

GUIDELINES FOR TARIFF POLICY: A CRITIQUE

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Tariff Commissioner Montano A. Tejam has recently discussed some of the bases for policy recommendations of the Commission (*Manila Times*, August 18, 1967). While warning that "tariff-making is not an exact science," he suggests that:

Broad statements of tariff policy may no longer be debatable and hardly need justification for their adoption. Among them are:

- (1) Protection for deserving domestic industries;
- (2) Low rates of duty on highly essential articles not locally produced in sufficient quantities and in desired quality;
- (3) High rates of duty on non-essential and luxury articles; and
- (4) Lower rates of duty on raw materials than those on finished products.

In fact, these and similar broad statements of tariff policy need not and have not been written in any tariff law but have nevertheless served as guidelines in the enactment of such laws.

It is evident from Commissioner Tejam's full statement that these guidelines are not of his making, but that he is merely recognizing what are, I think, widely approved principles of tariff policy. Hence he cannot be blamed for their shortcomings, if they exist. That could be the fault only of the economics profession, where the ultimate responsibility for clear economic thinking resides. Unfortunately, these guidelines do appear to me to have serious weaknesses, so I feel an obligation to try to point out where these weaknesses lie. If I am wrong my colleagues in the profession will correct me. But if I am right there are important implications for tariff reform as a means of enhancing Philippine economic development.

Of the four guidelines, the first, as it stands, is harmless, but not very helpful. The real question is, of course, the meaning of "deserving." This is the heart of the whole rationale of protection and, therefore, should include the others as sub-criteria. I shall return to this broad criterion below, but it may help to clear the ground by directing attention first to the other three.

The second and third can be considered together. Restricting imports of "non-essentials" while permitting the liberal importation of "essentials" commends itself, no doubt, to common-sense everywhere. Hence, these guidelines tend to have a universal appeal. Let me play the devil's advocate, however, and suggest reasons why the exact opposite—i.e., restricting "essential" imports and liberally importing "non-essentials"—might be superior.

First, consider the case of goods that are essential or non-essential on some consumption standard—i.e., consumption goods that are identified either as "luxuries" or "necessities" (to keep the argument simple). Suppose that, via exchange control, imports of luxuries are excluded and imports of necessities are freely allowed. What will be the resulting pattern of incentives to investment?

Clearly, the scarcity of luxuries (and resulting high prices) will strongly encourage investment in facilities to produce them (or similar luxuries as substitutes). On the other hand the free, or more liberal, import of necessities from abroad will keep their prices low and discourage investment in their production. Thus import substitution will occur, but the new domestic industries will tend to concentrate on goods less essential from the standpoint of consumption. This can continue until domestic production has risen sufficiently to meet fully the market demand for these goods. At the same time imports will become concentrated on necessities.

What are the consequences of this? First, growth of output and employment in the new industries will depend on growth of luxury consumption. Any desire on the part of a progressive government to accelerate economic growth or to redistribute its gains more equitably will be frustrated by the need to keep employment and output going, and growing, in the favored industries. More specifically, any attempt to raise saving or redistribute income by taxing luxury consumption will, at this point, create unemployment and idle capacity. Hence, there will be strong pressures against the kind of tough fiscal policy that is needed both for growth and social justice.

At the same time, the nation will have become heavily dependent on the world for its supply of essentials, and consequently will have diminished its degree of flexibility in import policy. Any shortfall in foreign exchange earnings from exports (or in capital inflow) will face the government with the dilemma of choosing between artificially encouraging the expansion of traditional exports, with the consequent terms of trade risks, or restricting "essential" imports. (Of course, borrowing from abroad is always a third possibility.)

Suppose instead, however, that the policy had been to permit free imports of luxuries and to restrict imports of necessities. Domestic industries would have been encouraged to produce the latter, while the import bill

would be concentrated on non-essentials. Any balance of payments crisis could be met by restricting imports at no cost except the luxury consumption of the rich. Moreover, a progressive government could easily implement a program to raise saving (for development investment), or to redistribute income, in either case simply by taxing luxury consumption—and this time at no cost in unemployment or idle capacity.

At this point, the reader should have at least a mild sense of outrage at my complete neglect of the time interval between the initiating of the alternative protection policies and the resulting pattern of industrial production and imports. After all, these industries do not spring up overnight. And in the meantime, necessities are scarce and expensive while luxuries are abundant and cheap. The key to resolving this dilemma is the distinction between the “consumption effect” and the “protection effect” of imports restriction. Policy-makers usually have the former in mind when they set priorities for imports favoring necessities. But, as we have seen above, the protection effect will operate nonetheless to encourage production of luxuries and discourage production of necessities. The obvious way to avoid this is to control *consumption* by domestic taxes (and subsidies) so that tariffs (or other import restrictions) serve only to determine whether domestic *production* or imports shall be the source of supply. That is, while there might be duties on necessities to encourage domestic production, their consumption could be subsidized (and this would be a further spur to investment in these industries). Luxuries, on the other hand, could come in duty-free to discourage their production, while their consumption could be discouraged by heavy domestic taxes (which, in turn, could finance the subsidies).

A very important category of essential goods has been neglected so far, however. You will recall that I restricted the question of essentiality to a consumption standard. What ordinarily happens in the course of an import-substitution-oriented development process is that the import bill becomes increasingly dominated by materials, intermediate goods, and capital goods that are “essential” to the operation and expansion of the new manufacturing industries. These essential goods tend also to be treated liberally by the import control system, so that their domestic production, too, is discouraged. There is a bias against so-called backward-linkage in production.

While Commissioner Tejam’s fourth criterion mentions only raw materials as qualifying for lower duties, I suspect he would also include intermediate materials and capital goods. At least this is consistent with the actual tariff structure in the Philippines.

The effects of this “escalating” of tariff structures—i.e., higher duties on finished products and lower duties on products at the earlier stages

of production—are by now well-known.¹ However, to dramatize the results, a simple hypothetical example might be permitted.

Consider two industries, each of which imports materials and adds value to them to produce a finished product.

	A		B	
	FREE TRADE	WITH TARIFF	FREE TRADE	WITH TARIFF
Material imports	80	80	20	20
Value added	20	70	80	130
Value of output	100	150	100	150

Industry A has imported inputs worth 80 to which value of 20 is added to yield an output of 100. Industry B has imported inputs of 20 and value added of 80 to yield also 100 of output. Now, suppose that a 50% duty is placed on both A and B while their inputs are still allowed to enter free. The price can rise in each case to 150 and value added—the reward to labor and capital—can in each case rise by 50. In the case of A, however, this means rewards three and one-half times as large as before, while in B value added is only 62.5% greater. A greater incentive, by far, is given to new investment and employment in A than in B. Yet, A is more heavily dependent on foreign supplies—i.e., the bigger user of foreign exchange. Moreover, no encouragement at all is given to investment in domestic production of the materials now imported. So what might appear to be equal protection of 50% given to two industries turns out to be 350% to one and 62.5% to the other *at the finishing stage of the production process*, and no protection at all to potential output at the earlier stages.

Moreover, while domestic production in the favored industries is protected against world competition in the home market, no similar protection is accorded the same goods, or others, when competing in the world market. The protection of a price differential for domestic goods (of favored industries) in the home market encourages relatively inefficient use of resources to save foreign exchange via replacement of non-essential imports; while the absence of any price differential *vis-a-vis* foreign goods in the world market means that only industries that use resources relatively efficiently can earn foreign exchange via exports.² The result is that it costs more resources at the margin to save a unit of foreign exchange

¹ H. G. Johnson, "Tariffs and Economic Development," *Journal of Development Studies* (October, 1965). Also J. H. Power, "Import Substitution as an Industrialization Strategy," *The Philippine Economic Journal* (Second Semester, 1966).

² In the Philippines, sugar is an obvious exception, being protected by U. S. import restrictions and the Laurel-Langley Agreement.

through import substitution than it does to earn a unit through export expansion. (This abstracts from terms of trade effects, but see below.)

The likely results, then, of a tariff policy based on guidelines (2), (3) and (4) are: discouragement to exports and backward-linkage import substitution (intermediate goods, capital goods and raw materials), together with the greatest encouragement to import-dependent industries producing less essential products. These are the implications of some of the guidelines that serve tariff policy-making in the Philippines (and elsewhere).

The discouragement to exports and backward linkage is particularly disturbing from an economic growth standpoint, since there are obvious limits to an industrialization based on finishing-stages manufacture of consumption goods (even without the bias against essentials). Increasingly investments opportunities would run up against domestic market limitations and the pace of industrial growth would retard unless: (1) manufactured goods are able to penetrate the world market, (2) import substitution moves back to the earlier stages of production, or (3) the domestic market should somehow begin to grow very rapidly (from sources other than industrialization).

Considering the last-named possibility first, an agricultural revolution that raised per-capita income very rapidly without substantial capital inputs would enable the pace of industrial growth to be sustained over the course of the revolution. But if growth of domestic income depends substantially on capital inputs, we are back to requirements (1) and (2) above. For rising investment implies either rising capital goods production (2), or rising capital goods imports. The latter, in turn, requires either export expansion (1) or further import substitution (2). (I am neglecting rising dependence on external financing.) But it is precisely these—exports and backward-linkage import substitution—against which the market system is biased by the policy of protection described above.

Moreover, with the expansion of domestic production of substitutes for the restricted consumption goods imports, the control over consumption increasingly depends more on taxation and restriction of imported supplies for these industries. The latter would encourage backward-linkage import substitution, but is likely to be opposed by the using industries that make up the bulk of the manufacturing sector. The same is true of consumption taxes. So, there will be strong pressures in the direction of maintaining the "import-dependence" (a phrase borrowed from Dr. Gerardo Sicat) of the import-substitution industries, and corresponding constraints on the government's ability to control consumption via taxation. Thus, the shift in income distribution to the industrial sector may result in high urban consumption at the expense of the rise in saving that development theory postulates.

There are several other possible characteristics of an industrialization induced by such a biased protection system that I shall mention only briefly. (1) Because of the more liberal restraints on capital goods imports, there is a bias in favor of capital-intensive techniques. This reduces the employment effect of industrial expansion. And, together with the more liberal restraints on imports of intermediate goods and raw materials, it means also that the industries most heavily dependent on imports receive the greatest relative encouragement.

(2) Because of the import-dependent character of industrialization, there is a bias in favor of location near the principal ports. When the principal port is also the seat of government (Karachi, Manila), there is a double advantage since one can more effectively press for import licenses and other favors.

(3) The manufacturing sector becomes partly an enclave—an opposite sort from the traditional enclave in a colonial situation—but an enclave, nevertheless. Instead of linking backward on the supply side to the agricultural and mining sectors, it is dependent on the world for a substantial part of its inputs. Even on the demand side, many of the new industries depend for their sales on the free-spending new urban classes.

(4) The agricultural and mining sectors remain dependent on the world market, while the manufacturing sector grows increasingly dependent on the former's foreign exchange earnings as the imports bill rises. This poses the dilemma of pushing traditional exports harder, with the attendant terms of trade risks, or increasing dependence on foreign aid and capital. (This seems to be the case of India despite considerable industrialization.)

(5) The non-manufacturing sectors may not yield to the terms of trade loss required by protection of manufacturing. In this case, an incomes struggle ensues with chronic inflation as the result. (This seems to have been true in Chile and other Latin American countries, but not in Pakistan or the Philippines.)

These, it seems to me, are some of the logical implications of the kind of protection that is likely to result from the application of guidelines (2), (3), and (4). How does this picture of distortions, biased against efficiency, equity and growth, compare with the actual structure of protection in the Philippines? Preliminary estimates of rates of protection of value added in 55 manufacturing industries have been reported recently in *The Philippine Economic Journal*.³ These rates have been calculated in a manner similar to that in the numerical example above on

³ Power, *op. cit.*, pp. 184-186.

page 66 (though the actual calculations are considerably more complex).⁴ In the table below, the 55 industries have been classified into five groups for each of which an unweighted average rate of protection is indicated.

GROUP	AVERAGE RATE OF PROTECTION
Exports	-.14
Capital Goods	.06
Intermediate Goods	.49
Inputs into Construction	.56
Consumption Goods	.83

Exports have negative rates because, while they receive no protection (sugar excepted), they are penalized by having to buy some inputs that are protected. Capital goods industries include both construction and manufacture of equipment. The low level of protection for the latter plus the penalty on the construction industry from highly protected inputs means a double-edged bias against expansion of production of capital goods.

Intermediate goods are more favored than capital goods, but much less favored than finished consumption goods. Among the latter non-essentials like autos (2.03), perfumes and cosmetics (1.44), cigarettes (1.21) and candy and chocolate products (1.19) have very high rates, but so have essentials like vegetable lard and margarine (1.34) and cotton textiles (1.32).

I think it is safe to conclude that the system of protection in the Philippines is biased toward industries that are less essential on growth criteria and possibly on consumption criteria also, though this is less certain. And, since the 55 industries are rather evenly spread within a range from -.22 to +2.03, it is likely that the distortion in resource allocation resulting from the system is very substantial.

This judgment must be qualified, however, by a warning that the rates estimated indicate the protection *accorded* to various industries and say nothing about the extent to which protection is actually used. Of the twenty with the highest rates of protection, twelve show imports as less than five per cent of output and seventeen as less than ten per cent. For many of these, tariff protection may not be fully utilized. A casual survey suggests that this is true for soap, men's and women's garments, shoes, knitting mill products, soft drinks, furniture, cotton textiles, toilet preparations, vegetable lard and margarine, and metal closures and crowns. It is true even for autos where imports are twelve per cent of output.

⁴ *Ibid.*, Appendix, pp. 201-204.

Hence, there is considerable doubt that the rates estimated—particularly at the high end of the scale—are “effective” rates in the sense that they can be said to have raised domestic prices above world prices to that extent. Of course, price comparisons must take into account possible quality differences; and the system of protection may be protecting inferior quality rather than high price. Moreover, there appears to be a strong bias among the wealthy and foreign elite in favor of imported goods. Thus, there may be a small market for imported goods that is separated from the larger market and the system of tariffs and taxes has a revenue effect but little protective effect since the two types of goods are not really competing at the margin. This might be true of men and women’s garments, shoes, cotton textiles (especially Italian and Swiss), cosmetics, and even cigarettes.

Moreover, it is believed here that evasion of the system of protection is widespread, though quantitative evidence is difficult to come by. George L. Hicks has compared aggregate imports with exports to the Philippines from trading partners and has concluded therefrom that a substantial portion of imports is under-reported.⁵

In addition, I have not taken into account the effect of tariff preference (10%) for U.S. goods exported to the Philippines. On the other side, I have not estimated the influence of exemptions from taxes on imported machinery and equipment for certain industries. The reason for neglecting the former is my feeling that this simply permits high-priced U.S. goods to compete with, say, Japanese exports, rather than to reduce the level of Philippine protection. The reason for neglecting the latter is that the list of industries is a changing one and, in any case, the differences would not be great since taxes and duties on machinery are generally very low as are their input coefficients (depreciation). (These exemptions might be quite important, however, in affecting investment incentives.)

These qualifications should warn us to be cautious about drawing conclusions from these estimates concerning relative efficiency in the use of resources. In particular, I think that price distortion, especially at the high end of the rate scale, is not as great as the raw calculations suggest. Nevertheless, these estimates probably give a rough indication of the *order* of bias in the system of protection.

What would an unbiased system be like? First, protection would have to be equalized among production activities at the various stages in the production process—raw materials to finished goods. This could be done by setting equal tariff rates on all products, since this would also equalize rates of protection of value added.⁶ But exports sell at world prices (in the absence of monopolistic price discrimination), so they cannot be

⁵ “A Revision of Philippine Export and Import Statistics” (unpublished).

⁶ For a proof of this see Power, *op. cit.*, p. 176.

protected by tariffs. Instead, subsidies, proportionately equal to the uniform tariff rate, should be given to exports. Exceptions could be made for those few exports for which terms of trade effects might be significant. Depending on estimates of world demand elasticities, they should receive less or zero subsidies, or possibly even be taxed.⁷

Since this general subsidy would greatly encourage exports while leaving the subsidy to import substitution just where it was, the trade balance would be improved and the equilibrium price of foreign exchange reduced. Alternatively, however, the exchange rate could be held at the previous level and the average degree of protection reduced while at the same time introducing the matching subsidies to exports at the same lower level. These would be roughly equivalent means of rationalizing the overall level of protection, the second method having the additional advantage of exchange rate stability.

In this way, the biases against backward linkage and exports would be eliminated. But this is really equivalent to free trade with an equilibrium exchange rate! (Except that a few exports would be taxed for terms of trade reasons.) To protect everything equally is to protect nothing. For the equilibrium exchange rate will simply move to offset any degree of protection. So, a 100 per cent duty and subsidy to all industries will simply be offset by a 100 per cent rise in the value of the currency *vis-a-vis* foreign exchange.

Where does protection come into the picture, then? What should be protected, and how? First, there might be a case for protecting against all imports—i.e., discriminating against all exports—because there are some terms of trade effect arising from the whole range of exports and imports. Since we have already set aside, however, those exports with “significant” terms of trade effects, the rest will be “insignificant” and the degree of protection warranted for this reason will be very slight. This could be accomplished by giving a slightly lower subsidy to exports in general than the general degree of protection against imports. But this is a trivial problem. Once the exports for which world demand elasticities are significantly below infinity have been separated out for special treatment, the terms of trade justification for protection is very slight.

But the infant industry argument for protection is a real one. It depends simply on the existence of economies of scale and the fact that earning processes take time. But, while tariffs could be used to give special encouragement to certain industries that are judged to be more responsive than others to scale economies and time-consuming earnings processes, the better method might be a direct subsidy. For the tariff has the dis-

⁷ *Ibid.*, pp. 174-175.

advantage of penalizing the users of the product protected and there is a welfare loss from misallocation associated with this whether the users are business or consumers (since they face a price that does not reflect opportunity cost). On the other hand, a direct subsidy must be financed by taxation and the tax system may not be capable of raising the necessary revenue without equal or greater distortion than that which results from tariff protection. So the choice in the end is likely to be a practical one.

However, since the gains from infant industry protection depend on concentrated, not dispersed, growth, the temptation to extend infant industry protection too broadly must be avoided. Just as protecting everything equally means protecting nothing, bringing too many industries into the infant category simply dilutes the inducement to concentrated growth in the most responsive industries.

Finally, I think we should admit that tariff policy is in part an international problem. We must deal with the reactive protectionism of the advanced countries in the face of competition from new manufacturing industries in the less developed countries. This, together with the obvious difficulties of basing an industrialization on limited demand in the home market, leads directly to the case for preferential tariffs among less developed countries. The point is to achieve import substitution in a wider market, so as to take mutual advantage of the gains from concentration and scale.