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INDUSTRIAL POLICY AND THE DEVELOPMENT OF
MANUFACTURING IN THE PHILIPPINES

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The following paper can also be tentatively entitled
"Philippine Industrial Development Policy Reconsidered."

Industrial policy in the country has been largely of the import-substitution type. The desire to establish domestic industries that would replace imports of certain commodities has been under discussion even before the war. Subsequent measures whether made by the Congress of the newly installed Republic or by the executive branch of the government were designed primarily to help in achieving this objective of industrial policy. Moreover, one of the reasons offered to the country when the question of "parity" was a constitutional issue in 1946 was that the coming of American investors in the country would lead to a more rapid pace of overall development, including the industrial sector.

However, so long as the country had at its disposal the relatively high levels of foreign exchange reserves brought about

*Not to be quoted. All acknowledgments and some footnotes have been suppressed for this preliminary version.

by certain windfalls,¹ the case for domestic import substitution was still not so strong. Tighter measures had to be imposed by 1949 when it became apparent that direct control of the use of foreign exchange rate had to be maintained to preserve the country's balance of payments position. [In the process, the import and foreign exchange control policies became associated directly with the desire to promote new manufacturing activities]

DMU.

ANTI-TRUST LAW

Start
X
Tax-Exemption of Industries

The choice of manufacturing industries to establish was something that was not thought out carefully, it appears. The executive circulars were issued defining the scope and meaning of the term "new and necessary." An examination of the various definitions of the term showed clearly the lack of clarity on the matter. These circulars progressed from a crude to a less crude set of definitions, but they never really got to defining exactly which industries were to be chosen in the sense of, say, using explicit criteria for industrial enterprises. Thus, if I may hasten a comment at this point, a broad class of industries were given industrial exemption without necessarily being "necessary" from a national viewpoint.

¹See my own paper, "The Philippine Economy", in G.P. Sicat (ed.), The Philippine Economy in the 1960's, Institute of Economic Development and Research, 1964, p.8.

Prior to 1951, there was little industrial expansion under the Act. But as soon as the period of import and foreign exchange controls were imposed, the law on new and necessary industries became a relatively important means of promoting domestic manufacturing. Thus, a clear understanding of industrial policy in the 1950's should start with an analysis of the relationship between these two important policies -- the twin arms in the import-substitution policies affected in the decade of the 1950's -- tax exemption and controls on imports and foreign exchange.

Any further discussion of these policies has to start with the nature of the law on new and necessary industries. This consisted of two steps. The first step covers the period when Republic Act 35 was in force. The corresponding second step is embodied by the period when Republic Act 901 was in effect. As will be shown briefly, the administrative measures connected with the Acts mentioned were important in defining the scope of the law. In both cases, quite a lot of discretion was left to the executive department (under the Department of Finance) of the government. Therefore, much really depended on the measure in which the Department of Finance and the President's Staff interpreted the terms "new" and "necessary", especially the latter term.

Republic Act 35. This was an amazingly short law, which left practically everything to the executive department for definition and implementation. Known as "An Act authorizing exemption

of new and necessary industries from the payment of Internal Revenue Taxes," the law simply gives the President the right to exempt any person, partnership company or corporation who engaged in a new and necessary industry from the payment of all internal revenue taxes² for a period of four years from the date of the organization of the industry.

End

A number of circulars from the President's office were issued defining the meaning of "new" and "necessary" industries. A brief examination of these attempts reveal the ambiguities inherent in the word "necessary", which was a most crucial term. Three circulars were issued during the period ~~1950~~ to ~~1951~~, evidently as part of the conscious effort to use import and exchange controls to promote manufacturing. The first circular gave the word "necessary" a broad definition ("an industry ... conducive to sound economic development "). The next two circulars, which were issued only four months apart, and which gave more detailed definitions of the term "necessary", were generally agreed on one principle, that the imported raw material content of the industry should not exceed 50 per cent of gross value of output. In the earlier circular was employed a more restrictive definition of "necessary" to exclude those items considered as luxuries under the Internal Revenue Code and the

²Residence tax, fixed privilege tax on business, advance sales tax on imported raw materials, real estate tax, income tax, and sales tax,

limitations regarding capitalization and employment. Apparently, pressure made the government revise the definition of "necessary" into something more broad. The term necessary could apply to an "industry" which, in addition to fulfilling the raw material content requirement, was "conducive to the establishment of a stable economy"³ and could operate on a commercial and profitable scale after period of exemption. Under these broad definitions, almost any proposed industrial effort could qualify so long as it was "new".

Start Republic Act 901. Approved on June 20, 1953, RA 901 was passed to increase the incentives to create "new and necessary" industries. The taxes exempted were broadened to cover "all" taxes, whereas the supplanted RA 35 only exempted "new and necessary" industries from the payment of "internal revenue" taxes. The exemption could be sought by "any person, partnership, company or corporation." All taxes were to be exempted until December, 1958.⁴ However, any firm enjoying tax exemption for six consecutive years

³The only qualification was the additional phrase "taking into account the number of such enterprises already in existence and their collective productive capacity relative to the size of the domestic and/or export demand for their products."

⁴This four-year transition period allowed that the proportion of taxes to be exempt are 90 per cent in 1959, seventy-five per cent in 1960; fifty per cent in 1961, 10 per cent in 1962, zero per cent thereafter.

was to be subject to the full income tax thereafter. Firms whose four year period of exemption under RA 35 were still in operation were automatically exempted under RA 901; if their exemption expired before the enactment of the new law, such firms could reapply for an additional six years of exemption.

The Department of Finance took over the implementation of law. The law defined a "new" industry as "one not existing or operating on a commercial scale prior to January 1, 1945"; the Department of Finance considered an industry on a "commercial scale" if it was not operating merely on an experimental stage and if the industry was still incurring a loss as a whole.

A "necessary" industry was considered one that (1) contributes to the attainment of "a stable and balanced national economy," (2) that can operate on a commercial scale and (3) where raw material imports would not exceed 60 per cent of gross value of product. A rider to the last provision made even the 60 per cent rule useless, for notwithstanding such requirement, an industry might be classified as necessary:

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

Such definitions are not operational enough in the sense of restricting the meaning of "new and necessary." The only other guidance of the Department of Finance in restricting the definition of "necessary" is an appendix to the implementing circular of RA 901, which listed the following industries as "conductive 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
raw plastic materials
porcelain products
paper and paper products
medicinal and pharmaceutical products
rubber manufactures.
electrical motor
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 above list contains a number of important industries, which might be defined in a more restricted sense as "necessary". Yet, the tax exemption to all of them is probably too generous a subsidy to offer, for a number of alternative marginal inducements short of tax-exemption would have been helpful to make the establishment of such industries possible. The import control,

foreign exchange allocation, tariff protection and credit policies would have been sufficient inducements to some of the industries desired to be established. (I shall discuss these things shortly).

Flow | As regards the administration of the law, the Screening Committee of the Department of Finance took charge of most of the paper work in processing applications for tax exemptions. Left with little guidance from the law, the Screening Committee had little explicit guiding rules as to the merits of the application. General principles were recognized, but they would have been difficult to assess in terms of the dynamic future of the establishment or industry under consideration. The establishment was expected to be on competitive footing eventually from articles imported abroad. Flow sheets of the products proposed to be manufactured were submitted to the Department, with comparisons of unit average costs of producing locally and the prices of the imported end products c.i.f. Manila or at unit selling prices. At most, these flow sheets and price data were statical data, and gave little information on the prospects of longer run competitive future. What were lacking, it appears were explicit criteria through which the Screening Committee could guide itself by ranking the industries under consideration in terms of "necessity". As will be pointed out later, the state of economic theory on project evaluation, was partly responsible for the crude state of administrative application. However, some basic difficulties

could have been avoided, if only the law or its implementing circulars were made more explicit.

✓ Suffice it to say that it took about eight years before the authorities responsible for screening applications for tax exemption could adopt a more explicit criteria for selecting proposals. In 1960, the Secretary of Finance required all applications to pass the National Economic Council, before processing of applications by the Screening Committee. The NEC used the well-known Industrial Priorities Formula in ranking industries applying for tax exemption and returned those applications to the Finance Department with proper notation. *end*

Start Multiple Protection of Import-Substituting Industry

✓ An aspect of industrial policy which is not made explicit in standard discussions of industrial development⁵ is the fact that multiple protection was given to industrial growth. This protection took either the form of subsidies and of restraints to competition from external sources.

① Tax exemption is a prime example of the subsidy to manufacturing growth. Its impact on manufacturing development has been noted already. The enjoyment of tax-exemption is identical to

⁵For instance, F.H. Golay. Although the idea pervades in Golay, it never quite got out explicitly.

the receipt of subsidies from the government in the amount of all collectible taxes had there been no tax exemption.⁶

⑨ Another form of subsidy was the preferential treatment given to new and necessary industries in the procurement of foreign exchange. During the period when domestic industrial development was in progress, industries which were granted tax exemption were given high priority in the purchase of foreign exchange to import capital equipment as well as inputs. It was however one thing to be given preference in foreign exchange rationing and another to be given a differential advantage in the purchase of the foreign exchange. This is another aspect of the subsidy to domestic industrialization. I shall recount this aspect by citing the three important laws that created such differential advantage for new and necessary industries.

a) 17 Per Cent Tax on the Sale of Foreign Exchange. A law in 1951 was passed in order to help relieve the pressure on the balance of payments position. Known as Republic Act 601, it provided that a 17 per cent tax be imposed on the sale of foreign

⁶But it is not a valid exercise, of course, to estimate how much taxes have been forgone on the basis of all the tax-base data provided by the tax-exempt industries, since some of these industries or establishments would not have been around had there been no tax exemption. Moreover, had the taxes been applied, the price-output configurations for each establishment would have been different at least for those taxes which had an influence on marginal costs or on demand, and even on pure incentives.

exchange by the Central Bank and its agents. This meant that the effective foreign exchange rate under the law was ₱2.34 for every dollar bought. However, certain exemptions to this tax were given, among them the foreign exchange used by "new and necessary" industries.⁷ This law was in effect until 1955⁸, and for a time was a substantial source of new tax revenues for the government. A multiple exchange rate existed, with new and necessary industries being allowed to purchase foreign exchange at the official 2/1 rate between the peso and dollar.

b) Special Import Tax. With the revision of the Trade Agreement with the United States under the Laurel-Langley Agreement of 1955, a special tax on the sale of foreign exchange was imposed as a substitute measure for the tax on foreign exchange.⁹ This tax did not apply to invisibles, and therefore freed quite a lot of the foreign exchange transactions from the tax base. It specifically exempted all importations of machinery and/or raw

⁷Such users of foreign exchange however had to be granted exemption only upon application for foreign exchange allocation. The proofs required for this was a true copy of the certification of tax-exemption granted by the Secretary of Finance and a guarantee by the applicant that the machinery and/or raw materials to be imported were to be used by the establishment granted tax-exemption as a "new and necessary" industry.

⁸Through extensions of the date of effectivity.

⁹This was included in the Laurel-Langley Agreement as a compromise measure because American interests in the Philippines regarded the 17 per cent tax on foreign exchange as a violation of the Treaty.

materials to be used by new and necessary industries as determined in accordance with RA 901.

c) "Margin Fee on Sale of Foreign Exchange" By July 1959, a new law (RA 2609) had to be passed to salvage the serious balance of payments position of the country. This law authorized the Central Bank "to establish a uniform margin of not more than 40% over the Banks' rate stipulated by the Monetary Board." This was almost identical to the tax on foreign exchange, although it was not a tax in the sense of providing revenues for the government. The margin fee accrued to the Central Bank. This law signified the break from traditional differential rates of foreign exchange extended formally to new and necessary industries. But since the exemptions in the import tax law still applied, the subsidy for new and necessary industries was still in effect. Moreover, a close examination of the list of exemptions will show that the exemptions are quite extensive. Many firms considered by law as new and necessary would have benefited from them.¹⁰ Thus, the exemption from differential foreign exchange treatment was not completely lifted until after "decontrol" in 1962.

¹⁰ No attempt is made to prove this statement, but the interested reader need consult only Section 2 of the law, which listed 19 categories of importations exempted.

Table 1

DIFFERENTIAL RATE ON SALE OF FOREIGN EXCHANGE
(Peso Cost Per Dollar Bought)

Year	Rates for "Ordinary" Import Transactions	Rates for New and Necessary Industries	Pick's Currency "Black Market" Rate**	Stock of Foreign Exchange Reserves**
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	2.96	297.99
1955	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

*Some special exemption listed in margin law were acquired at 2 to 1 rate (prior to decontrol).

**Middle of the year items.

Table 1 demonstrates the differential foreign exchange rates enjoyed by new and necessary industries as against "ordinary importations." The rates were based on the different laws affecting foreign exchange transactions in the 1950's. It can be seen that foreign exchange transactions favored the new and necessary industries substantially, especially as the decade wore on. With the imposition of the margin fees, however, some of the industries ceased to enjoy this privilege, except the differential advantage offered by the special import tax and some specified exemptions in the "margin" law which were used as inputs by new and necessary industries.¹¹

The last columns of Table 1 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 items give an indication of the state of the balance of payments as well as the relative "strength" of the Philippine peso in the foreign exchange market during the period. For obvious reasons, the peso-dollar exchange rates quoted by Pick's are higher than those that obtained for normal foreign exchange transactions in Manila. [The attempt to control foreign exchange rates even after the "legal" differentials are allowed for will inevitably lead to a higher "market" exchange rate, because the presence of "controls" implies the existence excess demand for foreign exchange.]

¹¹The list is rather extensive, too. See footnote 10.

Import and Exchange Controls ⑧

Up to now, discussion has only hinted the roles of import and exchange controls in relation to the growth of import substituting industries. These controls performed a special function:

- ① they were instrumental in providing the second major type of protection that was given to manufacturing -- the creation of constraints or restraints to competition, either from goods coming in from the "rest of the world" or from participation by foreigners.

Import controls were imposed in 1949 to restrict the outflow of foreign exchange due to excessive spending for foreign goods relative to the balance of payments position. Gradually, they took the form of quantitative and qualitative attempts to favor certain types of imports over others. The history of import controls seems to have been like that of a player using a hit-and-miss method until the target and the aim became more familiar.

Designed to curtail imports as short-run measures for balance of payments adjustment, the controls became more or less a part of the import substitution program. Most final goods were quantitatively restricted, but the intermediate goods were allowed as imports. Here, familiarity again with developments regarding new and necessary industries should be helpful. ^{imp.} The import pattern shows that the proportion of intermediate goods increased during

the period. However, the classifications used by the statistical agencies do not give a functionally comparable commodity classification in terms of the Standard International Trade Classification. What are available are classifications of imports according to "end-use" and according to "official" categories defining commodities in terms of essentiality. A third classification comes from the ECAFE. This last classification scheme separates imports into two principal categories -- consumption goods or capital goods. An examination of the import values, however, reveals that although proportions of the subcategories in favor of unfinished goods have changed, the total values of imports have not grown. *a growth in its output!* *the manufacturing sector exhibited* In fact from 1954 to 1960, import values were different only by a few million dollars,¹² although during the period in between there was humped pattern of imports, the highest level being reached in 1957. These were years of difficulties in terms of balance of payments position of the country. In the absence of sufficient growth in the export sector¹³ to offset all the demand for foreign exchange at the rates used officially (up to margin fees or taxes), the foreign exchange resources of the country were rationed along the lines of imports and exchange controls.

¹²Which is not much considering the total magnitudes involved.

¹³The country's exports grew in dollar value. In fact, exports in 1963 were more than twice the value of 1949 exports, but to begin with, the value of imports were relatively higher than exports, therefore the balance of payments crises.