic, political and social framework conditions as well as the role and actual performance of the private sector in the Philippines (chapter 3). The study identifies and analyses enabling environment, business services, and access to finance as major constraints to private business development (chapter 3.5-3.7).

In chapter 4 programs and projects of German Development Cooperation and other donors are presented.

Chapter 5 of the report outlines the broad concept for a Private Sector Development Program (PSDP), including the rationale, focus and principles of the PSDP, cross-cutting themes, program objectives, target groups, results and activities. Major program components are presented in chapter 6, while possible interfaces with other programs and projects are described in chapter 7. Chapter 8 presents the recommended implementation structures, arrangements, and implementation planning.

The report ends with the necessary next steps (chapter 9).

3. The Status Quo

3.1 Economic, Political and Social Framework

3.1.1 Recent Macroeconomic Developments and Policies

The Philippines achieved growth rates in the range of 5% p.a. prior to 1998 and was less affected by the regional financial crises than its neighboring countries. This comparatively robust economic performance could be attributed to structural and stabilization reforms of the 1980s but also to the delayed start of the “bubble investment” financing in the Philippines. Since the financial crises, however, the country has achieved only a modest economic growth rate of 3-4 percent between 1999 and 2001. This is still higher than in most of the other economies in the region, but the resulting increase of per-capita GNP of about 0.8% p.a. since 1998 is insufficient to provide the basis for sustained reduction in poverty.

Gross domestic investment as a percentage of GNP was 17-18 percent in the last 3 years, lower than the average 20% in the 1980s and 1990s. This compares unfavorable to the other countries in the region with a 30-40 percent range in the last 20 years. Another major problem is the low total factor productivity with growth rates significantly below the rates in other economies in the region. Investments have been financed largely from domestic sources, as foreign investment and capital inflow evaporated until end of 2001. Gross domestic savings as a percentage of GNP grew steadily from 17.5% in 1995 to over 28% in 2000.

Overall growth in recent years has been mainly fueled by continued expansion in agriculture and services, compensating for weaker industrial growth. After suffering from the effects of el Nino in 1998, the agricultural sector bounced back in 1999 and has maintained an average real growth rate of more than 4.5% between 1999 and 2001. Services grew in the same period at 4.2%, while the industry sector growth was less than 2% on the average.

Slow industrial growth has limited industrial employment and consequently limited the absorption of surplus agricultural labor. In absolute terms employment in the industry sector remains currently still below its 1997 level and its percentage share of total employment has decreased from more than 16% in 1995 to 15.4% in 2001. The service sector provided more than 45% of the total employment, up from 40.5% in 1995. The agricultural sector absorbs around 38% of employment, but farm employment remains vulnerable to natural calamities, has relatively low wages and productivity. Total employment rose only by 1.6% on the average in 1998-2001. Consequently, the official unemployment rate remains more or less stable for the last 3 years at around 10-11 percent. The underemployment rate stood at almost 22% in 2000 and the labor underutilization rate at 30.5%.

Accounting for more than 50% of Gross Domestic Product (GDP) in 2001, the service sector has constantly increased its share since 1995 and is the dominant economic sector in the Philippines. The contribution of the industry sector has basically remained the same with almost 30% of GDP in 2001 (1995: 31.2%). Manufacturing accounts for 21.5% of GDP (1995:22.4%). The agricultural sector's development is rather erratic with growth rates between minus 6.6% and 6.5% and the contribution to GDP has continuously declined from 21.0% (1995) to 14.4% by the end of 2001.

Inflation has remained modest, mainly due to good rice and corn harvests and sound monetary policies in recent years. However, rising oil prices and the devaluation of the peso added to inflationary pressure in the last 3 years. This led to a tightening of monetary policy in the second half of 2000, followed by a relaxation during 2001, with reserve requirements and interest rates eased. Inflation figures in 2001 and 2000 were well below 6% per annum. The peso has been relatively stable in 2001.

Exports growth showed double-digit figures until 2000, mainly driven by electronic and IT-related exports, which account for about 60% of total exports. Export growth slowed to 9% in 2000 and experienced a double-digit contraction in 2001 largely as a result of a worldwide downturn in electronics industries. Philippine exports, and especially electronics, have high import contents in the range of 40%.

While in 1999-2000 the Philippines saw large trade and current account surpluses, these surpluses contracted in 2001 due to falling exports, stagnant worker remittances and weak capital inflows, leading to a deterioration of the balance of payments. Portfolio investments, trade credits, and currency deposits registered large net outflows in 2000 and 2001. In particular, portfolio investments declined to their lowest level in more than a decade as a consequence of global market uncertainties but also aggravated by the law-and-order situation in the Philippines.

Until 2000 the debt service ratio remained comfortable at less than 13 percent of exports of goods and services, but rose to more than 17% in 2001. International reserves decreased by one percent after growth rates of 2-4 percent in 1998 and 1999.

The Philippines were able to eliminate its chronic fiscal deficits until the mid 1990s, but this positive development has been completely reversed since then. The national government deficit reached almost 4% of GNP in 2001. Public sector debt has increased to 126% of GNP end of 2000 compared to 99% in 1996. Both developments are mainly due to a steep fall in fiscal revenues. These deficits led to huge government borrowing requirements, rising interest rates and consequently a partial crowding out of private financing demands.

Philippine economic performance has been constrained by a combination of external and domestic factors. The regional financial crises in 1998, the worldwide recession in the electronic industry and the general downturn in the world economy were external factors influencing the performance of the Philippine economy. On the other hand, however, domestic political and economic factors have also contributed to the modest performance in recent years. These include the crises of political leadership in 2000 culminating in impeachment proceeding against then president Estrada, the unstable law and order situation, and governance problems in the country. On the economic side, the fiscal deficit, deficiencies in infrastructure and the insufficient framework for private sector development are the main issues responsible for a weaker long-term economic performance than elsewhere in the region.

3.1.2 Political Developments

With the overwhelming election of President Estrada in 1998 poverty alleviation became one of the prime political and economic themes in the Philippines. The immediate signature of Republic Act 8425, the Social Reform Agenda and the

Poverty Alleviation Act, and the establishment of a National Anti-Poverty Commission clearly showed the new administrations emphasize.

However, the political situation deteriorated in 1999 and 2000 with an obvious "governance deficit", culminating in charges of graft and corruption against the former President. This led to a Senate investigation and an impeachment trial by the end of 2001, followed by public unrest and the replacement by a new Government.

While the new administration was able to improve policy credibility and announced improved governance as a major priority, it remains to be seen if and when concrete action will follow political proclamation. One of the major constraints of the new Government is its lack of democratic and constitutional legitimacy which might hamper its political capacity to continue with structural reforms and tackle widespread and deeply entrenched vested interests.

3.1.3 Good Governance

Improvement in governance issues is a main challenge for any Philippine government and has to tackle the widespread and deeply entrenched underlying institutional, political and cultural weaknesses. According to Transparency International's corruption rating the Philippines not only ranks a relatively poor 65th out of 91 countries, but the rating has deteriorated in 2000 compared to previous years.

The Philippine's relatively poor performance indicates problems in areas such as the law and order situation; the effectiveness, predictability and honesty of the judicial system; enforceability of contracts; weaknesses in public financial management and accountability; and quality of civil services.

These issues affect the general climate for private (foreign) sector investment, the fiscal position of the government, and the administration's ability to deliver public services. In particular, the weak enforcement of property, contract, investor, and creditor rights are, together with personal security concerns, working against a much needed stronger role of private sector in the overall economic development of the Philippines.

3.1.4 Socio-economic Developments

Social indicators for the Philippines have improved in the 1990s. According to the 2000 United Nations Human development report, the Philippines ranked number 70 out of 162 countries in terms of human development, as measured by the human development index. This is a significant improvement from place number 82 in 1998.

However, looking at the poverty situation, the picture seems slightly different. The incidence of poverty in the Philippines fell sharply in the first half of the 1990s, dropping from 34% in 1991 to 25% in 1997. Since then, however, poverty reduction has stagnated with poverty incidence rising to 26% in 2000 or above the level of 1997.

The deteriorating social situation is also evident in the development of the percentage of people living on less than 2 US-\$ per day. Almost half of the Philippine

population, 46% in 2000 compared to 46.5% in 1996 and 53.5% in 1990, is nearly poor, and only relatively modest reduction in their low income can push them into absolute poverty.

The main reason for the stagnation in poverty reduction in the last few years are economic growth rates well below the population growth of more than 2% per annum, and a still very unequal income distribution. Population growth rates in the Philippines are much higher than the regional average of 1.1% in 1999. Poverty in the Philippines remains predominantly a rural phenomenon with about 75% of the nation's poor living in rural areas.

In terms of health indicators (maternal mortality rate, infant mortality), there has been a steady improvement in the 1990s, though to a much lesser degree than its Southeast Asian neighbors. Public primary health care facilities are mainly used by the poor and the quality of services is generally very poor.

In education participation rates are climbing steadily, but dropout rates are also rising. Participation in school has increased at the primary level from 95% in 1996-97 to 97% in the school year 1999-2000. However, three out of ten pupils do not complete grade 6, and in secondary school, less than half of the first-year students complete the fourth year. Especially poor households are hard-pressed to sustain their children's education.

3.1.5 Gender and Development

According to the 2001 Human Development Report, the Philippines ranked 62nd out of 146 countries in the gender-related development index. The Philippines ranked 46th out of 64 countries in the gender empowerment measure.

Women's participation in the labor force is high in the Philippines, compared to other Asian countries; their access to education is not restricted. Overall gender equity is also high with Philippine women holding a major share of higher management positions in Government and the private sector. In addition, women play a major role as manager and/or as owners of SME.

At legislative level Republic Act 7882 is recognizing the special role of women entrepreneurs who are engaged in manufacturing, processing, service, and trading businesses. Government financing institutions are mandated to provide financial assistance to NGOs engaged in developing women's entrepreneurship and to existing and potential women entrepreneurs up to a limit of P 2 million.

However, especially in rural regions and in the poorer strata of the Philippine society women have still to shoulder the domestic burden as well as to contribute to the livelihood of the family.

3.1.6 Environment and Sustainable Development

The deteriorating environment and the effects on the sustainable development of the country are of major concern, mainly in 5 areas:

- Solid waste management;
- Water pollution;
- Air pollution;
- Forest resources; and
- Coastal resources.

Especially, the degradation and depletion of natural resources, such as forests, fishery stocks, and soil erosion, have a direct impact on the livelihood of the vast majority of the Philippine rural population.

In urban areas, and in particular in Metro Manila with roughly 65% of the country's industrial facilities and a population of more than 12 million, surface water quality, air quality and increasing domestic and industrial solid waste are the main areas contributing to a rapid deterioration of the environment. All four major river systems in Metro Manila are biologically dead as a consequence of the discharge of untreated or only partially treated industrial waste; and the Metro Manila's air has been classified as one of the most polluted in the world.

The effects of environmental degradation, whether in the urban centers or in the rural areas, are always felt more by the poor, who do not have the means to mitigate the decline in their resources, living conditions, or health.

Regarding industrial pollution and air and water quality the laws and regulations are basically in place and sufficient. However, enforcement of environmental standards has been less than effective so far.

On the positive side it has to be recognized that environmental awareness amongst representatives of the civil society has been increased in recent years. In addition, decentralization of national mandates and more decision making authority of local government units could provide an opportunity for a stricter implementation of existing environmental standards.

Finally, environmental standards and eco labeling is becoming more and more an important precondition for access to international export markets. Thus, at least export oriented enterprises will have a strong financial incentive to comply with environmental minimum standards.

3.1.7 Regional Analyses

The differences in incidence of poverty and other social development indicators across the regions mainly reflect the disparities in their access to economic resources. A large proportion of the Philippine's economic activities and population is concentrated in the National Capital Region (NCR), which accounts for almost 31% of the GDP between 1997 and 2000. The per capita income in the NCR was at P 28,321 in 1999, compared to the national per capita income of P 11,948, the income per capita in the Visayas of P 8,851 or in Mindanao of P 8,481.

The NCR has the lowest poverty incidence and the highest Human Development Index (HDI). Two regions adjoining the NCR, Regions III and IV, have the next largest shares to GDP and are also second on poverty incidence.

While the HDI for the national capital region (NCR) is higher than those of Thailand and Malaysia, the index in some regions in Mindanao and Visayas is comparable to those in Laos and Cambodia. Life expectancy ranges from 71 years in Pampanga to 52 years in Tawi-Tawi. Primary school enrollment in NCR is 99% compared to 43% in Sulu, and infant mortality rates in the poorest quintile are twice as high as that of the richest quintile.

In general, social indicators follow economic patterns with the Luzon regions (with the exception of the Cordilera Administrative Region) better off than those in the Visayas, and the Visayas regions with lower poverty incidence and higher HDI index compared to Mindanao.

Regions 6-8 in the Visayas have been selected during the last bilateral negotiation as regional focal area for future German development cooperation projects. Their economic growth between 1995 and 2000 has been above the national average of 3.2%, with Region VII (Central Visayas) posting a growth rate of 4.3% per annum, followed by Region VIII (Eastern Visayas) with 3.5% and Region VI (Western Visayas) with 3.1%. This translated into a contribution to the national GDP of 7%, 6.7%, and 2.4%, for Regions 6-8, respectively.

Regarding the poverty incidence Region VI and VIII have the highest figure with 43.0%, while Region VII is below 39.0%. All 3 regions are well above the national average of 34.2% in 2000. Likewise, the HDI index for the 3 regions is well below the national average of 0.625 in 1997.

3.1.8 Decentralization

The Local Government Code (LGC) of the Philippines of 1991 is one of the most far-reaching decentralization approaches in developing countries. The code established 3 levels of local government units (LGU), provinces, cities, and barangays and devolved important responsibilities in almost all administrative areas from the national agencies to the LGU. Likewise, up to 40% of national revenues are channeled to the LGU.

Decentralization has increased local autonomy and provided the basis for government decisions and services more adapted to the specific local needs and requirements. However, the following factors have limited the expected benefits of decentralization:

- Institutional responsibilities for service delivery remain unclear in many areas, with national agencies still playing a significant role in some functions;
- Uneven resource allocations with insufficient resources being channeled to the poorer LGU;
- Revenues mobilized at the LGU level through local taxes are not significantly higher than before the LGC became effective; this indicates that fund allocations from the national government may create disincentives to mobilize local resources;
- LGU have limited capacities for financial management, investment appraisal and planning, and often LGU financial integrity is weak.

There is a strong need for a more systematic and comprehensive evaluation of the LGC implementation. One objective could be the exchange of experiences and lessons-learned between the various LGU and to replicate innovative approaches and concepts to building local capacity, fiscal integrity, and accountability.

3.2 Government Priorities and Policies

The Medium-Term Philippine Development Plan (MTPDP) 2001-2004 lays down the strategies of the new administration for poverty reduction and formulates the development framework for the Government. The MTPDP is based on 4 strategic areas:

Macroeconomic stability with equitable growth based on free enterprise; this includes well-coordinated fiscal, monetary and exchange-rate policies, and the strengthening of the banking system and the development of the capital market, as well as the modernization of all sectors through human resource development and technological progress; major focus will be on the accelerated development of SME, information and communication technologies, and the improvement and expansion of infrastructure facilities; strengthening the role and the participation of the private sector is a major focus.

Modernization of agriculture and the fishery sector with social equity through accelerating agrarian reforms, improving rural infrastructure and implementing land reforms.

Poverty reduction and comprehensive human development by providing improved education and training, enhanced health care, access to shelter and basic services such as water, and electricity; strengthening social protection for the most vulnerable groups through the social welfare system, local safety nets, and social security systems; pursuing balanced regional development and securing peace and order, and development in Mindanao.

Good and effective governance by improving transparency and accountability, reducing graft and corruption, and improving law enforcement and the judicial system.

The MTPDP follows the basic tenets of medium-term plans of former administrations. It is consistent with its diagnosis of major issues and challenges hampering economic growth and social improvement. The priority areas and the strategies outlined are comprehensive and consistent. It remains to be seen, however, to what extent the existing administration has the political capability to implement these strategies. The history of the Philippines contains many ambitious development plans without delivering much.

3.3 Donor Assistance

The Philippines received a total of US-\$1.05 billion of official development assistance (ODA) in 2001, which is an increase in disbursement of more than 5% compared to the previous year. ODA loans commitments stood at US-\$ 13.2 billion financing a total of 202 projects and programs. Major funding source was the Japan Bank for International Cooperation (JBIC) with 61% of committed funds and 91 projects,

followed by the Asian Development Bank (ADB) with 22% and 52 projects. The World Bank (WB) accounted for 12% and 29 projects.

Almost 70% of committed funds were allocated to infrastructure projects, with the energy, power and electrification sub-sector alone accounting for over 37% of total commitments. Agriculture, natural resources and agrarian reform cornered around 15%, the industry and service sector almost 9%, and human development projects slightly over 5%.

The regional distribution of committed ODA funds shows a 21% share of the NCR. The rest of Luzon accounted for 19.4%, the Visayas for almost 10% and Mindanao for slightly less than 7%. Multi-regional and nationwide projects and programs had a share of 20.5% and 22.5%, respectively.

There is a growing consensus among the major donors that poverty reduction is the overarching goal of development cooperation. To reduce poverty in the Philippines requires strategies that will promote sustained economic growth, reduce inequalities in income and wealth distribution, improve the delivery of basic social services, and reform the system of governance. Additional thematic priorities are human development, private sector development, environmental protection and gender.

3.4 Private Sector and Socio-Economic Development

3.4.1 The Role of the Private Sector for Economic and Social Development

Poverty and unemployment remain the Philippines' most serious economic and social problems. If the government is to "win the war against poverty" at the end of the decade, the economy must grow on a sustained basis and across all sectors, in order to cope with the still high growth of population. Special government or donor financed projects or programs will by far not be sufficient to generate the jobs and income required for a more equitable socio-economic development. The fight against poverty will not be won without a stronger private sector.

At the same time the Philippines are challenged by a continuously increasing global competition to improve the competitiveness of key export sectors and of the country as a whole. In order to meet these challenges the Philippines have to increase the export of non-traditional exports such as electronics and microelectronics, diversify its foreign markets and develop its domestic markets.

Philippine foreign trade policy is designed in the context of regional integration efforts, such as the Association of Southeast Asian Nations (ASEAN) or the Brunei Darussalam-Indonesia-Malaysia-Philippines East ASEAN Growth Area (BIMP-EAGA). But the distribution of potential benefits from closer policy coordination, free trade and free flow of capital between the members will be mainly determined by the competitiveness of the individual countries.

The private sector therefore, plays a pivotal role in generating equitable growth which translates in more jobs and income for the poor and at the same time maintains international competitiveness. Competitive industries and service sectors are sustainable sources of stable jobs and income, and consequently, crucial to poverty reduction.

In addition, the role of the private sector in social and infrastructure development has also to be strengthened in order to improve and secure social and infrastructure facilities, e.g. as effective private-public partnerships. Further reforms in individual infrastructure sectors, such as the power sector, have to be accompanied by establishing fair and transparent implementing rules and regulations. Otherwise, there is great risk of only replacing “natural monopolies” by private monopolies.

The philosophy of a market economy and free enterprise requires a fundamental change of paradigm in the Philippine economic policies. To support a flourishing private sector the government has to set framework conditions that are conducive to free entrepreneurship but at the same time will also secure fair competition. Thus, in future, the role of the government will increasingly be to make markets work and to a lesser extent to directly intervene in market processes or even substitute private sector activities.

Basic prerequisites for the efficient functioning of the private sector are the development of the capital market and financial infrastructure; the deregulation of industry, trade, and investment; and the implementation of appropriate policies conducive to efficient market functioning.

3.4.2 Private Sector Structure and the Importance of SME

The Philippine private sector comprises big corporations with less than 1% of all enterprises, a small and medium enterprise (SME) sector with around 9% and micro enterprises, which account for about 90% of the total enterprises in the Philippines. The SME sector employs about 42% of the total enterprise labor force and generates about 15% of the value added. In the manufacturing sector SME account for 37% of gross value and 55% of total employment.

According to official definitions small enterprises are classified as enterprises with assets below P 15.0 million while medium sized enterprises are firms with assets between P 15.0 million and P 60.0 million. Enterprises with assets below P 15.0 million are classified as micro enterprises.

SME are crucial for the generation of employment and income and for the reduction of poverty. They disperse economic activities to the countryside, and thus contribute to a more equitable distribution of benefits from economic growth. Likewise, this segment provides a strong domestic supply base for globally-competitive industries; and last, but not least, a strong SME sectors can contribute to the development of a strong middle-income class in the Philippines, thus leading to a more stable and domestic driven growth process.

Experience in other countries show that most of the larger businesses started small or even at the micro level; and small or medium-sized exporting companies first started their business by supplying the domestic market. So, today's SME are the potential corporate enterprises and exporters of tomorrow. Likewise, not all micro enterprises remain at the micro level, but some of them grow into the small business segment. How many micro enterprises with long-term growth potential will eventually decide to become a formalized small company mainly depends on the conduciveness of the business environment.

Despite their economic and social importance SME have been largely sidelined and somehow fall in between the different government programs aimed at either improving the business environment for the corporate sector or at giving incentives to the numerous micro enterprises. SME are also the ones mostly affected by existing legal and bureaucratic constraints and they are suffering most from a lack of financial and non-financial services.

3.4.3 Anti-Competitive Market Structures

A variety of surveys indicate that Philippine industry is suffering from monopolistic behaviour both at national and at local level. Profit margins are very high in these sectors and prices exceed by far international levels. SME are affected in various ways. They depend heavily on overpriced products and services of monopolized sectors, thus losing competitiveness. They are denied access to distribution channels or networks and forced to sell their products with prices and conditions dictated by cartels.

In the Philippines restraint of competition or unfair trade practices are prohibited by law. However until recently competition laws were not really enforced. Besides being drafted in vague and without precise obligations and fines there was no dedicated body to enforce them. There are some indications that the juridical system and the Government is today more willing to act in favour of competition.

If there is any Philippine authority formally mandated to prevent unfair trade and uncompetitive behaviour it is the DTI through its Consumer Welfare & Trade Regulation Group. It is mandated to oversee pricing via the Fair Price Act and to ensure access of the population to goods and services via an efficient and fair trade. However the DTI is also responsible for industry and export promotion and it cannot be excluded that there have been cases of conflicting interests within DTI.

3.4.4 The role of Business Associations and Chambers

The **Philippines Chamber of Commerce and Industry (PCCI)** is a voluntary organization composed of business enterprises, chambers of commerce and industry associations nationwide. PCCI promotes the interest of the business community through Government representation and advocacy work while also providing business and trade services. PCCI claims to represent all Philippine enterprises. A vice-president is representing the interests of SME in the chamber itself as well as in the various SME related consultative groups of the Government.

The **European Chamber of Commerce of the Philippines (ECCP)** is a service-oriented organization whose main goal is to foster ties and business relations between the Philippines and Europe. The ECCP does this by providing a wide range of consultancy services and by creating linkages between companies, organizations and individuals with existing or potential business interests in Europe and the Philippines. ECCP represents its members' viewpoint on economic and business issues, legislative measures and administrative regulations; it identifies business opportunities and facilitates business contacts. The ECCP has currently about 900 members.

The **Confederation of Philippine Exporters (Philexport)** is a non-profit association of Philippines manufacturers and exporters dedicated to assisting members develop markets, professional management methods and marketing techniques. Philexport admits sectoral exporters associations as well as individual firms.

There are many other associations which claim to represent the SME at national and at local level. Most of these small business associations (SBA) are organized along sectoral or regional lines. SBAs are experiencing major problems such as lack of membership interaction, limited organizational capabilities as well as lack of funds. Only a few SBAs are providing satisfactory services to their members and even less are able to adequately fulfill their advocacy role.

Of all the associations and chambers PCCI is probably the best known and most recognized by the Government and the general public even when it comes to represent the SME. However, it appears that some issues are dominated by the interests of the larger corporate groups and that the interests of the SME sector are considered only if they do not contradict them.

Strengthening business associations and the weight of the SME within, should contribute to a more vigorous national competition policy. The SME sector currently has not enough weight to make its voice heard against the concentration of economic and political power of the large corporate groups.

3.4.5 Summary Assessment of the Performance of the Private Sector

The Philippines is a largely private sector-led and market-based economy, but has achieved relatively modest rates of productivity growth and investment over several decades compared to other countries in the region. There are several reasons for the mediocre performance of the private sector:

- Macroeconomic stability, an important precondition for private sector development, has been elusive during the past;
- Public sector performance and governance have been more detrimental than conducive to private sector development;
- Significant infrastructure deficiencies persist despite considerable progress in the 1990s; and
- The largely oligopolistic structure of the Philippine private sector with high concentration of asset ownership in the hands of large and politically well-connected shareholders and a lack of competition, leading to high barriers to the entry of new firms.

In particular, the SME sector has been suffering from the above mentioned problems, thus leading to a performance well short of expectations and potentials.

3.4.6 Major Constraints of SME Development

The potential role of SME in creating employment and income and in contributing to the reduction of poverty can not be overstated. However, it also has to be

acknowledged that currently the SME sub-sector is largely lacking competitiveness. The lack of competitiveness is mainly the result of inadequate production facilities, low production productivity, insufficient product quality and a lack of market information.

There are several reasons for this:

- The business environment is not conducive to a dynamic development of a SME sector with high cost of formalizing and operating small businesses; while the Philippine Government has established special institutions for SME promotion and has implemented various SME programs, their impact seems to be not sufficient to compensate for existing unfavorable rules, regulations and practices;
- Business services, e.g. in the areas of product development and quality, market development, eco labeling, etc. are still mainly provided for by government agencies, special programs or NGOs; variety and quality of business services are insufficient, are not market driven; and, because of subsidization, not sustainable;
- The financial sector is not offering adequate and sufficient (medium- to long-term) financing facilities to SME; while there are banks catering to the SME market segment, they have institutional deficiencies, limiting their contribution to SME financing;
- Another obstacle for SME which want to improve their competitiveness is the lack of adequately trained personnel, in particular if they want to upgrade their technology or introduce new product lines.

These major bottlenecks are interrelated and reinforce each other; for example, if a small enterprise opts, for good reasons, not to become formalized, it might save business transaction cost; but on the other hand, it will not be eligible to special SME financing facilities or any bank loan because of its informal status.

The following chapters will present a detailed assessment of the 3 areas business environment, business services and financial services considered as most crucial for a dynamic development of the SME sector. The other area, skills development, is not elaborated further, because it is already part of the Project "Expansion of Dual Education and Training (EDET) with TESDA

3.5 The Business Environment for SME

SME operate in a business environment that is determined by government policies, public and private sector institutions, and the availability of infrastructure.

3.5.1 SME Related Economic Policies and Institutions

3.5.1.1 SME - Specific Laws and Regulations

The basic law for SME is the Magna Charta for Small Enterprises, approved by the House of Congress in 1991 and amended in 1997.

Its guiding principles are:

- Minimal set of rules and simplification of procedures and requirements;
- Participation and integration of the private sector;
- Coordination of Government efforts;
- Decentralization and deregulation of authority to the regional and local government levels.

The Magna Charta recommends both general pro SME policies and specific action by the various government agencies at national and local level. In particular it:

- Creates the Small and Medium Enterprise Development Council (SMED). The SMED Council is responsible for facilitating and closely coordinating the efforts of the various public and private institutions concerned with SME;
- It requires all lending institutions, whether public or private, to set aside at least 6% (for small enterprises) and 2% (for medium enterprises) of their total loan portfolio. (This clause will be discussed more in detail in section 3.3, financial sector);
- It creates the Small Business Guarantee and Finance Corporation (SBGFC), which provides direct lending, a rediscounting facility and guaranteed loans to SME.

To qualify for the benefits of the programs under the Magna Charta, enterprises have to be formally registered as business entity.

Another law which was already foreseen in the Magna Charta is currently revised and amended. The “Barangay Business Enterprises Act of 2001” shall encourage the formation and growth of barangay enterprises, particularly those of the informal sector, through the absence of bureaucratic restrictions and the granting of incentives. Barangay Business enterprises (BBE) are defined as microenterprise according to the official definition of assets below 1,500,000 P. Its main provisions are:

- Local Government Units (LGU) are encouraged to establish “One-Stop-Shops” to handle efficient registration and processing of permits and licenses. They are allowed to charge a maximum fee of 250 P (50 US\$) for covering administrative costs;
- BBEs are exempt from national income tax, in addition LGU are encouraged either to reduce or to exempt PPEs from local taxes, fees and charges;
- BBEs are exempt from the Minimum Wage Law;
- Land Bank, Development Bank of the Philippines and the Philippine National Bank shall set aside at least 5% of their total loan portfolio whereas the Small Business Guarantee and Finance Corporation (SBGFC) shall set aside 25% of its funds for BBEs;

- The public institutions that provide non-financial services for BBEs, like DTI, TESDA and others, shall set aside 10% of their budgetary allocations for production, management training and marketing assistance.

This proposal, currently discussed in Congress addresses basic flaws of its predecessor, which got watered down after intense political discussions especially in regard to the exemption from the coverage of the minimum wage and other labour laws. It remains to be seen if this proposal is passed, because even now opposition from various concerned institutions is mounting.

The Magna Charta and the new “Barangay Business Enterprises Act of 2001” are cited here more in detail to demonstrate that in the Philippines there is indeed considerable legislation in place to foster SME development and provide a conducive and enabling business climate in particular for small and micro enterprises. Most of the clauses and stipulations are sensible and justified.

However, it seems that the impact of these laws and regulations is limited both at the firm level and at the institutional level. In practice many of the problems identified in the Magna Charta persist and changes in rules and regulations, if there were any, did not result in significantly reducing the overall administrative burden. The Magna Charta is unknown to many of the micro and small entrepreneurs and considered as not very effective by others.

In the case of the “Barangay Business Enterprises Act” LGU are mainly encouraged to reduce the regulatory burden, but there is no effective mechanism to really ensure corresponding action. There are only a few microenterprises which up to now have registered under the BBE Act, mainly because of fear they would have to pay minimum wages or to come under scrutiny from government.

3.5.1.2 SME in the Medium-Term Philippine Development Plan

The 5 years Medium Term Philippine Development Plan mentions the importance of SME in regard to economic development and to employment generation.

SME are referred to two strategic policy priorities:

- For the Government to “win the war against poverty” at the end of the decade, further action is required to generate the necessary employment and income for the poor. Therefore promotion of microenterprises via microlending and other programs have become a high priority;
- To promote the competitiveness of the Philippine economy in a global environment, the Government is focussing its attention on the promotion of 10 so called "revenue streams", i.e. product clusters in which the Philippines have both international market potential and comparative advantages. Of particular importance is the development of the IT services sector, i.e. call centres, medical transcription centres, software development, etc.

SME play an important part in both strategies. They provide employment and income for the poor and buy products and services of microenterprises. On the other side they perform vital functions as producers, suppliers and service providers in the

prioritized revenue streams. However in both strategies SME are not specifically mentioned and considered.

It is in line with the current discussion on SME promotion not to focus exclusively on SME but to take in account their links and functions in a wider policy frame. Therefore the two current Government priorities, e.g. microenterprise promotion and competitiveness via revenue streams, offer enough entry points for promoting SME. In addition, it is the authors' conviction that both strategies will not succeed with a strong and dynamic link to the respective SME sectors.

3.5.1.3 Small and Medium Enterprise Development Council

The Small and Medium Enterprise Development (SMED) Council which was created by the Magna Charta in 1991, is the country's highest policy making body for SME. It is responsible for facilitating and closely coordinating the efforts of the various public and private institutions concerned with SME. Members from the public sector are the Department of Trade and Industry (DTI), the National Economic and Development Authority (NEDA), Department of Labor and Employment (DOLE), Department of Agriculture, Department of Environment and Natural Resources (DENR), Department of Tourism, the Department of Science and Technology (DSCI) the Chairman of the Monetary Board and others. The private sector is represented by the Philippine Chamber of Commerce and Industry (PCCI), representatives of three regional associations and one representative from the private banking sector.

The SMED Council is chaired by the Secretary of the Department of Trade and Industry (DTI). The Bureau of Small and Medium Enterprise Development (BSMED) in DTI is providing secretariat functions for the Council.

The SMED Council is meeting every month. Although participation should be at secretary's level, actual attendance in routine meetings is often at director's level. The council has established five permanent working groups related to finance, human resource development, information, marketing and technology.

Each province has its own SMED Council, chaired by the Governor, which has set up SME Centers to provide business services to SME. The centers are operated jointly by the private sector, the local government and provincial offices of national agencies involved in SME development. They provide business information, training, consulting services and the use of basic office equipment.

The long-term goal is for the private sector to operate these centers and sustain them by charging fees. Since until now there is not sufficient demand for such services, the government and its partners are continuing to subsidize these centers. In order to reduce this dependence from subsidies 22 pilot centers were selected, which receive additional financial and technical assistance from DTI to strengthen their professional capacity.

In 1998 the SMED Council agreed on the Philippine SME Development Strategy. Its main recommendations are:

- Select priority sectors based on global competitiveness and capacity to generate employment;

- Promote industrial subcontracting, strengthen SME associations and establish linkages and cooperation between small, medium and large firms;
- Strengthen technology and R&D initiatives;
- Create, expand and improve curricular training programs in entrepreneurship, management and technical skills for SME and identify HRD requirements in specific industries;
- Improve access to finance and develop innovative financing schemes.

Another major initiative of the SMED Council is the organization of the annual SME Week in July, where all the concerned public and private sector institutions present their policies and contributions to SME development.

3.5.1.4 Department of Trade and Industry

Within the Philippine Government SME policy formulation and coordination is primarily concentrated in the Department of Trade and Industry (DTI). The DTI has promotional as well as regulative functions. Its objectives are to:

- Create a climate where business can grow, compete and succeed in local and global settings;
- Promote the country as an investment location and an export base for products and services;
- Facilitate major investment projects and provide services to international and domestic companies seeking to establish or invest in projects in the Philippines;
- Promote the competitiveness of SME;
- Promote consumer choice and best value for money through competition;
- Ensure a level playing field for business and enforcement of trade laws;
- Forge alliances with consumer groups to strengthen consumer power.

DTI is composed of 20 line bureaux/support agencies and 14 attached agencies. Satellite offices in 16 regional centers and 78 provinces replicate the work of central office for firms and consumers located in the countryside.

DTI plays a central role in regard to SME development. It is directly responsible for important SME related issues as well as for assisting the SMED Council in coordinating and facilitating SME policy with other concerned public and private institutions. Responsibility for SME development lies with the Bureau of Small and Medium Enterprise Development (BSMED). However, SME development is also a crosscutting issue; therefore a SME group was formed with representatives from various concerned bureaux and coordinated by the Chairperson of the SBGFC.

3.5.2 Major Business Environment Related Constraints to SME Development

Certain aspects of the business environment place a disproportionate burden on SME, hindering their growth and competitiveness relative to larger firms. These include restrictions on access to markets, regulations and fees that add to the fixed costs of doing business, and laws governing commercial transactions and property rights. In addition to biasing the size distribution of firms, some of these constraints can create incentives for firms to operate in informal rather than formal markets.

To establish a level playing field, there is a need to re-evaluate the costs and benefits of regulations that place a disproportionate burden on SME, search for ways of implementing regulations that provide the flexibility needed by small firms, and place greater emphasis on competition and procurement policies to open SME access to markets.

3.5.2.1 Business Permit

To start operation each business has to obtain a Business Permit from its LGU with a string of other permits attached to it. The Business Permit has to be renewed every year. To ensure that the name of a new business is not already given to someone else, the name of a new business has to be registered in the National Business Name Registration System maintained by DTI. In the provinces just getting the name registered could take weeks or even months. DTI is currently undertaking a major effort to modernize the system and make it accessible via the internet, so that the registration can be completed in significantly less time. DTI is planning to further develop this system into a national data base on businesses.

Other national authorities included in the permit process are the Department of Finance (DoF), the Department of Health (DoH), the Department of Environment and Natural Resources (DENR). For example a registration with the Department of Labour is recommended for all businesses with five employees and more, but mandatory from 50 employees onwards.

Even the microenterprises of the informal sector are affected by this regulation. Although only a few of them undergo the entire registration process and become a formally recognized SME, most are registered and subject to specific permits.

In his recent publication "The Mystery of Capital", Hernando de Soto shows the results of research on the procedure needed to formalize informal urban property in various countries. In the case of the Philippines the entire process could necessitate 168 steps, involving 53 public and private agencies. Formalizing informal property is very important for micro and small business, because property is currently the only collateral accepted by banks. This is just an extreme example of how regulation constrains the development of SME.

3.5.2.2 Tax Structures

The business permit process includes registering with the Bureau of Internal Revenue (BIR) for getting an individual tax account number (TAN) and the authority to print receipts, invoices and others. National taxes which affect SME are the value added tax (firms with sales less than 50 000 US\$ are exempted) and in case of the owners the income tax.

Under the Local Government Code, city and municipal governments are collecting taxes on real property, sales and a variety of minor taxes and fees. It appears that the actual amount of taxes paid by the micro and small enterprises is quite modest. They have developed strategies how to avoid the attention of the authorities. However, this does not apply for the group of small and medium enterprises which are fully formalized and have access to the formal banking system. These firms suffer under the complexity of the tax regime, especially in regard to the value added tax which is both complicated to administer and yields little in actual taxes.

3.5.2.3 Investment Promotion

Investment promotion in the Philippines has evolved into a complex and sometimes overlapping system in terms of organizational structure and incentives offered to investors. DTI's Board of Investments (BOI) is charged with the overall coordination, promotion and strategy for attracting investors. In addition there are a variety of other institutions and organizations which administer special economic zones or territories and which offer a wide range of incentives to investors.

At the local level LGU establish their own incentive systems under which investors can qualify for incentives.

Incentives under the Omnibus Investment Code are given to economically desirable projects which are listed in the annual Investment Priorities Plan, IPP. SME which engage in the priority areas of IPP, are entitled to the standard incentives granted under the Code. Among these incentives are income tax holiday, 50% deduction of labor expenses, tax and duty exemption on imported capital equipment and others. SME, which apply for these incentives have to be registered with BOI or the other concerned bodies.

Although there is no direct discrimination of SME, the types of incentives provided are more appropriate for large firms. In general, incentive structures are confusing and overlapping and geared towards attracting foreign or large national investors.

The Retail Trade Act of 1954 reserves the business of direct selling to the ultimate consumer to 100 % Filipino entities. There are now pending bills in Congress which would allow foreign investors to engage in retail trade, thus increasing significantly the pressure on the millions of small stores and retailers.

3.5.2.4 Customs Administration

Another area of concern is customs and regulations related to import or export. This includes storage, shipping and transport. The Philippine economy has opened up considerably in the last years. Tariffs have been reduced and simplified; by 2004 a

uniform tariff of 5% will be adopted. The reduced costs of imported equipment should encourage technology innovations among SME but also increase competition.

The Bureau of Customs is currently undergoing a both technical and organizational modernization process to adapt to WTO standards and facilitate exports and imports.

However, in the actual business of importing or exporting there is still a lot of bureaucratic and intransparent behavior. SME are not benefiting much from the computerization of entries and valuation systems. Often they have no access to the internet or do not use the electronic gateway facility. SME rely on agents or middlemen to overcome their lack of knowledge of procedures and of personal relations. This results in higher transaction costs, reducing the competitiveness of the firms.

3.5.2.5 Environmental Regulation

There are a variety of environmental and sanitary regulations affecting SME. The most important one is the Clean Air Act of 1999 which provides a comprehensive policy for preventing air pollution. The responsibility for implementing the Clean Air Act lies primarily at LGU level. The Department of Environment and Natural Resources, DENR, is responsible at national level for its implementation and enforcement.

The Clean Air Act defines specific limits for air pollutants emitted by industrial plants. The general business permit includes a permit regarding environmental regulations. All enterprises have to prove that they are not exceeding the limits of the Clean Air Act and other pertinent laws. Otherwise they have to provide for an environmental management system and adequate pollution control devices.

Depending on the LGU and on the specific industry sector this can be a time consuming and costly bureaucratic process for SME.

3.5.3 Labor Market

There is no general consensus whether labour market regulation is a major constraint for SME or not. Labour productivity is low but so are the wages. SME are most concerned with the minimum wage setting procedure. Many small and micro enterprises pay wages at or below the minimum wage; therefore, any increase directly affects their cost structure. However, the minimum wage in the Philippines is so low, that it barely guarantees the survival of the workers. Thus, the dependence of many SME on minimum wages only reflects their low productivity and high intensity of the use of unskilled labour.

As a rule, labor laws, including labor standards and labor relation laws apply to employees in all registered SME and in theory even for the microenterprises of the informal sector. These laws include wage rights, tenure rights, working hours, collective bargaining, rights to safe and healthy working conditions, equal opportunities and prohibition of child labor.

The Department of Labor and Employment (DOLE) is charged by the Government to make proposals for liberalizing the labor market through changing the labor code and

making the minimum wage setting process more flexible. However, labor relations are highly politicized and efforts to simplify regulations can meet heavy resistance by trade unions or concerned political parties.

SME react by staying informal or by non compliance with the law. According to findings of a study commissioned by ILO there is a significant gap between the requirements posed by labour related laws and regulations and the actual compliance by the SME, e.g. about 51% of establishments inspected by the Department of Labor in 1999 were found to have violated labor and safety standards, and that about 19% did not pay the correct minimum wage.

SME maintain a very informal work system; they avoid formal employment contracts and do not keep employee files, etc. Incomes are often at minimum wage level or even below. There is only limited knowledge of labor laws and safety and health regulations.

Most affected by complex labor laws and regulations are the medium sized enterprises. They are fully visible for the authorities and even for the trade unions but lack the internal structures which would allow a professional handling of labor relations.

3.5.4 Policies and Initiatives to Improve the Business Climate for SME

3.5.4.1 Initiatives at National Government Level

There are various initiatives going on in reducing the “costs of doing business”. For micro enterprises the above mentioned “Barangay Business Enterprises Act of 2001” should ease administrative requirements and facilitate getting legal. But doubts remain if the act is really passed and implemented at LGU level.

DTI is assisting the SMED Council in conducting a comprehensive review of all laws, policies and programs affecting SME. Among the provisions that will be reviewed is the mandatory credit allocation for SME and the Charter of the SBCFG. DTI will propose an amendment to the National Internal Revenue Code to give SME an option to compute their income tax as a fixed percentage of either gross revenue or gross income. Various other laws are under review.

3.5.4.2 Philippine Cities Competitiveness Ranking Project

A very interesting initiative backed personally by the Secretary of Trade and Industry is the “Philippine Cities Competitiveness Ranking Project”, developed by DTI and the Asian Institute of Management (AIM).

Most businesses and in particular the SME feel the impact of a positive or negative business climate mainly on the local level. In addition, the devolution process in the Philippines has significantly strengthened the mandate of the Local Government Units (LGU) to improve the business environment and attract new firms.

The Cities Competitiveness Ranking Project aims to:

- assess the perception of the businessmen on the competitiveness of their cities;
- to encourage local governments to transform mentally from service providers to economic managers;
- to recognize best practices in city management;
- to build capacity of less competitive LGU by applying lessons learned from other cities.

The study shows that there are a significant number of cities in the Philippines which have successfully tried to create a supportive and enabling business climate.

Benchmarking creates transparency and a competitive spirit. Positive examples and lessons learnt in successful cities become accessible for the others. Although still in its infancies this initiative of DTI and AIM is innovative and merits support to further refine the methodology, to include more cities and to establish it as a national ranking recognized by the concerned cities and LGU.

This project addresses a fundamental problem encountered in many initiatives to improve the business climate for SME. Typically the business climate is the sum of a multitude of regulations, procedures and behaviours defined by various public, parastatal and private institutions at national, regional and local level. There is no such institution which on its own can significantly alter such an environment and have a significant impact on firm level. In particular it is important to raise the awareness of the Local Government Units.

3.5.5 Summary Assessment

The Medium-Term Philippine Development Plan explicitly states the Governments commitment to reduce the cost of doing business and to remove key bottlenecks to investment. However, the problems and bottlenecks to be removed relate more to the foreign and national corporate sector and less to the majority of the SME. SME should benefit from an increase in foreign investment or in exports through their role as providers of services and intermediate products. But there are other laws and regulations which affect mostly the formalized small and medium businesses and which for them are cost and time consuming either to adhere or to circumvent.

Generally, SME wouldn't describe their environment as an enabling one. The more formalized they are the more they feel the burden of administrative and regulative requirements. Thus many SME prefer staying informal and neglecting the laws. Because of the still ineffective enforcement structures both at national and local level this appears to be the most convenient and cost effective way of coping with a failing environment.

The cost of such behavior becomes apparent when a SME needs to invest and realizes that for getting a loan, full compliance with the laws is required. It is a vicious circle which condemns many SME to a stagnant business cycle and excludes them from realizing their growth potential.

DTI and in particular its Bureau of Small and Medium Enterprise Development (BSMED) of DTI has started to address this problem and is now in the process of developing a comprehensive and integrated policy.

However, it has to be taken in account that efforts to reduce the regulatory burden will be met by resistance of all the middlemen who gain their living from it and by certain apathy of the SME themselves. They know how to cope with bureaucracy and see this as part of doing business which affects their competitor in the same way as themselves. Other problems, like access to markets or to finance are felt far more directly and specific and rank higher in their individual problem hierarchy.

Therefore, a policy to improve the enabling environment for SME can not be limited to formulating better laws and regulations. Experience in other countries suggests that simplifying or in some cases even abolishing laws and regulations is preferable. Thus, interest and lobby groups have no entry-points to twist and amend the laws in their favour. It is important to foster alliances between reform minded groups and in particular to involve the private sector both at national and local level.

Creating an enabling environment is not a one time job of formulating a new law but a continuous effort of trial and error from both public and private sector to identify bottlenecks, elaborate proposals, follow-up their approval and implementation. Crucial for success is the combination of initiatives at national and at local level. Ultimately it is at the local level where the impact and success of such initiatives becomes visible.

Actual implementation, however, is rarely successful, because of a lack of cooperation culture and of a tendency to even increase the bureaucratic burden by ever more detailed regulation.

3.6 Business Service Sector

3.6.1 Conceptual Background for Business Services in the Philippines

3.6.1.1 Business Services as a Key Input to Private Sector Growth

Most Asian Governments are now committed to the private sector as an engine of economic growth. It is agreed that in today's business environment, success depends more than ever on coping with rapidly increasing global market forces. In fast changing business circumstances, the private sector urgently demands a more conducive framework and suitable services to establish or sustain competitiveness. Globally, this demand has resulted in dynamic and large business service sectors with an increasing share in national economies. The growth of these service sectors is driven by ever expanding markets for Business Services (BS) which are playing a central role in increasing the competitiveness of the private sector.

Business Development Services respectively Business Services refers to any non-financial service accessed and utilized by an enterprise to assist its business functioning or growth, provided in a formal or informal manner. Examples of BS include but are not limited to training, consultancy, management services, marketing, packaging, product design, quality assurance, distribution logistics, information, internet, computer services, legal services, advertising and accounting. The

availability of appropriate and quality business services for small and medium enterprises forms an essential part of an environment conducive for enterprise growth and development.

3.6.1.2 Changing Approaches to SME Promotion

The promotion of Small and Medium Enterprises (SME) has been an element of Philippine - German Technical Cooperation for many years. Current concepts recognize that access to business services is an essential element of SME support programs. However, experience suggests that the most effective and sustainable way to increase access to business services is by developing private sector markets for those services.

Recent reviews of SME promotion projects have found that business services delivered by subsidized public or NGO organizations do not cater very well to SME' actual demand for business services. Therefore, the provision of services often could not be sustained beyond externally subsidized support and the impact of these services on SME has often been minor. It was also found that the projects' services were not well synchronized with other, supplementing components, such as finance or marketing services. These findings have led to critical debates about how to effectively promote the delivery of business services.

After extensive research and dialogue over the last few years, the Donor Committee on Small Enterprise Development in which GTZ is a member now encourages the development of private markets for BS. The Committee recommends that donors and projects should a) understand existing BS markets, b) identify constraints that prevent BS markets from functioning effectively and c) formulate intervention strategies that stimulate BS markets with minimal distortion of private sector forces. These principles can be followed using a variety of intervention strategies. For example, initiatives can aim to enhance "systemic competitiveness," promote BS product development, expand business information networks, improve the management of supply chains or promote clusters and regional economies. GTZ has embarked on a number of innovative programs using these types of strategies in several other Asian countries including Vietnam, Nepal, Sri Lanka and Thailand.

3.6.1.3 Business Service Market Development

In the efforts to promote private sector growth, there is now an increasing consensus that developing markets for business services is the best way to enable a large proportion of private enterprises to obtain the services they need and want. Programs to develop BS markets aim to address factors which are limiting firms' purchase of the services they want, and / or endeavor to better exploit market opportunities for improving the firms' access to and use of the BS they want.

Experience in other countries show that the necessary conditions for conducting a BS market development program are:

- There is a dynamic private sector;
- There is demand for specific business services. A preliminary indication of demand is that services are being bought, even if the current market is small;

- There is a supply of business services through either public or private providers;
- There are opportunities for market expansion to match increasing demand with supply;
- There are problems constraining the growth of the market, limiting the private sector's propensity to invest and seize the opportunities;
- Some of these problems and opportunities can be addressed by appropriate program interventions.

Examples of market issues that have been addressed with program interventions in other countries are:

Market Issue	Interventions
Consumers want more information about BS. Information available is not validated.	Develop the supply of ICT driven business information services.
There is a lack of appropriate business service products, particularly for small and medium sized enterprises.	In cooperation with existing suppliers, develop and commercialize new business service products.
There is a lack of supply of specific business services. Enterprises cannot get the services they want.	Assist start-up suppliers and help existing suppliers expand or diversify.

3.6.1.4 Developing Business Service Markets in the Philippines

As part of the effort to design the PSDP, the appraisal team commissioned basic research into business services and business service markets in the Visayas region of the Philippines. An initial Rapid Market Appraisal (RMA) for 13 selected BS in the Visayas region was conducted in March-April, 2002. The study indicates that, together with other constraints, the malfunctioning of BS markets in the Philippines is hindering the development of SME. The study also indicates that the necessary pre-conditions for effective BS market development exist in the Philippines. As a result, there are a number of ways the PSDP could stimulate the markets for BS in the Philippines.

Because of its experience in other countries, GTZ is well positioned to develop BS markets in the Philippines. The lessons that GTZ has learned about BS market development in other countries have now been applied in the design process for the PSDP in the Philippines. In April, the results of the rapid market appraisal were used for planning the Component 2 as part of the broader program. This component will complement the other two program components focused on contributing to the creation of a business-friendly environment at the national level and the delivery of demand-driven financial services.

3.6.2 Summary of Business Service Markets Assessment in the Visayas

The rapid appraisal of BS markets in the Visayas was undertaken to determine which of the necessary conditions for BS market development exist in the Philippine context. The rapid appraisal also gathered basic information about BS markets in the Visayas in order to determine if there is a useful entry point for GTZ to make a contribution to the development of these markets. The results of the rapid market appraisal were validated through discussions and field visits conducted during the GTZ mission to the Philippines in April, 2002. The main conclusions from the rapid appraisal and field visits are summarized below.

3.6.2.1 Private Sector Development

The Visayas has a vibrant and growing private sector. The Visayas contributed 16% of GDP nationwide in 2001. GDP for Regions 6 and 7 specifically has experienced growth for the past five years. This growth has been higher than regions in Luzon but not as high as many regions in Mindanao.

Gross value added in the manufacturing and service sectors in Regions 6 and 7 has continued to grow over the past 5 years. Gross value added in construction, mining and quarrying has declined in the past years for Central and Western Visayas. Agricultural, fishery and forestry gross value added declined from 1999 to 2000 in Central Visayas but slightly increased in Western Visayas. Personal consumption expenditure has continued to grow in both regions.

The Visayas is home to 13.5% of the SME in the Philippines or approximately 8,000 SME. These SME provide employment for 263,000 people.

3.6.2.2 Market for Business Services

There is already an existing market for a wide variety of BS in the Visayas. All 13 categories of business services included in the study have been used by SME to some extent. SME' awareness and usage of basic services such as communications, transportation, courier, accounting and legal services is quite high. Awareness and usage of advertising, internet/email services, market information, marketing and sales and training is moderate. Awareness and usage of computer-based marketing and training as well as consulting is somewhat low. While SME' usage of some services is still moderate, the fact that SME are already getting services from existing BS providers shows that there is both a demand for and a supply of business services.

In the Visayas, the most developed BS markets are in Cebu; providers from Cebu often serve clients from other areas. The BS markets in Iloilo are somewhat less developed and those in Aklan are even less developed.

3.6.2.3 SME Demand for Business Services

The study shows that SME demand a wide variety of business services. Demand for basic services is particularly high but there is also some demand for more sophisticated services, particularly from growing SME. The study also showed that in many cases SME can not currently get all types of services they want to help them

develop their businesses. In particular, the study suggests that SME would be willing to pay for relevant and useful business information. In addition, the study identified unsatisfied demand for a variety of other specific business services including better transport facilities, advertising, packaging and package design and computer training.

SME spending on business services appears to be increasing. However, SME in the study often indicated dissatisfaction with the current quality and availability of business services. Many SME in the study create in-house services in order to control the quality and costs of the services.

3.6.2.4 Business Service Providers

There are a wide variety of private and public BS providers in the Visayas. The private sector, business membership organizations and public agencies are all offering some services to SME in the Visayas.

The private sector already offers a variety of services to SME. In general, large private sector companies supply communications services, internet connections, courier services, transportation, training and marketing related services. Small private sector companies provide advertising services, internet access and business centers. Private individuals provide accounting services. In general, private BS providers suffer from many of the same limitations as their SME clients. Many private providers have limited business planning and marketing capability. They are often not aware of the potential of the SME market. They do not proactively try to reach new markets or develop new products. However, some private providers are starting to realize the importance of improving their businesses and providing better quality services to their clients.

Business membership organizations (BMOs) offer a wide range of services to their members, such as training, marketing linkages, market information, accreditation, technical assistance, consulting and policy advocacy. However, services are usually limited to members and business membership organizations often exclude SME from their market.

A variety of public agencies offer services to SME. The most active of these is the Department of Trade and Industry (DTI) which offers business information and consulting as well as investment promotions and trade development. Other public providers offer training, some business information and consulting. These services are free or highly subsidized.

3.6.2.5 Main Constraints of Business Service Development

There are a number of problems which are limiting the growth and effectiveness of BS markets in the Visayas. These key problems can be summarized as follows:

Demand-Side:

- Some SME are unaware of the value of business services;
- Some SME are unaware of the availability of some services;
- SME lack information about business services.

Supply-Side:

- Some services are unavailable;
- Many services are poor quality, inaccessible or inappropriate for SME;
- There is a lack of competition in many BS markets;
- Private providers and BMOs do not perceive SME as a good market;
- Providers lack information about SME demand for services.

Addressing these issues would stimulate the growth of BS markets, enabling more SME to get the services they want to develop their businesses.

3.6.3 Potential Entry Points for the PSDP

The analysis of the rapid market appraisal results suggests three high potential entry points for the PSDP: Business service market analysis, business information and service development. The rationale for each is discussed briefly below.

3.6.3.1 Business Services Market Analyses

There is currently little known about BS markets in the Visayas. Both private and public providers themselves lack information on demand and competition. For many service markets, there are few specialized services appropriate for SME or for specific business sectors such as agro-processing. Many SME lack awareness and information about available services and the providers of those services. Gathering, analyzing and disseminating information on business services markets would stimulate market development by helping providers meet SME demand for services and SME learn about existing services and providers. Information on BS markets would also be useful to public agencies and donors aiming to promote SME development in the Visayan region.

3.6.3.2 Business Information

There is a lack of relevant and useful business information available to SME in ways that they demand. This includes information about business services but also about a variety of other business topics such as markets, technology, prices, suppliers and regulations. In fact, most SME rely heavily or exclusively on personal sources of information which limits the reliability and range of the information. Existing information and information services are not tailored to the demand of SME and are used mainly for academic purposes. The study suggests that SME would be willing to pay for accurate and relevant business information. DTI realizes the significance of business information for regional growth and is open to exploring innovative delivery mechanisms. A variety of private providers are well placed to diversify into the delivery of demand-driven business information. In other countries, the development of business information services has helped to stimulate other BS markets as well.

3.6.3.3 Business Service Development

Many services that SME want are not available, are inaccessible or are poor quality. A general weakness among BS suppliers is their lack of proactive service development. GTZ has experience in other countries in assisting providers to develop new, specialized service products that are demanded by SME. Assisting

Visayan BS providers to develop and commercialize new service products in a variety of service areas would strengthen the supply of services, increase competition and provide SME with access to more services they want.

3.7 Financial Sector

3.7.1 Legal and Regulatory Framework

Extensive reforms in the 1990's and especially a more autonomous central bank have contributed to a far less depressed Philippine financial sector. Likewise, the legal and supervisory framework of the Philippine banking system has been improved over the recent years. Since the Asian financial crises, the Philippine central bank (BSP) has significantly tightened its policies in order to strengthen the banking system. The General Banking Act enacted in May 2000 provides the legal basis for a major overhaul of prudential regulations and supervision. Prudential regulations have been improved e.g. in the areas of higher capital norms, tighter loan classification and provisioning rules.

However, the ability of the BSP to implement and enforce new rules and regulations is still hampered by limited resources and staffing. A number of recent bank failures resulted from violations of already existing regulations, which were not detected by the regulators. In addition, the Philippines have a highly fragmented banking system with more than 1000 financial institutions. Thus, the sheer number of financial institutions imposes a heavy burden on the supervisory function of the BSP. Consequently, while statutory accounting guidelines in the Philippines are sound, there is limited institutional capacity to enforce accounting principles and prudential norms.

Other impediments to an effective supervision are the poor standard of governance and disclosure, especially in many smaller and family-owned institutions. But even in larger private and especially government-owned banks political influence and "special personal relationship" sometimes might be more important than economic considerations.

A major constraint for the development of an efficient and effective financial system is the weak protection of creditors under law as well as under bankruptcy protection. Even secured creditors do not have adequate protection from stay of foreclosure and do not necessarily enjoy a priority in payment. Creditors do not have sufficient say in the reorganization of companies of defaulted borrowers and most default cases are solved in a friendly settlement between creditor and borrower (through *dacion en pago*) without legal recourse. This weak state of creditor rights (and reinforced by judicial problems like case delay and corruption) tends to prevent the banks from lending to new clients and supports the already existent preference of commercial banks for intra-group lending.

In summary, the financial sector framework conditions have been considerable improved over the last decade. The basic prudential regulations are in place and the supervisory powers of the BSP have been enhanced. However, further action is needed to improve the enforcement of existing laws and regulations, especially regarding prudential norms and disclosure requirements. The insufficient protection of creditor rights seems to be one major impediment to a more efficient functioning of the Philippine financial system.

3.7.2 Major Features of the Philippine Financial Sector

3.7.2.1 Institutional Structure

The Philippines' financial system is dominated by the banking sector accounting for more than 80% of financial assets. The contractual savings sector (public and private pension plans, life insurance companies) and capital markets are less important and cater mainly to the domestic financing needs of the government. Within the banking sector commercial banks are the dominant players with more than 90% of assets, loans and deposits, followed by thrift banks and rural banks (and cooperative banks) with 7.5 % and 2 %, respectively.

Philippine banks are represented by three associations:

- The Bankers Association of the Philippines (BAP) representing the commercial banks;
- The Chamber of Thrift Banks (CTB) representing the private development banks, the savings and mortgage banks and the stock savings and loan associations; and
- The Rural Bankers Association of the Philippines (RBAP) representing the rural banking system.

The mandate of all three associations is to support their respective member banks in the areas of information-sharing, publications, conduct of seminars and trainings, and advocacy.

The RBAP currently cooperates with USAID in a micro finance program in Mindanao.

3.7.2.2 Major Features and Issues

The Philippine banking sector has three distinct features: It is highly concentrated, it is fragmented and it is segmented.

There is a high concentration with the largest 6 commercial banks controlling about 60% of all bank assets. Commercial banks are often part of family owned business conglomerates, and tend to operate more as in-house banks and less as commercial financial institution for the private sector. The conglomerate structure of banking in the Philippines is not only a challenge to effective supervision but leads to serious weaknesses in transparency and information disclosure.

Regarding the institutional structure, the Philippines have a highly fragmented banking system with more than 1000 financial institutions. The rural banking system alone accounts for more than 800 banks. The impact of the Asian financial crises has increased the pressure for consolidation and many smaller and even medium sized banks will not survive in the medium to long run. Many of these banks, which suffer from poor management, inadequate corporate governance and a vulnerability to related-party abuses, have recently run into financial difficulties. For example, it is estimated that not more than 50% of the currently existing rural banks will be capable to survive under increased competition and without prolonged subsidies.

With regard to service markets the banking sector is still considerably segmented: Small and medium sized businesses are mainly financed by private development

banks, larger rural banks and only a few small commercial banks. Commercial banks are normally only catering to the need of corporate finance and export financing. Micro enterprises generally receive loans from rural banks, the cooperative sector, NGOs and informal financial institutions.

Banking operations and especially the lending business are concentrated in the Metro Manila area and the regional growth centers, while the majority of enterprises in rural areas have to depend on rural banks, informal and semi-formal financial institutions.

Commercial banks have increased their presence in areas outside Metro Manila, mainly through acquisition of select thrift banks and rural banks. But their activities are mainly restricted to deposit mobilization and not lending, thus transferring mobilized rural resources to urban areas and for consumer and corporate lending. Private development banks and rural banks on the contrary have regionalized activities and use locally mobilized resources mainly for local lending.

The Philippine banking system is mainly focused on short-term tenors and prefers highly collateral based lending.

3.7.3 Performance of the Banking System

3.7.3.1 Asset Quality

The performance of the banking system as a whole has continuously deteriorated in the last years but is still better off compared to other countries in the region. In particular the asset quality has declined from 12% in 1999 to almost 19% at the end of 2001. In absolute terms non performing loans (NPL) increased from 1999 to 2000 by almost 26%; and from the second quarter to the third quarter in 2001 alone NPL rose by almost 6%. In addition, foreclosed assets have grown significantly over the last years and currently (9/2001) account for almost 5% of total assets of the commercial banking system in the Philippines (1997: 2%). The deterioration in portfolio quality is reflected in rising loan loss provisions with an increase of nearly 35% between end of 1999 and August 2001. Loan loss provisions are currently 7.8% of total loans (1999: 5.7%), covering almost 44% of current NPL (1999: 46.5%; 2000: 43.6%).

It is rather doubtful whether the problem of rising NPL and deteriorating portfolio quality can be solved in the short run. The magnitude and the political sensitivity of the NPL problem together with the Philippine culture of “muddling through” will definitely prevent the implementation of fast and consistent remedial measures. The creation of asset management corporations (AMC) has been discussed in the Philippines for some time, following the examples of South Korea, Japan and Indonesia. AMC are designed to acquire NPL from the Philippine banks at discounted rates thus cleaning the bank’s balance sheets. The major issue to be solved is the initial capitalization of the AMC which mainly has to come from foreign private investors. However, foreign investors are not allowed to own and control real estate property in the Philippines and the elimination of existing restrictions needs legislative approval.

3.7.3.2 Financial Performance

While Philippine banks have been one of the most profitable banks in the region profitability is steadily declining since 1996. Returns on average assets (ROA) and equity (ROE) declined between 1996 and the first half of 2001 from 2.2% to 0.6% and from 15.9% to 4.3%.

The capital base of the Philippine banks is also deteriorating, although the banks' nominal capital levels remain strong relative to their neighbors. Capital/Asset ratio was at the end of 2000 at 10.9% compared to 11.7% in 1999 and 13% end of 1998.

Decreasing asset quality and deteriorating capital adequacy has led to almost stagnating loan releases of banks in the past years. As one consequence, credit access problems of SME have increased and SME have been largely "crowded out" by conservative lending policies and stricter credit requirements.

3.7.3.3 Major Issues in SME Finance

SME credit access problems are mainly caused by three interrelated issues: The information problem, the cost problem and the collateral problem.

SME have difficulties in conveying reliable and trustworthy information about their ability and willingness to repay a loan to the lending bank. Banks request audited financial statements as major source of enterprise information. Majority of SME are not able to provide these statements and even financial statements audited by domestic auditors are in many cases not accepted by the banks because of doubts about their reliability.

Knowing the unreliability of the financial reports from SME, banks have to reconstruct the financial standing of the business through extensive site visits, and double checking with the SME's main clients and suppliers. This is cost intensive and the willingness and ability of banks to undertake this extra effort is limited due to cost considerations. SME are confronted with an unfavorable cost-income ratio compared to bigger companies: The high screening cost of banks can not be sufficiently compensated by higher income because of the comparatively small loan amounts borrowed by SME. While part of the higher cost can be covered by higher interest rates, there is a limit due to adverse selection problems of too high interest rates.

The credit access problem of SME is even worse because of the difficulties of SME to provide acceptable security. Generally, collateral has two functions for the bank: Firstly, it serves as a fall back position for the bank in case the financed investment will fail and the loan has to be repaid from the proceeds of the liquidated collateral. Secondly, it serves as an important instrument to prevent moral hazard of the borrower by enforcing and securing his willingness to repay. Thus, collateral also reduces the information requirements and screening costs of banks. Traditionally, real estate mortgage is the most acceptable form of security required by the banks, while SME typically can only offer inventories, purchase orders and accounts receivables as collateral. One instrument to close existing collateral gaps is a credit guarantee by a third party. However, existing credit guarantee schemes in the Philippines have not proven to be very significant and efficient.

The above mentioned problems render the relation between banks and SME into a “precarious partnership” characterized by information problems and lack of mutual trust. This is especially valid for new SME borrowers and for banks not accustomed to the SME credit market. So it is not surprising that SME down-scaling approaches of commercial banks, for example, have not been very successful and have been implemented only on a very limited scale; and the start of such schemes is sometimes more attributable to political rather than business motives.

Due to the segmentation of the Philippine financial system it seems more promising to strengthen banks, which already cater to the SME market. These “SME banks”, mainly private development banks, bigger rural banks and a few small commercial banks, need support on two levels.

As in the case of micro finance there is a need for the development of a special SME credit technology, which has to find solutions to the above discussed information, cost and collateral problems of SME. Based on the experience of SME banks already existing SME credit procedures and products have to be reviewed, improved and standardized.

In addition, these SME banks have to be supported to increase their corporate governance structure, common management systems and institutional planning capacities, thereby enhancing their competitiveness and institutional viability. Increased competition and the pressure for consolidating the fragmented banking system will increase the willingness of many SME banks to undergo major institutional restructuring.

Both support approaches will also help SME banks to get better access to wholesale lending facilities as they will be in a better position to meet accreditation criteria of existing and new wholesale lending programs.

3.7.4 Existing Training Facilities and Concepts

Existing training facilities and concepts in the Philippines are not adequate or sufficient to improve both the credit technologies and the institutional viability of SME banks. The vast experience in on-going SME financing projects provide strong evidence that bank training without commitment of the bank management and without intensive on-the-job consultancy is not very effective. In particular, formal class-room-type trainings or a “bank academy” approach are not catering to the specific needs of individual banks.

In the area of micro finance USAID is implementing an institutional improvement program for rural banks together with RBAP, the Microenterprise Access to Banking Services (MABS) program. The main features of the technical assistance and training package are the assessment of the of the candidate bank, the involvement of top management, an 8 months on-the-job coaching by consultants, and 18 months of monitoring, advising and troubleshooting by the consultants.

While the content and methodology of the MABS program is not suited for SME banks, the general assistance approach could provide valuable experience for the PSDP.

3.7.5 Special SME Credit Policies

While subsidized interest rates have basically ceased to exist as SME support instrument, the Philippine Government is still intervening in financial markets with the objective to increase SME access to credit. The 1991 Magna Charta for Small Business requires banks to allocate 2% and 6% of total lending to medium and small enterprises, respectively. However, there are legal means to circumvent these credit allocation requirements by referring to the “substitution clause”, which allows banks to meet the requirements by acquiring government securities or invest in the Small Business Guarantee and Financing Corporation (SBGFC). It is difficult to measure the effectiveness of these credit allocation requirements in redirecting funds to the SME sector in quantitative terms. Based on experience in other countries, it remains rather doubtful whether mandated lending has increased the access of SME to bank credit.

Both Government owned banks, The Development Bank of the Philippines (DBP) and the Land Bank of the Philippines (LBP) play major roles in channeling externally financed long-term credit facilities directly or through retail lending banks to SME (see para). In addition, they are the major implementing agencies of nationally financed directed SME credit programs. At a much smaller scale, the SBGFC is providing financial assistance, mainly in the form of loans and rediscount facilities, to SME. All wholesale lending programs are currently suffering from a lack of active retail lending banks, mainly due to accreditation problems and high transaction cost.

In addition, there were and are various special credit and guarantee programs sponsored by the Philippine Government but most of them have been stopped either voluntarily or because of financial difficulties. Also, the number of borrowers and the volume of loans and guarantees extended were not significant.

3.7.6 Summary Assessment

The financial sector framework conditions have been considerable improved over the last decade. The basic prudential regulations are in place. Further action is needed to improve the enforcement of existing laws and regulations, especially regarding prudential norms and disclosure requirements. The insufficient protection of creditor rights seems to be one major impediment to a more efficient functioning of the Philippine financial system.

The banking sector in the Philippines is still highly segmented. Small and medium sized businesses are mainly financed by private development banks, larger rural banks and only a few small commercial banks, which could be grouped as SME banks. Efforts to down-scale commercial bank lending are insignificant and not very successful.

SME credit access problems are mainly caused by three interrelated issues: The information problem, the cost problem and the collateral problem. SME banks could be supported in developing new or improved special SME credit technologies to mitigate these basic constraints; and there is an additional need in enhancing the overall institutional capacities of SME banks to ensure their long-term viability.

As discussed in chapters 3.7.2.2 and 3.7.3.3, the main natural partners for a SME financing component are the private development banks, the larger rural banks and a

few small commercial banks. Thus, the main criteria for PSDP partner selection is not the type of banking institution but the main target market of the respective bank.

Existing training facilities and concepts in the Philippines are not adequate or sufficient to improve both the credit technologies and the institutional viability of SME banks. In particular, formal class-room-type trainings or a “bank academy” approach are not catering to the specific needs of individual banks.

Assessment of the individual needs of the bank, a strong commitment (in the form of resources) of the bank management and intensive on-the-job consultancy are some of the necessary requirements for a more suitable training approach.

4. German Development Cooperation and Projects of Other Donors

4.1 Projects of German Development Cooperation

The overarching objective of German Development Cooperation in the Philippines is poverty alleviation. Its focal areas are:

- Environmental policy, protection and sustainable use of natural resources;
- Economic reform and development of the market system;
- Drinking water, water management, sanitation and waste management;
- Health, nutrition and family planning.

To complement these focal areas the following crosscutting issues are developed:

- Good governance;
- Decentralization;
- Private-Public-Partnerships (PPP) focused on IT.

Implementation will take place both on national level and on regional and local levels with a focus on the Visayas Regions.

Contribution of German DC in the focal area “economic reform and development of the market system” parts from a systemic approach to competitiveness on the macro level (legal and administrative framework conditions), on the meso level (institutions, associations and chambers, private service providers, networks) and on the micro level (enterprises, employed men and women, young people, etc.). In the future, the contribution of German DC will concentrate on the framework conditions and on systematic meso level interventions.

4.1.1 Technical Cooperation

On-going TC projects with relevance for the proposed PSDP are:

- The Project “Expansion of Dual Education and Training (EDET) with TESDA which is promoting modularized dual education and training in regard to improve the supply of skilled labor for SME;

- The upcoming Project “Support of Decentralized Structures in the Visayan Region” with NEDA. Its main focus is to strengthen the capacity of local government offices in regard to integration of planning, budgeting and management of local and regional government. This project will be of particular importance for the proposed activities on improving the business climate on LGU level in the Visayan Region;
- The “Coastal and Fisheries Resources Management in the Visayan Sea Project”;
- The Leyte Island Program (Sustainable Resource Management Leyte) (see chapter 8);
- The various ongoing and upcoming PPP initiatives.

4.1.2 Financial Cooperation

On-going projects of German Financial Cooperation (FC) in the SME sector are 4 credit lines funded by the German Government through KfW. 2 projects, “Credit Line for SME”, with an amount of Euro 45 million each, are channeling loans through DBP and LBP for the financing of the foreign exchange cost of SME investments. Both projects are experiencing disbursement problems caused by a lack of demand from SME for foreign exchange denominated credits and problems of accrediting a sufficient number of retail lending banks. Both projects are being redesigned.

The project “Promotion of Small Enterprises Project II” is a long-term wholesale lending facility channeled through the NGO Philippine Business for Social Progress (PBSP) to small banks, mainly private development banks and rural banks. LBP is acting as legal borrower of the Euro 6,5 million KfW loan. The sub-loans are financing fixed asset investments and working capital requirements of micro enterprises and SME. The project applies an innovative wholesale lending approach and is highly recognized by the retail lending banks. Despite the impact of the financial crises the repayment rates, both at the enterprise and retail lender level, are still satisfactory compared to industry average.

KfW has one more project, namely the Industrial Pollution Control Project, Phase II, which involves the provision of sub-loans to industrial enterprises, primarily SME, to finance environment related investments. DBP is the project executing agency. A technical assistance consultant is supporting DBP in project implementation. The loan amount is Euro 18 million and the project implementation started in 2001.

Phase I of the project has been completed in 2001 after financing 26 investments, primarily in SME in the food industry and in metal works. Waste water treatment, hazardous waste treatment, and air pollution abatement were the priority environmental sectors. The technical assistance which started in 1998 provided on-the-job coaching and training to DBP on environmental technology aspects. In addition, the consultant assisted in conducting seminars and workshops on the principles of ISO 14 001, on environmental due diligence and on good housekeeping.

4.1.3 Other Forms of Cooperation

Integrated experts and volunteers from the German Development Service are working in institutions related to vocational training and SME development. The PSDP will look for developing synergies wherever possible.

Of particular importance is the work of the German Political Foundations. Although they are not explicitly involved in private sector development, they are very active in promoting good governance and capacity building of local and regional government units. Cooperation potential is seen when it comes to improve the business climate at local and regional levels, in particular within the Initiative “Competitiveness of Cities”.

4.2 Projects of Other Donors

4.2.1 SME Promotion Projects

The enabling environment for SME is becoming an increasingly important aspect on the donor’s agenda. In the monitoring list of the Donors’ SME Roundtable eight activities relate to SME policies. The more relevant activities are:

- In the sub-sector of finance and industry ADB’s support has a special focus on SME development, financial sector reforms, promoting competition and fostering competitiveness, liberalization of trade and investment. The Asian Development Bank (ADB) has just finalized a technical assistance project with DTI on “Strengthening Export Competitiveness” and is preparing a substantial loan program for promoting exports in the Philippines. An interesting and special new focus of ABD operations is the promotion of sub-regional economic cooperation within the BIMP-EAGA Initiative. It aims at achieving cross-border complementarities in production (with part of Indonesia), joint infrastructure provision and closer cooperation in trade and finance;
- CIDA has been implementing a comprehensive support program for SME Private Enterprise Accelerated Resource Linkages (PEARL) in the Visayas. Recently, the planning process for PEARL II from 2002-2007 with a TA-component of US \$8.6m has started. In the upcoming second phase of CIDA’s SME Promotion Program, improved policies and regulatory frameworks is included. PEARL II will operate in the Visayas with a new mandate. Its office will be located in Cebu;
- World Bank is involved in programs accelerating environmentally sustainable rural development and enabling expansion of the private sector;
- International Finance Corporation (IFC) promotes agri-business and support to SME;
- Japan’s JICA, which has engaged an expert on policy reform and institutional set-up for SME and contributed to the Philippine Small and Medium Scale Enterprise Development Plan (JICA) 2002;

- To assist the Philippine Government on policy reform USAID offers “demand-driven technical assistance” to concerned government and non-government organizations;
- DENR has completed the first phase of its PRIME Program, which aims to introduce and promote cleaner production and the concepts of eco-efficiency. The program was financed by UNDP and a second phase is under consideration.

However, up to now there is no major programme directed mainly to improve the enabling environment for SME, either they are directed to improving the investment or export climate or they are broader programmes in which enabling environment is only one aspect.

4.2.2 Business Services

Swisscontact designs, manages and implements market-driven enterprise development programs to enhance competitiveness in selected sectors or regions. The programs are in line with the international discussion and guidelines for donor interventions to develop Business Development Service markets. The company maintains a network of field-based specialists and is currently involved in the implementation of a variety of programs with the assistance of USAID, ADB and EU, such as:

- The Enterprise-Based Training (EBT) program is a dual vocational skills training program for workers in the metal sector. EBT aims to improve productivity, product quality and enhance workers' employability. The program covers the area of Mindanao and the Visayas;
- In the Department of Agrarian Reform (DAR) –ADB program, Swisscontact is working with two Agrarian Reform Community (ARC) projects, primarily on gender mainstreaming and planning for a 'gendered' enterprise development support program' for the ARC;
- The Product Development Program (PDP) of the Caraballo and Southern Cordillera Agricultural Development Program (CASCADE) is implemented through the Department of Agriculture, co-financed by the European Union (EU) and the Philippine Government. It covers 19 municipalities in the area of micro-enterprise development, formulation of development plans, BDS-support packages and BDS market development.

4.2.3 SME Finance

Only three major donors are currently active in SME credit and finance. ADB has commissioned a SME Development Technical Assistance Project and plans a SME Export Development Program in 2002 and a Rural Microfinance II Project in 2003. Details of both projects have still to be determined.

IFC has invested US-\$ 25 million through a loan and quasi-equity in Planters Development Bank, which is the largest Philippine bank specializing in SME lending.

IFC is providing technical assistance to Planters Bank in various areas, e.g. credit risk management, asset/liability management and overall corporate strategy development.

In addition, IFC has principally agreed to provide financing for an apex bank project with Planters Bank as wholesale lending institution and thrift banks and rural banks as credit retailers.

IFC and Rabobank are in the process of preparing the concept and design of a Bank Holding Company with a possible engagement of FMO and ADB. The basic idea is that the bank holding company will invest minority stakes in local and regional SME banks, most likely private development banks and rural banks. The Holding Company will be capitalized with around US-\$ 40 million and will be managed by Rabobank. The objective of the project is to strengthen SME banks through equity contributions and technical assistance provided by the Holding Company. It is envisaged that after enhancing the institutional capabilities and competitiveness of SME banks they will be able to generate a return on investment for the Holding Company sufficient for its sponsors to develop further activities. Details of the project have still to be determined.

US-AID is supporting the Microenterprise Access to banking Services (MABS) program, jointly implemented by the Rural Bankers Association of the Philippines (RBAP) and the Office of the President. Since its start in 1999 the MABS program has assisted 74 rural banks and bank branches in Mindanao to develop the capability to profitably provide financial services to the micro enterprise sector.

On the basis of an institutional assessment the program selects rural banks, which will receive an intensive and comprehensive on-the-job training. The main features of the technical assistance and training package are the involvement of top management, an 8 months on-the-job coaching by consultants, and 18 months of monitoring, advising and troubleshooting by the consultants. Reportedly, the MABS program is very successful and it is planned to extend its outreach to the Visayas via franchising.

4.2.4 Summary

So far, there is no donor agency concentrating its efforts on the SME sector as a cross-cutting intervention area for development. No donor has a comprehensive support strategy for the SME sector in the Philippines as of now.

One consequence for the general PSDP approach is to provide for a comprehensive intervention concept for SME development. With limited resources, the PSDP has also to ensure an approach providing sufficient room for cooperation and networking with other donors and agencies.

5. The Private Sector Development Program (PSDP)

5.1 Program Rationale

The analysis of the status-quo has demonstrated the potential economic importance of the SME sector but likewise it has shown that SME in the Philippines are confronted with various problems hampering their competitiveness and employment and income generating capacities.

While some problems, such as lack of macroeconomic stability or deficiencies in infrastructure are negatively affecting all enterprises, the following problems are identified as the major constraints detriment to the development of a more dynamic SME sector:

- The Philippine business environment at national and local level is not conducive to a dynamic development of a SME sector with high cost of formalizing and operating small businesses;
- The lack of adequate, sufficient and sustainable business services for SME contributes to low product quality, low production technology and low efficiency and constrained access to markets; related to the lack of business services is the insufficient availability of skilled labor in SME;
- The financial sector is not offering adequate and sufficient (medium- to long-term) financing facilities to SME, thus restricting financing of investment to limited own funds;
- Another obstacle for SME which want to improve their competitiveness is the lack of adequately trained personnel, in particular if they want to upgrade their technology or introduce new product lines.

These major constraints are interrelated and reinforce each other; for example, if a small enterprise opts, for good reasons, not to become formalized, it might save business transaction cost; but on the other hand, it will not be eligible to special SME financing facilities or any bank loan because of its informal status. The area skills development is not elaborated further, because it is already included in the Project "Expansion of Dual Education and Training (EDET) with TESDA, which will be part of the wider program approach.

Therefore, a future PSDP should focus its interventions on these 3 areas.

The findings of the report are in line with the recommendations in the sector strategy paper for the Focal area "Economic Reform and Development of the Market System". Likewise, the proposed intervention areas are principally confirming the program proposal discussed during the last bi-lateral negotiations.

5.2 Program Approach

The following major elements of the proposed PSDP have to be reviewed and confirmed or amended by the various stakeholders of the program during a planning

workshop, tentatively scheduled for August 2002. Particularly, this refers to the results, activities and indicators for the PSDP and its respective components.

5.2.1 Program Focus

The SME sector is the main target group, because SME have the highest potential to contribute to a balanced and equitable growth, as well as to the creation of employment and reduction of poverty. SME are also the ones mostly affected by existing legal and bureaucratic constraints and they are suffering most from a lack of financial and non-financial services.

For the purpose of this Program the official SME definition based on assets is widened to include the micro enterprises, both formal and informal, which show potential for growth. The SME sector thus defined comprises about 25% of the total enterprises. However, the Program should not focus entirely on SME, as it is evident that SME are linked in various ways to the corporate as well as to the micro enterprise sector, e.g. through supply and product chains, outsourcing, contract production etc.

Therefore, the private sector has to be addressed in general, with a focus to free the potential of SME and improve their competitiveness. A systemic approach to competitiveness is applied, departing from the macro level (legal and administrative framework conditions) to the meso level (capacities of relevant private and public institutions, networks, etc.) and to the micro level (enterprises, employed men and women). This should be embedded in a social and cultural structure valuing entrepreneurial spirit and transparent and democratic decision-making.

Improving the competitiveness of the SME and increasing growth patterns requires interventions at various stages and entry-points to improve:

- Enabling environment and policies;
- Access to business services;
- Access to financial services;
- Skills and staff development (the capacities of TESDA and the expertise of the respective GTZ Project are considered to have a significant mutual synergy potential).

It is recommended that IT based information will be promoted throughout the Program as a tool for corporate and public governance and the development of business and financial services.

As part of the Focal Area "Economic Reform and Development of the Market System" the Program will be developed and implemented within the framework and priorities outlined in the Focal Area Strategy Paper which was agreed on by both Governments.

5.2.2 Principles and Cross-cutting Themes

5.2.2.1 Principles

It is recommended that the Program consists of three distinct components consolidated within the framework of a coherent program approach. The components are Enabling Environment and Policies (EE), Development of Business Services (BS) and Improvement of the Access to Financial Services (FS).

Each component will have interventions on national and local levels. It was established between the Philippine and the German Government that the German Development Cooperation (GDC) should have a regional focus in the Visayas regions. This will allow a better cooperation between the different projects and programs and create opportunities for mutually beneficial synergies.

Therefore the Program will introduce innovative and replicable models in the Visayas region and use them as an input for training and capacity building in the concerned institutions, both at regional and national levels (elevator principle).

The interaction between the components is guided by the following principles:

- Principle of mobilizing already existing local resources to avoid duplications and over-lapping (principle of subsidiarity).
- Principle of synchronizing different, compatible business-related services (e.g. business- and financial services)
- Principle of sharing resources between components (advisory personnel, data banks etc).

Special emphasis will be put on the willingness of interested public and private institutions to contribute with their own financial and human resources.

In the case of private sector led components, the objective is to develop or improve markets for financial and business services: sustainability will thus be ensured by the profitability of the service provided.

The program promotes the creation of local employment and income opportunities – particularly in viable labor-intensive industries. The engagement of different promotional tools follows respective selective criteria.

5.2.2.2 Gender

Women's participation in the labor force is high in the Philippines, compared to other Asian countries. Overall gender equity is also high with Philippine women holding a major share of higher management positions in Government and the private sector. However, especially in rural regions and in the poorer strata of the Philippine society women have still to shoulder the domestic burden as well as to contribute to the livelihood of the family. In addition, women play a major role as manager and/or as owners of SME. The proposed program with its aim to provide access to key areas of SME development will thus contribute especially to the economic and social empowerment of women.

5.2.2.3 Environment

Sustainable enterprises and, therefore, the national economy depend as much on natural, freely available resources as they do on human and capital resources. The sustainable management of natural resources, therefore, is a concern of the new program. In addition, environmental standards and labeling is becoming more and more an important precondition for access to international export markets. Access to cleaner technology, regulation and training are needed to raise standards in these industries. In fact, due consideration of environmental and social issues can improve SME growth. Introducing low or no-cost methods of waste minimization, energy efficiency and changes in process technology can all enhance business profitability and offer new market opportunities in their own right. Within its partner structure at different levels, environmental issues are addressed as follows:

- Introducing and promoting experiences, concepts and instruments of how to combine economic development and environmental legislation or enforcement of existing environmental laws in a business friendly way;
- Selective promotion of new industries and products emerging from environmental legislation. Encourage business service providers to improve their offer of eco-friendly or energy-saving services to SME;
- Introduction of a variety of promotional tools in either enterprises or institutions dealing with enterprise promotion, e.g. to carry out training and consultancies in “Good Housekeeping”, Environment-Oriented Cost Management, and Company-based Resource Management for SME’s etc.;
- Contacts should be established with existing projects of financial cooperation (KFW’s environmental credit line with DBP) and of technical cooperation, e.g. “eco-parks”, Natural Resource Management in Leyte” and initiatives like “Pilot Program for the Promotion of Environmental Management in the Private Sector of Developing Countries” (P3U).

5.3 Program Objectives, Indicators and Beneficiaries

5.3.1 Objectives

The program’s **overall goal** should be to contribute to the generation of employment and income for the poorer strata of the Philippine society.

Program objective is to promote the development of a strong and competitive private sector.

5.3.2 Indicators

Possible indicators for the overall goal are:

- Sustainable reduction of unemployment to at least the official unemployment rate before the Asian crises (9.8%);

- Reduction of poverty according to the forecast by the Philippine government;

It is suggested to measure the achievement of the program objective by the following indicators:

- Increased contribution of SME to production and employment in Regions 6-8;
- DTI's positive attitude towards subsidiarity is documented in policy documents.

5.3.3 Beneficiaries

Final beneficiaries will be SME and micro enterprises with growth potential, their workforce and people looking for work with a specific consideration of female entrepreneurs and workers; small artisans with development potential in rural areas; school graduates and young employees as potential founder of SME.

5.4 Intermediate Organizations

The development of the private sector cannot be the responsibility of one public or private sector institution alone. Various government departments and authorities at national as well as at local levels are involved. In addition the various private sector organizations like chambers and associations, but also the corporations and enterprises themselves play an important role.

Intermediate organizations are all SME relevant organizations such as management and technical staff of DTI at national and regional level; management and concerned staff of banks and private business service providers; bank associations and representatives of the private business sector; LGU representatives; and NGOs.

Specifically, it is assumed that private SME banks and providers of business services will be the "core group" of intermediary institutions of the PSDP.

5.5 Results and Activities of the Program

5.5.1 Methodology

Each component will have interventions on national and local levels. It was established between the Philippine and the German Government that the German Development Cooperation (GDC) should have a regional focus in the Visayas regions. This will allow a better cooperation between the different projects and programs and create opportunities for mutually beneficial synergies.

Therefore, the Program will introduce innovative and replicable models in the Visayas region and use them as an input for training and capacity building in the concerned institutions, both at regional and national levels (elevator principle).

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- Principle of sharing resources between components (advisory personnel, data banks etc).

Special emphasis will be put on the willingness of interested public and private institutions to contribute with their own financial and human resources.

In the case of private sector led components, the objective is to develop or improve markets for financial and business services: Thus, sustainability will be ensured by the profitability of the service provided.

5.5.2 Program Results and Activities

Program Result 1:

DTI and selected public and private organizations both at national and at LGU level have improved their capacity for creating an enabling environment for SME.

Indicators:

- SME of at least 3 LGU in the Visayas acknowledge improvement of the business climate;
- DTI has launched xx initiatives to address specific regulatory problems;
- Private sector organizations participate actively in the policy formulating process.

Activities to achieve Result 1 are:

- DTI has improved its technical and coordinating capacity to create a supportive business climate for SME;
- In selected LGU of the Visayas the relevant public and private institutions have improved their capacity for coordinated action to improve the local business climate;
- Proposals for the improvement of specific policies relevant for SME development are elaborated.

Program Result 2:

BS markets in the Visayas grow and develop because of increased demand for services from SME, expanded diversity of products, improved supply of quality services and increased market transparency.

Indicators:

- Consumption of BS by the private sector in the Visayas has increased by 5% more than private sector's GDP growth rate by 05/2006;

- Increased number of BS transactions in the Visayas in 4 regions and in 16 sectors:
 - 2002: 50%
 - 2003: 75%
 - 2004: 100%.

Activities to achieve Result 2 are:

- Adapted market assessment methodologies are developed, applied within the PSDP and disseminated within and outside the Philippines;
- The market for business-related information services in selected sectors is improved;
- Business service markets in selected sectors are developed.

Program Result 3:

Select SME-banks are applying profitable SME retail and wholesale credit technologies and have improved their institutional viability.

Indicators:

- Share of SME loans to total loan portfolio in the target banks has increased;
- NPL ratio in the target banks is below industry average;
- Profitability indicators (e.g. ROE, ROA) in the target banks are above industry average.

Activities to achieve Result 3 are:

- Develop, apply and disseminate improved SME credit technologies;
- Develop, apply and disseminate institutional improvement packages for SME banks;
- Develop, apply and disseminate a wholesale lending concept for SME banks in Plantersbank.

5.5.3 Program Risks and Assumptions

The general program risk lies in the economic and political framework conditions in the Philippines. It is assumed that the economic reforms will be continued and the political stability is secured.

With reference to the program component 1 (enabling environment) the following assumptions are made:

- The Philippine Government continues its drive for market friendly policies and a conducive business climate, especially for SME;
- In the selected regions and LGU the concerned parties are willing to ensure efficient horizontal and vertical communication and cooperation.

In the case of program component 2 (business services) it is assumed that:

- Economic growth will continue, including a growing SME sector;
- Economic integration of the Philippine economy into world markets will continue;
- DTI and other public organizations will continue to have a positive attitude toward private sector led service delivery and will refrain from offering free or highly subsidized business services;
- Other donors will respond positively to coordination attempts with regard to the use of subsidies for business services.

The achievement of Component 3 (financial services) will mainly depend on:

- A monetary policy of BSP securing relative price stability and a stable real exchange rate;
- The Philippine Government's ability to limit its fiscal deficits and public sector debt in order to avoid a crowding-out of the private sector;
- The willingness of SME banks to improve their institutional capacities and to commit own resources.

6. The Program Components

6.1 Program Component 1: Enabling Environment

6.1.1 Objective and Indicators

The proposed **objective** of Component 1 is:

- DTI and selected public and private organizations both at national and at LGU level have improved their capacity for creating an enabling environment for SME.

Possible **indicators** to measure the achievement of the objective of component 2 are:

- SME of at least 3 LGU in the Visayas acknowledge improvement of the business climate;
- DTI has launched xx initiatives to address specific regulatory problems;
- Private sector organizations participate actively in the policy formulating process.

In this component DTI will be supported in addressing these problems both at national and at local levels. Although most of the proposed areas are coordinated and implemented by DTI it is understood that a wide range of relevant public and private institutions have to be included, both at national and local levels in the Visayas regions.

6.1.2 Methodology

Creating an enabling environment for SME is not a one time job of formulating a new law but a continuous effort of trial and error from both public and private sector to identify bottlenecks, elaborate proposals and follow-up their approval. The task of analyzing the multi-faceted climate for investors and setting priorities to establish a more favorable environment is an essential function of government. Since several governmental departments or line ministries share responsibility for this task, there is typically poor co-ordination and duplication across agencies. Creating the right policies and the regulatory, judicial, and legal environment for SME involves extensive collaboration between business, government, civil society and donors. Crucial for success is also the combination of initiatives at national and at local level.

Within the Philippine Government the Department of Trade and Industry (DTI) is most concerned with formulating and coordinating SME policy and promotion. DTI is chairing the Small and Medium Enterprise Development Council the country's highest policy making body for SME. It's Bureau of Small and Medium Enterprise Development provides secretariats functions for the Council.

In this component DTI will be supported in improving its technical and coordinating capacities to improve the business climate for SME. There is a need to train officers and staff from DTI to develop adequate analytical, regulatory and public advocacy skills. Another area of concern is the improvement of the SME related information and data bases in DTI. Although most of the proposed areas are coordinated and implemented by DTI it is understood that a wide range of relevant public and private institutions have to be included. Therefore, promoting efficient coordinating and cooperating mechanisms between the public and the private sector will be a major activity.

As in the other components, activities will take place both at national and local levels. At local level practical experience on improving the business climate in selected LGU will be acquired. Close cooperation will take place with initiatives to strengthen LGU or capacities at regional level, in particular with the new NEDA/GTZ project on strengthening the regional offices of NEDA in the Visayas region but also with projects of other donors like e.g. CIDA.

Improving the business climate in selected LGU will be tied in the initiative "Competitiveness of Cities" This initiative will be supported at national level too, to help establishing it as a recognized nationwide benchmarking for business climate in cities.

There are other areas which are relevant for improving the enabling environment and which might be addressed by the Program, e.g. competition policy or quality management systems for SME. However further study is required to specify the exact Program interventions.

6.1.3 Sub-Component 1: Building Technical and Coordinating Capacity of DTI

6.1.3.1 Main Intervention Areas

Capacity Building in DTI

DTI and in particular its Bureau of Small and Medium Enterprise Development (BSMED) is mandated with promoting the development and competitiveness of Philippines SME. It provides secretariat functions for the SMET Council, the major policy making and coordinating body for SME development where all relevant public and private institutions participate. The BSMED continuously analyses the situation of the SME and elaborates proposals for improvement. In the last years aspects of the business climate and the adverse effects of specific policies have become more important compared to the more traditional SME problems like access to business or to financial services. DTI has initiated a process to build institutional and professional capacities capable of developing comprehensive policy proposals and regulatory reforms. However, the implementation of DTI's policy proposals depends on the cooperation of other line departments responsible for the respective sector or policy theme. Modern concepts of policy reform insist on a close cooperation with the private sector, in particular with its organizations like the Philippine Chamber of Commerce and Industry, or other chambers and associations but also with individual entrepreneurs. Extensive coordination and communication skills are required both at national and local levels.

Improving the Information Base on SME

Efforts to improve the business climate are hampered by the unavailability of accurate and timely data and information. DTI has started to put the "National Business Registry" on a web-based platform which would allow easy and fast business information registry everywhere and at the same time allow access to timely data on SME.

It is recommended to assist DTI in further developing this database as a tool for planning, program design, and linking to other databases (e.g. of DOLE and TESDA). Ultimately an outsourcing to a private sector agent might be desirable, giving its potential to generate revenues.

At the local level selected DTI regional/provincial offices should be supported in improving their information services, in particular related to regulatory and administrative requirements for SME. This activity is closely linked to the improvement of business related information services in component 2.

6.1.3.2 Results, Activities and Indicators

As a **result** for Sub-component 1 it is proposed:

- DTI has improved its technical and coordinating capacity to create a supportive business climate for SME.

Indicators might be:

- An inventory and analysis of factors which affect the business climate for SME is available;
- DTIs databases on SME are web based;
- Consensus exists between the relevant public and private institutions regarding to priorities;
- DTI has proposed a comprehensive policy for improving the business climate for SME.

Main **activities** are:

- Establish a prioritization and implementation process for the cooperation between the BDS Program and the concerned Bureaus of DTI;
- Elaborate together with the concerned DTI bureaus and the other public and private stakeholders an inventory and analysis of key factors which affect the business climate for SME is available;
- Elaborate a proposal for an integrated web-based information system on SME;
- Work with selected DTI SME centers (if possible in the LGU selected in R 2) in improving their information systems and linking it to the national system;
- Assess the existing coordination and cooperation mechanisms between the private and public sector;
- Identification of training needs and implementation of trainings;
- Elaborate a comprehensive strategy for improving the business climate for SME.

6.1.4 Sub-Component 2: Improving the Business Climate in selected LGU

6.1.4.1 Main Intervention Areas

Competitiveness of Cities

DTI and the Asian Institute of Management (AIM) launched a benchmarking study ranking 33 leading and emerging secondary urban centres according to their ability to attract industries to locate in their area. This should create a competitive climate between municipalities giving them incentives for improving their business climate and at the same time making information available about good practices elsewhere. It is recommended that DTI should be assisted in developing further the methodology, making this initiative a permanent and respected feature and help enlarge its scope to include more urban centres. A close cooperation with the AIM is required.

Improving the Business Climate in selected LGU

At the local level, in the Visayas regions, it is proposed to select up to three urban centres, which show a marked interest in improving their business climate. Applying the concepts and methodologies of “local economic development” these selected urban centres would be supported to identify solutions and implement improvements.

6.1.4.2 Results, Activities and Indicators

As a **result** for Sub-component 2 it is proposed:

- In selected LGU of the Visayas the relevant public and private institutions have improved their capacity for coordinated action to improve the local business climate.

Indicators might be:

- A comprehensive strategy for improving the business climate is available in at least 3 LGU;
- SME acknowledge improvement for at least xx of the identified bottlenecks;
- The scores of the LGU in regard to the parameters of the “Competitiveness of Cities” have improved by xx points.

Main **activities** are:

- Based on the parameters of the “Competitiveness of Cities” initiative at least three LGU in the Visayas have been selected by a competitive selection process;
- Relevant public and private organizations in the LGU have elaborated a comprehensive strategy and identified critical bottlenecks;
- An activity and impact monitoring system is installed;
- Cooperation with programs of other national agencies or donors are agreed on and specified;
- Measures to remove bottlenecks are implemented.

6.1.5 Sub-Component 3: Improvement of Specific Policies relevant for SME

6.1.5.1 Main Intervention Areas

There are other areas which are relevant for improving the enabling environment and which might be addressed by the Program. However further study is required to specify the exact Program interventions. Generally, they should be phased in at a later stage, according to priorities and available resources. In this component DTI will

be supported in addressing these problems both at national and at local levels. Although most of the proposed areas are coordinated and implemented by DTI it is necessary to include a wide range of relevant public and private institutions, both at national and at local levels in the Visayas regions. There are two specific policy areas where DTI has explicitly requested technical assistance:

Competition Policy

DTI requested technical assistance for formulating and implementing a competition policy. It should start with a comprehensive review of the existing competition laws and regulations as well as with the actual implementation experiences so far. A comparison of models and experiences in other countries might also be helpful. It is understood by the Mission that unfair business and trading practices and a business environment dominated by a few large corporate groups is clearly limiting the growth potential of the SME sector. However, the Program should carefully evaluate the actual legal and political situation to ensure that there is a realistic chance of an impact.

Promoting Quality Management in SME

DTI promotes “total quality management” to improve quality and productivity at the enterprise level. However, its main initiative, the Philippine Quality Award, is heavily geared to the large corporations. Assistance could be provided to open this Award for SME, thus creating incentives for SME to improve quality and productivity. Another area might be the improvement of the accreditation and certification process regarding international norms like ISO 9000 and ISO 14000. This could also provide a link to promoting eco-efficiency and cleaner production. Potentially, TESDA could play an important role for improved quality and productivity by providing adequate training, setting appropriate training standards (in close cooperation with industry), accrediting training institutes and certifying training courses.

6.1.5.2 Results, Activities and Indicators

As a **result** for Sub-component 3 it is proposed:

- Proposals for the improvement of specific policies relevant for SME development are elaborated.

Indicators might be:

- A comprehensive review of existing competition policies in the Philippines and comparative experiences in other countries is available and discussed with the relevant stakeholders;
- A proposal for extending the quality award system to SME is available and discussed with the relevant stakeholders.

Main **activities** are:

- Establish a prioritization and implementation process for the cooperation between the BDS Program and the concerned Bureaux of DTI;

- Assessment of training needs and implementation of necessary trainings;
- Competition Policy: Review of existing competition laws and regulations as well as actual implementation experiences;
- Competition Policy: Identification of relevant experiences in other countries;
- Quality Management: Review of existing policies and structures to improve quality management for SME, including certification and accreditation;
- Quality Management: Elaborate proposals for increasing the participation of SME in the quality award system;
- Work on other policies according to the prioritization.

6.1.6 Assumptions and Risks

It is expected that the Philippine Government continues its drive for market friendly policies and a conducive business climate. It is further assumed that this extends also to SME and that SME with its specific problems and weaknesses are considered in the respective Government policies.

The PSDP intends to work on the national and local level simultaneously, systematically developing feedback of experiences to either level. However, it appears that sometimes there is a communication and cooperation gap between the national level and the LGU level. It is assumed that in the case of the selected regions and LGU this risk can be minimized and full cooperation between national and local authorities is assured.

It is also assumed that in spite of the upcoming elections a minimum of political continuity exists at both at DTI and LGU level and that the cooperation between the public and the private sector will not be compromised.

6.2 Program Component 2: Business Services

6.2.1 Objective and Indicators

The objective of the component is: BS markets in the Visayas grow and develop because of increased demand for services from SME, expanded diversity of products, improved supply of quality services and increased market transparency.

Achievement of the purpose of BS (Component 2) will be measured with the following **indicators**:

- Consumption of BS by the private sector in the Visayas has increased by 5% more than private sector's GDP growth rate by 05/2006;
- Increased number of BS transactions in the Visayas in 4 regions and 16 sectors:
 - From 2002: 50%
 - 2003: 75%
 - 2004: 100%.

6.2.2 Methodology

The overarching methodology for Component 2 will be the development of BS markets. There will be three main areas of intervention, which correspond to the high potential entry points identified as a result of the rapid market appraisal: Analyzing business service markets, business information and service development. Each of these sub-components is described below.

Activities on the ground will focus on future-oriented sectors with high SME participation in the Visayas region. The sectors will be chosen based on an assessment of the regional competitive advantage of Iloilo, Cebu and Leyte. Strategies, activities and results from the Visayas will be documented and disseminated in order to promote BS market development though out the Philippines. In addition, some activities under Component 2 will be implemented in coordination with Component 1 at the national level.

6.2.3 Sub-Component 1: Analyzing Business Service Markets

6.2.3.1 Main Intervention Areas

This component will focus on regularly analyzing business service markets in selected sectors and clusters, e.g. food and agro-based products. The objective will be to identify market constraints and opportunities for market growth which could be addressed through program interventions.

There are a variety of analytical tools currently in use that can be adapted and used under this sub-component as follows:

- Sub-sector analysis looks at the product supply chain from raw materials through processing, wholesaling and retailing. This analysis enables program managers to identify interventions which will expand the sub-sector and enable SME to capture more value added in the product supply chain;
- Business Service Consumer Surveys look at the markets for various business services from the point of view of SME consumers. This analysis enables program managers to identify constraints to and opportunities for the growth of BS markets;
- Participatory Appraisal of Competitive Advantage (PACA) examines the various factors which create systemic competitiveness of particular areas. This analysis enables program managers to identify ways in which the competitive advantage of particular areas can be developed.

Under the component, these tools will be adapted and applied to the Visayan context. In addition to contributing to the development of service markets, the adapted methodologies will also be documented and disseminated to contribute to BS market development throughout the Visayas and to the BS field in general.

6.2.3.2 Results, Activities and Indicators

The preliminary result for this sub-component is: “Adapted market assessment methodologies are developed, applied within the PSDP and disseminated within and outside the Philippines.”

Indicators are:

- 6 Sector/cluster studies in the Visayas have been conducted by 5/06;
- Market assessments are carried out on a regular basis;
- An assessment of systemic competitiveness of the Visayas has been conducted;
- The results of the assessments have been disseminated;
- The methodology is documented and disseminated.

Activities to achieve the result are:

- Develop a combined sub-sector analysis – BS market assessment methodology. The methodology will first identify critical constraints in product markets through sub-sector analysis; then proceed to identify services that could address these constraints, and finally assess the constraints on that service market. This approach is in its early stages. Preliminary findings using such an approach in Mali have shown promising indications. A donor consortium project in Bangladesh which will start in June 2002, will try to apply this approach;
- Analyze up to 6 sectors/clusters using the new methodology;
- Assess BS markets on a regular basis;
- Conduct an assessment of systemic competitiveness of the Visayas at the regional level;
- Use the results of the various assessments in the development and implementation of the other sub-components of the PSDP;
- Disseminate the findings of the various market assessments;
- Document and disseminate the market analysis methodologies used.

6.2.4 Sub-Component 2: Enhancing Business Information Services in Selected Sectors

6.2.4.1 Main Intervention Areas

The rapid market appraisal identified the low utilization of business information as a cross cutting constraint to the functioning of service markets. Presently, SME gather important information internally from known business partners or friends and take

decisions based on these limited sources. At the same time, there is a high demand for validated information about new technologies, costs, prices, sector trends, etc. among SME. Presently, this demand can not be met by existing providers of business information, such as the business information centers of DTI or the Chambers. There is a high potential to cater to this demand by providing business information on a commercial basis through existing ICT infrastructure.

This area of intervention is the core of programme Component No.2 because there are a number of linkages and interrelationships between the availability of validated business-related information and the analysis and development of business service markets. Furthermore, there are a number of links to Programme Component 1) Enabling Environment and Component 3) Financial Services. This sub-component also provides a wide range of opportunities for linkages with other GTZ-supported projects, e.g. Technical Education and Skills Development Authority (TESDA).

This sub-component will deal with establishing an Information and Communication Technology (ICT)-based Business Information System for selected growth regions or sectors. The rapid market appraisal indicates that business information services should be targeted at specific sectors or regions and be delivered as a distinct BS with a commercial orientation. Best practices in other developing countries, for example in Sri Lanka, have shown that there are clear advantages for the delivery of distinct BIS through private companies and chambers:

- The generation of BIS with ICT requires a high degree of technical skills that are predominantly available in private companies and chambers;
- The delivery of BIS as a marketable product suggests a high degree of marketing skills and sensible marketing strategies;
- The supply of BIS through private companies and chambers will be regulated by real demand from clients;
- Private companies and chambers are commonly based on risk conscious revenue models that ensure sustainability;
- The motivation to provide quality services is regulated by open market forces;
- The introduction of BIS through private companies and chambers contributes to the creation of a competitive market for business services.

According to the rapid market appraisal, there are a number of competent private companies and chambers in the Visayan region. A supportive institutional environment, incentive models and available technical assistance can encourage these organizations to diversify into the delivery of business information for specific sectors or regions on a commercial basis.

This component will support DTI in facilitating the delivery of business information services through private providers. DTI can play a role in sourcing and accreditation of relevant information. It will also promote IT-based business information as a distinct business service with private providers. At the national level, the project will work towards improving the existing IT-based information systems and databases such as DTI's business registry, Tradeline, etc.

6.2.4.2 Results, Activities and Indicators

The preliminary result for this sub-component is: “The market for business-related information services in selected sectors is improved.”

Indicators are:

- Increased revenue through the sale of BIS by partners, 200% by 2006;
- Annual 25% increase of daily BIS transactions;
- An increase of repeated clients for BIS by 100% from 2003 to 2006.

Activities to achieve the result will be implemented in four phases, covering 3 years as follows:

- **Start-off:** Clarify functions and roles of institutions, ICT infrastructure, access to information sources and demand for BIS. In particular, the following questions will be answered in this phase:
 - What are the overall, region specific frame conditions relevant to ICT and institutions already involved in promoting BIS?
 - What does the demand for BIS look like and for what kind of BIS are SME prepared to pay?
 - What type of commercial information products can be delivered as a distinct market-driven BS?
 - How can commercial strategies for BIS be launched in selected growth sectors or regions?
 - Who qualifies as actor and partner to perform various BIS-related functions and what role do they play?
 - Which institutional model for BIS delivery is most appropriate to provide access and wide outreach?
 - How does BIS contribute to the creation of a competitive market for other BS in the selected regions or sectors?
- **Planning:** Assist BIS providers to prepare business plans, including information product development, ICT-hardware and software, organizational development, networking and marketing;
- **Core Service:** Guide BIS providers in the implementation of business plans;
- **Stabilization:** Introduce Total Quality Management to ensure profitability and sustainability of BIS.

6.2.5 Sub-Component 3: Developing Business Services Markets in Selected Sectors

6.2.5.1 Main Intervention Areas

The rapid market appraisal indicates that there are a number of constraints to the effective functioning of a range of business service markets in the Visayas. Among the most severe are:

- SME' lack of awareness about some services;
- SME' low valuation of some services;
- A lack of availability of some services;
- Poor quality and low relevance of many services;
- Providers lack of interest or ability to effectively target the SME market; and
- Frequently subsidized services which depress SME willingness to pay for services and discourage private sector investment in the delivery of services.

Interventions in this sub-component will be informed by the conclusions of the market assessments conducted under sub-component 1. The focus will be addressing the issues above by raising demand for business services and building the capacities of service providers to deliver relevant, quality services to SME on a commercial basis. The main strategy will be to assist providers to develop new products and reach new markets. The program will also implement complementary demand stimulation activities such as awareness raising events and social marketing.

Commercial services can be delivered either on a transaction basis (fees) or as part of a commercial transaction (such as design services from exporters). The project will try to cover both types of business services. In connection with sub-component 1, the project will implement activities in specific sub-sectors. The mission was briefed on the "2+1" formula of DTI. The "2" refers to business development – consisting of business information, SME promotion and business regulation – and consumer welfare through enforcement of fair trade laws among others. The "1" refers to focusing these activities at the regional level on a certain industry. Therefore, at the Visayan level there would be 3 priority industries. However, there are also provincial priorities. A cross cutting area of focus is food and agro-processing related industries. This component could start with sector specific service interventions in these areas.

6.2.5.2 Results, Activities and Indicators

The preliminary result for this sub-component is: "Business service markets in selected sectors are developed."

Indicators are:

- Market expansion strategies for 15 BS products have been supported;

- Aggregate fee income from the 15 service products is 1.5 times the project expenditure on pre-delivery support by 05/2006;
- 40% of those SME receiving services apply a new business practice within six months of buying the BS;
- 30% of recipients of services rate the new business practice as "highly important" for their competitiveness;
- 40% of participating SME rate the probability of purchasing more BS as "highly probable" in a post-delivery survey.

Activities to achieve the result are:

- Identify gaps between the demand and supply of specific business services based on the market assessments conducted under sub-component 1;
- Conduct qualitative marketing research, such as Focus Group Discussions, to generate ideas and information for potential new service products;
- Define and implement provider partner criteria and selection system;
- Work with BS providers to develop and commercialize new service products and reach new markets;
- Analyze options for demand stimulation based on the market assessments conducted under sub-component 1 and the qualitative marketing research;
- Implement high impact demand stimulation activities such as awareness rising through events or media and social marketing campaigns.

6.2.6 Assumptions and Risks

BS market development is likely to be most successful in a growing economy facing increasing local and global competition. This is the current situation in the Philippines. The targets and activities for Component 2 have been developed based on the assumption that this situation will persist for the duration of the project. The relevant factors of the political and economic situation include political stability, growing GDP, a growing SME sector and increasing integration of the Philippine economy with global trade. If this situation changes substantially, the targets, strategies and activities for Component 2 will need to be reviewed.

One of the greatest risks to BS market development is a large quantity of free or highly subsidized services being offered by public or donor sponsored providers. Both the DTI and other donors are recognizing that massive subsidization of business services suppresses demand for services and discourages private investment in the delivery of business services.

The design of Component 2 assumes that DTI and other public organizations will continue to have a positive attitude toward private sector led service delivery. It also assumes that other donors will respond positively to coordination attempts with regard to the use of subsidies for business services. This will result in an increasing rationalization of the use of public money away from subsidizing BS transactions and towards stimulating the sustained supply and demand for BS. A significant change in this situation will put the results of Component 2 at risk.

6.3 Program Component 3: Financial Services

6.3.1 Objective and Indicators

Objective of Component 3 is: Select SME-banks are applying profitable SME retail and wholesale credit technologies and have improved their institutional viability.

Indicators to measure the achievement of the objective of component 3 are:

- Share of SME loans to total loan portfolio in the target banks has increased;
- NPL ratio in the target banks is below industry average;
- Profitability indicators (e.g. ROE, ROA) in the target banks are above industry average.

6.3.2 Methodology

In this program component innovative and replicable models of SME retail credit technologies will be introduced and tested in the Visayas region. Likewise, SME wholesale lending technologies for SME banks will be developed and applied on a test basis in Planters Development Bank.

Good practice examples and lessons-learned will be disseminated to the Rural Bankers Association of the Philippines (RBAP) and the Chamber of Thrift Banks (CTB). This will take place by developing training modules and assistance packages, which later might be replicated in other SME banks both at regional and national levels (elevator principle).

Besides providing direct assistance to selected banks in selected areas, the general approach will be to act more as a facilitator and match-maker between the SME banks and already on-going or planned activities of other agencies and donors.

6.3.3 Sub-Component 1: SME Credit Technologies for SME Banks

6.3.3.1 Main Intervention Areas

Selected SME banks - rural banks, thrift banks and smaller commercial banks engaged in SME lending – will be assisted in improving their SME credit technologies. The assistance will cover support in the development of a credit scoring system, client risk assessment, credit approval process, loan monitoring, procedures for workout loans, collateral valuation, organization of the credit

department, etc. Support will also be given in the preparation of a credit manual for SME.

6.3.3.2 Results, Activities and Indicators

The preliminary result for this sub-component is: Improved SME credit technologies are developed, applied and disseminated.

Indicators are:

- Documentation of assessment results in at least 2 target banks after 3 months;
- Not less than 50% of concerned staff has participated in trainings in at least 2 target banks after 3 months;
- New/amended credit manuals are used in at least 2 banks after 12 months;
- Dissemination of SME credit technology packages to member banks by at least one bankers association after 2 years.

Activities to achieve the result are:

- Identification of potential target banks in the Visayas;
- Assessment of applied credit technologies and identification of major weaknesses;
- Identification of training needs and implementation of trainings;
- Development of new or improved credit technologies;
- Integration of new technologies in formal credit procedures;
- Dissemination of training modules and assistance packages.

6.3.4 Sub-Component 2: Institutional Capacity Building for SME Banks

6.3.4.1 Main Intervention Areas

The selected SME banks will also receive assistance in improving their institutional capacity. The major target group will be the owners and the management of SME banks. The support will cover development and improvement of e.g. the bank strategy, asset-liability management, management information systems (MIS), product development and marketing. Support will be given in form of on-the-job-training, workshops and seminars. Possibly, this assistance will be implemented in cooperation with the IFC/Rabobank Bank holding Project.

6.3.4.2 Results, Activities and Indicators

The preliminary result for this sub-component is: Institutional improvement packages for SME banks are developed, applied and disseminated.

Indicators are:

- Documentation of assessment results in at least one target bank after 3 months;
- Not less than 50% of concerned staff has participated in trainings in at least one target bank after 3 months;
- New/amended credit manuals are used in at least one target bank after 12 months;
- Dissemination of SME credit technology packages to member banks by at least one bankers association after 2 years.

Activities to achieve the result are:

- Identification of potential target banks in the Visayas;
- Assessment of major institutional weaknesses;
- Identification of training needs;
- Implementation of trainings;
- Development of improved management and control systems;
- Integration of improved management and control systems at all organizational levels;
- Dissemination of training modules and assistance packages.

6.3.5 Sub-Component 3: Wholesale Lending Technologies for SME Banks

6.3.5.1 Main Intervention Areas

Plantersbank is planning to introduce a special wholesale lending concept for SME banks and will be assisted in the development of this concept (e.g. accreditation criteria and monitoring of retail banks). Based on the experience with the new wholesale lending concept a dialogue with Development Bank of the Philippines (DBP) and Land Bank of the Philippines (LBP) will start, with the objective to replicate the wholesale concept in these banks.

Once the concept is developed, assistance will be given to the selected SME banks in the Visayas to become accredited as retail lenders in the wholesale lending programs.

6.3.5.2 Results, Activities and Indicators

The preliminary result for this sub-component is: Wholesale lending concept for SME banks in Plantersbank is developed, applied and disseminated.

Indicators are:

- Documentation of Planters Bank assessment results after 3 months;
- Training of concerned staff finalized after 6 months;
- Wholesale lending department is established after 12 months;
- New wholesale lending concept is applied in at least one additional bank after 2 years.

Activities to achieve the result are:

- Review of existing wholesale lending concepts in SME credit projects;
- Assessment of organizational requirements in Planters Bank to establish a SME wholesale lending facility;
- Assessment of training needs;
- Implementation of necessary trainings;
- Assistance to establish a wholesale lending department in Planters Bank;
- Accreditation assistance to SME banks in the Visayas;
- Dissemination of training modules and assistance packages.

6.3.6 Assumptions and Risks

Achievement of the objective of component 3 is mainly dependent on a continued macroeconomic stability in the Philippines. In particular, a monetary policy of BSP securing relative price stability and a stable real exchange rate are important. In addition, the Philippine Government has to limit its fiscal deficits and public sector debt in order to avoid a crowding-out of the private sector.

Due to the political autonomy of the central bank, it can be assumed that monetary stability is less prone to short-sighted political interference. In the case of fiscal policy, however, political considerations, in particular before elections, can not be ruled out completely.

6.3.7 Areas of Technical Assistance to be Further Explored

6.3.7.1 Credit Bureau

To improve the access of SME to formal finance, the establishment of a credit bureau, supplying the SME banks with accurate and reliable information about the SME-borrowers is essential. All contacted representatives of SME banks expressed strong interest in the establishment of a credit bureau. The details and principal feasibility of a credit bureau have to be further explored. A first step would be to prepare a background/fact-finding study.

6.3.7.2 Credit Rating

Support in the establishment of a rating system for SME banks is considered as an effective and systematic instrument to differentiate and benchmark different SME banks in a transparent way. By supplying reliable information about the institutional capabilities and the financial status of SME banks, their access to wholesale refinancing facilities will improve. In addition, they will be more attractive as deposit banks for the public.

7. Interfaces with Other Programs and Projects

The complexity of necessary interventions in support of a more dynamic SME sector requires the use of the whole range of German DC instruments; in addition, close cooperation and coordination with other donors is demanded. Coordination and cooperation with other projects should take into account the specific competencies and experiences of donors and projects, thus saving resources of the PSDP and avoiding duplications and inconsistencies of interventions.

7.1 Projects of German Development Cooperation

7.1.1 Technical Cooperation Projects

To ensure that synergies and cooperation will be realized, a wider program approach of "Economic Reform and Development of the Market System" is desirable for the various projects of the Focal Area.

7.1.1.1 TESDA Project

Potential synergies are promising between the upcoming PSDP and the ongoing TESDA/GTZ Project, in particular in the skills and staff development area.

Cooperation should be most intense in the Visayas regions in areas like:

- Skills and staff development together with business service development;
- Developing product sectors, e.g. food and agro & fisheries based;

- Promoting employment and entrepreneurship.

Therefore the further planning process should consider a closer cooperation with the TESDA/GTZ Project, eventually in form of an overarching program, which should be open also for other relevant projects.

At the operational level, TESDA provides direct support to vocational training schools and centers as well as firms to implement dual training programs. Its activities are mainly concentrated in the national and regional offices of TESDA in the National Capital Region (NCR) and in Regions III, IV, VII, X and XI. The project also collaborates closely with other German institutions active in education and vocational training.

As part of a comprehensive reform process, TESDA intends to hand over the management of a number of vocational training schools and centers to the private sector. In this process, the concept of market-driven Business Services could be well placed. TESDA could be supported in developing business plans for the delivery of demand-driven training programs or innovative products which can be provided at viable costs. There are also opportunities to develop databases for career guidance and job-matching facilities at the level of the training centers. This could be jointly developed with the International Labor Organization -supported Department of Labor and Employment initiative.

7.1.1.2 Other Projects

Additional synergies will be developed through close cooperation with ongoing or upcoming projects, e.g.:

- Improving business climate at the local level with the upcoming NEDA/GTZ project for strengthening NEDA's regional offices in the Visayas and with the German Political Foundations;
- Developing business services for food and agro-based products with the "Coastal and Fisheries Resources Management in the Visayan Sea Project";
- Leyte Island Project.

7.1.2 Financial Cooperation Projects

7.1.2.1 Promotion of Small Enterprises Project

Co-operation possibilities are also seen with the KfW project Promotion of Small Enterprises. PBSP as project executing agency has vast experience with SME banks and could be instrumental to identify potential SME banks in the program regions.

In addition, PBSP could share its experience with the wholesale lending approach applied in the KfW project and thus could provide essential inputs for the development of a wholesale lending concept of Planters Development Bank. The PSDP, on the other hand could assist these SME banks in the areas of credit technology and overall institutional development.

7.1.2.2 Industrial Pollution Control Project

Interfaces with the Industrial Pollution Control Project (IPCP) could be created on national as well as on regional level. Possible areas of cooperation are the experience the project gained in providing on-the-job coaching and training to DBP on environmental technology aspects and in conducting seminars and workshops on the principles of ISO 14 001, on environmental due diligence and on good housekeeping. The PSDP could benefit from these experiences. In addition, the PSDP could avail of services and assistance already provided by the ICPC, e.g. technical assistance for SME and SME banks in the Visayas region, and financing for environment related investments of SME.

7.2 Projects of Other Donors

7.2.1 Future Cooperation with CIDA

CIDA has been implementing a comprehensive support program for SME Private Enterprise Accelerated Resource Linkages (PEARL) in the Visayas. Recently, the planning process for PEARL II from 2002-2007 with a TA-component of US \$8.6m has started. PEARL II will operate in the Visayas with a new mandate. Its office will be located in Cebu. There are a variety of synergies and complementarities between PEARL II and the new GTZ-supported PSDP, foremost in the area of Component 2. Details will be developed during the next planning phase.

7.2.2 Future Cooperation with ADB

The development of the private sector and in particular the promotion of SME is a major concern also for other donors. To improve information flows and coordination Donors' Roundtable Meeting are organized, usually chaired by ADB. Of particular relevance for the Program is the Donors' SME Roundtable Meeting. The Program takes care of coordinating and complementing its activities with those of other donors.

ADB is supporting a program on promoting equitable growth.

7.2.3 Cooperation Potential with IFC

The planned and ongoing projects of IFC seem to offer the best potentials for close co-operation with the planned PSDP. As IFC is providing financial assistance in the form of long-term loans and equity, the PSDP could zero in with strategic inputs in the field of technical assistance. Both the Planters Development Bank projects and the planned Bank Holding Company project of IFC could offer the PSDP a high impact leverage.

7.2.4 Other Donors

Other donors involved in SME-promotion are JICA, which has engaged an expert on policy reform and institutional set-up for SME and contributed to the Philippine Small and Medium Scale Enterprise Development Plan (JICA) 2002.

World Bank is involved in programs accelerating environmentally sustainable rural development and enabling expansion of the private sector.

Close cooperation and complementation is sought i.a. with:

- ADB, JICA and CIDA at the program level;
- CIDA, Swisscontact and JICA in the Visayas region regarding business services;
- IFC, USAID and ADB regarding the support of SME banks.

7.3 Partnerships with Private Banks and Private Enterprises

The Program actively seeks to involve private enterprises and banks as partners for implementation and to establish Public Private Partnerships. While in the case of private enterprises or business service providers possible partners still have to be identified, the mission had already the opportunity to discuss possible forms of cooperation with Planters Development Bank.

Planters Development Bank or Plantersbank is a privately owned and managed private development bank and the largest bank in SME finance in the Philippines. Starting as a small provincial development bank with assets of P 6.0 million some 40 years ago, Plantersbank's resources has since grown to over P 20.0 billion. Plantersbank is one of the biggest thrift banks and number all banks in the Philippines. Its operations cover the whole Philippines with about 50% of its financing activities outside of Metro Manila.

Foreign shareholders of the bank are the Netherlands Development Finance Company (FMO), the ADB and the IFC with a total share of 40% of the bank's shareholdings. Majority shareholder is the Tambunting family.

Plantersbank is actively involved in various SME financing schemes financed from KfW. In 2000 IFC provided US-\$ 15 million in debt and about US-\$ 10 million equivalent in convertible preferred shares to strengthen the bank's capital base.

Currently, Plantersbank is negotiating with the IFC a financing facility for wholesale lending to other SME banks. In this context, the bank is looking for technical assistance for setting-up a wholesale lending unit.

With a contribution of at least 40% of the wholesale lending facility from its own resources, Plantersbank would definitely meet the conditions for cooperation with the PSDP.

8. Program Implementation

8.1 Implementation Structure

8.1.1 General Approach

In the past, TA-interventions were tied to one selected partner organization (either private or public). New approaches are more flexible and require not only one but rather a heterogeneous network of partners.

The development of the private sector cannot be the responsibility of one public or private sector institution alone. Various government departments and authorities at national as well as at local levels are involved. In addition the various private sector organizations like chambers and associations, but also the corporations and enterprises themselves play an important role.

However, the Department of Trade and Industry (DTI) has a specific mandate for promoting private sector development and coordinating initiatives of other government institutions.

DTI faces the challenge of improving its outreach by adopting a clearly defined "facilitator"-role and outsourcing activities to the private sector in future.

DTI's philosophy is that it provides direct services only if there is no private sector provider willing to offer such services. The upcoming PSDP will support DTI to efficiently and effectively implement its role as a regulatory and coordinating body in private sector development.

8.1.2 DTI as Lead Agency

The Department of Trade and Industry (DTI) formulates plans, implements policies and programs to support the growth of private industries in the country. The Bureau of Small and Medium Business Development (BSMBD) under the DTI is responsible for promoting small and medium enterprises. Other DTI agencies handle programs for investment and export promotion, quality and productivity, and training (such as BOI, BETP, BPS, CITEM).

The Philippine Government has explicitly commissioned DTI to create an appropriate environment for SME, to streamline regulations and procedures and to implement policies that will curb unfair business and trading practices. DTI's Bureau of Small and Medium Enterprise Development (BSMED) has offices in every province to provide services to SME.

Given the mandate of DTI and its central role in both private sector and SME development, it is recommended that DTI should be the national lead agency of this Program. In addition a steering committee should be established in which additional stakeholders from the private sector (e.g. RBAP, PCCI) and civil society (e.g. PBSP) will be represented.

In the program implementation DTI should focus on those areas of the Program, which concerns its regulatory and coordinating functions both at national and at regional levels.

8.1.3 Implementation Structure at National Level

A tripartite steering committee shall be established. The public sector is to be represented by DTI, the private sector by one representative from the Philippine Chamber of Commerce and Industry (PCCI) and one from the bank associations, the civil society by PBSP and as an additional member GTZ.

DTI, represented by an Undersecretary, should chair the steering committee.

The Steering Committee will be responsible for defining the strategic and conceptual framework, and for monitoring the implementation and the impact of the program. The Secretariat of the Steering Committee shall be set up within the program structure.

Implementation at national level will be carried out by a program office within DTI, but open for cooperation with private sector institutions.

- Implementation of Component 1, enabling environment, is carried out by and with the concerned bureaus of DTI;
- Implementation of Component 2 and 3, financial services and business services will be private sector led;
- Skills development and TVET is an important concern of the Program in particular in the regions, where immediate synergies can be seen between the development of business service and the qualification of labor. As there is already a Philippine – German project with TESDA in place, close cooperation with this project will be established both on a regional and national level.

DTI should nominate a fulltime Philippine program coordinator, who reports directly to the Undersecretary responsible for the overall program. The GTZ program adviser will be the main counterpart for the Philippine program coordinator.

8.1.4 Implementation Arrangements at Regional Level

It is suggested to set-up a Project Implementation Unit (PIU) in the Visayas to implement the program at regional level. This PIU will implement the TA-component with regard to the 3 identified sub-components. The PIU operates as an independent entity to ensure equidistance with all related project partners that would primarily come from the private sector. These partners could be suppliers of BS, regional SME-banks or facilitators like DTI and the SMED Councils. They will be selected using a set of criteria in line with the programme objectives.

The autonomy of the PIU is also important to portray a more business like approach to PSDP interventions. This is especially important in an environment where public development activities have taken on a more donor-client relationship even in the sphere of private sector development. One of the novel approaches in the program would be to increasingly use business indicators to monitor and evaluate project activities.

The PIU will be guided by PSDP policies and strategies. These are formulated and discussed by a steering committee consisting of selected stakeholders. The PIU will also provide field level inputs to and coordinate the various program components as well as the GTZ / TESDA project. The PIU will network with various stakeholders at the provincial and regional levels, in consultation with PSDP management.

The PIU will be staffed with qualified international and national professionals in the areas of business promotion and financial services. The role of the PIU is to act as a catalyst and not as a service provider in the business services market and financial services market. Hence the PIU infrastructure shall be kept to a minimum.

Project activities in the Visayas will concentrate on the 3 market centers of Regions 6, 7 and 8. The hub of commercial activity in the region is Cebu City that acts as a market for products from Iloilo and Tacloban as well as a supplier of inputs and services for Regions 6 and 8. In this context, it may be sensible to establish the PIU in Cebu City.

8.2 Assessment of Necessary Inputs

The focus of the Program is institutional and behavioral change. Therefore it should be given a long-term perspective of 6 to 8 years, actual program phases should be 3 years each with a 2 years phasing-out.

Its philosophy is private sector oriented, therefore only such activities are implemented for which a definite interest from public or private partners exist. A clear indicator for such an interest is the willingness of the partner institution to share investment and operational costs.

8.2.1 The Contribution of DTI

- As a counterpart for the German Programme Manager, DTI seconds a Philippine programme coordinator, who reports directly to the Undersecretary responsible for the programme;
- Two professionals, one at programme level the other at regional level;
- Office space, furniture and the necessary telecommunication facilities in DTI Building in Manila;
- Administrative and service personnel (secretary, driver, janitor).

8.2.2 Private Sector Contribution

The private sector will be mainly responsible for the implementation of Components 2 and 3. Significant parts of these components will be implemented in the Private Public Partnership modus, therefore the modality of sharing inputs and resources have to be specified with each private partner. However, the relation between the private partners and the Program should be an equal one, even in sharing the necessary resources and investments.

As a minimum for ensuring its operation in component 2 and 3 the Program requires for its Program Implementation Unit in the Visayan Region:

- Seconded personnel from the private partners to ensure effective knowledge transfer and capacity building;
- Office space, furniture and the necessary telecommunication facilities for the PMU in the selected region;
- Administrative and service personnel (secretary, driver, janitor).

At national level the selected banks association in Component 3 “Financial Services” should seconded professional personnel and provide office space to ensure dissemination at the national level.

8.2.3 German Contribution

The German contribution is estimated only for the first 3 years phase. The Program will have a decentralized structure with the Program office in Manila, preferably in a building of DTI, and an independent office in the Visayan Region, preferably in Tacloban City.

Although each Component has its own concept, structure and partners, the German advisors will not work entirely for one component only. They will have different professional backgrounds according to the requirements of the different components but will be responsible for the implementation of every component at national and at regional level.

Therefore the German long-term advisors will not be assigned to specific components.

A first estimate of the German contribution is following:

National level:

- 1 long-term international expert for up to 36 PM (person months) as advisor to DTI and as program coordinator with experience in private sector development, SME policies and financial sector development;
- Short-term international experts for up to 8 PM for monitoring and impact evaluation, program integration and team building etc.;
- Short-term national experts for up to 12 PM for crosscutting issues, cooperation with other German DC and other donors etc.;
- Support staff and sufficient resources for administrating the Program overheads related to the German contribution;
- IT equipment and means of transportation.

Regional level:

- 1 long-term international expert for up to 36 PM (person months) as regional coordinator with experience in developing markets for business services and promoting local economic development;
- Support staff and sufficient resources for administrating the overheads of the regional office related to the German contribution;
- IT equipment and means of transportation.

Component Enabling Environment

- Short-term international experts for up to 10 PM;
- 1 long-term national expert for up to 36 PM (based in the regional office);
- Short-term national experts for up to 18 PM;
- Funds for promotional measures up to 30 T Euro.

Component Business Services

- Short-term international experts for up to 12 PM;
- 1 long-term national expert for up to 36 PM (based in the regional office);
- Short-term national experts for up to 12 PM;
- Funds for promotional measures up to 90 T Euro.

Component Financial Services

- 1 long-term (intermediate) international expert up to 24 months specialized in financial services with a focus on SME lending;
- Short-term international experts for up to 9 PM;
- 1 long-term national expert for up to 36 PM (based in a banks association);
- Short-term national experts for up to 18 PM;
- Funds for promotional measures up to 30 T Euro.

Summary of the German contribution

- Long-term international experts up to 96 PM;
- Short-term international experts up to 39 PM;

- Long-term national experts up to 108 PM;
- Short-term national experts for up to 60 PM;
- Funds for promotional measures up to 150 T Euro;
- Operational costs up to 90 T Euro;
- Materials up to 65 T Euro.

Funds for promotional measures are relatively high, because of the flexibility needed when working in market and PPP oriented structures.

9. Next Steps

- **Beginning of June:** The mission suggests establishing a task force on the Philippine side consisting of the potential members of the future steering committee, and NEDA as coordinating body during program preparation.
- **June and July:** Internal discussion of the report on both sides. The task force should prepare a joint position paper of all stakeholders presenting the major issues for the planning workshop.
- **August:** Planning workshop with German and Philippine authorities plus the relevant stakeholders. Final decisions should be made during the workshop.
- **August onwards:** Planning and program preparation according to administrative procedures on both sides.
- **By mid 2003:** Tentative start of the program subject to approval by German and Philippine Government.