of the absence of relative inducements to export, they were contented with producing profits from a highly protected market.

VI. Some Salient Points Concerning Foreign Investments

At the risk of repetition, we summarize a few salient findings and further elaborate on them.

1. Most of the new industries encouraged in the Philippines, including those which brought in foreign capital, were import substituting. The natural response of businessmen to a situation in which the promotion of industrial import substitution is a major goal of growth policy was to establish import replacing industries.

The entry of foreign enterprise in import substituting industries is a common result of import substitution development strategies. We find it in Latin American, and it is being repeated today in many countries where there is a strong bias of the industrial program to import substituting industries.[13]

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[13]On the Latin American industrialization program, see, for example, A.O. Hirschman, "The Political Economy of Import-Substituting Industrialization in Latin America," Quarterly Journal of Economics, vol. 82 (February, 1968) and L. Gordon & E.L. Gromemers, United States Manufacturing Investments in Brazil (Boston: Graduate School of Business Administration, Harvard University 1962). In Thailand, Singapore and Malaysia, this pattern is being repeated, too. See, for instance, Helen Hughes, "Australians as Foreign Investors: Australian Investment in Singapore and Malaysian Manufacturing Industries," Australian Economic Papers, vol. 6, June 1967. More sharply, some unpublished recent work of Roland I. MacKinnon in Singapore is quite revealing.

2. The rates of return to foreign investment in the Philippines have been quite high compared to the world rates of return on investments. Manufacturing industries had relatively high rates of return compared to non-manufacturing. Naturally investments were attracted into those sectors where the rates of return were high.

Since these high profit rates were the result of shielding the Philippine market from import competition, foreign enterprises likewise depended on profits generated by domestic sales operation. In the absence of any strong inducements to export, businessmen found the course of least resistance by concentrating on the local market. This situation led to a market sharing conflict of interest between Filipino and foreign investments. The competition between foreign investments and domestic investors for a share in the Philippine market has justified the claim that foreign investments could hurt the development of Philippine entrepreneurship.[14] This point has been developed in another paper.[15]

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[14] I am sure that if the eminent nationalist Claro M. Recto were alive today, he would agree with me on this major point: that if only foreign investments had a greater degree of export orientation many of the problems which nationalists blame upon direct foreign investments would not be in existence in the Philippines today. The paradox of this all is that Philippine policy created the incentives which led to the result. For instance, review pp. 27-31, of this paper above.

[15] G.P. Sicat, "A Design for Export-Oriented Industrial Development," this volume.

3. Why was it that in spite of their relatively higher rates of return in the Philippines, American investments had not been higher than what has been observed?[16] Again, the answer lies in the relative structure of incentives found by American investors in the Philippines.

During the period of controls there were major impediments to the remittance of profits. The presence of controls acted as a preventive mechanism on the inflow of investments. Some of the investments grew in value due to reinvestments. Another reason was the inability of the Philippine government to have consistent policies towards foreign investments in the 1950's. The policy of attraction was countervailed by foreign exchange controls.

Decontrol made the investment climate relatively more favorable, thus encouraging new investments from abroad. But the inflow of American capital could have been more than what was actually realized. Some applications to set up American enterprises in the Philippines became criticized from extremely nationalistic viewpoints, which emphasized

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[16] We note here that in relative proportion to total investment in many industries, American investments are already considerable. But, as many have observed, the inflow of American capital could have been much more.

that Filipinos be given a preferred market position within their own country. A notable example of this case was the rejection of the application of a cement firm to set up a plant in the country. The objections to a proposed banana plantation investment by United Fruit in 1965 appeared to have been based on political grounds.

Lack of organization in the attraction of foreign capital and these experiences of rejection may have created a damaging effect on the enthusiasm of future entrants although this is hard to prove. But probably an important reason for not attracting more inflows was the lack of well defined incentives for foreign investments. The Philippines competes with other countries in attracting foreign investments which take advantage of certain factor proportions to establish an export base. These other countries have actively engaged in the attraction of investments in export industries. The Philippines did not pay any strong stress on organizing for the attraction of foreign capital engaged in export activities in the past mainly because of its emphasis on import substitution. As a result, the foreign enterprises which felt very strongly about entering the Philippine market (with the exception of the agricultural investments in pineapples) were induced largely by the protective tariff or, what amounted to the same thing in the 1950's, import and exchange controls. It is therefore fair to say that the Philippines lost its early advantage (emanating largely from the preferential trade agreement with the United States) in attracting efficient export-oriented foreign investments, notably to its neighbors, Hongkong, Taiwan and now perhaps to South Korea.

The Investment Incentives Act of 1967 defines areas of foreign participation by restricting them to "pioneer" industries. As I have argued elsewhere,[17] these incentives apparently favor industries designed to serve only the domestic market, notwithstanding some incentives for export industries. But the provisions concerning foreign investments are somewhat restrictive.

American business worries over the future of Philippine-American relations after 1974 is largely bred by the special preference given to American enterprises operating in the Philippines. Having been encouraged by the pattern of incentives to be largely Philippine-market oriented, American interests became concerned about their future status,

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[17] G.P. Sicat, "An Analysis of the Investment Incentives Act of 1967," this volume.

about the retail trade law, and other matters relating to their operations within the Philippines. If the investments which had been attracted were largely export-oriented, the problem of special status which worries American business interests in the Philippines would be a very minor one.

VII. A Suggested Approach to Foreign Investments

It is now the task to define specifically the approach needed in order to attract foreign capital into the Philippines. From the discussion immediately preceding, it is obvious that we want to encourage foreign investments in export-related activities. But more than this is apparent for a more rational policy towards foreign investments.

A rational and operational guideline for attracting foreign investments is by emphasizing the gains on value added that accrue to Philippine factors relative to nationality of the factor gains. It is possible to assign the benefits of the Philippines for every peso of claim that accrues to foreigners.[18] These measures are based on the direct value added benefits that foreign enterprises bring.

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[18] For a more thorough discussion, including international comparisons, see 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," op. cit.

An international comparison,[19] of these gains for recipient countries to American investments shows that the advanced countries are able to reap more benefits per dollar of US current claims on their direct investments. The Philippines performs below the world average in terms of benefits from foreign investments, but perhaps at par with many less developed countries. A strategy that this country can adopt is to attract investments in which the benefits derived per dollar of foreign claims on value added is high. Perhaps the Philippines should not be content until for every peso of foreign claims on value added generated by a foreign enterprise, Philippine factors get at least three pesos worth of corresponding claims. The comparable figures for the European Common Market is ₱6.88 for every dollar of US claims. In 1957, this was only about two pesos of Philippine gain for every one peso of foreign gain.

A brief outline of incentives (and disincentives) towards achieving this strategy will be given below.

1. Encourage foreign investments in manufacturing and processing industries. One of the reasons why the finding that more developed countries gain more per dollar of

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[19] *Ibid*.

foreign gains arising from the foreign investments is that most of the investments in these countries are in manufacturing and processing industries. Manufacturing requires the combination of great deal of host-country factors like labor, land and domestic raw materials. While this suggestion appears to be so obviously performed by past policy, it is necessary to have it qualified by the succeeding incentives.

2. Encourage labor-intensive foreign investments. Labor is an important economic asset if it finds employment. Foreign investment should be encouraged in activities that absorb relatively more labor. The transmission of skills through these activities help to increase labor productivity, which is an important part of growth. Any additional absorption of labor by foreign enterprises will largely be from the Philippine labor force. From the standpoint of the Philippines, an increase in the wage bill aaid to Filipinos represents a gain for the country. Incidentally, if the provisions of the Investment Incentives Act of 1967 are to be taken literally, this suggestion appears to be the opposite of what is being sought to be promoted in view of the stress on capital-intensive foreign enterprise.[20]

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[20] However, J. Encarnación has suggested an interpretation which is in the direction of promoting more labor-intensive activities. [unpublished memorandum to the Board of Investments, March 26, 1968].

3. Encourage the increase of Filipino share in the capitalization of foreign companies which sell mainly to the Philippine market. An important statement in the Investment Incentives Act of 1967 is helpful to clarify the importance of increasing Philippine equity participation in foreign enterprises. Only companies which are owned and controlled by Filipinos at least to the extent of 60 per cent can benefit from the incentives of the law. In a growing economy, it is a natural aspiration to have nationals partake of the benefits of growth by seeing to it that a great share of that growth is the result of native capital and initiative, by assuring that gains from transactions within the domestic market primarily accrue to nationals, not to foreigners.

Foreign companies that sell their output mainly to the domestic market should be sharing their profits with Filipino nationals. This requires that some portion of the equity of these foreign enterprises be opened up for sale to Filipinos. The encouragement of joint ventures has always been a government policy. The suggestion made here only concerns foreign enterprises that sell mainly to the Philippine market. This assures that the residual claims to the value added, which constitute profits, do not simply go to foreigners but would be divided up, in accordance with the nationality of the equity, between foreigners and Filipino nationals. If foreign companies which are operating in the Philippines are subsisting only because their sales are to Philippine nationals, then it is important that Philippine factors get a proportionate share from these residual gains. Taxation can reduce these residual gains. But it may be desirable still to have Filipinos to have a residual interest in the gains arising from the operations of the enterprise. One corrective legislation in this area is to specify that companies which derive, say, 70 per cent of their total sales from the domestic market cannot be completely foreign-owned. They must be incorporated within the laws of the Philippines and must sell a portion of their common stock to Philippine nationals.

(4) Encourage export activities by foreign investors. In support of the flexibility of foreign enterprise, we may quote Hirschman,[21] whose reflections are largely in the context of the Latin American experience:

> "...Foreign firms have been known to be quite adaptable to in their manufacturing and export policies. Just as they have been coaxed by national politices to produce or procure domestically a larger proportion of their inputs, so they could be induced to engage on export drives."

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[21] A.O. Hirschman, op. cit., p.

The profit margins derived from exports are normally lower than the profits earned from domestic sales of protected industries. This is because selling to the world market is a very competitive activity. Foreign enterprises that engage in these activities are often dependent on scale of operations because of the relatively low profit margins per unit of sale. Thus, such operations will have to hire relatively more factors which belong to the Philippines. In view of this, they will have higher impact on employment as well as on rentals for land and other property belonging to Filipinos. It follows from this reasoning that enterprises in exporting industries will yield residual gains on value added going to foreigners which are relatively smaller compared to the gains of Philippine factors. One can also argue that even if there is complete foreign ownership in the export enterprise, any large profits will not be at the expense of Philippine nationals but at those which will be buying the export product.

Thus, the Philippines should encourage completely owned foreign enterprises to take advantage of its factor proportions as an export base.

(5) <u>Utilize the corporate income tax as an incentive device</u>. We have noted that many foreign enterprises in the Philippines have been attracted to import-substituting industries ~~by~~ a system of protection of these industries. Taxation of

profits through the corporate income tax enables the host country to increase the gains arising from the value added created by foreign enterprises. The corporate tax system is the final channel through which a country adds to its domestic gains on foreign investments. After that, profits are either repatriated or reinvested.

However, there is an important qualification to the use of the corporate income tax. In order for the government to encourage export activities of foreigners, there is a strong case in favor of built-in export incentives into the corporate income tax such as one suggested in another paper.[22] Such incentives should be able to help foreign corporations hitherto looking directly to profitable Philippine market operations go into the export business.

6. Regulate monopoly power and eliminate restrictive trade practices. Sound economic policy toward business presupposes that restrictive trade practices and monopoly power should be minimized, if not entirely eliminated. The general proposition here applies to all types of investments, whether by foreigners or by nationals.

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[22] See my "A Design for Export-Oriented Industrial Development," this volume.

Regulating monopoly position is relatively recent as a concern in the Philippines, and it is even a wonder if the effort should be attempted at this time so as not to detract from the problems of promoting development. In the case of the oil refining firms, there is now enough justification to do this. A recent Senate economic committee investigation on this matter[23] appears to have documented the need for regulating the trade in petroleum products. The evidence seems to point out a systematic overpricing of crude oil and of transport charges by the oil refining companies in the Philippines (which are with the exception of one, fully owned subsidiaries of foreign companies). In addition, there has been a uniform domestic price for gasoline suggesting a lack of competition.

The way to break monopoly or oligopoly power in some industries is simply to allow for the entry of new firms or by more regulation. I have expressed worry on the provision of the Investment Incentives Act which tended to put too much attention on capacity setting, because such policies encourage the creation of monopolistic or oligopolistic positions. Capacity setting as a development strategy can only be effective in planning industries which serve the domestic market. When

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[23]Headed by Senator Jose W. Diokno.

applied, they tend to discourage the creation of exportable surplus. The cement industry is a classic example of an industry that has been allowed to maintain a highly oligopolistic position in the Philippines, to the extent that it prejudiced the country's export potentials in cement products. Had the government not paid any attention to the "cement surplus" argument of the cement industry, the Philippines would have been a cement exporter long ago.

Some foreign enterprises in operation in this country as well as Filipino enterprises which enter into licensing arrangements with foreign firms are restricted to specific markets. These market restriction arrangements are in the use of proprietory rights, largely built into product brands, production rights, and technological assistance.[24] Some foreign investments buy equity position because of the use of a patent which carries with it restrictions on market expansion. If foreign and Philippine investments are forced into such market limitation contracts, then their market horizons are indeed limited. National policy should discourage restrictive practices of this sort, so that firms whose experience grows are able to expand their markets beyond their national boundaries.

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[24] The description of the trade in licensing arrangements is contained in J.N. Behrman, "Foreign Investment and the Transfer of Knowledge and Skills," in R.F. Mikesell, US Private and Government Investment Abroad (University of Oregon, 1962), pp. 123-135.

A possible policy arrangement in this area is taxation: impose an additional sales tax on commodities which are produced within the Philippines using a foreign brand name. This suggestion has been outlined elsewhere.[25]

7. Maximize flow of relevant information to investors. Given that the objective of attracting foreign investments in desired areas of economic activity is accompanied by appropriate instruments of policy, a helpful device for successful investment attraction is to see to it that information flows relevant to investors are facilitated. Puerto Rico and Taiwan have organizations for investment promotion which are models to emulate. In this aspect of organization, the Philippines can improve immensely. The setting up of the Board of Investments under the Investment Incentives Act should be able to help improve this picture immensely.

A Brief Note on Capital Flight

We end this paper with a brief note on capital flight from the Philippines.

There is another side to the question of investments -- outflow of capital to other countries. It has been observed -- although no documentation has been made -- that since decontrol

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[25] See my "Design for Export-Oriented Industrial Development," this volume.

a significant amount of capital had left the Philippines for other countries -- more generally to the U.S., Spain, and some countries in Asia. We shall be concerned in this brief note only on the policy implications of minimizing capital flight and on maximizing foreign capital inflows into desired areas of investments.

The approach suggested towards foreign investments in the previous section should be able to create the necessary and sufficient incentives for attracting investments in desirable areas of production. These new investments may be in the form of new inflows or of reinvested earnings. The Investment Incentives Act of 1967, with all its many attractions for investments by Philippine nationals, should also help to make it relatively more favorable for Filipinos to retain their savings in the Philippines.

The forces determining capital flight depend on the rate of return to capital and on the relative security of such profit rates. If incentives are at work, which stabilize this rate of return at a relatively attractive level compared to overseas investments, then there is no reason why a net inflow of capital cannot be achieved.

Thus, the best policy of assuring that no foreign capital flight from the country happens is to have an attractive investment climate in the desired areas of foreign investments. Insofar as foreign capital is concerned, the guarantee of profit remittances and of ease of exit (should there be any need for such) is essential to the attraction of new foreign capital inflow. Any disincentives to foreign exchange remittances covering profit and capital repatriation exercised on foreign capital should be carried out with caution.

But a major disincentive device should be adopted insofar as Filipino capital flight is concerned. At a stage when the country is encouraging the inflow of foreign resources in order to help accelerate the rate of development, Filipino savings should not be allowed to move out without some penalty. In addition to the incentives contained in the Investment Incentives Act, it may be helpful to put a direct disincentive to foreign exchange remittances of Filipino nationals or corporations seeking expenditure outlets in foreign countries. One step in this direction is to tax private (Filipino) remittances on invisibles. With this additional disincentive, all other things remaining the same, the relative incentives for investments made by Philippine nationals in their own country become more attractive. If the Philippine national still prefers the foreign expenditure or investment, then at least the government is able to tax him and collect a return for the loss of the funds to other countries.