

BUSINESS PROCESS OUTSOURCING

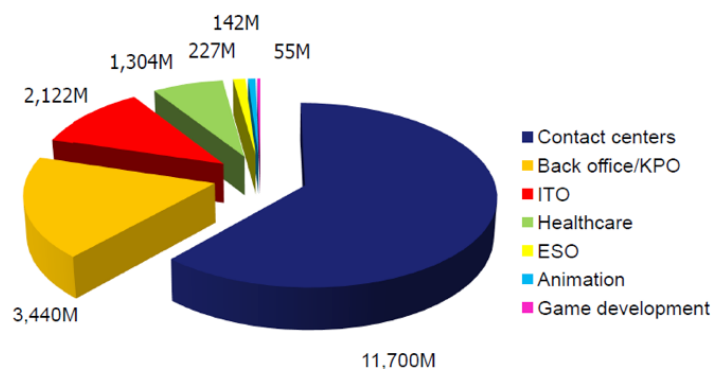
A POLICY NOTE
March 1, 2016

A BOLDER AND MORE INCLUSIVE DECADE

Bold Inclusive Reforms for Business Process Outsourcing for the Next Decade

In late 2015, PAMURI organized a roundtable with the Joint Foreign Chambers of Commerce and the IT and Business Process Association of the Philippines” (IBPAP) to assess progress of the IT-BPM industry since the original *Arangkada* Roundtable Discussion (RTD) in 2010 and make recommendations for its future over the coming decade. This note includes an assessment of how the IT-BPM industry has progressed over the last five years, an analysis of the growth catalysts and challenges, and a summary of what is required for the Philippines IT-BPM industry to deliver future sustainable, inclusive growth.

Figure 1: Philippine IT-BPM Industry revenue, by sub-sector, 2014



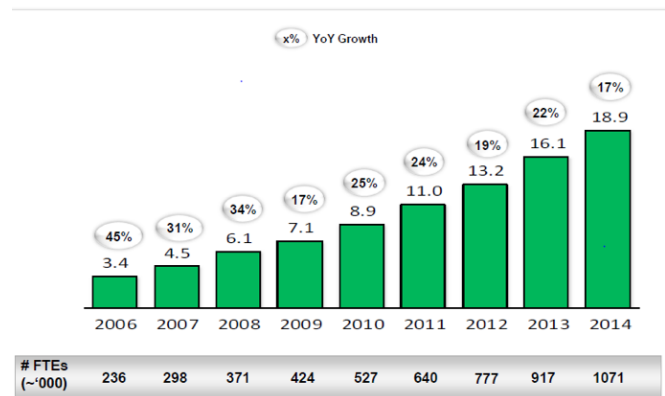
For reference, the IT-BPM industry includes the following subsectors - Contact/Call Centers (which is the oldest and largest segment of the industry), Back Office and Knowledge Process Outsourcing (Finance & Accounting, HR, research, analytics), Global In-House Centers (“Captives”), Information Technology and Engineering Services Outsourcing, Healthcare Information Management services outsourcing, and Creative services (Animation and Game Development).

IT-BPM Industry Growth and Accomplishments

Overall, the IT-BPM industry has been one of the shining stars of the Philippine economy as it has grown to include over 1.2 million direct employees, generating over USD \$21 billion in revenues, which is on the cusp of being the largest (industry) contributor to the Philippine GDP by 2017. The growth of the industry has been very steady and consistent (+20% CAGR since 2006) and the most dynamic rate of growth in recent years comes

from higher value services (i.e. Finance/Accounting, Healthcare Information Management services, IT) which are generating inclusive growth as it fuels growth of the middle class. This is particularly evident when compared to the current largest contributor to the Philippines’ GDP -- Overseas Filipino Workers’ (OFW) remittances -- which do not provide the same amount of economic benefits given the earners’ indirect spending and tax payments are made outside the Philippines.

Figure 2: Philippine IT-BPM Industry size 2006-2014; US\$ billion



This growth has been enabled by a large population of young, highly literate and English speaking workforce. The talent pool of university graduates (approx. >500,000 annually) has continued to improve their English proficiency and critical thinking skills, thanks to programs like the “Service Management Program” developed by the IT & Business Process Association of the Philippines (IBPAP) with funding from the CHED. This specialization track of 5 subjects and a 600-hour internship program to address the skill gaps of potential IT-BPM employees. Programs like this support the industry’s growth by ensuring a sustainable supply of qualified talent, and indirectly benefiting other industries by improving the overall quality of college graduates.

The government also stimulated the growth of the industry by extending both fiscal and non-fiscal incentives to multinational companies (MNCs) and outsourcing services providers (third party) to encourage them to locate operations in the Philippines and to help offset

training costs and the higher cost of doing business in the Philippines (i.e., prohibitive cost of power, gaps in basic infrastructure, number of non-working holidays, and a restrictive labor law).

There has also been recent evidence of growth of start-up firms, primarily in the software/e-commerce space, some of which were designed to support the growing IT-BPM industry. There has been evidence of increased “idea generators” and funding vehicles, but not yet at a critical mass to make a lasting impact.

Given that 75% of Filipino graduates are in the provinces, IBPAP and the ICT Office of the DOST partnered for the Next Wave Cities project wherein areas outside Metro Manila are evaluated based on a scorecard to gauge their capabilities to host IT-BPM companies. These locations are graded based on the following criteria – Talent, Infrastructure, Cost & Business Environment. Roadshows are also conducted in efforts to promote careers in IT-BPM and enable more sustainable growth of the industry outside metro Manila.

Industry Challenges

While the industry has experienced significant growth, and future growth projections are promising, there are multiple challenges that have likely limited historical growth and will put future growth rates at risk. The key challenges for future sustainable growth are the continuity of government incentive programs, predictability of government policies/regulations and bureaucracy/red tape, the supply of qualified talent, quality of higher education curriculum and technical skills development, and Philippine infrastructure. If not addressed, these challenges may become larger risks going forward, given the rapid pace of technology-based change and increased competition from other ASEAN countries.

Government Incentives/Bureaucracy – While both national and local governments have supported the growth of the IT-BPM industry through certain incentive programs (i.e., ROHQ and PEZA entity structures), the unpredictability of the government’s incentive program, uncertain tax environment, government bureaucracy, and lack of direct support & funding for MSME’s/start-up firms are negatively impacting current and future investment choices. The negative impact on Philippine investments is exacerbated when compared to positive progress and flexibility being shown in this sector by other ASEAN countries.

When companies choose to invest in an emerging market, they are seeking as much certainty as possible to offset the risks of investing in a developing country. This is particularly the case as the global economy becomes more volatile. In the context of the Philippines, investing firms are concerned about the financial volatility associated with the sustainability of current tax incentives and future tax liabilities (including ability to receive refunds for legally owed VAT refunds). This is evident as the government continues to debate continuing current incentive benefits, as some local governments do not honor special laws and national agreements, and as firms continue to find it extremely difficult to recover VAT payments which they are not legally obligated to pay. The propensity of the BIR to deny applications for VAT refunds is creating a huge disincentive for companies to increase or even maintain current investment levels, particularly when compared to options to invest in other markets.

When the level of financial uncertainty is coupled with the high administrative local and national administrative effort to establish businesses, pay taxes, and secure licenses, it becomes increasingly difficult for businesses to choose to increase investment levels.

This issue is most acute for MSME’s (Medium/Small/Micro enterprises) that typically do not have access to government incentive programs, have less experience and do not have sufficient financing opportunities. Growth in these firms, particularly those that are introducing new technology/innovation to the marketplace is critical for the success of this industry. For some of the smaller industries (particularly the animation services sector) that have huge growth potential, the lack of government support, and inherent bureaucracy are holding back their growth due to their inability to fund software and capital investments. Hopefully, this will change as a result of the government’s emphasis on supporting MSMEs at the APEC 2015 Summit and the December 2015 Nairobi WT ministerial meeting.

Technical Skills Development/Education - While past public/private investments in education have helped support the growth of the overall industry, we believe growth is being inhibited by a lack of graduates with higher level Science, Technology, Engineering, and Mathematics (STEM) degrees. There must be a concerted effort to increase STEM capability starting in the K-12 years.

The industry is rapidly evolving, and we expect change will accelerate with an increased reliance on higher levels of IT technology/innovation. This is evident in the new industry segments (software development and animation) and will become more so in the more mature segments (contact, BPO, GIC) as robotics and artificial intelligence become more commonplace. In order for the Philippines to participate actively in the growth associated with this evolution, there must be an improvement in the technical skills of college graduates, starting with increased exposure to computers and a stronger math/science curriculum in K-12.

Infrastructure/Broadband – The current levels of transportation (air, ground, and marine) and broadband infrastructure are having a negative impact on the growth of the Philippine IT-BPM industry. It is reasonable to expect the impact to worsen as the industry moves more towards cloud computing and other emerging ASEAN markets move faster to improve their infrastructure.

Enactment of the DICT bill will considerably strengthen the industry with the appointment of a cabinet-level champion in 2016. Even before its creation, however, it is urgent for the President to appoint the National Privacy Commissioner, thereby creating the National Privacy Commission, which will, in turn, bring about the creation of the Implementing Rules and Regulations to allow for the full implementation of R.A. 10173, signed in August 2012.

See the separate Arangkada Infrastructure and Broadband discussion papers for more perspective on the opportunity and recommendations.

Recommendations

We expect the IT-BPM industry will rapidly evolve with increased reliance on IT tools/robotics and as the industry transitions into new sectors. Workforce skill levels, the government support structure and other infrastructure that enabled the growth of the IT-BPM industry over the last 20 years, may not be enough to support future inclusive growth given how rapidly the industry and other ASEAN markets are progressing. The following recommendations should enable the sustainable, inclusive growth of the IT-BPM industry for future generations.

1. **Improve government incentive programs** – Incentive programs must evolve to best support growth of the established industries/sectors and
2. **Develop the infrastructure to support investment** – The potential growth of the IT-BPM industry is fully dependent upon breakthrough improvements in Philippine infrastructure and broadband capability. This includes more aggressively developing and executing plans to modernize transportation infrastructure (roads, public transportation, seaports, and airports) and broadband capability to support future growth.¹ The future broadband capability must enable highly network dependent businesses (i.e., “big data”, analytics, etc.) to prosper as well as enabling “work from home” as a viable alternative for mitigating risk associated with major business disruptions, while also alleviating traffic congestion.
3. **Talent development** – While we believe the K-12 intervention will provide some benefit, there must be a shift towards improving technology and science education and computer access at all grade levels. As noted in the ICT Manifesto.² “We need to re-orient the educational system to cultivate a new breed of creators, not just consumers, of technology.” This includes access to broadband for more households, integrating technology into all levels of education and an increased focus on the STEM curriculum. To make this possible, tax measures need to be amended to enable IT-BPM companies to donate their used computers (used for 3 to 5 years) to public schools/state universities and colleges without being obliged to pay donor’s tax, VAT and custom’s duties. IBPAP’s Service Management Program (SMP) should also include training modules for other industry sub-sectors (e.g. coding for HIM, storyboard for Animation, etc.).
4. **Government policy** – The government should have a more coordinated approach to support the sustainable growth of this industry through tax policy

and an improved regulatory environment that brings the Philippines up to international data privacy and cyber-security standards.

- Create the DICT which will oversee the development and maintenance of policies that directly support the sustainable growth of the IT-BPM industry including the implementation of the Data Privacy Act and cyber-security regulations to protect investors from data fraud and theft.
- A tax policy that incents investment including lower, more competitive corporate income tax rates and assurance that companies will receive VAT refunds that they are legally owed.
- By fostering the development of an innovation ecosystem to support start up ideas/innovation and to support the growth of new sectors (i.e. animation).

- Work to reduce the overtime cost of the high number of non-working holidays through holiday rationalization and to make employee dismissal more flexible.³

Conclusion

There is no doubt that the IT-BPM industry has been a significant economic driver for the Philippines over the last 20 years. But it is important to recognize that the technology/global economic landscape that enabled the past growth of the Philippine IT-BPM industry may not support future growth as technology gains and global economic factors rapidly change. The recommendations above are required for the industry to capitalize on these changes to enable future growth and offset inevitable employment losses behind robotics/artificial intelligence.

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1. The Arangkada Philippines Project (TAPP) hosted a roundtable on December 3, 2015 to discuss recommendations to improve the speed and lower the cost of broadband service in the Philippines. Results were published late February 2016.
 2. Shared Prosperity: An ICT Manifesto for the Philippines for 2016 and Beyond, Lee Kuan Yew School of Public Policy and Microsoft (undated) released in November 2015.
 3. Non-working holidays are considerably higher in number in the Philippines than in competitor countries. For example, Vietnam has only ten a year, while the Philippines has twenty or more.