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TOWARDS INDUSTRIAL AND EMPLOYMENT EXPANSION: ALTERNATIVE
PROPOSALS FOR ECONOMIC INCENTIVES LEGISLATION APPLIED
TO EXPORT AND INDUSTRIAL PROMOTION

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To be a part of a forthcoming book
by G.P. Sicat, *Industrial Export
Growth, Economic Incentives, and
Philippine Development*

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"The promotion of social justice to insure the well-being and economic security of all the people should be the concern of the state."

*Constitution of the Philippines,
Article II, Sec. 5*

Whether or not many are fully aware of it, the pursuit of the objective of social justice for all Filipinos in the postwar period, at least in the area of industrial promotion, has been a combination of attracting investment geared towards cheapening the cost of new expenditures on capital goods and raising the (legal) price of labor. In the meantime, population and the labor force have grown at rates as fast as 3.2 to 3.5 per cent per year. The combination of these policies have hurt labor and has made the state fall short of the goal of national policy as enunciated in the Constitution.

*Earlier discussions with J. Encarnación, John H. Power and J.G. Williamson have been very helpful. I must also acknowledge the helpful comments of Loretta M. Sicat who carefully read an early draft. However, I am alone responsible for the views expressed here.

The above statement is boldly phrased. It remains for this paper, firstly, to substantiate this statement and then to propose measures that will help to achieve the "well-being and economic security of all the people." This will take the form of suggesting alternative policies necessary to shift the pattern of incentives from being against labor to being in favor of labor use. The proposals are first geared towards the area of export promotion. It is hoped that a revolution in thinking in this area will shift industrial incentives more directly to labor use. It is of critical value for those engaged in policy formulation to take into account those features of policy-making which take advantage of the economy's resource endowments.

I. CURRENT AND PROPOSED POLICIES AND ECONOMIC REASONS AGAINST THEM, OR ECONOMIC REASONS AGAINST OVER-ENCOURAGING CAPITAL-RELATED EXPENSES

✓For over two decades the Philippines has been adopting policies which are basically biased against the employment of labor. Industrial promotion policies have been largely in the form of cheapening the price of capital -- either through preferred access to low long term interest rates, tax-exemption of capital equipment imports or of raw materials, or through low exchange rates (in the last case, during the controls). In addition, the country's preoccupation with social legislation -- like the minimum wage law, the social security system, and the encouragement of unionism -- have raised the per unit price of labor.

✓This mix of incentives (and disincentives) has encouraged two results: firstly, the growth of industrial activities which were relatively more capital-intensive and secondly, the inducement to displace labor whenever the techniques of production made such choices possible. This will be substantiated, as we shall see later. Further, the incentive provisions of the Investment Incentives Act are in the tradition of the policies which are biased in favor of capital-use in industry.

Two major criteria are proposed so that we can evaluate economic incentives which are in effect or being proposed in the Philippines. The economic incentives should

- 1) encourage the utilization of economic resources that the country has in abundance;
- 2) the incentives are *specifically* related to actual export performance.

Labor is an abundant economic resource in the Philippines. On the other hand, capital (or investment funds) is a scarce resource. On the basis of our first criterion, the incentives that should be given to entrepreneurs should attempt to maximize labor use and therefore to utilize investments that have higher labor employment impact. In no field is this economic axiom more important than in international trade. Countries attain economic efficiency in commodities which require relatively more of their abundant factors.

Now, one version of the export promotion bills being considered in the Senate contain the following incentives:

- (a) double deduction of organizational and preoperating expenses,
- (b) accelerated depreciation of fixed assets,
- (c) net operating loss carry-over, and
- (d) double deduction of promotional expenses

Easily, these incentives, especially the first three, are designed to reduce the cost of capital, and as a consequence, they make the relative price of labor more expensive. The incentives run counter to our first criterion, the encouragement of the use of more labor. Indeed, we are over-encouraging capital-related expenses, the scarce economic resource.

There are still stronger economic reasons why these incentives as proposed should not be allowed to continue. Firstly, ^①the incentive to buy machinery cheap induces entrepreneurs to adopt technology and even new industries which may be ill-suited to the country's factor endowments. Thus, industry is induced technologically into a capital-labor intensity which is not in accordance with the country's capital-labor resource endowment. Secondly and perhaps more important, as a result of the first inducement, ^②any incentive directions on the part of entrepreneurs to adopt innovations which are labor-intensive in character may be stifled.

When tested against the criterion of relationship to actual export performance, these incentives fail even more. Organizational and pre-operating expenses are only designed for firms not yet in existence. Loss carry-over deductions and accelerated depreciation have practically no relationship with the capacity to export. On this ground, too, it can be said that double deduction of expenses for export promotion

fail the test. Although it is true that successful export businesses depend on promotional work in foreign markets, allowing their double deductions may encourage spendthrift corporate officers to charge many items under promotional expenses.

✓ The capital-use oriented incentives adopted by the government would be commendable for economies such as the United States, where labor costs are high, labor unemployment rates are low and where an encouragement of domestic economic growth often has to stem from the expansion of the domestic capital goods industries, which in turn have high linkage structure with the rest of the economy. One of the important reasons for the success in inducing American economic growth of the tax credits and accelerated depreciation policies given to investments during the Kennedy administration¹ is the sensitivity of activity within the capital goods sector on the rest of the American economy.

✓ But the reverse situation in the Philippines occurs. Many economists, including this writer, have supported the view that the economy is essentially a "labor-surplus" economy. Moreover, the capital goods industry is only a fledgling

¹See, for instance, R.E. Hall and D.W. Jorgensen, "Tax Policy and Investment Behavior," *American Economic Review* (vol. LVII, no. 3, June, 1967), pp. 391-413.

industry and in fact tariff and development policy as currently practiced, as John Power² has recently shown, is biased against the creation of a strong capital goods sector. Moreover, it is very likely that most initial machinery would have to be imported anyway. Thus, any encouragement of capital-use often has a high import leakage. In turn, such investment demand translated directly in the form of a high import demand has immediate unfavorable consequences on the balance of payments.

More important is the effect of such policies on economic efficiency. A fundamental problem of economics as a science is its concern with the problem of efficient allocation of resources. Have our development policies, which have their historical roots in the postwar period, led us to the most efficient use of our economic resources, specifically capital and labor? Results of a recently completed study of J.G. Williamson and this author³ supply some evidence with respect to the manufacturing sector which has been, after all,

²J.H. Power, "Import Substitution as an Industrialization Strategy," *The Philippine Economic Journal* (vol. 5, no. 2, Second Semester, 1966).

³J.G. Williamson and G.P. Sicat, "Technical Change and Resource Allocation in Philippine Manufacturing, 1957-1965," Discussion Paper 68-21, June 15, 1968, University of the Philippines, Institute of Economic Development and Research.

the major concern of economic policy in the last two decades.

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The industrial promotion policies of the fifties has led the Philippines to a mismanagement of her scarce capital resources by encouraging the utilization of capital in areas where its productivity is low. *What is alarming is that we hear still traces of arguments which favor the continuation of the very same policies that have caused this mismanagement.*

✓ The above finding does not necessarily mean that entrepreneurs decided incorrectly. As a matter of fact, a generalization that can now be made about entrepreneurial behavior in the Philippines is that they respond correctly to factor and output price incentives, and this is confirmed by the study referred to. This basic generalization is of such great importance for economic policy and for the future directions of Philippine economic development. In fact it is the fundamental assumption upon which all economic incentives legislation are based. The lessons, therefore, appear plain: entrepreneurs will respond accordingly to economic incentives, pursuing their self-interest.

Perhaps the most important economic reason is intertwined, above all, with the social goals of the Filipino people as stated in the Constitution, which we quoted at the beginning. The increasing amount of the Sunday *classified ads* of the leading Philippine newspaper for "helpwanted" vacancies

is the best departing point to illustrate my views. Note how much demand there is for skilled workers and highly educated, qualified persons to work in industries. On the other hand, urban slums have grown, unemployment, juvenile delinquency, and crime have become major social problems, migration from rural areas has continued unabated, creating a multiplicity of demand for broader and intensified government services.⁴

Some observers see irony in the scarcity of job openings (with high pay) requiring high levels of skills and the high rates of unemployment in the economy. It is indeed ironic but not paradoxical. The premium placed on highly skilled labor is a natural consequence of the package of policies concerning incentives for industrial promotion which stress new capital-intensive industries and create opportunities to substitute capital for labor. There now exists strong evidence to indicate that indeed this is true.⁵ Only that

⁴Note for instance, the findings of sociologist Dr. Estefania Aldaba-Lim that parents of delinquent children in slums average only a daily income of ₱3.50, of roughly 60 per cent of the required minimum wage in urban areas. {See "Delinquency Roots Listed," *The Manila Times*, June 21, 1968}.

⁵See G.P. Sicat, *Industrial Production Functions in the Philippines*, especially the estimates of the elasticity of substitution between capital and labor in Chapter 5, and J.G. Williamson and G.P. Sicat, *op. cit.* on the growth in capital-intensity of manufacturing.

labor which can add to the value of the firm's product by at least the wage rate paid to it (higher than the minimum wage) will be hired.⁶ Naturally, this prevents a great mass of relatively unskilled workers, who will welcome wages at a rate lower than the minimum wage, from securing steady employment.⁷

The danger of this pattern is obvious. There is no assurance that the industries which are capital-intensive and/or substituting capital for labor will expand much faster than the requirements of labor absorption of the expanding labor force. The result, which is exactly what we observe in the industrial urban sectors of the Philippines, is a gap in the incomes of relatively few factory workers with steady employment in organized manufacturing and those members of the labor force who are kept out of steady industrial employment and have to seek other not-so-productive livelihood. Thus, a growing portion of the labor force go into relatively low-income, low- or non-productive self-employment like the service trades. It is easy to cite examples of these activities which provide hand-to-mouth existence for the growing

⁶For further analysis of this question, see G.P. Sicat, "Analytical Aspects of Two Current Economic Policies," *Philippine Economic Journal* (vol. IV, no. 1, First Semester, 1965).

⁷It is unfortunate that many leaders in the Philippines are still concerned so much with the passing of legislation that raises the price of labor. The most recent of these is the so-called "equal-pay for equal-work" bill, which was

labor force. Note the growing abundance of sidewalk or street hawking; of "fixing" papers in government offices which involve minor government clerks, thus helping to erode our own public services; of the "watch your car" service at the curb; and of even begging. On the growth of mendicancy and urban poverty, notice that a great proportion of new entrants in the begging and street hawking "trades" are children. If parents have steady employment, it can easily be surmised that there will be a reduction of children self-employment in these unproductive trades. Thus, for the large bulk of the labor force that seek livelihood in the urban areas, life has become increasingly more difficult. The laborer who is kept out of a gainful and steady employment absorbs a personal cost (perhaps immeasurable in pesos and centavos) in the sense of loss of potential skills learned from employment. For it is now well documented that there are substantial gains learned by persons just from actual-on-the-job-training.⁸ If there is a way of aggregating these personal costs, we get some idea of the magnitude of the total social costs, for which society, govern-

passed by Congress only recently and which *should* be vetoed outright by a President who is advised about its economic consequences.

⁸See for instance, Gary Becker, *Human Capital: A Theoretical and Empirical Analysis with Special Reference to Education* (New York: Columbia University Press for National Bureau of Economic Research, 1964).

ment -- particularly those who would like to think of themselves as nationalists -- must share a burden of responsibility.

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It becomes clear from the above that domestic policies should aim at expanding employment opportunities directly by emphasizing industries as well as investment expansions which are geared towards relatively more labor employment, per unit of capital expenditure. Incentives which are tied to labor employment, to overcoming the high cost of (legal) employment of labor, and to inducing firms to introduce innovations tied up with the training of labor skills ^{should be} are the order of the day for the Philippines. If we remove all those incentives related to encouraging capital expenditures *per se* and substituted those ones enumerated in this paper, there is every hope that we can make the country's progress accelerate by creating steady employment opportunities for the growing labor force.

The simple message of all that has been said above is this. Far from seeing a conflict between the economic goals of employment and growth, I see the two forces as self-reinforcing in this country. ✓ *Incentive policies which emphasize labor employment more than any other factor and which are, in addition, tied to productivity goals in labor-intensive enterprises, are necessary for the healthy development of the Philippine economy while it still has large unemployed labor resources.*

II. POLICY ALTERNATIVES BUILT INTO THE FISCAL SYSTEM

Incentive Policies Biased in Favor of Labor Use

We shall have a better set of policies if we can abolish all the incentives currently in effect by law which tend to encourage capital use. Then, I shall wish to make this proposal apply to all industrial activities. But not having them,*the proposals should first be made to apply to our export promotion activities for the moment. As a long run goal of policy, while the Philippine economy continues to display "labor-surplus" characteristics, there should be a basic reconsideration of our incentive policies so that those policies which over-induce capital-intensive activities can be eliminated and substituted by employment-inducing industrial incentives. f

The proposals here rest on an imaginative application of fiscal incentives which take into account the employment objective and the need to attract actual export performance by individual corporate enterprises. The proposals made here have two novel features. *The first feature involves double deduction from the income tax (a) of direct labor costs incurred *in connection with export manufacturing* and (b) of productivity-related additional labor costs. Thus, this proposal is to be interpreted as an incentive to hire more labor.

② The second feature is a tax-exemption incentive device, which is geared to *actual* export performance. 4 (TN)
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(a) * Deduction of Wage Costs of Production Workers

The export ratio and manufacturing for export. It is essential to define clearly what we mean by *manufacturing for export*. This should be very difficult to determine if we go down to pinpointing the actual inputs of production used for export. However, I suggest the following as a simple and workable procedure. We first define the *export ratio* of the firm as the value of documented export sales of the corporation to total sales during a specific year -- normally, the fiscal year of the firm. Then, the production workers engaged in export manufacture will be *total production workers employed by the firm year certified by the Social Security System multiplied by the export ratio*.

There are alternative definitions of the export ratio that may be used for purposes of the proposed incentive. Three possible (and perhaps most useful) variants from which policy makers can make a direct choice are listed as follows:

- (1) current year's ratio (instantaneous)
- (2) last year's ratio (lagged, one year)
- (3) historical 3-year moving average ratio.

The current year's ratio gives instantaneous incentives to current performance during the year as an exporting firm. The lagged ratio will have the advantage of delaying incentives {or deductions} for export gains made during a specific year by one year. It will also delay any shortfalls in performance during the current year compared to a past year from taking a heavy toll on removals from exemptions. The historical 3-year moving average ratio method has the advantage of stabilizing the value over time of the export ratio. In order to use this method of computing the export ratio effectively, any export incentives law along this direction should probably use, say, for the first seven ~~years~~ the instantaneous export ratio. Then it should require, on the 8th year of the effectivity of the law, the use of the historical moving average export ratio. I think this method is superior from the standpoint of effectiveness in protecting the economy and individual firms from the effects of violent export fluctuations. Moreover, it has the desirable feature of eliminating the effects of inventory disposals to the export market, which may affect the export ratio but which have little connection with the production process during the year.

Economic advantages of double deduction of wage costs.

The logic of double deduction from taxable income of wage costs related to direct production for export should be clear by now.

Double deduction of production-related wage costs has the effect of reducing the price of labor by one-half to the employer. From a tax viewpoint, this reduction will approach what many observers consider to be the equilibrium price of labor in the economy. We shall briefly summarize the important reasons for the need to substitute these labor-use-oriented incentives for those designed to cheapen capital.

(1) It will help to offset the overwhelming bias against employment which exists in the statute books of the Philippines.

(2) One of the major objectives of the Philippines is to reduce the amount of unemployment and to make income more equitable. The encouragement of labor employment will lead to the absorption of more members of the population into productive employment at higher wage levels. The deduction of wage costs can be thought of as a subsidy to manufacturing enterprises to enable them to earn more profits through more labor hirings. The inducement to hire more labor has an immediate effect on the incomes of people who are employed, who are mostly certainly Filipinos. In contrast, deduction of capital costs induces the importation of machinery, so that the major beneficiary of the new capital purchased are foreigners, not Filipinos.

(3) Double deduction of expenses for wages may lead to an increase of personal income tax collections, especially in the low income tax bracket. Since we assume that this deduction of labor costs will be tied up with the implementation of the social security law and the income tax withholding mechanism, we will be able to foster greater tax consciousness among the laboring class employed by industry.

(4) The wage deduction incentives will strengthen the social security system. Laggard or non-compliant firms which find export benefits useful may now find it advantageous to comply with the law. Moreover, in view of the relative inducements to hire more labor, the collections of the social security system will grow much faster. Because of the growing function of the system in providing a source of development finance, the strengthening of the system will have a positive feedback on the economy.

(5) An inducement to hire more labor at lower price may cause Filipino entrepreneurs to adopt, if not invent, production methods which are more suited to the factor endowments of the country. It is essential to encourage innovating energy in the direction of labor-use in this country.

(6) Last, but not least, the emphasis on labor employment in a country where 10 to 12 per cent of the labor force

is either underemployed or unemployed⁹ has very useful political value to our leaders and legislators.

On the last point, our legislation concerning labor has been, on balance, *misdirected*. ✓ We have legally raised the price of labor and encouraged new industries which are capital-intensive. ✓ While the social goals of labor laws are unquestionably desirable, the instruments used help those who are already employed but make it more difficult for newcomers into the labor force to get employment. It is time to emphasize *genuine* employment creation as a goal in the political process. ✓ The logical force of economics on this major issue draws attention to incentives which directly helps employment.

✓ (b) Productivity Related Incentives for Labor

In order to upgrade labor skills and therefore encourage labor productivity growth, double deduction from taxable income of labor training expenses of firms should be seriously considered. This proposal is a productivity-oriented complement to the proposal on deduction from wage costs. This proposal will induce productivity-raising expenditures which are, again, biased in favor of labor. However, so as to put a limit on the expenses that may be charged to this item and not

⁹See, for instance, the period surveys of the labor force by the Census and Statistics Survey of Households.