1 OVERVIEW

From its birth as an independent nation, the Philippines has held great potential. A 1960 World Bank report described the "dynamic qualities…of an economy in the 'take off' stage of development," noting the country's strong prospects due to its "good natural resources, a relatively high level of education, and political stability," along with its government economic policies and close ties to the United States. Additional advantages are its links to China, strategic location in the heart of East Asia, and population of industrious people, evidenced by the high demand for Filipino workers around the world in a wide variety of professions.

Despite these advantages, for decades the country's economic performance remained disappointing while many of its neighbors became celebrated success stories and lifted millions out of poverty. In 1960, the Philippines was one of the wealthiest countries in the region, with a higher level of GDP per capita than China, Thailand, and the Republic of Korea. By the close of the 20th century, the Republic of Korea's GDP per capita exceeded that of the Philippines by tenfold. The country failed to reach its potential, held back by a long period marked by martial law, corruption, coup attempts, and macroeconomic mismanagement.

Steps taken during the 1990s provided the foundation for the Philippines to begin a second chapter in its development story at the start of the new millennium. During that decade, the country righted its macroeconomic ship, achieved institutional stability, and pursued a series of structural reforms. The country opened up to trade, began to liberalize foreign direct investment (FDI), and expanded competition in the air transport, oil, power, and financial sectors. Reforms in the telecommunications sector helped make possible the flourishing of the business process outsourcing (BPO) sector, which has grown rapidly over the last 15 years to comprise 8 percent of GDP today. Overseas remittances, equivalent to about 10 percent of GDP, have provided a steady source of consumption-based growth. The foundation from the 1990s reforms in tandem with these factors have generated substantial growth across the economy since 2003 and in particular over the last decade following the global financial crisis. Annual economic growth rates over 2010-2018 averaged 6.3 percent, one of the fastest rates in the world.

Decisions the country is making today will determine whether the Philippines will start a third chapter in its development story and achieve its dream for 2040. The government's *Ambisyon Natin* 2040 vision, which derives from a wide consultation conducted with the Filipino public in 2015, describes the kind of life the Filipino people aspire for themselves and for the country by 2040: a prosperous middle-class society free of poverty. Achieving this long-term vision implies a tripling of per capita income by 2040.

The Philippines will not achieve *Ambisyon Natin* 2040 by simply riding its current wave of success. The Philippines needs to prepare its people for a future marked by technological change and the climate crisis. Technology has given the country a thriving BPO sector, but technology may also take it away, as some tasks become increasingly automated. And global heating threatens to devastate the economy over the long term in the absence of efforts to adapt. To achieve the country's goals, policymakers will need to build on the country's success with an eye to this future.

Realizing *Ambisyon* will require an expansion of inclusion. Only in the last few years has there been an appreciable decline in the poverty rate, and about 20 million Filipinos remain poor. Throughout much of its history, the country's institutions have been erected by and for a narrow slice of Philippine society, serving primarily its interests rather than those of the broader

populace. In particular, portions of Mindanao have suffered from neglect and exclusion, leading to a vicious cycle of poverty and conflict. The areas of Mindanao most affected by conflict stand out as the one part of the country left behind in the country's broader economic success. The highest levels of poverty are found in conflict-affected portions of Mindanao and areas at the eastern edge of the country that are highly vulnerable to typhoons.

This Systematic Country Diagnostic (SCD) identifies a four-part diagnosis of the constraints to the Philippines achieving its *Ambisyon Natin* 2040 goals. First, the country can enact policies that maintain its high rates of growth but also make that growth more inclusive and generate good jobs. Second, investments in human capital can ensure that Filipinos can lead healthy lives and have the skills for those jobs. Third, the Philippines can build its resilience to natural disasters and the looming climate crisis, while continuing to build peace in Mindanao. The common thread across all these challenges is the need for follow-through and implementation, which points to governance as the core cross-cutting challenge. The SCD addresses these thematic areas—inclusive growth and jobs, human capital, resilience, and governance—in turn.

1.1. Inclusive Growth and Jobs

Growth in the Philippines has not been highly inclusive. Median incomes have grown much more slowly than GDP per capita, while the wealth of the richest Filipinos has expanded much faster than the overall economy. The pace of creation of good jobs also remains inadequate. Millions of Filipino workers have moved out of low-productivity jobs in agriculture, and half of all workers now hold wage jobs with private firms. But the large bulk of these jobs pay meager wages, and fewer than half offer basic benefits.

Historically, many policies have not favored broad-based growth. Economic competition has been restricted by policies that favor existing conglomerates. Labor regulations have benefitted only those with formal wage jobs—less than a quarter of the workforce. Decades of underinvestment in infrastructure have limited possibilities for the private sector. And the country has failed to realize the promise of its natural resources; agriculture has been hampered by a heavy focus on rice to the detriment of other products with far greater potential. Confronting these constraints can simultaneously help the country maintain its high levels of growth, boost inclusiveness, and create good jobs. Further private sector growth will increase the demand

for labor, which will in turn lead to more employment and higher wages. Emphasis on addressing areas that most directly affect the less well-off can make growth more inclusive.

Limited competition. The Philippines has the highest level of market concentration and oligopoly power among major countries in the region. One reason many sectors are dominated by a small number of firms is that regulations create high barriers to entry. The Philippines is one of the most difficult countries in the world for launching a new business: only Equatorial Guinea and Venezuela require more procedures to legally start and formally operate a company. Such barriers particularly impede the growth of small enterprises that can be engines of jobs and inclusion. The 40 percent foreign ownership cap in most sectors further limits competition. In recent years, the government has taken steps towards improving competition: the Philippine Competition Commission was established in 2016, and the Ease of Doing Business Law was enacted in 2018.

Restrictive labor regulations. In practice regulations make it very difficult and costly to dismiss regular employees. Consequently, many workers are employed informally or on short-term "endo" contracts without benefits and job protections.

Weak infrastructure. International indices rank the Philippines as having the weakest infrastructure among major countries in the region. The country has achieved some notable successes including near-universal access to improved water sources. But it lags peers in developing digital infrastructure, and the critical elements of connective infrastructure—ports, rural roads, and urban public transport—are deficient, particularly in Mindanao. The government's stated top priority is infrastructure, with a focus on Mindanao.

Underperforming agricultural sector. Longstanding agricultural policy has been singularly focused on promoting rice, a crop for which the country does not have a comparative advantage. The Philippines was

until recently among a handful of countries with quota restrictions on rice imports. These quotas kept the price of rice very high, benefitting only the small number of farmers who were net rice sellers. The policies on rice also effectively discouraged farmers from moving into other products, stifling the growth of agriculture. The government recently enacted a law to convert the quotas to tariffs and move away from the focus on rice. Two other major constraints for agriculture have been lack of adequate extension services for farmers and poor rural infrastructure.

1.2. Human Capital

Human capital is critical to both economic growth and inclusion. The prospects for continuing economic growth in the Philippines will depend on harnessing the rising tide of technological change and expanding its high-skill services sector. The Human Capital Index (HCI), which captures the impact of human capital on future growth prospects, is a useful starting point for considering the country's human capital challenges. The country's HCI score of 0.55 indicates that due to shortcomings in education, health, and nutrition, the future productivity of an average child born today in the Philippines will fall 45 percent below potential.

Absent interventions to shore up human capital investments in low HCI regions, the gaps between wealthy and poor stand to widen. Children from the wealthiest one-fifth of families accumulate 40 percent more human capital than those from the poorest one-fifth. Children born into poor families have less access to high quality education and are more likely to suffer from health and nutrition deficiencies. They face an uphill climb through the education system partly because their families' income is less stable and disproportionately vulnerable to shocks resulting from natural disasters and catastrophic health expenses.

High level of child malnutrition. One in three children under 5 years old—and half of those in the poorest fifth of households—are stunted, a key marker of undernutrition. Research tracking Filipinos from a young age has shown that children who are stunted at age 2 may struggle to learn in school, will be at greater risk to drop out early, and will be less likely to hold formal sector jobs as adults. The expansion of public insurance in recent years dramatically improved health care access, but challenges remain in leveraging that insurance to boost the quality of services.

Low quality of schooling. There have been huge advances in recent years in the education system. Kindergarten was made universal and mandatory, and the basic school cycle was expanded from 10 to 12 years with the creation of senior high school. However, the quality of schooling is low, such that children who attend 12.8 years of schooling in the Philippine system learn as much as a child in a high-performing system learns in 8.4 years. Boosting learning will require following through on plans to improve teacher training, instructional materials, curricula, and school infrastructure.

1.3. Resilience

Geography and history have saddled the Philippines with twin risks of natural disasters and conflict. Many countries have natural disaster hazards or conflict hazards, but few face high levels of both. These threats have stifled development and poverty reduction in the areas most directly affected. The enduring high level of these risks points to the critical importance of efforts to enhance resilience.

Severe climate, environmental, and disaster risks. The Philippines lies within the path of Pacific typhoons and along the Pacific Ring of Fire where the risk of earthquakes is high. It is one of the countries most at risk for the impacts of climate change, which poses the largest threat to the prosperity of the Filipino people over the long term. Global warming will increase the intensity of typhoons, threaten agriculture yields, decimate the coral and fish ecosystem, and curb economic growth. Climate change also threatens to amplify levels of violent conflict. These risks highlight the need to ramp up a wide variety of measures for climate change adaptation and disaster risk reduction. The government has launched a Risk Resiliency Program (RRP), but the program has yet to become an effective vehicle for these efforts. The country can also help lead the worldwide effort to slow global warming by moving away from coal-fired power and tapping its high potential for renewable energy, particularly solar and wind power.

Continuing armed conflict. The multiple conflicts in the Philippines derive from a complex web of historical drivers, led by historical and social exclusion of the Muslim population in a portion of the Mindanao region. Armed groups do not pose a threat to the state. However, ongoing conflicts have paralyzed development and poverty reduction in particular places, with a secondary impact on the Mindanao region and the country as a whole. The recent formation of the Bangsamoro Autonomous Region in Muslim Mindanao (BARMM) as the result of a peace agreement offers new hope for peace in the region. The road to lasting peace will be long, and full implementation of the agreement will face challenges, among them the increasing terrorist threat posed by more radical groups.

1.4. Governance

The Philippines faces a complex mix of governance challenges. These pose a primary impediment to addressing the constraints related to inclusive growth and jobs, human capital, and resilience. There have been promising developments on many fronts in recent years. Almost every constraint has a corresponding existing program, law, or strategy intended to address it. The challenge is largely a question of follow-through and implementation.

Difficulties in implementation of policies and programs to address constraints weaken government effectiveness. Public administration challenges in the Philippines include weak public financial management, inefficient public procurement, overlapping agency responsibilities, limited civil service capacity, inconsistent decision-making over time, and excessive

caution of civil servants due to the personal liability they face. The government has taken steps to resolve some of these challenges.

A major rule of law concern in the Philippines is weak judicial efficiency, which stymies economic growth and regulatory effectiveness. The heavily overburdened judiciary suffers from significant governance challenges, with large backlogs at all levels of the court system. Important reforms critical for economic and social development can face delays of several years due to court battles. Due to poor performance of the judiciary, the Philippines ranks 152 out of 190 countries in the "Enforcing Contracts" sub-index of Doing Business. The court system is viewed as favoring the wealthy and powerful. Substantial rule of law concerns have also been raised about the deaths resulting from the war on drugs.

Voice and accountability are limited by political dynasties and vote buying. Members of political families or dynasties hold most elected positions, and vote buying is pervasive. These twin phenomena stifle voice, discouraging active political participation by those without family connections and wealth. They reduce incentives for policymakers, particularly at the local level, to focus on improving the lives of their constituents.

Vote buying and political dynasties lie at the nexus between extreme concentration of wealth, oligopoly power, and the weak rule of law. Although systematic data is lacking, numerous case studies demonstrate how historically the political system in the Philippines has been hijacked by the interests of economic elites. Politicians with money and the right family ties enjoy an edge in elections. Politicians often block implementation of policies and programs that threaten the dominant oligopolies and their owners, who may be the politicians themselves, their family members, and others who fund their election campaigns. The weak rule of law also favors the elites, who can navigate the courts and use them to tie up legislation they oppose.

Figure 1: Thematic Areas and Key Priorities

1.5. Priorities

The SCD team identified seven priorities to achieve *Ambisyon Natin* 2040, eliminate extreme poverty, and boost shared prosperity. The priorities were determined by considering the steps needed in the near term to lay the foundation for achieving the long-term vision for 2040 and beyond. Following the preparation of the initial diagnostic analysis and extensive consultations with government, the private sector, civil society, and academic experts, a prioritization exercise was carried out among the extended World Bank team. Drawing on the diagnostic analysis and input provided in the consultations, the team rated candidate priorities based on the extent to which addressing them will contribute to achieving *Ambisyon Natin* 2040 and the World Bank's goals of eliminating extreme poverty and boosting shared prosperity, the strength of the evidence basis for the priority, and the extent of complementarity between a given priority and others.

The priorities are not intended to be a comprehensive set of areas for government action. They were identified as having the highest importance for achieving *Ambisyon Natin* 2040. Many areas of more near-term concern and those in which government action has been effective—such as macroeconomic and monetary management—are discussed in the SCD but were not identified as top priorities.

A strong consensus emerged in the consultation process and the Bank's prioritization exercise that the overarching priority is upgrading the country's governance institutions to be "fit for purpose" for *Ambisyon Natin* 2040. Key steps include following through on implementation of the budget reform, improving the function of public procurement, and boosting the capacity of the civil service.

The remaining six priorities were categorized by the level of additional policy effort needed. Two priorities are classified as "Get in Gear", meaning that a major shift in effort is needed: tackling malnutrition and protecting the country from climate and disaster threats. Two fall into the "Press on the Accelerator" category: building the foundation for peace and closing the learning gap in basic education. These are areas where the current policy direction is appropriate but effort needs to be enhanced. The third category, "Keep Driving," covers two areas where the existing policy is on the right track but continued follow-through is needed: opening up economic competition and constructing quality infrastructure. Figure 1 shows the seven priorities mapped to the four thematic areas of the SCD.