of land use, which will in due time come to the Supreme Court.

A law which Filipinized the retail trade was enacted in 1954. Originally intended to drive the Chinese from the small-scale retail business, the law failed to give a statutory definition of "retail." This was therefore left to the Courts to determine. In a decision of a lower court, sales in bulk of large petroleum refining companies to petroleum distributors were interpreted as "retailing" for purposes of the law. Another lower court, however, subsequantly arrived at an entirely different ruling by accepting the more common definition of retailing as sale to "final users" for consumption. These semantical differences in interpretation have obviously important economic consequences. However, some foreign-owned companies have created, as a hedge against adverse court decisions, 100 per cent Filipino-owned corporations to perform all marketing functions.

The constitutional limitation on owning land is based on the historical fear of the evils of landownership concentration traceable to the injustices of land policy during the Spanish regime. The constitutional provision takes the form of limitations on the amount of land that corporations and individuals can acquire through purchase or lease of public lands, and of prohibition on the ownership of agricultural lands by foreigners. Under subsequent legislation immediately after the Constitution became operational in 1936 under the Commonwealth Government, Congress extended the definition of agricultural lands to include residential, commercial, and industrial

land, both urban and rural. The Constitution provides a limitation of up to 40 per cent of equity for foreign ownership if they engage in the exploitation of the country's natural resources. All these provisions are the results of the wishes of the framers of the Philippine Constitution to preserve for Filipinos "the patrimony of the nation."

The legality of leases of large tracts of land to foreign investment subsidiaries in the pineapple and banana plantations in Mindanao has recently become an issue which is bound to be decided ultimately by the Supreme Court. In fact, a large banana plantation project by United Fruit Company was ~~ultimately~~ rejected in 1965 on grounds of the size of the public land area to be leased.. (Of course, the ~~ultimate~~ decision was colored very much by the reputation of this company in Central America in respect to political matters.)

Another issue to be ultimately decided by the Courts, which is of great consequence to the status of all American direct investments in the Philippines, is the interpretation of "parity rights," first acquired under the constitutional amendment of 1946, which gave to Americans all rights reserved for Philippine nationals with respect to investment in natural resource exploitation; and later extended by the 1955 amendment to the original Trade Agreement, to all forms of American investments. The Philippines has recently taken the stand that "parity" rights will not be subject for discussion in any negotiation of trade agreements in preparation

for the termination of the current arrangements which end in 1974. An important economic power of the courts, therefore, arises from the fact that they will interpret the status of all types of rights acquired by American nationals under the "parity provision" before 1974. The American government, in response to pressure by Americans with interests in the Philippines, has taken the position that these rights should be retained even after 1974. The current view in the Philippines is that all rights acquired previous to 1974 also expire in 1974. In a recent test case, a lower court ruled that Americans can own lands after the termination of the parity provision.

In brief, the Courts will have to make decisions which will have important economic consequences in the 1970's. It might be added that the question of landownership by foreigners need not have a major effect on the foreign investment climate. Many countries in Asia have the same restrictive laws and yet this has not deterred the entry of foreign capital.

The Forthcoming Constitutional Convention

The above discussion is based on the Constitution of the Philippines of the 1930's on which the present Republic is based. In 1971, a constitutional convention will meet and the total basis of Philippine political organization will be placed under scrutiny. Since the present constitutional framework required the approval of the U.S. President, this will be the first

truly nationalist constitution. 5/ An apparent emerging consensus among Filipinos is that the term of the President (which was originally for one six-year term until it was amended to accommodate the personal intentions of the popular incumbent Commonwealth President in 1940) will be fixed at a single term, probably in excess of 4 years (the current length of a term) but not more than 7 years, with provision against reelection. Another question concerns the bicameral nature of the legislature. To many observers, these changes would reduce the economically wasteful drain on resources from frequent elections. They would consequently usher in a more consistent direction of economic policies for perhaps at least six years and further simplify legislative procedures.

Entrepreneurship

The Philippine economy is based on private enterprise. It has experimented with government enterprises in certain areas of pioneering industries, especially in textiles, cement, and fertilizers. But experience with these efforts has, by and large, produced little impact on the course of industrial activity. The Government has, of course, large interests in railroads, hydroelectric power, and water distribution, but major public utilities may be privately operated provided they meet legal requirem

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5/ See the duscussion of the Constitutional Conventi
et al, Underdevelopment and Economic Nationalism (Ithaca
nell University Press, 1969), pp. 42-51. The chapter o
nationalism in this book provides a very good backgr
concerning nationalism and economic policy.

concerning the nationality of equity capital, which is 60 per cent Filipino (as amended of course by the parity provision).

Beyond taxing and spending policies, the regulation of bank credit, and other similar indirect economic polices, the only important areas where the government exercises direct functions are commercial banking and long-term finance. The government-owned Philippine National Bank controls about one-fourth of the total commercial banking system assets. Government long-term financing institutions (the Development Bank of the Philippines and the social insurance agencies: the Government Service Insurance System and the Social Security System) generate more than 90 per cent of the external long-term finance funds available for industry. It should be added, however, that firms often finance their long-term needs with short-term bank credit.

In this setting, private entrepreneurship plays a critical role. Economic development depends to a significant degree on the direction given to the private sector by the economic policies of the Government. The sources of domestic entrepreneurial supply in industry traditionally came from commerce, finance, trade, the universities, and foreign investors. The industrial promotion policies of the 1950's shifted entrepreneurial resources away from traditional areas into manufacturing. The development of import-substituting industries in the 1950's is the best illustration of the positive response of entrepreneurs in the Philippines to policies which change the relative attraction of different industries.

First, nationals engaged in other activities -- commerce, finance, and traditional exports -- seized the opportunities of establishing new and relatively (even if artificially) profitable enterprises. The growth of many new product lines in manufacturing industries was a direct result of the incentives offered by the various new protective measures. Licensing arrangements in cigarettes, drugs, food products, beverages, and automobile assembly favored entry by Filipino capital, sometimes in joint equity ventures with foreign companies.

On the other hand, as in many other developing countries, erstwhile sources of imported supplies threatened with the loss of their market were attracted to establish industries based in the Philippines. This was the usual motive for foreign investments in the Philippines in the 1950's. Joint venture arrangements were actively encouraged by Government policy. The foreign investments which came in therefore were largely import substituting in character. The oil refining companies, drugs, metallic and non-metallic manufacturing, as well as trade and commerce in the wholesale field, were heavily dominated by foreign investments, largely American.

The only other foreign nationals with substantial equity in the Philippine enterprises are Chinese. Investments by British, Swiss and Spaniards in manufacturing are relatively small. On the other hand, Japanese capital has been literally knocking at Philippine doors, especially in the 1960's. But many aspects of policies relating to Japanese investments must await

the ratification of the treaty of commerce and friendship with Japan, which has long been shelved in the Senate. With the exception of the Chinese, therefore, the entry of direct investments by foreigners other than Americans has been negligible.

However, foreign capital in the form of supplier's credit has increased in importance in recent years and this is an area in which Japan has been dominant. The increase of supplier's credit from Japan was helped substantially by the use of reparations for private industrial projects. After the mid-1950's, reparations became a steady source of new capital goods imports for private and public development projects. This was the initial exposure of Filipinos to Japanese capital goods, in addition of course to aggressive Japanese export trade policy.

In general, capital has moved in response to entrepreneurial decisions in the directions to which policies have pointed. The "net" structure of economic incentives resulting from the various policies has induced entrepreneurs, whether domestic or foreign, to move into import-replacing industrial activities. Whatever difficulties have developed in this process cannot be blamed on a lack of entrepreneurship.

The nature of the investment response has been documented in several studies.6/ Small firms have been highly motivated by the availability of profits as inducement and larger firms by the sales generated through a captive market. There has been an encouragement of final goods import

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6/ See R.W. Hooley & G.P. Sicat, "Investment Demand in Philippine Manufacturing" (Discussion Paper 67-2); J.H. Power, "Import Substitution as an Industrialization Strategy, "Philippine Economic Journal, vol. V, no. 2 (Second Semester 1966), pp. 167-204; J.G. Williamson & G.P. Sicat, "Technical Change and Resource Allocation in the Philippine Manufacturing: 1957-1965 (Discussion Paper 68-21). See also John J. Carrol, The Filipino Manufacturing Entrepreneur (Ithaca, Cornell University Press, 1965) for the social characteristics of a sample of the emergent entrepreneurial class.

substitution, an excessive dependence of industry on imported material inputs, a neglect of industries based on agriculture (except the traditional exports), and a tendency for a relatively capital-intensive factor mix. And these are what the system of incentives called for, a matter to which we turn in greater detail in the next two chapters.

Economic Planning

There is a well known propensity on the part of governments in the Philippines to have paper development plans. Many such plans have been prepared, but the bottleneck in implementation has always been administrative organization.[7] We shall outline briefly here the organization for planning that has existed in the past, as well as the emergent organization that has arisen as a result of a demand for an administrative framework more consistent with the desire for rapid development.

The National Economic Council (NEC) was created as early as 1936, but was reorganized in the mid-1950's. Its broad base, desirable on the surface, has become its major weakness from the standpoint of effectiveness. Its membership is a mixture of representatives from the two houses of Congress and appointees of the President. This diffused membership subjected it to congressional interference and correspondingly encouraged its isolation from the executive. It has drafted grandiose plans which are beyond the limits of government resources. It has little connection with the rest of the governmental machinery for planning. What might have been its most important function, the administration of foreign aid programs, has been of negligible significance because of the relatively small inflow of direct foreign aid.

A second problem with the NEC is its manpower complement. It has not been able to attract the most competent high-level technicians nor retain

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7/ For a lucid discussion of problems of Philippine planning, see the respective papers of Armand V. Fabella, Frank H. Golay, and Sixto K. Roxas in the Philippine Economic Journal, Second Semester 1965, special issue on Economic Planning in Southeast Asia.

its best staff members, although its middle level technicians could be encouraged to produce good work, given leadership at higher levels. This has greatly limited its accomplishments. In its task of preparing the national income accounts, for example, it has been fairly criticized for falling below standards required for effective economic planning.

This situation gave rise to the need for a technical economic staff directly under the office of the President. Thus in 1962, a Program Implementation Agency (PIA) was set up. The same agency was reorganized into the Presidential Economic Staff (PES) in 1966 upon the assumption of Ferdinand Marcos as President. This agency has taken a more active role in planning and in implementing the plans. Its strategic location within the office of the President has given it greater access to all the operational agencies of the government. Its most successful accomplishment, for which President Marcos subsequently got tremendous political leverage in his successful reelection bid, was the infrastructure investment program, with emphasis on elementary schoolhouse construction, as well as on roads and irrigation to complement the revolution in rice culture based on new seed varieties.

In a bid to reassert its role in economic planning, the lower house of Congress recently created a Congressional Economic Planning Office (CEPO). In the upper house, an Economic Affairs Committee coordinates closely with the CEPO. Although itiis the newest planning agency, CEPO succeeded in preparing, in consultation with the economic planning agencies in the executive branch and with the private industrial sector, Joint Resolution No. 2 of Congress, known popularly as the Magna Carta of Social Justice and Economic Freedom. This resolution, passed by Congress in 1969, represents a statement of national economic and social objectives, with only very general references to the means by which these are to be achieved.

It is hoped by Congress that this will serve as a guideline to future legislation on economic and social matters.

The broad objectives are self-sustaining economic development, a more equitable distribution of income and wealth and a greater degree of national independence. National planning is endorsed as a means of guiding and coordinating the private economy. In this "the State shall be guided by what is socially and economically desirable rather than by what is profitable alone." Austerity and self-reliance are urged, especially in the use of foreign exchange, which "shall be subjected to a rigorous system of priorities ..." On the other hand, the State has the responsibility to maintain a favorable climate for investment that will encourage the people to implement the plan, and will not stifle individual initiative, innovation or free economic choice subject to such limitations as the national interest may dictate." Finally, the section on "Commitment to Economic Independence" strongly endorses Filipinization of capital ownership, as well as diversification of the direction of international trade so as to reduce dependence on the United States.

In addition, the CEPO has revived the concept of a National Economic Development Authority (NEDA) first proposed in the mid-1950's, which operates along the guidelines of a mixed Executive-Legislative planning of economic development. NEDA is being proposed as a super economic body which will replace the NEC, the PES, the Budget Commission and other agencies with planning and execution functions. These measures are currently (late 1969) being discussed and are part of a proposal for overall governmental reorganization.

Planning Private Industrial Growth

The need to guide private industrial growth more in accordance with social priorities gave rise also to the Board of Investments (BOI) in 1967. Previously, industrial promotion had been undertaken by a mix of different agencies. A technical staff of the Department of Finance was responsible

for processing applications for tax exemption privileges under earlier laws. Then a Board of Industries, composed of heads of several governmental ministries, administered import tax exemptions to industrial enterprises. Since these favored industries were by and large also seeking long-term financing from the government financial institutions, decisions at the latter end were also important in industrial promotion. In addition, by controlling foreign exchange allocations to private industries during the period of controls, the Central Bank played a key role in influencing private investment allocation. After decontrol the tariff structure became the most important policy influence on private investment decisions.

In the face of a variety of scarcely coordinated public policies, administered separately by various government agencies, all affecting the profitability of private investment, the Board of Investments, under the Investment Incentives Act, has the responsibility to present yearly plans of private industrial priorities. These are to contain the industrial activities to be promoted and the extent of capacity expansions required, as well as a report of achievements in the past year. It has the power to give tax, credit, and other incentives to new industries. Unfortunately, the industrial plan has to pass through the National Economic Council prior to its endorsement to the President. The inadvisability of this procedure has been confirmed by the early experience of the BOI, wherein considerable delay has resulted from NEC counter proposals and criticisms of a rather ambiguous and general nature. While maintaining good relations between these agencies is important, it is at the same time fortunate that the BOI plan can only be reviewed, not revised by the NEC, a feature which helps to preserve some degree of unity and consistency in the investment priorities plan.

The BOI is the one planning agency that seriously attempts to counter the various biases arising from the whole complex of government policies that turn private investment away from social priorities. Use is

made of shadow prices for labor and foreign exchange. New exports, backward integration and employment creation are given high priority in recognition of the existence of distortions that discourage them. Nevertheless, the BOI cannot simply turn socially profitable, but privately unprofitable enterprise into commercially viable ones. Their weapons are not that powerful. Accordingly the Board tends to restrict its alternative choices to those already commercially profitable. / Because the shadow prices remain on paper only, some of the most severe distortions -- e.g., the effective exchange rate for new exports -- remain largely untouched.

A year after its creation, a complementary law was passed which gave the BOI regulatory and supervisory powers over the entry of all foreigners and enterprises with at least 30 per cent equity foreign ownership. Thus, the BOI has been given broader powers in investments [redacted] than those defined as preferred in the investment incentives act.

Nationalism

Nationalism takes many forms. The constitution which is the basis of the present republic is a very nationalistic one. We have adverted to this in discussing the political framework. Here the focus is on economic nationalism.

Economic nationalism has its long historical roots in colonial experience under both Spain and the United States.8/ We shall simply trace the form it has taken in recent years, however, especially in relation to industrial development. As we have already noted, in response to incentives from protection, Filipino and foreign capital moved largely into import substituting industries. In effect they were taking over a market that had previou

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8/ Many studies have been made on this. See, for instance Horacio de la Costa, Essays on Nationalism; [redacted] t al., Nationalism in Southeast Asia, op. cit. See also F. H. Golay's work on industrialization polic[redacted], G.D. Corpuz, The Philippines.

been supplied from abroad. As this process continued and the limits of the domestic market were approached, Filipino businessmen became more sensitive to foreign competition. This was due not only to a "market sharing conflict" with foreign enterprises, but also because of competition for scarce foreign exchange (in the days of controls). Naturally Filipino business urged a "Filipino first" policy. Joint ventures were encouraged in lieu of completely foreign-owned equity. Foreign investment policy was watched with extreme caution on the assumption that foreign enterprise, with its superior resources, was bound inevitably to gobble up domestic enterprise. It must be added that many of these fears are not unique to the Philippines. They have their counterparts in other countries where import-substituting industrialization controlled by foreign companies is a fact -- even in the more developed countries like Canada and France, for instance, and in many less developed ones, particularly in Latin America. Foreign capital engaged in natural resource exploitation, prevalent especially in the Midlle East, is another dimension of the foreign investment question, which colors attitudes toward foreign investments. These are some of the bases of the fears and biases of Filipino economic nationalism. They have been well propagated, and they have had an important influence on investment policy.[9/]

The historical and economic roots of nationalism have been related also, of course, to the predominant control of the retail trade by Chinese, and to the unfortunate revision of the Constitution which granted rights belonging only to Filipinos also to American citizens in the exploitation of the country's natural resources. The correction of the first problem

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9/ This "market-conflict" hypothesis concerning economic nationalism is discussed more fully in G.P. Sicat, "A Design for Export-Oriented Industrial Development," Discussion Paper 69-4 (June 20, 1967), Institute of Economic Development & Research, University of the Philippines, pp. 44-48.

was politically solved by the Filipinization of the retail trade. But as we have already mentioned, it brought along a number of peculiar semantical extensions with adverse effects on some industrial activities.

The granting of "parity" rights to American investors has cast a shadow of unfortunate, although sometimes justified, opposition to foreign investment, which has been costly in terms of national progress. It is ironic that the parity provision in the Trade Act (which required amending the Constitution) was defended at the time as a means of attracting American capital to spur economic development. Instead it was protection through import controls that brought American investment to substitute production in the Philippines for what was formerly exported from the United States. So the parity clause was simply another unnecessary irritant alongside the market-sharing conflict. Hindsight allows us to speculate on how much better would it have been a policy which treated all foreign nationals alike, but which favored an export orientation of foreign investment.

Conclusion

Economic nationalism, the distribution of political and economic power, the governmental and institutional framework for planning, together with the character of private entrepreneurship form an important part of the setting within which policies to promote industrialization have operated. To a degree these have imposed constraints on what could be done. Nevertheless, if industrialization has faltered, it is not, we believe, because of obstacles inherent in the institutional, political or ideological setting. It is rather because of mistaken policies. And better policies need not be incompatible with the various forces, institutions and attitudes described in this chapter. Optimistically, we see an emerging greater understanding of the industrialization process, matched by a growing rationality in policy recommendations-- particularly in the Board of Investments and the Presidential Economic

Staff. It appears likely, moreover, that these views will prevail in the new National Economic Development Authority.

Accordingly our main concern here is not institutional reform, though we recognize that much is needed in this area, but rather the reform of economic policies. In the Chapters that follow, then, we attempt a more detailed analysis and critique of industrialization policies in the Philippines, together with suggestions for changes in policies to point industrialization in new directions so that it can play its natural leading role in economic development.

Chapter Four

POLICIES AFFECTING INDUSTRIALIZATION

Positive government policies toward industrialization became more explicit only after balance of payments pressures had led to a conscious policy of reduction of imports through quotas and exchange controls in the 1950's. As is evident from the discussion of decontrol and devaluation in Chapter Two, the policies of the 1960's have differed markedly from those of the 1950's. We shall try to make this distinction as fully as possible. However, tax incentives policies in both decades have fallen within a neat and uniform pattern. The task of this chapter is to recount the basic policies which encouraged import-substituting industrialization. In Chapter Five, we shall analyze critically the basic weaknesses of the present industrial structure and suggest reasons for them.

1. Tax Incentives

Industrialization policies in the Philippines began in the area of tax incentives. Tax exemptions or credits are, of course, indirect subsidies. They are a substitute for direct financial transfers from the government in a setting where taxes are fully non-exempt.

One of the first laws passed in 1946 by the first Congress of the newly independent government was Republic Act 35 which authorized the exemption of "new and necessary" industries from the payment of internal revenue taxes for a period of four years from the date of organisation of the industry. Included were the residence tax, the fixed privilege tax on business, advance sales tax on imported materials, real estate tax and the sales tax. It was an amazingly brief law, which left undefined the meaning of "new and necessary" industry.

The classification of "new and necessary" industries fell under presidential discretion, with the emphasis on "necessary". The response to the law, however, was not immediately encouraging, although some tax exemptions were granted. There was little interest in industrial development so long as (a) the economic climate allowed and encouraged the country to import great quantities of new consumer items, (b) leaders were busy rebuilding the prewar economic capacity of traditional industries, and (c) exogenous new income streams were fed into the economy from extra-ordinary postwar military and war damage payments. The breadth of coverage of the tax incentives was most obviously stated in a statement of the Secretary of Finance in 1949. "... Inasmuch as the Philippines is just entering the initial stage of its industrialization, it may be stated as a general proposition that a wide variety of industries or enterprises which may be established locally would fall within the scope of the exemptions granted under the provision of Republic Act No. 35."

After 1949, with import controls in force, there was an attempt to introduce more discretion in the implementation of the law. Thus, during the period from 1950 to 1951, executive circulars were issued to define a "necessary" industry as one "conducive to sound economic development." Later, this broad definition was qualified to mean an industry which would have an imported material content no greater than 50 per cent of the gross value of output and which could operate on a commercial and profitable scale after exemption. Still, with import controls, almost any proposed industrial effort could qualify under this definition as long as it was "new".

The response to the tax exemption law was still not encouraging and a more liberal tax exemption law supplanted the first one when it expired in 1953. This was Republic Act 901, which extended exemptions from "internal revenue" taxes to "all" taxes, thus adding exemption from customs duties. All taxes were to be fully exempted until December of 1958, with a four-year transition following during which the proportion of taxes to be exempted diminished gradually to zero.

Any firm which enjoyed tax exemption for six consecutive years was to be subjected to the full income tax thereafter. Firms which had only four years of full operation under the first tax incentive were automatically exempted under the law. If their exemption had expired before the new law, they could reapply for an additional six years of exemption. Such was the generosity of the new tax incentives law.

The Department of Finance administered the implementation of the new law which was now more explicit in its definitions of "new" and "necessary". A "new" industry was "one not existing or operating on a commercial scale prior to January 1, 1945". A "necessary" industry was considered one that (1) contributed to the attainment of "a stable and balanced national economy", (2) that could operate on a commercial scale and (3) that did not require material imports in excess of 60 per cent of gross value of product. (Note the concession to higher import content compared to the first law.) A rider to the last provision, however, made even the 60 per cent rule useless; for notwithstanding such requirement, an industry could be classified as "necessary":

(a) "if it is determined that a substantial portion of the imported raw materials may, as local industri-

alization and technological development advance, be available locally so as to enable the industry to utilize substantially greater quantities of domestic materials or if its products are used principally in the manufacture or preparation of products of another necessary industry or products intended for exports;" and

(b) "if the initial investment in machinery and equipment will be at least two hundred thousand pesos."[1/]

The Department of Finance tried to define "necessary" in an appendix to the implementing circular of RA 901, which listed the following industries as "conducive to the attainment of a stable balanced economy":

iron and steel products
processed local fuels
chemicals
copper and copper alloy products
refractors
processed foods
textile and fiber manufactured from local raw materials
fertilizers
agricultural equipment
refrigerator and airconditioning machinery
porcelain products
raw plastic materials
paper and paper products
medicinal and pharmaceutical products
rubber manufactures
electrical motors
office and school equipments and supplies
household and kitchen utensils
industrial abrasives and others which would be manufactured from by-products and wastes of local agricultural materials

The screening of applications and the supervision of the tax-exempt was undertaken by an inadequately staffed department. If the number of exemptions is an indication, however, this law proved effective in attract-

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[1/] At the official exchange rate, this was US$100,000.

ing many new industries. But of course there were other incentives that were stronger than the tax incentives themselves. The favored treatment given to industry by foreign exchange and import controls was an especially important factor. Table XVIII shows the number of product lines that received tax exemptions. By the end of the 1950's there were more than one thousand, with the years 1955 to 1957 accounting for almost one-half of the total.

The industrial classification of products exempted is given in Table XIX. Food industries, basic metal products, textiles, chemicals, and electrical machinery were the most numerous.

One important point that should be remembered is that the tax exemptions were based on product lines, not firms. While the greater bulk of tax exemptions were secured by firms for a single product line, a significant number of firms were awarded two or more exemptions. It is not surprising that large and well-established firms were able to take full advantage of the benefits of the law. For instance, San Miguel Corporation, the largest industrial corporation in the Philippines, was able to secure the largest number of tax exemptions (eight).

It will be noticed that there were suspensions of tax exemption privileges; these suspensions became more common toward the end of the 1950's. This corresponded with the steady tightening of import controls. The major reason for these suspensions was rampant violation of foreign exchange procedures. "Ghost industries", as they were referred to in Congressional investigations of the violations of the tax exemption law, took advantage of

TABLE XVIII

NUMBER OF TAX EXEMPT PRODUCT LINES

	1949	1950	1951	1952	1953	1954	1955	1956	1957	1958	1959
Product lines exempted within year	14	50	80	44	112	102	174	150	171	111	13
Cumulative total of exemptions	14	64	114	118	300	402	573	726	897	1008	1021
Number of suspensions of tax privileges within year*	-	-	2	1	3	1	14	5	17	41	28
Cumulative totals net of suspensions	14	64	112	185	294	395	552	701	855	925	910

Source: Department of Finance.

*In 1960, 18; 1961, 68; and 1962, 33.

their import privileges while diverting their imports to the domestic market without further manufacturing. Of course, these suspensions were probably smaller in number than the cases of infractions of the law. In any case, as the transition to exchange liberalization measures (decontrol) was in process, in the early 1960's, the new and necessary industries were no longer accounting for a large proportion of total imports.[2/]

By the time the second tax incentives law was about to expire, a great number of exemption-dependent industries were already in operation. Altogether, they represented a strong pressure to enact a new tax incentives law. What resulted was the Basic Industries Act, which was passed by Congress in 1961. The law recognized the errors of extensive tax exemptions given by the previous tax incentives act as well as the fact that many of the industries already in existence had been long-standing recipients of tax exemptions.

The new law exempted imports of machinery, equipment and spare parts by firms engaged in "basic" activities from the special import tax, compensating tax, foreign exchange tax and tariff duties. Eighteen industries were especially defined as basic.[3/] The list was broad enough to include again many of the "new and necessary industries" already in existence.

[2/] For an analysis of this, see G.P. Sicat with A.A. Arcelo and H. Reantaso, "Transition to Decontrol and the Imports of the New and Necessary Industries," The Philippine Review of Business and Economics, Vol. 5, No. 2 (December, 1968), pp. 1-29.

[3/] (1) Basic iron, nickel, aluminum and steel industries; (2) basic chemical industries, including anti-biotics and fungicides, cement manufacture and its allied industries and fertilizers; (3) Copper and alumina smelting and refining; (4) pulping and integrated manufactures of paper industries; (5) deep sea fishing and the canning of sea foods and manufacture

Morever, even under each category, the broadness of the definitions certainly gave much latitude for flexibility in identifying "basic" industries. In an effort to reduce the broad scope of the definition of basic industries, an amending act, passed two years later by Congress (R.A. 4093), deleted 12 industries,[4/] but added 10 more.[5/]

The Basic Industries Act benefited mainly firms already in operation before the passage of the law. Up to 1966, 93 (40 per cent) of the 232 firms which received incentives from this law had received tax

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of fish meals; the manufacture of nets and other fishing gear; (6) refining of gold, silver and other noble matals; (7) mining and exploration of base or noble minerals or metals, and crude oil petroleum; (8) production of agricultural crops; (9) coal and dead burnt dolomite; (10) cattle industry; (11) logging and the manufacture of veneer and plywood; (12) vegetable oil manufacturing, processing and refining; (13) manufacture of irrigation equipment, farm machineries, spare parts and tools for such farm machineries, trucks and automobiles; (14) production and manufacture of textiles, cotton, ramie, synthetic fibers, and coconut coir; (15) manufacture of cigars from both native and Virginia tobacco; (16) manufacture of gasoline and diesel engines; (17) manufacture of ceramics, furnaces, refractories and glass; and (18) manufacture of food products out of cereals, forest and/or agricultural products.

4/ Those deleted were: (1) production of agricultural crops; (2) manufacturing, processing and refining of vegetable oils; (3) integrated manufacture of paper products; (4) allied industries to cement manufacturing; (5) refining of silver and other noble metals; (6) dead burnt dolomite; (7) manufacture of spare parts and tools for trucks and automobiles; (8) production and manufacture of textiles from cotton; (9) manufacture of ceramics, furnaces and glasses; (10) logging; and (11) manufacture (except canning) of food products of local forest and agricultural products.

5/ Those included were: (1) mining and exploration of nuclear materials; (2) dairy industry; (3) manufacture of waterworks equipment; (4) manufacture of railroad stock; (5) manufacture of firearms; (6) manufacture of chewing tobacco and pipe tobacco; (7) manufacture of clay-silica refractories; (8) canning of food products out of local raw materials; (9) manufacture of cassava flour; and (10) manufacture of spare parts and tools exclusively for irrigation and waterworks equipment, mining equipment, railroad rolling stock, and gasoline and diesel engines.

TABLE XIX

INDUSTRIAL CLASSIFICATION OF PRODUCT LINES EXEMPTED, 1949 TO 1959

Food manufacturing	164
Tobacco curing	4
Textiles manufacture	88
Wearing and apparel	54
Wood manufactures	27
Furniture and fixtures	21
Paper and Paper Products ✓	65
Printing, publishing and allied products	4
Leather and leather products	19
Rubber products	13
Chemical and chemical products	97
Non-metallic mineral	45
Basic metal and metal products	199
Manufacture of machinery and parts	23
Electrical machinery and apparatus	76
Manufacture of transport equipment	13
Miscellaneous manufactures	109
TOTAL PRODUCT LINES	1,021

Source: Department of Finance.

privileges under earlier tax incentives laws. More than 60 per cent (150 out of 232) of the firms received their exemption for the expansion of existing capacity; the rest were for new projects. Finally, it must be pointed out that of the total of US$143 million of imports of "basic industries" for the same period, only five per cent were made by new firms.[6/]

The Investment Incentives Act of 1967 is the most recent and the most comprehensive law yet enacted to make legally explicit a policy of attracting domestic and foreign capital. It grants a new set of broader tax incentives to all industries which qualify for registration. As mentioned earlier, the Board of Investments (BOI) was created to administer the act.

The two principal qualifications for registration are (1) that, except in the case of "pioneer" industries, which could initially be fully-owned by foreign equity, at least sixty per cent of the capital stock outstanding and entitled to vote is owned and held by Philippine nationals, and at least sixty per cent of the members of the Board of Directors are citizens of the Philippines; and (2) that the enterprise is engaged in a preferred area of investment. Excluded are financial, banking and trading organizations, as well as those furnishing services.

Investments may be registered as simply "preferred" or as "pioneer", the latter involving a product or process new to the Philippines. Preferred area investments are eligible for accelerated depreciation, net operating loss carryover, tax deduction for expansion reinvestment, tax exemption on

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[6/] The statistics in this paragraph were taken from A.S. Bascos, Some Aspects of Tax Exemption Under the Basic Industries Act (R.A. 3127), master's thesis submitted to the Department of Economics, University of the Philippines, 1969, pp. 44, 46.

imported capital equipment and an equivalent tax credit if domestic capital equipment is purchased. In the latter case the domestic manufacturer of equipment also receives a tax credit equal to one-half that of the buyer. It is evident that the incentives are strongly weighted toward subsidizing the use of capital.

Pioneer investments receive the same benefits plus exemption from all other taxes except income tax (though the exemption drops to 75 per cent after 1972 and diminishes gradually thereafter to zero in 1982). They also may receive new or additional tariff protection (up to 50 per cent) after production has begun on a commercial scale.

For the first time in tax incentive legislation, explicit incentives were included for exports, as follows:

(1) double deduction from taxable income on export promotional expenses;

(2) double deduction of shipping costs applied to vessels of Philippine registry and 150 per cent of freight costs to vessels of foreign registry when routes are not available to Philippine vessels;

(3) Special tax credits on raw materials used for exports, equivalent to 7 per cent of total raw material costs purchased by the registered enterprise or an amount equivalent to taxes annually paid by the enterprises on raw materials, whichever is higher.

The Board of Investments was organized immediately after the enactment of the law. Its performance in the first two years has been very creditable, largely because the President appointed very competent technicians to its governing board. We shall refer to the challenge that the BOI faces in reorganizing the structure of industry in later chapters.

The various investment incentives laws, described above, had important consequences for the mobilization of domestic savings and its allocation to investment.[7/] It must be emphasized, however, that a variety of other policies, affecting tariffs, the exchange rate, wages and interest, had sometimes competing, sometimes complementing, influences on investment allocation. The net incentive effect depended on the interrelation among all of these policies, a question to which we return in the next chapter.

There were quite a few specialized tax incentives laws related to industrialization which should not escape mention. These pertain to cottage industries, chemical fertilizers, mining, textiles, and exports. Most of these involve partial and temporary exemptions from the payment of customs and internal revenue taxes.

Cottage industries are corporations, partnerships or cooperatives with a capitalization not in excess of ₱200,000[8/] which are at least 75 per cent Filipino-owned. The industries especially cited are: fibercraft (abaca rope, twine, fiber extraction); woodcraft (carvings, wooden shoes, canes); weaving crafts (hat weaving, loomweaving); metal craft (jewelry, knives, etc.); ceramics (pottery, hollow blocks, ceramic products); shellcraft (shell buttons and coconut shell products); bamboo

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[7/] All these are more thoroughly treated in G.P. Sicat, "An Analysis of the Investment Incentives Act of 1967," Discussion Paper 67-10 (August 31, 1967), Institute of Economic Development and Research, University of the Philippines.

[8/] This is an administrative ceiling. It was not imposed by law.

and rattan craft; agricultural handtools; toycraft, embroidery, needlecraft (knitting and crocheting); machine parts manufacture (wheel and stove mortar); poultry; piggery; home cigar making; small mining operations; and "such other industries done in the home with the aid of electrical gadgets and/or hand manipulation". All of these enterprises are to be exempted for five years after the date of registration with the National Cottage Industries Administration (NACIDA) from taxes, including customs duties, except income taxes.

The textile industry was exempted at a diminishing rate from taxes and customs duties for the period, 1964-1970. In return a one per cent charge on gross sales is paid into a textile research fund administered by the National Science Development Board.

The fertilizer industry was exempted from all duties and taxes on imports for the period 1961-1965. New mines, or old mines resuming operations are exempted for five years from all taxes except income taxes. Gold mining, in addition, is given a subsidy in the form of purchases by the Central Bank at a price above par value, the subsidy being higher the higher is the cost of production. Finally, chemical manufactures were exempted for the period 1965-1969 from duties and taxes on the import of naphtha.

The Philippine internal revenue and customs codes have provisions which are designed to exempt exports from internal and external taxes. The internal revenue code generally exempts locally manufactured exports from the domestic sales tax, ranging from 7 per cent to 100 per cent, or

the millers tax of 2 per cent. The tariff and customs code provides a 99 per cent drawback on customs duties previously paid on imported materials or components of manufactured products which are exported.

Because of the nature of the policies adopted for import-substituting industrialization, complemented by the maze of bureaucratic procedures designed to plug holes in tax collections and import controls, these well meaning provisions have been largely buried in the statute books. Exporters have always found it next to impossible to collect drawbacks on imported materials or refunds of domestic excise taxes on goods exported. Reform in the direction of simplifying administrative procedures in obtaining tax refunds has been given wider hearing recently, however. A National Export Coordination Center was established in 1968 to cope with these problems. There has been up to now, however, only very modest success in efforts to make effective these tax exemptions for exports.

A critical analysis of the effects of these tax incentives will be postponed until Chapter Five. We will simply make some general comments here. /The Philippines has undertaken to give incentives to new industries in the form of tax exemptions ever since independence in 1946. Many of these have been very generous, with little attempt to discriminate in accordance with economic criteria. Morever, although the general principle when originally adopted was that these incentives were to be temporary, the pressures against their removal have been quite strong. Thus, the history of tax exemption for industrial promotion in the Philippines is largely one of repetitious grants of tax exemptions, as one law expires

and another succeeds it. The earlier incentives laws were poorly designed largely because of inexperience and the lack of any overall strategy. Moreover those that pertained to exports, in the customs and internal revenue codes, have not been effective because the administrative organization was designed primarily to promote an inward-looking industrialization. Finally, the latest law (1967) and the policies of the Board of Investments under that law have represented a great improvement in investment allocation criteria, though the means of creating incentives are weak and sometimes inconsistent with the goals.

2. Import and Exchange Controls

The reader will recall from Chapter Two that import and exchange controls were established in 1949 as a response to a rapidly dwindling reserve of foreign exchange. Import controls were sanctioned by an act of Congress which authorized the President to create an import control board for the purpose of restricting imports of luxury and non-essential goods. The authority was for one year only, beginning on January 1, 1949. It was not, however, until November of that year that really effective controls were implemented. Congress renewed the authority for four months and subsequently in May of 1950 passed a new law establishing an Import Control Administration. This time Congress specified the commodities to be included in the various control categories. Furthermore, for the first time there was a clear protective intent in the law as it provided that, where domestic supply of a commodity is deemed to be sufficient, the maximum percentage reduction in imports will apply. The law also was designed to promote Filipinization of industries by allocating a rising

proportion of quotas to firms that were at least 60 per cent owned by Filipinos.

Controls were attended by evidence of corruption in their administration almost from the beginning. This led to a new act in 1951, replacing the Import Control Administration with an Import Control Commission. Again, charges of corruption plus political maneuvering in the presidential election year of 1953 led Congress to permit controls to lapse. At this point the executive decided to continue to control imports through the Central Bank's control over foreign exchange.

In administering the exchange controls, the Central Bank relied on a classification of commodities by order of priorities. Although frequent changes in classification occurred, the pattern of priorities was clearly designed to restrict imports of non-essentials and to give preference to imports of "producer" goods. The official categories of imports, by "essentiality", were as follows: (1) essential producer, (2) semi-essential producer, (3) non-essential producer, (4) essential consumer, (5) semi-essential consumer, (6) non-essential consumer, (7) unclassified, and (8) decontrolled. The last group of imports referred to those which were allowed as a concession to export industries, a matter which is discussed briefly below. Table XX shows the distribution of imports according to this classification. The reader can compare this with Table IX in Chapter Two, which showed the decline in the proportion of consumer goods and the rise in the proportion of producer goods over the decade of the 1950's. It is evident that the Central Bank continued the direction which the earlier import controls had given to the changing pattern of imports.

The "essentiality" classification was the code book of the foreign exchange control authorities. It was the most powerful single incentive to industrialization during the 1950's. Owners of foreign exchange allocations could take advantage of an implicit scarcity premium. As a result a secondary (illegal) market for foreign exchange allocations soon developed. But more important than the windfalls from illegal sale of foreign exchange were the substantial profits from investing in the production of consumer goods, made possible by the differential character of controls. Virtual exclusion of foreign competition in "non-essential" industries plus the right to buy foreign equipment and supplies at an undervalued price of foreign exchange created the profit incentives that determined the pattern of industrialization.

The exchange control system was complicated by a number of other devices which established differential exchange rates for transactions within the permitted exchange allocations. A 17 per cent tax was imposed on the sale of foreign exchange in 1951, implying an effective foreign exchange rate of ₱2.34 for sanctioned purchases of US dollars. However, certain exemptions were given, among them the foreign exchange used by "new and necessary" industries. This law was in effect until 1955, during which time it was a substantial source of new tax revenues for the government.

The foreign exchange tax came under heavy attack in the renegotiation of the trade agreement with the United States in 1954 on the ground that it was a unilateral attempt by the Philippines to change the exchange rate. A special tax on imports was substituted for the tax on foreign ex-

TABLE XX

IMPORTS CLASSIFIED BY "OFFICIAL" CATEGORY
(As Per Cent of Total Imports)

Year	Essential Producer	Semi-Essential Producer	Non-Essential Producer	Essential Consumer	Semi-Essential Consumer	Non-Essential Consumer	Unclassified	Decontrolled
1954	40.2	16.5	7.9	2.1	1.1	6.8	12.6	12.7
1955	46.5	11.6	8.4	3.9	0.7	5.3	9.5	14.0
1956	54.8	12.1	6.8	2.5	0.5	3.2	5.6	14.4
1957	52.0	12.2	6.9	3.4	0.7	3.5	8.0	13.2
1958	50.4	12.4	4.9	4.9	0.5	0.8	7.1	18.9
1959	61.3	11.9	3.7	1.1	0.6	1.1	7.1	13.1
1960	59.4	10.2	4.8	2.0	0.4	1.1	6.7	15.3
1961	60.2	9.4	6.2	1.6	0.5	1.6	6.8	13.7
1962	64.0	11.9	6.9	1.3	0.5	1.8	5.4	8.2
1963	59.7	11.3	7.5	1.4	0.6	2.7	8.3	8.5
Average	54.9	12.0	6.4	2.4	0.6	2.8	7.7	13.2

Source: Central Bank Statistical Bulletin, Vol. 16, March 1964.

change. Since it did not apply to invisibles, it freed a substantial number of foreign exchange transactions from the tax base. It specifically exempted all importations of machinery and raw materials to be used by "new and necessary" industries, and its rates were to diminish over time until its expiry in 1965.

Continuing deterioration in the balance of payments precipitated the passage of a law in 1959 which allowed the Central Bank to charge a fee on the sale of foreign exchange of not more than 40 per cent over the bank's rate as determined by the Monetary Board. The fee was set at 25 per cent, but was reduced gradually until its suspension in January of 1962. In view of the strictures against the tax on foreign exchange raised in the Laurel-Langley negotiations, the fee could not be used as a tax revenue. Instead, the margin fee accrued to the Central Bank. This law signified a break from the practice of giving more favorable treatment to new and necessary industries. But since the exemptions in the import tax law still applied, a subsidy for new and necessary industries was still in effect.

A summary of the implicit foreign exchange rates enjoyed by new and necessary industries as against "ordinary importations" is provided by Table XXI. The rates are based on the official rate, tax exemptions, and the special import and foreign exchange taxes described above. It is evident that the "new and necessary" industries were substantially favored. Their advantage is actually understated since some of their imports were exempted also from the margin fee on foreign exchange purchases.

TABLE XXI

IMPLICIT EXCHANGE RATES FOR NEW AND NECESSARY INDUSTRIES
(Peso Cost Per Dollar Bought)

Year	Rates for "Ordinary" Import Transactions	Rates for New and necessary Industries	Pick's Currency "Black Market" Rate[a/]	Stock of Foreign Exchange Reserves (Million Dollars)
1951	2.34	2.00	-	383.29
1952	2.34	2.00	2.70	309.21
1953	2.34	2.00	2.82	294.63
1954	2.34	2.00	2.85	244.34
1956	2.34	2.00	3.21	233.81
1957	2.31	2.00	3.49	190.66
1958	2.27	2.00	3.21	135.85
1959	2.56	2.00	4.30	136.53
1960	3.67	3.53	3.81	197.56
1961	3.76	3.47	-	155.41
1962	4.08	3.82	-	142.57
1963	4.11	3.91	-	153.92

[a/] Middle of the year.

The third and fourth columns of Table XXI show the foreign exchange rate quoted in Pick's Currency Yearbook alongside that of the country's stock of foreign exchange reserves in the same period. These two columns give an indication of the state of the balance of payments as well as the relative "strength" of the Philippine peso in foreign exchange markets during the period.

To complete the picture of multiple exchange rates, exports enjoyed after 1955 a modest bonus in the form of the right to "barter" limited amounts for essential imports. In 1965 barter exports amounted to about ten per cent of total exports.[9/] This would imply an implicit rate for all exports of about P2.15 to the U.S. dollar, if we use Pick's black market rate as the true value of foreign exchange. This is no doubt on the high side, particularly as imports under this scheme were restricted to essential categories. However, there was, as was indicated in Chapter Two, widespread underdeclaration of exports in the late 1950's and early 1960's, so some exporters were faring better than this rate indicates.

Exchange controls became not only unpopular as a major source of graft and corruption, but also untenable in view of the increasing cost to the economy of maintaining them. By 1960, there was sufficient clamor for the removal of controls. The government responded with a gradual increase of the proportion of the export earnings which could be sold at a higher rate of exchange along with a rising proportion of imports at the free market rate. The result was an accentuation of the multiple exchange rate

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9/ Ibid., p. 157.

system, which gave more favorable rates to exporters at the same time that the costs of imports became gradually more expensive to industrial users of foreign exchange.

A unification of the exchange rate came on the heels of a change in political administration (a new president assumed office) in January, 1962. Exchange controls were abolished and the exchange rate was allowed to find its market level. By early 1962 the rate settled at about 3.90 pesos to one US dollar, and the Central Bank supported this rate. The rate was not completely unified at this time, however, since the Central Bank, fearing an export-based inflation, required all exporters to surrender 20 per cent of their earnings at the "official parity" of ₱2 to $1. Finally, in November of 1965 a total unification of the exchange rate came to being through an official devaluation.[10/] By then a host of new problems had already changed the economic picture.

3. The Tariff System[11/]

Because of preferential free trade with the United States, tariffs in the Philippines served only a modest revenue function prior to the late 1950's. The Laurel-Langley Agreement, however, provided for gradual removal

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10/ The only exception to this was the rule that legislators and the foreign diplomatic service could purchase their foreign exchange on official missions abroad at the "official rate" of ₱2 to US$1. The rule for legislations was abolished only in late 1969, after it had encouraged an already high propensity of legislators to travel abroad.

11/ This section is based largely on a study by J.H. Power, "The Structure of Protection in the Philippines," which will be published in The Structure of Protection in Developing Countries by Bela Balassa and Associates.

of tariff preferences beginning in 1956. This, together with the prospect of eventual decontrol, led to the passage of a highly protective tariff law in 1957. So long as exchange controls were in effect, the tariff system served mainly to permit the government to share in the rising scarcity premia on imported goods. With decontrol, however, the tariff structure became the principal instrument of protection for the new manufacturing industries.

The new tariff structure was biased in its protective effect in a manner similar to that of the system of exchange controls. In general, consumption goods were protected by very high rates, while intermediate goods had substantially less protection and most capital goods and raw materials had virtually none at all. Thus the tariff system seemed designed to preserve the same industrial structure and corresponding pattern of imports that the controls system had created. Moreover, after 1960 there were many pressures for adjustments in rates to offset the effects of decontrol, and a number of changes -- mostly upward -- did occur between 1961 and 1965. The effects of these changes on average tariff rates for several categories of manufactured goods are seen in Table XXII. The result was a system of protection even more similar to that in effect in the 1950's under exchange control. This no doubt helps to explain why the transition to decontrol was less painful than some had imagined it would be.

In addition to customs duties an important element of protection is provided by the discrimination against imported goods in the percentage sales tax system, which has been in effect since the early 1950's. While the same nominal percentage tax is applied to imported and domestically produced goods alike, the tax base in the two cases is vastly different.

TABLE XXII

AVERAGE* TARIFF RATES FOR MANUFACTURING 1961 AND 1965
(Per Cent)

	1961	1965
Consumption Goods	64.1	70.1
Intermediate Goods	24.6	27.4
Inputs into Construction	49.0	55.1
Capital Goods	16.2	16.2
Total Manufacturing	46.2	50.8

*Weights are total supply (production plus imports) in 1965 of more than 90 manufacturing industries at the ISIC four-digit level, representing more than 90 per cent of manufacturing production.

Source: J. Power, "The Structure of Protection in the Philippines," op.cit.

For imported goods the base is C.I.F. value plus tariff plus a percentage mark-up. For domestically produced goods, in contrast, the base is only that portion of the manufacturer's price that represents inputs not already taxed, which usually means gross value added plus electricity and fuel. The sales tax is seven per cent and the mark-up for imported goods is 25 per cent for most categories. For "semi-luxuries" like electric appliances, watches, synthetic textiles and furniture, however, the tax rate is 30 per cent and the mark-up, 50 per cent. For "luxuries" like automobiles, jewelry and perfume, the tax rate ranges from 50 to 100 per cent and the mark-up is 100 per cent.[12/] Thus it is possible for the true tax rate on imported goods to be several times that for similar domestically produced goods. In the case of the automobiles, discrimination in the application of the sale tax affords more protection than do the tariff rates, which range from 35 to 160 per cent.

Rates of protection of value added -- so-called "effective rates of protection" -- are more meaningful than rates of protection of the whole value of the product, however, since the value added represents the activity that is being protected. Moreover, measuring protection of value added takes into account the penalties arising from protection of inputs, as well as the rewards from protection of outputs. Effective rates of protection for the year 1965 have been calculated for 87 manufacturing industries, representing about 90 per cent of organized manufacturing

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[12/] The rates for "semi-luxuries" and "luxuries" were further raised in late 1969.

in the Philippines.[13/] These are shown, together with "nominal" rates of protection, in Tables XXIII through XXV.

Nominal rates are intended to represent the excess of the protected price over free trade price, expressed as a percentage of the latter. For exports it was assumed that nominal protection (t) was negative because of the implicit tax that prevailed for ten months in 1965. So it was set at -8 per cent for all of the exports in Table XXV, except sugar. The latter is sold only in the protected American and Philippine markets and its nominal rate was calculated by comparing the protected prices with a "world price", which is an unweighted average of C.I.F. import values of Japan, Hongkong and Malaysia.

For import-competing industries (those in which imports contributed at least ten per cent of total supply), the nominal rate is derived from the ad valorem tariff and the differential sales tax rates on the assumption that when foreign and domestic goods are competing in significant volume, the protection offered by the system is fully realized in the form of either a price or quality differential. For the non-competing group (imports less than ten per cent of total supply), however, this assumption is less tenable and an alternative estimate was made on the basis of direct price comparisons. In many cases this resulted in a much lower estimate of t. Whether this means that protection is redundant in these cases, or that the quality differential between imported and domestic products is very great, we are not prepared to say. In any case Table XXIII shows

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13/ Ibid.

both "potential" protection (that offered by the system) and "realized" protection (that indicated by price comparisons).[14/]

The effective rate of protection for any industry can then be deduced from a knowledge of the nominal rate for that industry (t_i), its ratio of value added (in domestic prices) to total value of output (w_i) and the coefficients of intermediate inputs into that industry (c_{ji}), also measured as proportions of total output. The formula is

$$E_i = \frac{w_i}{1/(1+t_i) - \sum_j c_{ji}/(1+t_j)} - 1$$

Since the t's represent the proportion by which domestic prices exceed free trade prices, this expression is equivalent to

$$E = \frac{W}{V} - 1$$

where W is actual value added and V is free trade value added. Comparing values for E, then, indicates the relative costs of earning or saving foreign exchange via import substitution or export from the various industries. For example, these estimates suggest that the cost to society of saving a unit of foreign exchange through automobile assembling (in 1965) was about eight times that of earning a unit of foreign exchange through plywood manufacture for export (assuming terms of trade to be unaffected).

[14/] An arbitrary quality differential of ten per cent of the difference between the potential rate and that indicated by the price ratios was assumed in estimated realized rates.

Tariff changes since 1965 have been relatively unimportant, so that the structure of protection today (January 1970) is roughly represented by these estimates for 1965. (An important exception with respect to exports is mentioned below, however.) It is evident from the tables that there is a very wide range of effective rates of protection, implying a strong incentive to misallocate resources within manufacturing. Some industries which save very little foreign exchange are rendered artificially profitable by very high protection, while others that are efficient foreign exchange earners are artificially penalized. The most extreme cases of inefficiency, however, are those in which estimated protection appears to exceed value added in domestic prices. The implication is that free trade value added would be negative. Both foreign exchange and productive resources could be saved by abandoning these industries, if the estimates of protection are correct. Since in these cases an effective rate cannot be calculated, they are indicated by asterisks in the appropriate columns.

These cases of apparent negative value added should be viewed with some skepticism, however. The results could be due to an overestimatimation of realized protection, or to the fact that value added was abnormally low in 1965. The former is possible, especially in the cases of import-competing industries where price comparisons were not made, because (1) of evasion of customs duties and sales taxes on imports and (2) a consumer bias against domestically made goods, which some believe is widespread in the Philippines. In addition, a correction of the undervaluation of foreign exchange that the system of protection defends would reduce the estimates of protection for all industries and thus might eliminate cases of apparent negative free

TABLE XXIII

RATES OF PROTECTION
MANUFACTURING, NON-COMPETING
(Per Cent)

1965?

ISIC Code	Description	Potential Effective	Realized Effective	Potential Nominal	Realized Nominal
2097	Starch	43	-27	27	3
3391	Structural Concrete Products	129	14	67	7
3394	Asbestos Products	179	18	92	9
2411	Shoes, except Rubber	71	20	71	7
2412	Slippers, except Rubber	125	23	70	7
2141	Soft Drinks	400	24	110	11
2621	Wood Furniture	1279	24	102	10
3011	Rubber Shoes	1992	32	104	10
2096	Feeds for Animals	248	33	49	5
232	Knitting Mill Products	115	43	111	11
3191	Matches	81	48	49	25
2431 & 2433	Ready Made Garments	821	53	110	11
2111	Distilled Liquors	375	58	162	16
3194	Soap	69	59	27	14
3341	Cement	93	59	56	25
3131	Paints, etc.	*	71	113	11
2211	Cigarettes	*	76	191	19
2094	Vegetable Lard & Margarine	*	87	79	8
2722	Paper Bags, Boxes	*	89	87	9
2034	Vegetable Sauces	*	106	119	54
2081	Candy	*	300	149	66
2314	Cotton Textiles	*	330	91	30
2082	Cocoa & Chocolate	381	350	85	39
2012	Sausages (uncanned)	*	400	102	10
2541	Wooden Boxes	*	400	220	22
3193	Perfumes, Cosmetics, etc.	1171	450	228	95
3851	Bicycles	1630	474	91	31
3831	Autos	*	533	167	54
2013	Ham, Bacon, etc.	*	*	114	71
2091	Vermicelli and Noodles	*	*	113	91
3742	Household Refrigerators and Airconditioners	*	*	163	90
3961	Pianos	*	*	318	180

TABLE XXIV

RATES OF PROTECTION
MANUFACTURING, IMPORT-COMPETING

(Per Cent)

ISIC Code	Description	Effective	Nominal
3832	Vehicle Engines, Parts, Bodies	05	18
3621	Agricultural Tractors	06	14
3622	Farm Machinery, except Tractors	06	16
3392	Lime	07	12
3632	Metal Forming Machinery	09	12
3412	Iron and Steel Foundry Products	10	10
3196	Agricultural Chemicals	13	15
3111	Inorganic Acids, Alkali, Chlorine	14	18
2056	Flour Mill Products	15	15
3651	Industrial Pumps and Compressors	16	16
3192	Pharmaceutical Preparations	22	25
3319	Structural Clay Products	23	19
3113	Compressed and Liquefied Gases	28	24
3092	Processed Natural Rubber	29	27
3646	Woodworking Machinery	29	15
3199	Inks and Dyes	38	30
3211	Petroleum Refinery Products	45	13
3511	Packers' Cans	50	25
3021	Tires and Inner Tubes	54	51
3591	Metal Barrels, Drums, etc.	64	40
3641	Rice Milling Machinery	65	41
2712	Paper and Paperboard	66	31
3831	Trucks and Buses	77	29
3321	Glass Containers	82	45
3322	Flat Glass and Mirrors	83	44
3198	Polishing Preparations	94	51
3411	Steel Mill Products	96	29
3731	Batteries	101	50
3734	Electric Wires and Wiring Devices	103	20
3551	Wire Nails, Brads and Spikes	109	29
3992	Fabricated Plastic Products	161	74
3532	Architectural Metal Work	164	60
3923	Eyeglasses and Spectacles	183	98
3312	Clay Tiles	261	102
3749	Sewing Machines, Household	363	78
3531	Structural Iron and Steel	431	81
3515	Plastic and Resin Materials	504	69
3732	Electric Lamps	4155	125
2641	Metal Furniture	*	104
2721	Paper Stationery, Envelopes, etc.	*	71
2911	Leather, Tanned or Finished	*	105
2316	Jute Mill Products	*	110
3722	Household Radios, Phonos and TV	*	147
3951	Jewelry	*	252

TABLE XXV

RATES OF PROTECTION
MANUFACTURING, EXPORTS

(Per Cent)

ISIC Code	Description	Effective	Nominal
2521	Veneer and Plywood	-32	-08
2031	Pineapple Canning	-27	-08
2093	Dessicated Coconut	-27	-08
2611	Rattan Furniture	-25	-08
2315	Ramie Processing Mill Products	-24	-08
2511 & 2513	Lumber	-19	-08
2331	Cordage, Rope, Twine and Net	-17	-08
2131	Beer	-13	-08
3121	Coconut Oil, Copra Cake and Meal	-11	-08
2072	Sugar	183	35

trade value added. We have not made such a correction, however, owing to the difficulty of estimating such undervaluation. Whether or not these industries are absolutely wasting resources, however, we note that they all enjoy very high potential nominal protection, with rates ranging from 70 to over 300 per cent. We should not be surprised if they appear to be at least relatively inefficient.

Exports (except sugar) appear as having negative protection owing to the eight per cent implicit tax and the penalty of having to purchase protected inputs. The implicit tax no longer applies, however, and if the drawback provision of the tariff law were effective (together with the rebate of sales tax on imports), exports would uniformly have zero protection. Even with this correction, however, the evident bias in the system of protection against exports is very great.

Other elements of bias also become apparent when we group industries by end-use categories, as in Table XXVI. Consumption goods have the highest average [15/] rate and capital goods the lowest among import substitutes. Intermediate goods and inputs into construction fall in between.

If we had included trucks and buses in the capital goods average, it would have completely dominated the result because of its size. Hence we have listed it separately. It is an assembly industry with a very low ratio of value added to total output. Included in capital goods, however,

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15/ Weights are free trade value added. Maurice Scott has shown that the industries with negative value added can be included in the average if we use these weights.

is the rice milling machinery industry, which also has a high effective rate of protection. If we excluded it, the capital goods average would drop to six per cent (for the remaining five machinery industries), and this is more representative of the degree of protection for this category.

The bias against exports of manufactures is what stands out most clearly in Table XXVI. At the other end, the bias in favor of producing consumption goods is also very evident. It seems, in fact, that using free trade value added weights understates this bias. An alternative calculation with total supply weights for all consumption goods industries except those with negative value added -- i.e., excluding the most extreme cases of high protection [16/] -- yields an average of 192, as compared to 87 in the table. On the other hand the averages for capital goods and intermediate goods are not much different when we use total supply weights. Hence we feel that the bias in the protection system toward the finishing stages of production is more pronounced than the averages in the table suggest.

Finally, in Table XXVII average effective rates of protection in other sectors are compared with the average for all of manufacturing. Mining and forestry are export sectors, which accounts for their negative rates. Agriculture appears to have modest protection, but this may be overstated. Some sub-sectors like fruits and nuts, vegetables and root crops are accorded high potential protection which may not be realized. In any case the bias in the protection system in favor of manufacturing is clearly evident from the table.

16/ They cannot be included unless the weights are value added.

TABLE XXVI

AVERAGE EFFECTIVE RATES OF PROTECTION BY END-USE CATEGORY MANUFACTURING, 1965

(Per Cent)

Exports (excluding sugar)	-20
Sugar	186
Capital Goods (machinery only)	35
Trucks and Buses	77
Intermediate Goods	67
Inputs into Construction	67
Consumption Goods	87

TABLE XXVII

AVERAGE EFFECTIVE RATES OF PROTECTION
BY MAJOR SECTORS
(Per Cent)

Agriculture	17
Forestry	-26
Manufacturing	51
Mining	-17

In sum, the tariff structure exhibits three important elements of bias. First, it favors manufacturing over the other sectors which produce potentially traded goods. Second, it penalizes exports, both within manufacturing and without. Third, it favors the finishing stages of producing consumption goods over intermediate goods and especially over capital goods. With these biases it is not surprising that neither backward integration in manufacturing nor the export of manufactures has developed at a pace sufficient to prevent manufacturing from becoming a lagging sector.

4. Other Policies

While every economic policy has at least a remote influence on the pace and pattern of industrialization, the three areas of policy described in some detail above have perhaps had the most direct impact on industrial growth. In this concluding section we add only brief mention of wage and interest rate policies, whose consequences will be analyzed more fully in the succeeding chapter. Before turning to these, however, we should note recent Central Bank policies that are designed to protect the deteriorating balance of payments, but whose long-range effects could be adverse to industrialization.

We have already noted the role in the 1950's of the Central Bank in setting priorities for imports and administering exchange controls. In recent years, the Central Bank has once again been obliged to set priorities and to curb imports by means, first, of special time deposits, and more recently by supervising ceilings, imposed by the commercial banks, on letters of credit. The priorities are reminiscent of those of the 1950's

and tend to reinforce the biases of the tariff system. Thus, if continued long, they would add to the disincentives to invest in the potential growth areas of new exports and backward integration. Moreover, they make it easier to postpone exchange rate adjustment and tariff reform.

A minimum wage law was introduced early in the 1950's and in 1965 the legal minimum was raised to offset for a small minority of workers some of the effect of devaluation on the cost of living. Still, as we noted in Chapter Two, real wage rates have apparently not risen over the past two decades. Real labor costs to manufacturing industries have risen, however, and the government's wage policy may have been partly responsible. The law actually underwrites the factor price disequilibrium described in Chapter One by setting a higher standard for industrial than for agricultural industries. Mining industries are wholly exempted. While there may be considerable evasion of the law, this is more easily accomplished by the smaller, more remote and less prominent firms. Moreover, even evasion involves an implicit risk cost. It is likely then, that the minimum wage law represents a significant penalty on modern labor-intensive manufacturing.

Interest rate policies appear to have a similar bias against labor intensity as well as against saving. During the 1950's, especially, the Central Bank was able to keep interest rates low, partly because investment demand was limited by foreign exchange availability. The rediscount rate was held at the ridiculously low level of 1.5 per cent between 1954 and 1957. It was raised to 4.5 per cent in the latter year and fluctuated between 3 and 7.5 per cent since then until very recently when it was raised

to 8 and finally 10 per cent in response to the rise in world interest rates and the worsening foreign exchange position of the Philippines.

One constraint on interest rate policy is a 1916 anti-usury law that limits interest rates to a ceiling of 12 per cent on secured loans and 14 per cent on unsecured loans. Rediscount rates have been kept low enough to allow commercial banks a reasonable spread between borrowing and ceiling lending rates. The same rationale has been used to justify low ceilings on time and saving deposits, which may adversely affect total saving.

Again, favored industries have been able to obtain long-term financing at low interest rates from the government's long-term lending institutions. The Central Bank, in turn, has supported the latter. And, finally, the Central Bank has consistently supported government borrowing at unrealistically low interest rates.

In assessing the influence of the price system in less developed countries, one usually focuses on the exchange rates, interest rate and wage rate to attempt to judge whether these are out of line with social opportunity costs. The preceding description of policies affecting industrialization strongly suggests that their influence has been on the side of undervaluing foreign exchange, understating the cost of capital and the value of saving, and overstating the opportunity cost of employment in organized manufacturing. We attempt in the following chapter to assess in greater detail the consequences of these influences for industrialization in the Philippines.

CHAPTER FIVE

A CRITIQUE OF INDUSTRIALIZATION POLICIES

The mix of policies related to industrialization is the principal explanation for the inability of industry to undergo a faster transformation. The combined effects of tax incentives, exchange rate policy, and tariff protection on resource pricing have been reinforced by minimum wage and advanced welfare legislation, as well as by interest rate ceilings imposed by law. These policies jointly have encouraged a capital-using bias in industrialization and an emphasis on final stage import-substituting industries which are import-dependent in character. On the other hand, we have already noted (in Chapter Three) that entrepreneurs in the Philippines, in common with what is observed in other progressing countries, tend to respond appropriately to price and profit incentives. Thus, if industrial expansion is unsatisfactory, we have to point to economic policies affecting industrialization as the critical reason.

In brief, these policies have led to the following consequences: (a) inward-looking manufacturing industries; (b) an excessive dependence on imported inputs; (c) an excessive reliance of the economy on a few primary exports, owing to the failure of the industrial sector to develop as a source of foreign exchange; (d) overly concentrated regional development; (e) greater inequality of income distribution; (f) the neglect of wage-goods industries; (g) slow growth of industrial employment; and (h) technical and economic inefficiency.

Inward-Looking Industries

Protected heavily by scarcity premia arising from exchange controls and, later on, by a tariff structure which gave support to the same indus-

tries, Philippine manufacturing has looked largely to the domestic market in its sales orientation. The implicit overvaluation of the peso defended by these protection measures has made exports appear unprofitable even in industries where the Philippines has a comparative advantage. What we might call the "overvaluation syndrome" in the form of an economic inferiority complex, arising from the artificial cheapness of foreign goods that overvaluation implies, has made the idea of expanding industrial exports seem far-fetched to businessmen and government officials alike. In addition it has led to the conflict, noted in Chapter Three, between domestic and foreign investors for the limited protected domestic market. Finally it has also encouraged an elasticity pessimism about export demand and supply that has been invoked to defend the protection system. This pessimism stems, of course, from the view that the marginal export response to an improvement in the exchange rate could come only from the major primary exports, not from the manufacturing sector.

The new class of industrial entrepreneurs which was nurtured by this system naturally tended to throw its political strength behind protection and against an exchange rate policy that would have encouraged exports. Aside from the modest export bonus scheme in effect for a few years after 1955, exports received no political concessions. In the succession of development plans of the 1950's and 1960's new exports were virtually ignored. And this inward-looking attitude made it easier after devaluation and decontrol in 1962 to impose an implicit export tax through the requirement to convert 20 per cent of export earnings at the official parity rather than at the free rate.

Moreover, the market-sharing conflict of domestic with foreign en-

terprises within the narrow protected market tended to strengthen the anti-foreign-investment element in the ideology of economic nationalism. Foreign capital was seen not as a supplement to Philippine resources nor as a complement to Philippine labor, but simply as a substitute for Philippine capital. This attitude has made it difficult for the government to arrive at a stable and consistent set of policies toward foreign investment.

Finally, the biased set of profit incentives which has led entrepreneurs to look inward rather than outward for their markets is partly responsible for the poor investment climate which has held back investment and encouraged both expatriation by Filipinos and repatriation by foreigners of earnings and capital. For as the limits of the domestic market for consumption goods were approached by import substitution, opportunities for the reinvestment of earnings came increasingly to depend on the profitability of backward integration and exports. To some extent the former did occur where it was clearly economical, since the bias in the system of protection is not as pronounced against intermediate goods as it is against exports. So the system was most effective in rendering privately unprofitable investment opportunities in manufacturing for export socially desirable. This has added further to balance of payments difficulties by discouraging private capital inflow and encouraging its outflow.

Import-Dependent Import Substitution

The failure of the protection system to prevent the recurrence of balance of payments difficulties is due partly to its adverse effect on exports, as noted above. But another part of the explanation is the tendency for many of the import substitution industries to remain heavily dependent

on imports. As a consequence, the net saving of foreign exchange may not be very great. And there may even be cases of net losses of foreign exchange from import substitution as is suggested by the number of industries, noted in Chapter Four, with negative imputed free trade value added.

This heavy reliance on imports is not surprising, of course, in the light of the policies that have prevailed. In particular one cannot blame the private foolishness of entrepreneurs for the phenomenon of import-dependent import substitution. For the cascading of rates of protection from low on capital equipment and intermediate inputs to high on finished products naturally encourages industries based on imported supplies. This is because the general level of protection defends an undervaluation of foreign exchange so that those imports that can be liberally imported at low duties are, in effect, undervalued in relation to domestic products. Moreover, with such cascading rates of protection, the effective rate on the final product will be greater the smaller is the proportion of value added (in world prices). Hence those industries which save the least foreign exchange, ceteris paribus, may have the highest effective rates of protection.

Sicat has investigated the import dependence of the "new and necessary" industries for the year 1960.[1] He found that these favored import substitution industries had an average ratio of imported to domestic intermediate inputs of 1.4 -- that is, imported inputs exceeded domestic by 40 per cent. In addition he found that the imported component averaged about

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[1] G.P. Sicat, Import Demand and Import Substitution in the Philippines, 1953-1963, IEDR Discussion Paper, no. 69-2 (January 25, 1969), ch. 6.

75 centavos for each peso of domestic value added. Imports were undervalued by almost 50 per cent, however, because of the overvaluation of the peso. With an equilibrium exchange rate (implying elimination of protection of domestic value added) the imported component would appear proportionally much larger. Moreover, these are average figures for the whole group of favored industries. In some extreme cases there may have been a net foreign exchange loss. In any case the evidence suggests that these industries were very expensive savers of foreign exchange.

Dependence on Traditional Exports

The failure of industry to generate new sources of export earnings is simply outward evidence of the nature of the industrialization drive. In a larger sense the industrial sector has been dependent on the traditional exports sector. Being unable to earn its own foreign exchange requirements to any significant degree, manufacturing growth was constrained by the growth of exports from the primary sectors -- agriculture, mining and forestry. Whenever these traditional exports stagnated, the resulting scarcity of foreign exchange forced a slowdown in the growth of output and employment through import controls and credit restraints. The result has been halting industrial growth and a chronic tendency toward excess capacity in many manufacturing industries.

The dependence of the economy on a few traditional exports can be seen in the fact that copra, logs, sugar and copper comprised about 70 per cent of export earnings over the past decade. Sicat has found some evidence of significant growth of manufactured exports during the 1960's, but this

is largely accounted for by plywood, coconut oil and canned pineapples.[2] The vast array of import-substituting manufacturing industries has yet to contribute significantly to export growth.

Regional Industrial Concentration

The effect of inward-looking, import-dependent industrialization on the regional pattern of development can be seen in the concentration of manufacturing industries in and around Manila. No doubt this would have occurred to some extent anyway, but the powerful forces of industrial policy tended to reinforce a natural agglomeration effect. In particular, the fact that the new industries depended on undervalued inputs from abroad rather than on materials from the agricultural, mining and forestry sectors biased location near the principal port. In addition, during the period of import controls there was an advantage in being close to the seat of government, so that Manila was doubly favored. As a result about two-thirds of the value added from the organized manufacturing sector is accounted for by establishments in Metropolitan Manila and the Southern Luzon region. The latter includes Rizal Province where, in an area surrounding Manila, the greatest growth of manufacturing has occurred.

Sicat has attempted to estimate regional growth rates from local government tax expenditure data. He found that on the basis of these proxies for regional production Rizal Province may have grown from three to five times faster between 1948 and 1966 than any of the nine regions into which he di-

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[2] G.P. Sicat, "The Manufacturing Sector After Decontrol," IEDR Discussion Paper, no. 67-9 (August 20, 1967), pp. 31-33.

vided the country. This suggests that the concentration of manufacturing has resulted in a very unequal sharing among regions in the postwar economic growth of the nation. This has probably accentuated the inequality of personal income distribution, as well.

As a result, Manila and the surrounding area has become what Hirchsman has called an "import enclave". Instead of linking backward to the other regions of the economy it links on the supply side to the rest of the world. Even on the demand side, the market for many of the consumption goods depends significantly on the free-spending new urban classes that were spawned by the industrialization itself. So, for example, the system encouraged the establishment in and around Manila of assembly industries for automobiles and television sets, most of which are then sold in Manila and suburbs.

The bias against manufacturing that links back to the natural resource base is particularly disturbing, not only for its effect on regional disparities. The Philippines still exports great quantities of copra, logs and metallic ores and concentrates which are often processed and re-exported by other countries. And studies invariably show that the rate of return to capital is greater for these crude material exports than for the export of manufactured products using them as inputs. Log exports are more profitable than plywood exports, for example. Hence there has been some reluctance on the part of the government to use tax and subsidy measures to discourage these crude exports in favor of further processing, despite widespread unemployment and underemployment of labor.

The comparison of the relative profitability of exporting the crude or the processed product misses the key point, however. The logs will be

exported whether as logs or as plywood. The rate of return on plywood manufacture for export should be compared not with that of log exports, but with that of other investments since it is these that would be displaced, not logging. But other investments include those in the artificially profitable import substitution industries like automobile assembling. And the heavy protection of these industries defends an exchange rate at which logs can be exported, but not plywood (except for a modest amount in the American market where the Philippines still has a diminishing tariff preference until 1974). So, while a host of reasons have been set forth in attempts to explain why the Philippines exports logs to Korea and Taiwan where they are made into plywood for re-export, a sufficient explanation appears to be the protection system and the unfavorable exchange rate it defends. This suggests that many other potential export industries based on domestic raw materials may also be victims of the protection system.

Neglect of Wage-Goods Industries

The bias against investment in so-called "essential" industries came from the set of import priorities under exchange controls and later from the differential rates of the tariff system, both favoring imports of essentials at the expense of domestic production. As noted previously, essential goods generally meant producers goods, but the system favored the import of some essential consumers goods also. Canned milk, wheat flour and pharmaceuticals have relatively low effective rates of protection, for example.[3]

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[3]Canned milk was not included in the list of effective rates of protection in Table XXIV of Chapter Four because the subsidized imports of the National Marketing Corporation (NAMARCO) imposed a heavy penalty on the domestic industry which disappeared after 1966 with the demise of NAMARCO. In 1965 the rate was actually minus 26 per cent, but even in the absence of NAMARCO it would have been no higher than 12 per cent.

But in addition to the biases in the protection system, the government has intervened through price controls, subsidies and direct control over imports of rice to try to keep the prices of staples low. Of particular importance were the activities of the National Marketing Corporation (NAMARCO) for a decade after 1955 and the government's rice import policy.

NAMARCO imported canned food -- principally milk, fish and meat -- at preferred exchange rates and then sold them below cost to retail distributors. Its effect was so pervasive that even today, four years after NAMARCO ceased operations, the country is still heavily dependent on imported canned foods. Nor was the policy successful in providing cheap wage goods. For whenever balance of payments difficulties required restraints on imports (through controls or devaluation) the price of these goods rose sharply.[4] Moreover, even during the time when imports were subsidized, the nature of the goods (the rich can enjoy them as well as the poor), plus the fact that they were marketed largely in urban centers, lends support to the suspicion that the middle and upper income groups may have benefited more from this subsidy than did the poor.

Rice import policy also aimed at keeping this basic staple cheap; and it, too, was unsuccessful. The story was told above (in Chapter Two) of the inflation of the mid-1960's which was dominated by rice prices. The government failed to import rice in sufficient quantities to match the shortfall

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[4]After this was written another devaluation occurred in early 1970. One of the loudest complaints of consumers against the new exchange rate stemmed from the sharp rise in the price of canned milk.

that resulted from shifting land to export crops after the devaluation. The failure seems to have been partly the result of poor planning; but sufficient imports to keep the price low might have presented a serious foreign exchange problem, and a continuation of the relatively low price might have caused continuing shifting into other crops.

In the late 1960's, rice policy turned from import subsidy to one of direct attack on land yields. It could be argued that this could not have been successful until the International Rice Research Institute had developed its high-yielding seed types in the mid-1960's. This argument, however, ignores the gap between yields on irrigated and non-irrigated lands for the traditional types of seeds. The key point is the neglect of agriculture that persisted throughout the the period of import-substituting industrialization, as evidenced in the scant attention given to investment in irrigation, roads, and other infrastructure in the rural areas. Most development theories emphasize the importance of gains in agricultural productivity to keep food prices from rising and, in turn, pressing up money wages and labor costs in manufacturing. This is especially important in the Philippines because of its substantial surplus of labor and the need, therefore, to expand rapidly employment in manufacturing and related sectors. And ample capacity to supply food and other wage goods would permit a correction of the overvaluation of the peso to break the foreign exchange bottleneck and permit a more rapid industrial development without fear of serious inflation. In contrast, the bias of policies against domestic production of essential consumers goods makes exchange rate reform more difficult because of the greater dependence of the cost of living on the peso prices of imports.

Slow Growth of Industrial Employment

The relatively slow growth of employment in manufacturing was noted in Chapter Two. From the evidence presented there we are forced to conclude that from the mid-1950's the proportion of the labor force in manufacturing has remained roughly constant at no more than twelve per cent, and that today no more than five per cent of the labor force is in so-called "organized" manufacturing -- i.e., establishments with five or more workers. About 60 per cent of the labor force is still dependent on agriculture and much of the remainder is in low-paying service and commercial activities. This is a disappointing performance for the postwar industrialization effort, especially in view of the labor absorption requirements in the Philippines where labor force growth is in excess of three per cent per year.

We have already referred to the existence of a "factor price disequilibrium" in the Philippine economy in the form of a wide gap between the social marginal opportunity cost of labor and the wage rate that the modern sectors must pay. While this phenomenon might exist even without the influence of government policies, the variety of laws related to industrial promotion, labor welfare, and interest rates that were discussed in Chapter Four have no doubt aggravated this disequilibrium. Their combined effect has been to encourage both an industry mix and a choice of techniques within industries that is excessively labor-saving. That this has had an important effect on labor absorption in manufacturing is suggested by the relatively high elasticities of capital-labor substitution found in studies of Philippine manufacturing.[5]

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[5]At the two-digit ISIC level of industrial aggregation, Sicat found elasticities generally to be around unity and, in some cases, higher. See his "Industrial Production Functions in the Philippines," IEDR Discussion

In addition to the bias toward labor-saving in manufacturing, there is another way by which the wage policies of the government deter the growth of industrial employment. That is by preventing manufactures from being competitive in the world market and thereby constricting the market for industrial labor. It was noted in Chapter One that the existence of a factor price disequilibrium between the primary producing and industrial sectors permits primary exports to maintain balance of payments equilibrium with the help of tariffs or import controls at an exchange rate that precludes effective competition in the world market for manufactures. In other words, it is the phenomenon of factor price disequilibrium that explains why a system of protection that implies a general penalty on all exports nevertheless permits primary exports to expand. And this is why manufacturing must have some form of protection (preferably, of course, a subsidy to employment) if it is to develop at all. But if the protection is one-sided -- i.e., protection in the domestic market only -- the market for manufactures is severely constrained and the growth of industrial employment is retarded.

To dramatize this point, consider what would happen if the manufacturing enclave in and around Manila were to secede from the rest of the country. The latter would no longer have to buy high-priced Manila manufactures and would elect to buy them cheaply from abroad or to produce them domestically behind protection. In either case the Manila peso would have to be devalued (or wages and prices generally reduced) to the point where exports of manufactures would pay for needed imports. Ideally tariffs would be eliminated (ex-

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Paper, no. 68-18 (May 23, 1968). These findings have been generally confirmed by J.G. Williamson in his "Relative Price Changes, Adjustment Dynamics, and Productivity Growth: The Case of Philippine Manufacturing," SSRI Workshop Series, University of Wisconsin, 1969.

cept, perhaps, for revenue purposes) and the exchange rate would protect comparatively advantageous manufacturing industries in both the domestic and world markets.

The similarity to the cases of Hong Kong and Singapore should be evident. The latter two countries must remain competitive in the world market for manufactures through a combination of exchange rate and wage policies. The dualistic character of the Philippine economy, on the other hand, makes it easy to fall into the trap of perpetuating factor price disequilibrium through a high wage policy in manufacturing offset by tariff protection. The resulting failure of industry to absorb the growing surplus labor from agriculture and other low productivity sectors has the effect of enhancing a dualism in the labor force between a small number of relatively well-paid industrial workers and the great majority of the labor force which remains unemployed or employed at far lower average earnings.

It might be argued that offsetting the wage penalty on manufacturing is the subsidy from low interest rates and cheap imports of capital equipment. These have the effect, however, of benefiting most the more capital-intensive industries which are likely to be the least comparatively advantageous from a social standpoint. So these subsidies are not likely to encourage exports of manufactures, and even where they might do so the effect on employment will be less than under an alternative policy of encouraging labor-intensive exports.

All economic development experience suggests that an essential ingredient for success is the relative shift in the proportions of employed labor from agriculture to industry -- in short, industrialization. The lack

of any evidence of this structural change since the late 1950's means that the industrialization process has stagnated for more than a decade, despite protectionist policies that were supposed to encourage industrial growth. The rate of labor absorption by the manufacturing sector depends both on its rate of growth and its average labor intensity in production. The growth of the sector will depend significantly in the future on its ability to reach the export market. Average labor intensity will depend on the selection of industries and techniques of production. Unfortunately the mix of wage, interest and protectionist policies in the Philippines today is perversely biased against both manufactured exports and the use of labor in production.

Income Distribution Again

It should be clear that these various policies affecting industrial employment have, like the neglect of agriculture and the regional concentration of manufacturing, tended to aggravate the inequality of income distribution. The reader is referred at this point to the section on income distribution in Chapter Three where the various consequences of these policies in affecting income distribution are discussed in some detail. Here it will suffice simply to emphasize several points.

We noted Kuznet's hypothesis that in the course of economic development income inequality tends at first to increase, but later to diminish to an extent that the full cycle implies a significant overall decrease. The hypothesis helps to explain Philippine experience, though the tendency toward greater inequality in this early stage has been enhanced by the slow growth of industrial employment. In fact it is possible through a sufficiently rapid absorption of labor in modern industry to eliminate altogether the

first phase of growing inequality. But that would require outward-looking trade policies, and wage and interest policies that would enable the economy to capitalize on its natural comparative advantage in labor-intensive manufacturing.

Since average earnings in urban areas, and especially in greater Manila, are much above those in rural areas, the effects of favoring industry over agriculture and concentrating industry around Manila also have undoubtedly been to increase the inequality of income distribution.

Again, it cannot be emphasized strongly enough that the effect of the minimum wage law, which is defended as a means of bridging the gap between the rich and the poor, is actually to widen income inequality. For it helps only a few who generally have good jobs in the modern sector rather than the many poor Filipino workers who do not. In addition, by holding back the growth of industrial jobs it tends to enhance the surplus of labor and, therefore, to depress the wages of those who do not come under the law.

As Kuznets argued, it is economic development itself that eventually brings a more equitable income distribution. The focus of distribution policy in the Philippines tends often, however, to be on the division of a given income rather than a growing one. Thus, by emphasizing short-run income redistribution policies, the more important problems of growth and development get sidetracked. And often the policies tend to aggravate relative factor price distortions rather than to correct them. This leads to less efficient patterns of industrialization, a slower growth of productivity,

more bottlenecks and eventually a worsened income distribution from the restricted employment and income opportunities for the poor.

Technical and Economic Inefficiency

Under usual profit-maximizing assumptions, a firm is assumed to be on the production function that incorporates the most efficient method known of employing each combination of factors; and to be producing at least cost. This kind of technical efficiency might hypothetically be achieved even in combination with an economically inefficient allocation of resources. That is, an industry that may not be economically justified, existing only because of protection, may nevertheless be producing its output at the least cost in the above sense. The assessment of technical efficiency is difficult to judge in this case, however. What standard should be used?

In contrast, the absence of protection automatically provides a standard -- international production costs. Moreover, absence of protection -- putting aside some possible qualifications for the moment -- tends also to promote economic efficiency in resource allocation. In particular it tends to insure that the costs of earning and saving foreign exchange are equal at the margin, so that the foreign exchange budget is balanced at least cost in resources. Firms and industries that could compete freely with the rest of the world would then exemplify both technical and economic efficiency.

A protection system like that of the Philippines may, on the other hand, produce both technical and economic inefficiency. It should be evident from the wide disparities in effective rates of protection described in Chapter Four that the costs of saving foreign exchange in various import substitution industries differ widely; and that, in general, the cost of earning for-

eign exchange through exports is much less. This implication of serious resource misallocation must be qualified on two grounds, however. First is the terms of trade effect that would result from encouraging more exports through a correction of the present price distortions. This applies in significant degree only to a few primary exports, however, so that a general penalty on exports from tariff protection is not the appropriate remedy. The other qualification is, once again, factor price disequilibrium. It can be shown that here, too, tariff protection is an inept remedy. We will forego pursuing these arguments further at this point, however, since they are developed in detail in Chapter Six.

The problem of technical efficiency is particularly important for less-developed countries like the Philippines since the small size of domestic markets means that in most industries the number of firms of economical size is not sufficient to insure a vigorous domestic competition. The only possible source of competitive pressure to maintain a drive for efficiency and technological progress is international competition. But the very high rates of protection for many manufacturing industries in the Philippines tend instead to produce a smugness and complacency that militates against the relentless pursuit of cost reduction and quality improvement.

There is yet another way in which the protection system has prevented Philippine manufacturing industries from attaining the level of cost efficiency that is possible. The favoring of finishing stages consumption goods industries at the expense of more basic manufactures, together with the bias against exports, has caused resources to be dispersed in many small consump-

tion goods industries, horizontally balanced in relation to consumer demand, rather than concentrated in vertically integrated large-scale industries producing both for the domestic and world markets. Consequently, the potential gains from economies of scale and from learning by doing in the context of more rapid, concentrated growth have been foregone.

For this reason the oligopolistic patterns in the Philippines contrast sharply with those found in advanced countries, at least in many cases. Whereas in the latter large size from the advantage of scale economies may be a reason for the oligopolistic structure, in the Philippines oligopolies, as exemplified by the automobile and electrical appliance assembly industries, have derived from protection of the small domestic market. Because of the high profit rates that this protection provided and the small size of the domestic market there has been little interest in expansion through competition to appropriate potential economies of scale.

This completes our critique of industrialization policies. The picture may seem not to be a very bright one. On the other hand, there may be room for optimism in the thought that with all of these policy defects Philippine growth performance has not been so very bad. What might the potential be under a better regime of policies? With this question in mind we turn in the final chapter to questions of policy reform.

CHAPTER SIX

NEW DIRECTIONS FOR INDUSTRIAL GROWTH

1. The Need For New Directions

The balance of payments crisis of late 1969 has forced to the fore basic issues of economic development policy that have too long been neglected in the Philippines. We noted in Chapter Two that the import controls of the 1950's had produced a brief "exuberant" period of finishing stages import-substituting industrialization. What was needed to sustain industrialization beyond this first easy phase was a reversal of policy incentives so as to favor backward integration and industrial exports. Instead the protective tariff system of the 1960's seemed designed to preserve the existing pattern of industry with the result that manufacturing became a lagging sector in economic growth. Only a remarkable growth performance in agriculture, abetted by forestry and mining, prevented a serious decline in the overall rate of growth. In short, after two decades of heavy protection of manufacturing industry, the economy found itself still mainly dependent on the primary producing sectors for its economic growth.

The dependence of the economy on agriculture, mining, and forestry was equally evident with respect to the balance of payments. Manufacturing remained heavily dependent on imports with only a very modest growth of export ability. It was a rapid growth of traditional exports, comprising primary and semi-processed products of agricultural, mineral and forestry origin, that made the foreign exchange position viable between 1960 and 1966. And it was the abrupt decline in the quantity of these exports after 1966 that brought a renewal of balance of payments difficulties, underlining the failure of manufacturing sufficiently to save foreign exchange through

backward integration or earn it through exports. It is ironic that the very measures that were defended as a means of freeing the economy from dependence on primary production had the effect of reinforcing such dependence. But this is the natural result of transforming the import bill from one comprised of consumption goods to one comprised of "essential" producers goods.

There are two reasons why the Philippines cannot afford to continue for long this dependence on primary production as the leading growth element. The first stems from its factor endowment: a large and rapidly growing population in relation to natural resources means that jobs must be created most rapidly in sectors where the principal resources complementary to labor are augmentable. This is the basic rationale for industrialization. A less important reason is the risk that world demand for the Philippines' primary exports may not be sustained at a pace that would lead the economy to successful development. Import substitution and export diversification are, therefore, secondary rationale for industrialization.

Thus a resurgence of industrial growth seems to be an essential ingredient of development strategy for the 1970's. And from the foregoing discussion it is evident that this means backward integration and export expansion in manufacturing. What is called for is a full-scale reform of economic policies to remove the biases against these new directions that industrialization must take if the 1970's is to be a development decade for the Philippines. Equally important is the need to remove the biases favoring substitution of capital for labor. For accelerating population growth will make the problem of labor absorption even more critical in the future.

A principal difficulty is, of course, the "distress" that reform will create for a number of marginal or extra-marginal manufacturing activities that were nurtured by the biased protection system. This is

one of the disadvantages of what Hirschman has called a "highly sequential" process of moving step by step from the finishing stages of production to intermediate and finally to capital goods.[1] The temptation is very great to give extra protection to the first phase industries by means of more liberal imports of intermediate and capital goods and this creates vested interests in opposition to any correction of the bias against integration. The highly sequential pattern, itself, is neither necessary nor natural and, as Hirschman has pointed out, was not followed by the earlier industrializers of Europe and North America. There is, therefore, no need to have distinct phases of industrial development requiring different sets of policies, with all of the difficulties of political adjustment that this entails. Instead, a relatively stable policy framework should enable the economy from the beginning to make rational choices with respect to import substitute and export industries at any or all stages of the production process without creating artificial barriers to continuing growth.

Had the Philippines, for example, devalued the peso in 1949, instead of adopting import controls (and if tariffs had been uniformly lower), the industrial structure would be vastly different today. Instead of a lop-sided emphasis on consumption goods industries, dependent for their survival on the foreign exchange earnings of primary exports, there would be a more select list of better integrated industries, some capital goods industries, more processing of domestic raw materials and a substantial complement of industrial exports. This is still what needs to be done, but progress has been long delayed and the task made more difficult by two decades of biased protection and peso overvaluation.

1/ Op. Cit., p. 6

2. Policy Reform

It is evident that investment and output decisions in the Philippines today are made in the face of strong biases arising from the protection system. One would not object to this distortion of r prices and profits if it led to more rapid industrial expansion and a higher overall growth rate. In fact, because it caters to the finishing stages import substitution industries which came into existence in the 1950's rather than to the prime opportunities for industrial growth in the 1960's and 1970's -- backward linkage import substitution and new exports -- the protection system stands today as a leading obstacle to the resurgence of industrial growth.

This is why the Board of Investment is obliged to set itself against this system by offering special incentives to industries that link backward to the natural resource sectors, to intermediate and capital goods industries and to those with export potential. In some cases the weapons of the BOI may be sufficient to neutralize the existing price and profit bias. But in many cases, especially for new exports, this is not likely. The net result is an overall system of incentives in which some socially valuable activities that could save and earn foreign exchange are rendered privately unprofitable, while many socially sub-marginal activities that are heavy users of foreign exchange seem attractive to private investors.

What can be done? An obvious place to start is the correction of the biases against backward integration and new exports in the protective system. This calls for uniform tariffs on all goods (including capital goods and raw materials) combined with equivalent subsidies for exports. This could be modified by withholding (or reducing) the subsidy to those

exports in which the Philippines share of the world market is sufficiently large to give rise to a concern about the effect on world prices from increased supply. And temporary tax, subsidy, and credit incentives could be added in selected "infant industry" cases. The latter should be restricted to a few whose efficiency response to scale and learning are expected to be exceptional, since spreading such inducements too broadly dilutes the effect for those that really warrant such classification.

The advantage of such a reform in the protection system should be evident. A tariff on a product gives the domestic producer a margin of protection against the foreign supplier -- a margin paid to the producer by the Philippine consumer. To avoid a bias against the saving of foreign exchange via backward integration, however, the same margin of protection must be given to the supporting industries -- capital goods, intermediate goods and raw materials. And to avoid a bias against the earning of foreign exchange via export of new industrial products, the same margin of protection against foreign suppliers must be given in the export market. To fail to redress the present biases, on the other hand, would be to continue a policy of favouring the heavy users of foreign exchange, the consumption goods industries, against the potential new savers and earners of foreign exchange. In addition it would mean continuing the bias against those industries with the greatest growth potential, thus maintaining the present poor investment climate.

The uniformity in rates of protection must apply, of course, not only between categories of goods but to all industries within the categories, as well. The only exceptions would be the export industries whose prices might suffer from more rapid expansion and a limited number of genuinely infant industries, as noted above. General uniformity in protection is especially important to encourage efficiency in investment and other resource

allocation. The present system, in contrast, tends to offer whatever protection is "needed" by a particular industry. Thus the least efficient industries are likely to receive the highest protection (i.e., subsidy from the consumer). The more efficient an industry is (or becomes) on the other hand, the more difficult it is to establish a case for protection. Such a system, then, systematically subsidizes inefficiency. The difficulties in the way of successful economic development are great enough without creating artificial barriers of this sort.

There remains the question how high should the general level of protection be. The answer is, simply, high enough to achieve balance of payments equilibrium. This need not be predicted in advance. Rather the reform of the protection system should proceed gradually in successive stages, with the highest rates declining and the lowest rates and subsidies to exports rising. In this way the authorities can feel their way toward the equilibrium level. Moreover, this gradual approach will ease the difficulties of adjustment to the new system.

A question naturally arises also as to the source of finance of the subsidies to exports. Ordinarily this would present the problem of new taxation which, in turn, might itself create new distortions and a partial offset to the impetus to growth that the new protection policy would offer. This is especially true when, in the political process, a new tax program emerges as a hodge-podge of compromise between the conflicting claims of various power groups. Fortunately, however, in the present situation in the Philippines, the inadequate fiscal machinery of the government need not present such an obstacle. For the subsidy would be paid only in connection with additional foreign exchange earnings and these, in turn, would permit expansion of output through greater use of existing capacity by

financing the necessary imports. Thus the subsidy could come from a rise in the government deficit since an increase in the supply of goods could occur together with the expansion of monetary demand. The point is that the foreign exchange bottleneck would be broken, permitting a fuller employment of existing resources. The principal inflationary danger would then come from food prices, so that continuing success in the rice program is essential.

There is an alternative means of achieving the same result, however, without requiring a direct subsidy to exports. A rise in the price of foreign exchange will give to domestic industry an additional element of protection against foreign competition in both domestic and foreign markets. In fact, the exchange rate adjustment can give more complete and effective protection than can tariffs simply because it protects domestic production both as import substitutes and as exports. Ideally, then, tariffs would be eliminated altogether except, as already noted, for selected infant industries. Even for these straight subsidies would be better than tariffs because the latter impose an unwarranted penalty on users of the products, whether producers or consumers. The advantage of subsidies, however, hinges on the question of the ability of the government to implement a rational tax program, since they could not be safely financed through government deficits unless the "infants" were foreign exchange earners or savers. Tariffs might, then, turn out to be the best available means of protecting infant industries, despite their unfortunate side effects. It should be emphasized, however, that this would be true only because of an inability on the part of the government to implement a tax system that involves less inefficiency in resource allocation than customs duties. (We are abstracting from the equity aspects of alternative taxes.) And it should also be

emphasized again that the general level of protection for all domestic industry can be much more effectively provided by a higher price of foreign exchange than by tariffs, since the latter is effective only in the domestic market.

The equivalence (for commodity trade) of system of uniform tariffs and matching subsidies to exports with a higher price of foreign exchange has been, we think, unsufficiently appreciated. Consider a country (e.g., Japan) that combines tariff protection with what is, in effect, a subsidy to exports by means of taxes that apply to sales in the domestic market, but not to sales in the world market. The fact that the price to the Japanese buyer is greater than that at which Japan sells to the world has led to charges that Japan is "dumping" its products on the world market. But suppose that Japan were to eliminate all of its tariff and taxes on sales. It would then have to devalue the Yen to restore balance of payments equilibrium. 2/ The devaluation would both protect the home market for Japanese industry and encourage its exports to a degree equal to that afforded by the combination of tariffs and subsidies. Yet in this case Japan would not be accused of "dumping!" It seems that adding export subsidies to a system of protection via tariffs or exchange control is a way of overcoming the bias against exports from an over-valued currency. And those countries in Asia that have implemented such a policy (Japan, Pakistan, Taiwan and South Korea) have found that industrial exports have boomed as a result.

2/ This assumes that there was initial balance of payments equilibrium. If Japan is, in effect, under-valuing the Yen by over-playing this game of tariff and subsidy, the argument must be stated in relation to a restoration of the initial disequilibrium in the balance of payments. Other than that the argument is unaffected.

Which means to employ --reduction of protection plus devaluation or subsidies to manufactured exports -- is largely a political question.[2a] Both, however, have one political difficulty in common. This arises from the desirability of discriminating against certain traditional exports. There is a sound, perfectly respectable economic argument for this. It stems from the term of trade effect of expanding exports whose world demand elasticity is less than infinity. The social value is measured by the marginal revenue from such exports, not by the world price. To bring private decisions into line with social values these exports should be taxed (relative to all others and to import substitutes) by a percentage equal to the reciprocal of the particular world demand elasticity. That is, if world demand elasticity for a certain export is estimated to be equal to ten, the appropriate relative tax is one-tenth, or ten per cent. This will adjust the world price to the level of marginal revenue, thus giving the exporter the correct indicator of the social value of his exports.[3]

The political power of the traditional export sector in some countries may render this aspect of the traditional industrialization policy difficult to implement. Albert Hirschman has commented on this with respect to Latin America.[4]

2a/ The tariff and subsidy alternative has the administrative disadvantage of encouraging the smuggling or undervaluation of imports and the overvaluation of exports, however.

3/ This assumes that the exporters are competing, taking world price as given. If the export industry is a monopoly, it should already be exploiting the world market to an optimal degree from the national standpoint. There remains in this case, however, the question of how the gain is distributed. The government might still choose to tax away the monopoly gain.

4/ Op. Cit., p. 27.

> . . . For example, why not tax the [traditional] export sector, subsidize the new industries and do away with the overvalued exchange rate so that industrial exports are encouraged? To ask this question is to answer it: in most Latin American countries such a course would have been politically impossible. The power of the groups tied to the primary export sector would hardly have permitted so direct an assault . . . .

For the Philippines, perhaps, subsidies that discriminate in favor of new exports might appear a less direct assault than devaluation plus a tax on traditional exports.

There is yet another element of bias against the modern industrial sector that needs to be corrected if the Philippines is to experience the resurgence of industrial growth required for successful development. This is the wide gap between the market wage in the modern sector and the marginal social opportunity cost of labor from the traditional sector -- so-called factor price disequilibrium. While we do not have, for the Philippines, a precise measure of the marginal social opportunity cost of labor to manufacturing, the great disparity (noted in Chapter One) between average earnings there and those in agriculture suggest that the gap must be substantial. This may help to explain why a system that discriminates strongly against exports via an unfavorable exchange rate defended by high tariffs nevertheless permits a strong performance in some export industries. Of course a real underlying comparative advantage may also help to account for the success of these industries, but the fact that manufacturing must pay such relatively high wages when unemployment and very low productivity employment are widespread suggests that this factor price disequilibrium is masking cases of real comparative advantage in manufacturing, especially where labor-intensive techniques are possible.

What are the remedies for this bias? The classical one, from Manoilescu, was tariff protection for manufacturing. This the Philippines has, and the

inadequacies of this remedy have been set out above. At best it can correct the bias only for import substitution, leaving manufactured exports at an even greater disadvantage, and in effect maintaining, rather than diminishing, the dependence of the economy on its traditional primary exports.

To avoid the bias against manufactured exports, Lary advocated a dual exchange rate instead of tariff protection. 5/ A higher price of foreign exchange for manufactured imports and exports alike would favor both import substitution and exports in that sector. Note that this is equivalent to uniform tariffs and subsidies for manufactured import substitutes and exports and also equivalent, of course, to a devaluation plus tax on traditional exports. The latter tax is separate from, or additional to, the optimum tax for terms of trade reasons, described above. Ideally, it would apply in just the measure needed for each industry to redress the effect of factor price dis-equilibrium.

The Lary proposal, while a vast improvement over crude tariff protection is still a second-best remedy, however, since another consequence of a wage rate in manufacturing above the social marginal cost of labor is a bias toward capital-intensive rather than labor-intensive techniques and industries. This bias, together with those in the protection system (described above) and the various direct and indirect influences from labor and social welfare legislation discussed in Chapter Five, help to explain the disappointing growth of employment in the 1950's and 1960's.

5/ H. Lary, "Economic Development and the Capacity to Import -- National Policies," in Lectures on Economic Development (Istanbul, 1958).

There are, then three unfortunate consequence of this kind of factor price disequilibrium. There is a bias against import substitution in manufacturing; there is a bias against manufactured exports; and there is a bias against labor intensity in manufacturing. 6/ Tariffs correct the first, but tend to worsen the second and third. The dual exchange rate (or equivalent) corrects the first two. A policy which would correct all three is a straight subsidy to employment in manufacturing. Whether or not the latter is, in fact, the ideal remedy turns again on the method of financing the subsidy. In contrast to the subsidy of exports (see above, pages 136-137), this one is not self-financing. So the choice between the subsidy to employment in manufacturing and the dual exchange rate (or equivalent) turns on whether the welfare loss from the taxes that would actually be imposed is greater or less than that associated with a failure to correct the factor mix. In any case, tariffs appear only third-best, as an inept and costly answer to factor price disequilibrium.

It is difficult to judge to what extent the phenomenon of factor price disequilibrium is a product of specific government policies or other institutional forces. In any case, it would be desirable to do away with those policies (described in earlier chapters) that artificially raise the price of labor and reduce the price of capital. The problem might then tend to disappear and the Philippines' natural comparative advantage in labor-intensive manufacturing could become evident in the world market.

What would be the likely effects of these reforms on Philippine economic development? First, the uniform degree of protection (exports included except, perhaps, for a few) would open the way for a much more rapid rate of industrial growth, characterized by a new phase of import

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6/ The bias may, of course, extend beyond manufacturing to other "modern" sectors. The argument should be interpreted to include these in "manufacturing."

substitution (via backward integration) and an expansion of industrial exports. These, in turn, would save and earn the foreign exchange needed to meet the import needs of a fuller utilization of capacity and a more rapid rate of growth. The further processing of crude materials from agriculture, mining and forestry would be encouraged. This, together with the strong incentive given to existing manufacturing industries to look for Philippine substitutes for imported materials and parts, would tend to spread the effects of industrialization more broadly to the various regions of the economy. Finally, manufacturing and related modern sectors would begin to absorb an increasing proportion of the labor force, an aspect of structural change that has been absent in the Philippines for more than a decade, but which is of great importance in enabling per capita income to rise.

Our focus is, on industrialization; hence we have neglected other aspects of Philippine development that could be equally decisive in determining success or failure. Two that must be mentioned are agricultural productivity and population growth. To the extent that policies are reformed so as to break the balance of payments bottleneck, the question of an adequate supply response in agriculture becomes more critical. There is some reason for optimism here, based on the progress of the "green revolution" during the past few years. The gap between average yields and the yields from the new techniques is so great that one can envisage continuing rapid gains for several years as the new agriculture is extended more broadly across the country. Finally, however, it must be emphasized that population growth, currently about three and one half per cent per year, will inevitably subvert all attempts at successful development unless it is brought under control. Despite this, the Philippines has yet to implement a population policy.

3. Postscript: The Floating Rate

Since all of the above was written, the Monetary Board on February 21, 1970 established a free market for most foreign exchange transactions. The principal exception is the required surrender of 80 per cent of the earnings of the four major exports (logs, copra, sugar and copper) at the official par value which remains at ₱3.90 per U.S. dollar. Within a short time the "floating rate" tended to settle between ₱6.10 and ₱6.12, a rise in the price of foreign exchange of approximately 57 per cent (eleven per cent for the major exports). At the same time import controls have been generally relaxed and a program of fiscal and monetary austerity has been adopted in principle. These steps were taken after consultations with the International Monetary Fund, which agreed to the use by the Philippines of its third credit tranche with the IMF. This in turn, persuaded American banks to renew their short-term credit to the Philippines. While it is too early to be sure, it seems likely at this point that an export tax (heaviest on major exports) and an official devaluation will eventually replace what is, in effect, a dual free rate system.

What can we expect from this new policy? Much depends, of course, on what other policies are adopted in the light of its effects. There is already agitation to raise the legal minimum wage, to enact price control legislation and to subsidize the import of basic commodities. It will be simpler, however, to assess first the probable effects of the foreign exchange policy reform, considered independently of other policy changes that might occur. The effects of the latter can than be added.

The greatest concern expressed in public discussion is over the effect on the price level. Yet the situation in the Philippines today seems to offer good prospects of holding price increases to a minimum

in the face of pressures from the de facto devaluation. There is widespread unemployment of labor and manufacturing plant capacity is considerably under-utilized. The rice harvest promises to be a bountiful one. Demand in the economy has been generally depressed below supply capacity for several years because of the foreign exchange problem. Accordingly there is room for expansion of output for import substitution and export without straining Philippine resources. The principal price increases will come, of course, in imported goods and in domestic products significantly dependent on imports. These are, however, inevitable and, in fact, desirable as a means of encouraging the saving of foreign exchange. In the light of this, the government's announced financial program could conceivably go too far in suppressing demand.

Still there will be some rise in the general average of prices. And there will be strong pressures to adopt measures to protect the real income of the "masses". In fact, however, the rural masses consume very little of imported or import-dependent products where the price increases will be concentrated. Hence the concern over the impact on the poorest segments of society is greatly exaggerated. The urban worker, on the other hand, will be somewhat more affected, especially by the rise in prices of certain imported food products whose domestic production has been discouraged for reasons discussed in Chpater Five. This is a short-run problem, however since the policy reform will provide incentives for increased domestic supply of these essentials. In any case it is the price of rice that is far more important to the urban poor and here the outlook is very favorable.

A devaluation encourages investment in all internationally traded goods industries vis a vis non traded goods industries, and backward linkage import substitutes and industrial exports will thereby be favorably

affected. It would seem on the surface, however, that the bias within traded goods in favor of finishing stages import substitutes would remain since the devaluation affects the peso prices of all foreign goods equally. Where import substitution has been virtually completed, however, protection may have become redundant. The reader will recall the many cases of apparently redundant protection among so-called "non-competing" industries in Table XXII of Chapter Four. In these cases prices of finished products are not likely to rise as much as the prices of imported inputs, implying a reduction of the effective rate of protection of the former. Therefore, there will be a tendency toward greater uniformity of effective protection even without tariff reform. Moreover, the rise in import prices of almost 60 per cent should produce many more instances of redundancy of protection than appear in the analysis of the structure of protection of 1965.

The bias against export of these finished industrial products will tend to be reduced for the same reason. Redundancy of protection means that prices for sale in the home market will not rise as much as will peso prices for sale in the world market. Hence these industries will find that the export market has become relatively more attractive. Where protection is not redundant, however, the biases of the protection system remain.

The above discussion of the effects of redundancy of protection suggests that even without tariff reform the devaluation may move the constellation of economic policies affecting industrialization much nearer to the ideal set forth in the previous section. For there are still the tax and credit incentives of the Board of Investments to give further encouragement to new exports, backward integration and the processing of primary products. In fact the new foreign exchange rate will make it easier for the BOI to render privately profitable those industries it formerly

deemed socially profitable on the basis of a shadow price for foreign exchange.

Despite the many encouraging implications of the foreign exchange reform, an atmosphere of pessimism prevails in discussions about its probable effects. The reason we suggest, is that it favors the future and penalizes the past. That is, past investments were encouraged by an undervaluation of foreign exchange offset by heavy protection and these past investments represent present interests that are hurt by the change. In contrast, the new system encourages the things that have yet to be done; hence there are no existing interests to speak for them. From an economist's standpoint this is the way it ought to be. No one should be rewarded for resting on past accomplishments. The rewards should go instead to those who seize the new opportunities. But the political process has another rationale, that of accommodating existing interests. Accordingly virtually all of the pressures for supplementary measures to accompany the devaluation come from those who want to be shielded from its effects. And these measures, if implemented fully, would go far toward vitiating the favorable effects of the reform.

First there are pressures to allow certain essential imports at the official parity instead of the free market rate. These range from basic foodstuffs to intermediate inputs into "distressed" industries. They are, of course, products whose production in the Philippines has long been artificially discouraged by the system of protection. The effect of importing them at a preferential rate would be simply to prolong this artificial discouragement.

In addition, a price control law has been proposed as a means of keeping the prices of basic essentials from rising. If effectively implemented this, too would artificially discourage the production of essential goods.

The pressure for a rise in the legal minimum wage comes mainly from organized labor in the modern sector. Roughly 75 per cent of the labor force does not come under the minimum wage legislation and it is in this group that

are found the majority of poor Filipino workers. A rise in the legal minimum for an already favored minority will hurt the majority of workers in two ways. First, the cost of living will respond to the wage increase. Second, and more important, it will slow down the rate of increase of jobs in the modern sectors, both by reducing the competitiveness of Philippine products in world markets and by encouraging substitution of capital for labor.

Finally, in the debates over an export tax to replace the required 80 per cent conversion at official parity for the four major exports, the interests represented by the latter have sought to include under the tax a much broader range of exports, presumably so that greater support can later be mobilized for its removal. This would have the effect, however, of discouraging many new exports with good earnings potential.

There remains, of course, the question of the rationale for taxing even the four major exports, since the tariff system imposes a tax on all exports as high, perhaps, as could be justified for terms of trade reasons. Sugar, however, is a special case because of the premium in the American market. It could be argued that the premium which arises from a political relationship between the two countries belongs to the nation, not to the sugar industry. The argument for taxing copper, logs and copra is to encourage copper smelting, wood processing and coconut oil manufacture, as well as other products that make use of these. There is merit to the argument since, as was noted above, the protection system tends to discourage such processing of primary products. Moreover, labor-intensive processing is further discouraged by unrealistically high market wage rates. On the other hand, the existence of unrealistic wage and interest rates means that it might be uneconomic capital-intensive processing that is encouraged. Thus a general reform of tariff and exchange rate policies of the kind described above, plus some means of bringing the prices of labor

and capital into line with their social opportunity costs, would be a superior means of encouraging processing where it is advantageous for the Philippines. A tax on the export of crude materials is only a second-best remedy. And insofar as the tax is extended to semi-processed and processed products, it will limit the favorable effect of the devaluation in promoting new exports without any compensating benefits.

It seems, then, that the pressures for measures to counter the effects of the new exchange rate policy may tend to reduce significantly its beneficial effect. If instead, however, the government is able to blunt these pressures so as to limit the extent of the counter measures, the 1970's could witness a significantly higher rate of growth for the Philippine economy, led by a second phase of import substitution in basic manufacturing and a vigorous expansion of industrial exports.

Institute of Economic Development and Research

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BY

John H. Power
and
Gerardo P. Sicat

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