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ECONOMIC INCENTIVES AND FOREIGN INVESTMENTS

by

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ECONOMIC INCENTIVES AND FOREIGN INVESTMENTS

*by Gerardo P. Sicat**

I. Introduction

An attractive profit opportunity induces investment. Given some reasonable degree of certainty when the rate of profit appears substantial, an entrepreneur moves in to appropriate the situation. It is the central point of many papers in this collection that entrepreneurs in the Philippines respond correctly to incentives, such as high profits (or conversely, to disincentives).

It will be the object of this paper to relate the pattern of foreign investments with the structure of economic incentives in operation in the Philippines during the post-war period. The major policy implication is that policy towards the promotion of industrial activity, in whatever forms it took, was responsible for bringing in the specific pattern of foreign investments observed in the Philippines. What this specific pattern is and how it can be influenced will be the subject of this paper.

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II. The General Pattern of Private Incentives, Post Independence

The overall pattern of economic incentives to private enterprise may be characterized, at least up to 1967, as an overwhelming policy in favor of domestic industrialization. This took the form of encouraging import substituting industries.

Prior to 1962, the major policy instruments for industrial promotion were import quotas, access to cheap foreign exchange (the overvalued exchange rate was maintained), tax exemption of new and necessary industries, and, in the case of Philippine entrepreneurs, favored access to long term funds through government financial institutions. After 1962, the tariff took over many of the functions of foreign exchange controls, but retained all other features.

All these measures appeared to have given differential incentives to the manufacture of goods at the finishing end, with the cost of importing raw materials kept cheap either by access to cheap foreign exchange (per 1960) or by low tariffs (post 1962). Thus, the structure of incentives was most favorable to finishing end manufacture, consumption goods industries. These incentives encouraged import dependent import substituting industries.[1] Intermediate manufacture

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[1]This point has been stressed in early versions of papers which are intended for a more thorough study of industrial development in the Philippines: "Industrial Policy and th Development of Philippine Manufacturing," DP 65-2, Janu-

and agriculture, especially in the early days of industrial promotion in the Philippines, were not given the same set of favorable incentives.

With the exception of laws Filipinizing the retail trade (passed in 1954) and the constitutional prohibition against the exploitation of natural resources by fully owned foreign companies, these incentives were available to any person or company, regardless of nationality. Americans, among all foreigners, enjoyed a special position because of the so-called parity amendment to the Constitution, effected by the Philippine-American trade agreement of 1946/ which gave Americans exploitation rights over Philippine natural resources. But these rights were not relevant to the growth of American enterprises engaged in manufacturing. The additional privilege extended to Americans which covered all forms of incentives was "national treatment", which came with the Laurel-Langley Amendment.

III. A Dramatic Contrast: Stonehill and Thompson, and the Role of Profit Incentives

A story about two former American soldiers who served during the Second World War in this part of the world

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ary 5, 1965 "Rates of Return in Philippine Manufacturing," DP 65-4, July 1965, "Import Dependent Import Substitution," DP 65-6, August 1, 1965. John H. Power has studied the effects of the structure of tariff protection. See his "Import Substitution as an Industrialization Strategy," Philippine Economic Journal, vol. V, no. 2 (Second Semester, 1966); see also a preliminary discussion paper J.H. Power and G.P. Sicat, "Industrialization in the Philippines: A Preliminary Overview," IEDR, DP 68-6, February 29, 1968.

dramatizes the relevance of the structure of incentives to the pattern of foreign investments. The first GI was Harry Stonehill, the other James Thompson. The former went to the Philippines, the latter to Thailand. They became both successful entrepreneurs in the two countries during the postwar period. The only difference is that today Stonehill's name is discredited in the Philippines, but Thompson's is highly regarded in Thailand.*

What were the major incentives that induced the activities of these two individuals?

In Thailand, Thompson developed handicraft silk into a big export industry. His success in marketing silk helped to create enormous employment in the home industries in that country. The profit possibilities in silk trading were largely long run. They required organizing skills at the procurement level, since the silk cloth was woven only in small scale handicraft enterprises. Thompson was not exposed to the same incentives that were capitalized on by Stonehill. At the time Thompson went to Thailand, there were probably few other opportunities that could have given him temptations to seek the path of overnight wealth in promoted industries. Had he gone back also faced with the inducements of the active industrial promotion activities

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*(Thompson mysteriously disappeared while on vacation in Malaysia early in 1967. Although there have been suggestions of a cloak and dagger plot about his case, he is held in high respect in Thailand for his promotion of the silk industry. For those interested in the mystery, see "Murder Compounds the Thompson Case," Life, Asia Edition, October 16, 1967).

now found in that country, one wonders whether he would have found the silk industry relatively more profitable.

Stonehill returned to the Philippines soon after the war. The system of import and exchange controls offered possibilities of quick gains in many areas of activities. Since many of the opportunities available were also linked to patronage and official corruption, Stonehill was able to master the in-roads to high profits and overnight wealth. His enterprises, largely engaged in industries which were highly protected, made him become within a short time span a millionaire. These activities ranged from cigarette manufactures to trade and real estate. In his road to wealth, Stonehill utilized methods which were quite underhanded. However, one is not sure whether some of these tactics were really part of the modus operandi built around a system of foreign exchange controls. Note for instance the many anomalies surrounding the exchange and import controls, "ghost" new and necessary industries, export undervaluation, and the like. When Stonehill's case was laid open before the public in 1962, the Philippines plunged into near national crisis.[2]

It is important to stress that the pattern of incentives which prevailed in these two countries at the time

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[2]See the speeches of President Macapagal (The Official Gazette or newspaper reports) and his advisers early in his presidency on the Stonehill case; also, during the 1965 presidential elections.

the two ex-soldiers returned attracted them to do what they did. I do not wish to suggest here that the personalities of the two persons did not matter in the making of their individual decisions. But the profit horizons opened to both persons were definitely important considerations in whatever business decisions they made. And these profit horizons were conditioned by the structure of economic incentives provided by economic policy.

Incentives create differential profitabilities for different activities. Some unintended results, like smuggling, are caused by differential profitabilities in favored industries. It is perhaps not unreasonable to assume that the entrepreneur maximizes his expected profits, that he sinks his investments to activities with the highest pay-off. The supply response of entrepreneurial effort will come if profits expected are sufficiently high enough. Thus, viewed this way, Stonehill's enterprising activities in the Philippines were not lone responses of effort to profit earnings.

The examples however should not be mistaken for typical cases. For indeed, it may be granted that Stonehill and Thompson were perhaps not ordinary men. Yet one wonders how much Stonehill could have contributed to Philippine development if the incentives he faced were those that led to

long run profit possibilities, if the institutions around which he worked were somewhat different from what they were.

IV. Quantitative Measure of Direct Benefits from Foreign Investment

Most arguments in favor of or against foreign investments are in terms of qualitative statements either derived from a priori economic or non-economic reasoning or from certain generalizations which have been verified from facts. We shall summarize these arguments briefly, and then go on to suggest a quantitative measure for analyzing the direct benefits from foreign investments.

The case for foreign investment summarized. I can think of several reasons why foreign investments are desirable. Briefly, these are: (a) to supplement inadequate domestic private savings in order to achieve a higher desired rate of economic growth; (b) to maximize on the transmission of technological change in the form of introduction of new products, production techniques, managerial and manpower training, etc.; (c) to increase the employment of domestic economic resources; (d) to encourage competition for nationally owned enterprises to make them more efficient; and (e) to effect a linking of domestic sectors.

There can be counter-arguments to many of the cases mentioned above. Particularly vulnerable are (b) and (d). What if technological change is made available at a high price -- e.g., the patent for a new product? What if there are unusually restrictive contracts for the use of technology, such that market possibilities are restricted? What if foreign enterprises, by virtue of their resources, are able to practice a high degree of monopoly power and thereby stifle domestic enterprise? These are valid objections to which attention will be directed towards the end of this paper.

But fallacious, unreasonable, or selfish arguments against foreign investments should be isolated. Cornelio Balmaceda, former high-ranking cabinet secretary and well-known public servant, has aptly summarized some of these arguments which we shall paraphrase: (a) well-established local industries want to enjoy pre-emptive rights in the matter of investing in the Philippines; (b) a few would raise the battlecry against foreign investment for the sole purpose of strengthening their popular or political stature; (c) a few would utilize the issue against foreign investment as a convenient means of drawing attention to some other issue; (d) there is the almost pathological dislike

of anything foreign by die-hard chauvinists; and (e) there is the fear of the competitive superiority of foreign industry, the alien domination of local enterprise, and, as a consequence, of control of political and social activities. "I honestly think that it would do well to dismiss all these motivations, except the last, as being misguided and patently selfish and unreasonable."[3]

A Proposed Measure of Direct Benefits from Foreign Investment. The most measurable benefit from a foreign investment is in the form of value added created for the domestic economy. Direct value added added is simply the sum of all wage payments, profits, taxes, and all payments due to capital, like rentals and depreciation charges and interest on borrowed funds.

An operational measure of direct benefits from foreign investments may be done by segregating from the direct value added created by the enterprise the claims of domestic and of foreign factors and then taking their ratios.[4] Over

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[3] Cornelio Balmaceda, "The Issue of Foreign Investments," The Philippine Economy Bulletin, vol. IV, no. 3 (January-February, 1966), pp. 10-13.

[4] This is developed in G.P. Sicat, "A Quantitative Measure of Host Country Factor Gains from Direct Foreign Investments: Applications to (1) Development Project Planning and (2) Gains from Overseas U.S. Investments," Institute of Economic Development and Research, University of the Philippines, DP 68-14, April 19, 1968.

the life of the investment, this ratio must exceed one. As a rule of thumb, it must exceed 2, if the investment is to be of major benefit from the standpoint of the balance of payments.

The foreign investor looks at an investment activity from the standpoint of the net return the investment brings to him. However, from a national viewpoint, the foreign investment should be viewed in terms of the net benefits it brings to the domestic economy, in particular to domestic factors. It is therefore important to quantify these net benefits and divide them in accordance with the claims of domestic and foreign factors.

This measure can be applied on an enterprise-to-enterprise basis. It can also be utilized in planning whether to allow a foreign investment to come in or not. We apply the measure to aggregate American investments in the Philippines. On the basis of data from a survey of American foreign investments in 1957 conducted by the United States Bureau of Commerce, we are able to infer data on the value added from foreign investment in the Philippines.

Table 1 defines the value added of foreign American enterprises according to the claims of domestic and foreign factors for every peso of sales in 1957. The methodology

Table 1

Value Added According to Claims of Domestic and Foreign Factors, in Per cent for Every Peso of Sale

Payments Made by Enterprise	Philippine Claims	US Claims
Wages and Salaries	16.2	0.8
Depreciation & Depletion	2.0	2.0
Other Taxes (Indirect)	7.2	-
Income Taxes	4.0	-
Interest	-	1.3
Undistributed Profits	0.2	5.7
Distributed Profits	0.2	5.4
TOTAL	29.8	15.2

$$\text{Ratio} = \frac{\text{Philippine Factor Claims}}{\text{U.S. Factor Claims}} = 2.0$$

used in constructing this table, the merits of the data used, and comparison of results with all regions and countries where there is known to be same form of American overseas investments are reported in another study of this author.[5]

[5] Ibid.

The ratio of total Philippine factor claims against US factors is equal to 2, implying that for every peso of foreign claim which was generated by the activities of foreign investments, two pesos of claims by Philippine factors were generated. So long as a foreign investment yields greater claims for the domestic factor, there are a priori some foreseen gains from a balance of payments viewpoint, if the domestic factors whose claims for payments are generated would have been unemployed otherwise. This may be true of some labor employment directly generated, especially in a setting where sizable unemployment is known to persist and if the enterprise requires relatively more workers with low grade skills. This may not be true of the skilled workers who may be hired from a tight or a gradually tightening labor market. However these domestic factors hired would have come from activities where their opportunity costs in other occupations are relatively low. Thus, their employment represents a movement to an occupation in which their productivity and consequently their wages are higher.

If we exclude the claims of foreigners which are reinvested in the country, the ratio of claims of Philippine factors to current American claims would exceed 3. The higher this ratio is, the better.

It may be of interest to examine the wages paid to Philippine labor as a ratio to total foreign claims. This ratio is 1.1, meaning that total wage earnings of Philippine factors exceed (slightly) the claims of foreign factors. When undistributed profits are removed from foreign claims, this ratio is 1.7. It is somewhat comfortable to see that wage payments to Philippine factors at least exceed the current claims of American factors. If labor has zero opportunity cost and it can at least be established that a foreign investment will be able to guarantee a wage payments to domestic labor at least equal to all repatriation of current foreign claims, the investment will be a major net gain to the economy.

Indirect value added generated. Just as important as direct value added is the total sum of wages, rents, profits, interest, etc. which are generated in other establishments in the course of interindustrial trade because of the activities of the foreign investment. The magnitude of this depends on the economic activity of the enterprise, to which sectors it sells and from which sectors it buys. It is harder to quantify.

A foreign enterprise which imports all its new materials practically has no indirect value added to sectors located

in more primary undertakings. Further, if the output is for direct domestic consumption, that is, the enterprise sells to no other sector but to final demand, it also has no indirect value added to sectors nearer to the final consumer. In this rather unusual case, the enterprise has zero indirect value added, and its only contribution to the economy is the direct value its activity creates.

Therefore, it matters much if the foreign enterprise buys some of its inputs from domestic sectors or sells its output to sectors which in turn use its output as a raw material. The greater is the occurrence of interindustrial trade of this sort, the higher is the indirect value added generated on the production side. One will therefore notice that indirect value added generated is defined here in the sense of input-output production linkages.

If the foreign enterprise has high indirect value added generated, it is easy to see why relative indirect domestic factor gains could be much higher than foreign factor gains. Suppose that an enterprise in one industry buys and sells inputs only to foreign owned corporations, so that in a sense, there is vertical integration of the operations of the different foreign firms. Then, the indirect domestic factor gains cannot be lower than the indirect domestic factor gains

cannot be lower than the whole vertically integrated industry. Since some companies owned by domestic nationals are likely to be buyers or sellers at some stage of this process of inter-industrial trade, it is obvious that domestic factor gains will be larger relative to foreign factor gains when the indirect value added generated is examined.

V. Foreign Investments in the Philippines and Response to Economic Incentives

Before we tackle the main objective of this section, which is to examine the specific response to the pattern of economic incentive already described, it is essential to present measures of the magnitude of foreign investments. Some on-going research attempts are being made in this direction, notably by some colleagues at the University of the Philippines.[6] I shall, however, push forward some ideas which are related to questions that I have independently pursued and on aspects which I believe they are not dealing on.

However, since it is only about American investments that more specific information is known, we shall direct our attention to these investments. This is not unduly restrictive

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[6]Niceto Poblador has tried to estimate the magnitude of American investments. His preliminary tables were briefly summarized by an issue of Business Day (Vol. I, No. 26, August 21, 1967). Felipe Suva Martin is currently writing a Ph.D. thesis at the Massachusetts Institute of Technology, based on an interview of executives of American-controlled corporations.

since, as we shall see, American investments are substantial relative total investments in the Philippines. When Chinese and American investments are added together in 1968, we probably can account for more than 90 per cent of foreign investments. Moreover, an analysis of American investments helps to describe to a great extent the investments of other nationalities.

A Measure of Foreign Investments in Manufacturing

It is difficult to get foreign investment figures for many areas of economic activities, especially in trade and finance. But some measures of the extent of foreign investments may be directly made about manufacturing. We begin with clues about the extent of foreign investments from Census data. The citizenship of controlling owners in Philippine manufacturing establishments are shown in Table 2. We only grope through since no tabulations are made of the fixed assets of establishments by citizenship of owners. This would have been very useful information.

The greater part of manufacturing establishments are owned by Filipinos. However, small as the number of American establishments are, they belong to the largest groups of firms in the country.[7] US Department of Commerce figures show that

[7]A yearly survey of the top 100 corporations in the Philippines always list American subsidiaries or American-controlled companies as among the largest, accounting for more than about half of total sales. These corporations are in different sectors, from trade, mining, to manufacturing. See U.E. Business Review, August issues, since 1962.

Table 2

Manufacturing Establishments in the Philippines by Citizenship of Controlling Owner

	Large Establishments		All Establishments	
	With More than 10 Employees	Per cent Distribution	Establishment	Per cent Distribution
Filipino	2,842	70	33,485	89.6
American	137	3	177	0.5
Chinese	1,068	26	3,644	9.8
Others	38	1	63	0.1
TOTAL	4,085	100%	37,369	100.0%

Source: Economic Census, 1961: Manufacturing.

American manufacturing investments were valued at $89[8] million in 1961. Even if we (generously) convert these figures at the rate of ₱3 to $1,[9] and assume that this equity investment is roughly equal to the book value of fixed assets; this amounts to ₱267 million. This sum would represent about 18 per cent

[8]We take this value, given by the US Bureau of Commerce, as total equity ownership by Americans. This may be inaccurate, but we have no other known figures.

[9]In 1962, decontrol was declared and the resulting equilibrium exchange rate became roughly ₱3.90 to $1.

of the total value of fixed assets of manufacturing enterprises with 10 or more employees. Chinese and other foreign-controlled enterprises represented 27 per cent of all total enterprises reported in the Census for manufacturing enterprises with 10 or more workers. These enterprises are small, compared with large American-controlled manufacturing industries, but large with respect to the average Filipino enterprise. Not having any further information, perhaps the assumption that Chinese enterprises have fixed assets equal to the arithmetic mean fixed assets for all enterprises is not too far from correct. This figure is ₱359,000 per establishment with 10 or more workers. Multiplying this by the total number of Chinese- and foreign-controlled enterprises, this amounts to ₱397 million, or 27 per cent of total fixed assets for manufacturing enterprises with 10 or more workers. On the basis of the above assumptions, Filipino owned manufacturing enterprises have a mean asset size of ₱284,000 and contribute 55 per cent of total fixed assets for enterprises of 10 or more workers.

The above data for Chinese enterprises can be misleading for two reasons: (1) some Chinese reporting to the Census may have become Filipino but ethnically consider themselves Chinese in answering the Census questionnaires