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Myths and Fallacies in Economic Policy Debate

by

*Gerardo P. Sicat**

*Professor Emeritus, School of Economics
University of the Philippines

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Abstract

A fallacy is often based on a correct argument but applied to a wrong set of circumstances. A myth is a worse form of fallacy because it is not true or correct. Myths and fallacies are used across the spectrum of debates on economic policies. Some fallacies keep acquiring a life of their own, and the object of this paper to expose them as such. The fallacies discussed are most commonly found in debates on the economy across a full spectrum of issues.

A number of examples are picked as arguments often used in the debates on industry and trade, social amelioration, and macroeconomics. Specifically, the first of these fallacious arguments fall under the protectionism and industrial policy. A second group of policies relate to the debates designed to help improve the condition of the poor. A few important examples are cited in the area of national economic management.

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Myths and Fallacies in Economic Policy Debates

By

Gerardo P. Sicat*

Myths and fallacies in economics are applied often in policy discussion, as in serious economic arguments. Used intentionally or not, they are the result of ignorance about economics or the economic effects of the policies being discussed.

Little is new. The myths and fallacies of today are the same myths and fallacies of yesteryear.

A fallacy is often based on a correct argument but applied to a wrong set of circumstances. This is what makes it a fallacy. One example is this. A policy that is designed to produce a short-run outcome is also kept for a long time to produce the same long-run result. Many common fallacies are of this type.[1]

A myth is a worse form of fallacy. A myth is a story that cannot be true, like Superman or Atlantis. It is a fairy tale. Used in an argument, it is an untruth. If there are two forms of stupidity, a propagator of a myth is simply more #!*!…, what shall I say!

I will be nice and just talk about fallacies, some of which are, in truth, myths.

Myths and fallacies are used across the spectrum of debates on economic policies. Some fallacies keep acquiring a life of their own, and it is best to expose them as such. These fallacies are most common in the discussion of policies affecting industry and trade, social amelioration, and macroeconomics.

The social policy arena is especially full of contentious arguments. A particular economic policy is often used to justify a social objective that is contradictory to the achievement of that objective. It is often the case that the instrument of policy that is employed is the wrong tool.

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[1] Fallacies remind me of a story once told by one of my former professors years ago, Evsey Domar at MIT. People in a remote village observed that wherever there were epidemics, doctors would congregate. The people concluded from this that the cause of epidemics was the doctors. And so, they tried to solve the problem by killing the doctors!

The Fallacy of Protection as a Tool of Progress

In the realm of industrial policy and trade, the dominant argument that has been used often in our country is to stress the importance of protection of industry as the means for achieving industrial and economic growth.

The opposite of the fallacy of protectionism is an argument for the promotion of industry based on the idea of selling to other countries to produce a trade surplus. This line of thought, known as mercantilism, is an equally fallacious argument for industrial progress. However, in our country, the mercantilist argument never had a chance (which is just as well)!

The protectionist policy prescription dominated the policy landscape for decades. Our leaders embraced protectionism when they crafted the constitution in the 1930s. NEPA (National Economic Protectionism Association), the Philippine Chamber of Industries circa 1950s, and Filipino First were a potent combination of organizational clout and slogans.

Protectionism was a kind of flag-waving. State policy decisions that were adopted during the early decades of independence, if not done in this light, were simply not patriotic. The policy prescription crept into other sectors of the economy. It prescribed various forms of limitations against foreigners and foreign entities, ranging from the distribution of goods at retail, promotion of investment, ownership of economic assets, and participation in banking and finance.

Some examples of industrial policy discussion come to mind below.

Fallacy. Protection of industry is the best way to achieve economic progress. Protection will strengthen fledgling industries by assuring them a larger market. This large market would become an instrument for improved efficiency and growth.

This argument has long been proven to be wrong (and at a high cost!) in our national experience. Yet we still get many commentators to propose protection of industry as a principal means of encouraging industry.

Many highly protected industries that were supported by policy in the past became a burden to all the people and to the government, even to the enterprising businessmen who made short-term profits for themselves.

For these businessmen, the short-term profits might have been welcome at the beginning. This was in fact one reason why many industries and Filipino entrepreneurs seized the opportunities of industrial import substitution during the 1950s and the 1960s. Over time, however, the continuous prosperity of these industries depended only on continuing favors granted by the government, not on the basis of their internal dynamics of growth. This came either from the protracted continuation of bad policies or the grant of financial favors from the financial institutions owned by the government.

As a result, it had become difficult for the country to pursue structural reforms in the economy, especially when those reforms required liberalization of tariffs, of investment rules, of participation by more investors and by more industrialists even in the country. The protected industries had become the obstacle to further progress, to improved economic efficiency, and to rapid economic redirections.

The acrimonious debates on industrial policy often ended in stalemate. Therefore, it led to a slow-down of the reform efforts, resulting in prolonging the structural defects of the regime of protectionism.

Thus, it is not an exaggeration to say that among the worst victims of protectionism were the businessmen themselves. They were enticed by the policy signals by committing their resources and their future to highly protected business activities. When the first signs of lack of sustainability of their enterprises became evident, they developed the habit of turning to the government for further protection and for additional privileges. If they were not wiped out by the failure of the business, they became perennial complainers against sensible change in policy. In this way, they had become obstacles to progress through structural reforms. And in the process, they had been transformed into the apologists of the protection regime.

But the costs to the nation were substantial.

The protection policy made Filipino workers poorer. Of course, those employed in the industry had their jobs. But because the industries based on protection failed to experience productivity growth, wages failed to rise. And, in the end, when the industries could not survive, the very same workers lost their jobs. The phenomenon of Filipino workers seeking employment abroad is really a shameful condemnation of the failure of industrial policy to provide the employment needed at home.[2]

The government suffered. It failed to realize new revenues that it had hoped to receive from viable, tax-paying industries. And it gave away a lot of tax benefits and subsidies, direct and indirect, which comprised the incentive package to encourage industry. Many state lending institutions – the first credit

[2] It is to the credit of this country that, at least, labor is allowed to migrate to better paying occupations. In fact, in a curious turn of events, the Department of Labor is often seen as an agency of the government encouraging labor to find jobs abroad! At home, it behaves to protect the rights of labor, and in the process, often becomes an obstacle towards increasing the availability of jobs at home. The cost of labor migration is often not counted as a loss in the educational investments that the country had put on the budget for public education. It seems that the foreign remittances of overseas contract workers are often seen as a source of economic bounty.

window of the industrialists – bankrolled the failures. In the end, these institutions were saddled with loans that could not be collected. They themselves had to face the prospects of bankruptcy without further state subsidies. The other private banks that followed the lead of the government experienced the same problems.

The nation suffered. The savings of the nation were squandered. The country rewarded these industries and their businessmen with credit, tax, and other fiscal benefits so that they would grow into sound industries to stand on their own and to lead the economy further. But they could only pay back to the nation very little in terms of efficiency gains.[3] Therefore, the improved fiscal resources from citizens and institution benefiting from progress did not come in abundance, if at all. Savings are supposed to finance sound investments. They represent the nation's ticket to growth in the next period. But the failure of the investment meant the waste of that investment and the reduction of future prospects.

Consumers suffered the most. They paid high prices. They got poor quality products. They failed to experience what the competition could have offered. Protectionism often began by preventing competition or pricing it out through prohibitive tariffs or through import controls – from reaching the local market. They provided enormous monopoly benefits to the industrialist. Those benefits made the industrialists dependent on the existence of continued protection, rather the vanguard for the search for new markets and an expanding economy.

Fallacy. <u>The economic success of our Asian neighbors is due to the strong role of the state in promoting and protecting industry.</u>

If this proposition were true, there would not be few successful Asian neighbors. Almost all those that have adopted a strong role for the state to promote growth would have become economic successes, too. And surely, this would include our country even during the earlier decades. But the fact is that these successful Asian countries were indeed only a handful set of success stories for a long time (even after the recent Asian crisis when the successes stumbled momentarily).

Indeed, there is a much longer list of countries that have adopted protectionist policies and their experience is the opposite of high growth. What they achieved invariably were low growth rates, inefficient industries, falling productivity, and massive unemployment.

The list of countries that have attained high and extraordinary economic growth rates over a sustained periods in recent times includes South Korea, Taiwan, Singapore, and, invariably, among the

[3] The studies of Philippine economists, both based at the U.P. School of Economics from the 1960s and from the Philippine Institute of Development Studies since the 1970s, have documented many of these results. For instance, see Romeo Bautista, John H. Power and Associates, <u>Industrial Promotion Policies in the Philippines</u>, Philippine Institute for Development Studies (1979), for a survey and analysis of the issues.

latecomers, China and our other partners in ASEAN. In spite of the recent economic crisis in Asia, these Asian countries are a unique set of countries that have achieved high rates of economic growth over a sustained period of time.

A different principle explains their success. What distinguished many of these successful countries was that they used the market mechanism effectively and sensibly in much of their policy endeavors. They let the factors of production in their economies to be priced in accordance with market forces. When some other policies – including highly protectionist elements interfered with those pricing policies – they utilized other policy tools to correct for any price distortions induced by protection. As a result, in general, they encouraged greater flexibility of pricing of resources and promoted investments to proceed in accordance with those pricing decisions.

Early during their industrialization period, they did not price labor too high, and so they encouraged labor-intensive industries. They priced capital more sensibly – through a more realistic interest rate both as a means to encourage savings and therefore investments and by not excessively subsidizing capital acquisition with low interest rates. They introduced domestic policies that reduced the inflation on basic goods like food. They allowed the raw material inputs used by industry to be priced at their world prices, especially when they were encouraging their exports. They acquired raw material inputs at world prices, without slapping any duties on their importation.

The factors of production were priced relatively more correctly, thereby reducing the gross and adverse impacts of protective price distortions.[4]

In short, the net value of their actions as state promoters of industry was to compensate for the many problems that the protection policy brought. The other components of their industrial policy allowed them to correct for the distorting effects of their protection policies.

Fallacy. The size of the domestic market depends on the size of the population.

Per capita income is the primary driver of the size of the domestic market. The number of people does not increase the size of the market unless the people have income that is high enough to represent actual demand for goods.

[4] An example was that in general, these economies did not introduce high minimum wage legislation, but they promoted the rapid entry of investments so that the demand for labor would expand fast. Although they provided cheap interest rates for industries that engaged in exports, for the general round of industries, including those designed mainly to serve the domestic market (the import substituting industries), there were no interest rate subsidies coming from government financial institutions. Also, interest rate policy was designed essentially to match the scarcity of capital, so that savers were attracted to serve. These were the types of policies that I had written about way back in the 1960s. See G. P. Sicat, Economic Progress in South Korea and Taiwan, Discussion Paper 69-2, U.P. School of Economics.

An economy with a small population, however, can have a very large market if its market is the world: examples, Singapore and Hong Kong. In terms of some products, the size of the market in Hong Kong or Singapore, in spite of their small population, is so much larger than our country. Add the size of the export markets for their goods, and the comparison is in large multiples.

Until India and China – the two largest countries with the largest economies in terms of population – began to improve their respective trade and industrial policies by encouraging some competition in the industries that they began to liberalize at first, these two countries had only potential to create a market. As their domestic per capita incomes began to rise because of productivity growth and wage increases, the size of their domestic markets enlarged as a consequence.

Fallacy. <u>Economic development depends mainly on industrialization. And industrialization begins with heavy industry</u>.

This view, I must apologize to say, is pigheaded. The true calculus behind economic development is based on economic efficiency and comparative cost advantage. When the argument starts with the assertion that economic development is not possible without industrialization, be sure that the next sentence says that the industry, at the initial stage, needs protection.

We should also be reminded that some progressive countries never had a steel mill. But steel mills – and power, fertilizer, and cement plants, etc. – grow where the market can justify it.

In short, it is more correct to state that industrialization is a consequence of economic development rather than its cause.

Fallacy. <u>Planners know better than the people how to order economic and social priority. Social planning is the key to improving the welfare of citizens.</u>

The Soviet Union no longer exists. (And the countries in Eastern Europe view their past history of being subject to the economic system of that country as a lost opportunity in their past. That's why they – including the former USSR – are trying to be like their Western neighbors.) The Soviet system was based on the paragon belief that the central planner knew better than the people.

Until China decided to experiment with economic liberalization at the level of rural communities in the 1970s, it was destined for the same fate. Then, it gradually broadened the experiments to special economic zones, using market tools as encouragement for enterprise and economic activity. Now, China has integrated many of the lessons that it had learned from these experiments and from contacts with the capitalist world. And it is on course to undertake further economic liberalization in many parts of the economy. Indeed, the price is right! China is on course to enter the World Trade Organization as a member. The WTO is the ultimate organization of capitalistic countries.

Fallacy. Government planners and bureaucrats know better than businessmen.

This kind of thinking continues to afflict some government planners in the same way that it had deluded central planners in the failed economic systems just alluded to above. I will not be surprised that some of these planners are still found in NEDA, BOI, and many government departments. Sometimes, one could hear proposals from some quarters about the government to do more strategic planning, targetting industries and other activities, etc. Yes, this kind of thinking still exists even in the private sector.

What is critical for government planners to do is to set the right conditions for doing business. Some of these measures would be along the following: improve the policies to ease the burden of bureaucracies and administrative requirements on business; remove complex provisions that only produce intermediaries and experts who raise the setup costs of doing business; and declog overburdened economic infrastructures by channeling investments in them. More than ever, their most important work is to allow prices to be right, by using the market mechanism most of the time, not the big stick of regulation, control, or state power.[5]

Years of consultations with private businessmen will not produce the right winners in industry if the prices of all the factors of production – labor, capital, inputs from abroad and from within (such as electricity, infrastructure in transport and communications, etc.) – are unfavorable towards making those industries efficient. The businessman who stakes his investment and who shoulders the risks of failure knows better than the government bureaucrat how to solve his own business problems.

The impressive expansion of Philippine exports in recent years, especially in manufacturing, as in the semiconductor exports, provides a lesson to all the foolish debates in the past about industrial policy. For the first time, the country has been experiencing sustained double digit export growth rate and a taste of export surpluses. Hong Kong, South Korea, Taiwan and our other Asian neighbors began to experience the same phenomena early during their discovery of export prosperity at least two decades before we began to experience ours.

During those years in the past when our Asian neighbors were fluorishing, the standard thinking in the country was focused on targeting and identifying export potentials, not in clearing the path for policies to make businessmen decide what exports would make profits.

[5] There are some exceptions when the market mechanism fails, and supplemental government effort has to be undertaken. These situations are most common in those processes of production with "external effects", like pollution and in industries with naturally declining cost. In the latter case, the case for direct subsidy is strong.

The recent surge in exports was less the result of targeting exports than in preparing investment promotion policies where industries could take advantage of the country comparative advantage in trade. It is also a major phenomenon that none of the import substituting industries that were promoted in a previous era had become the basis of this export prosperity.

Exports began expanding in impressive terms when private investors began to take advantage of the opportunities offered by the Philippine economy – the promise of economic liberalization and the commitment expressed by the government to pursue those policies. This change in policy outlook ushered in structural reforms in many directions of the economy. They included the following: reduction of tariffs and the removal of quantitative controls on imports; adoption of a market-based exchange rate for the peso; liberalization of capital flows, especially on the repatriation of profits by foreign investment; and opening of banking to foreign investment.

Additional impetus was provided by developments within ASEAN. The ASEAN Free Trade Agreement (AFTA) area has provided a major magnet for future investments by industrial countries seeking further markets. The AFTA is yet to come, but the agreement has been forged and the calendar for the future expansion of the regional economy is set on course. So, the decisions concerning market potential, exports, and future investment needs that affect the future in the Philippines (and elsewhere in ASEAN) are being followed by economic agents interested in the prospects of the larger ASEAN market.

The successful growth of the Philippine export sector has also been strengthened by an improvement in the domestic investment climate, aside from the measures and developments just mentioned. The establishment of industrial estates has helped to reduce the setup time for making locational decisions made by new and expanding investments. The transformation of the former military bases into industrial economic zones for exports by the early 1990s helped to increase the success.

But private industrial estates set up by private enterprises along the Southern reaches of Manila (the Calabarzon region) have also encouraged rapid growth of new factories. Within these zones also, businesses were able to get their imports administered more easily by customs and the opportunities for nefarious practices that killed businesses with undue delays were significantly reduced if not eliminated. Here, also, the factories could secure their raw materials at world prices.

The Fallacy of the Big Heart for the Poor

Social amelioration policies should be undertaken with an understanding of their true objectives and of the calculated direct costs to society. To be aware of their direct costs would make it possible to weigh the correct strategies related to the goals of social development.

The problem is that social amelioration policies are often undertaken without that calculus being put into effect. Policy makers hate to see the tax bill, but they see what the immediate benefits that certain quick fix measures would bring. So, they devise means to ameliorate social conditions <u>indirectly</u>. It is this folly that makes them choose policies that <u>seem</u> to correct the problem. They shift the cost to others. Little do they know that the total cost is borne by society and by the same people for whom those amelioration policies were supposedly intended.

<u>This is the formula of the bleeding heart reformer</u>. If low income is the problem, raise the income by legislating it. If high prices are the problem, reduce the price by regulating or controlling them.

The appeal of these measures to social reformers is very high. Reformers think that they help the cause of the poor. When adopted, the policies inevitably contribute to the further immiserization of the already poor. This represents even the failure to uplift the condition of other segments of the population who are not targeted by the policies. For instance, it could worsen the conditions of the middle class, that as a group are really bystanders in the framing of social policy for alleviating the conditions of the poor.

The measures succeed only in a temporary alleviation of the immediate condition. That is why these are mere palliatives. It is not surprising that the policies, when adopted, could become long run causes of misery for the same groups of the population who are supposed to benefit from them.

Fallacy. <u>Raising the national minimum wage periodically to a level that catches up with inflation will improve income distribution and therefore the welfare of labor.</u>

If inflation is the issue, the correction lies in anti-inflation policy, which is essentially a macroeconomic policy problem.

Raising the level of the minimum wage would benefit the employed person near the minimum wage level. He could lose his job if the employer is required to pay a higher wage and the business could not afford the new wage bill. But if the laborer does not lose his job because his employer could afford the additional wage cost, it is possible that the next person in search of employment might find it harder to get employed.

If the level of employment in an economy is high (for instance, if there is full employment or a very low rate of unemployment), a minimum wage hike would probably benefit all employed laborers. And there would be few, if any, losers.

But consider a prevalent condition in our country, with a high unemployment rate. In 1998, the unemployment rate in the country was estimated to be 9.4 percent of the labor force. During good economic years, the unemployment rate was not lower than 8 percent of the labor force. In fact, not all people who are employed receive the minimum wage. About 34 percent of the employed laborers[6] are likely to be receiving less than the minimum wage in the country. This estimate is probably quite optimistic.

A high rate of increase of the minimum wage could also hurt many of those who already have employment and whose productivity is way above the minimum wage. Their wage increases might be sacrificed to pay for the wages of those whose productivity is not justified by the higher wage.

A high wage rate arises because of the strong demand for labor, relative to the existing supply. A strong demand for goods translates into a high demand for labor. It is also related to the productivity of the labor.

Countries with dynamic economies – those that develop efficient industries and strong export performance – are likely to have a strong demand for labor and therefore their wage rates go up fast. Look at the examples of our successful, immediate neighboring countries.

It is clear that Philippine labor policy had prematurely emphasized welfare legislation ahead of job-producing employment strategies. This has ultimately caused a great majority of laborers in the country to suffer from low-income unemployment, if not from unemployment. The economic success stories of the Asian region have plentiful jobs today because they emphasized investment promotion, job creation, on the job training, and economic efficiency in industry as employment creating policies. These countries have very high productivity of labor today. They are countries where wage rates are quite high relative to Philippine wages. Therefore, it is not a surprise that that Filipino labor (even those receiving much higher wages than the

[6] The people who are fifteen years old and older in 1998 number 47.4 million. About 66 percent of these persons, or 31.3 million, are in the labor force. During the same period, around 1.6 million are government employees covered by the GSIS and 20.2 million are members of the SSS. All in all, therefore, around 21.8 million are covered by social insurance. This number of laborers would likely comprise the labor force that is covered and receives the minimum wage. A large number of the people who are not covered by social insurance could be largely people in search of any work. If we assume that 4 percent of those covered by social insurance are pensioners and therefore not in search of work, then 20.9 million members of the labor force are at least earning the minimum wage. This is only 66 percent of the total active labor force. I find this estimate to be on the high side. There is always a small proportion of those enrolled in the GSIS and the SSS who actually float between a state of employment and unemployment. The statistics of membership in the two social insurance programs report gross numbers. They do not include net withdrawals from the system, including probably a rapid verification of retirements and a count of deaths within the systems. Therefore, a little more than 34 percent of Filipino laborers are likely to be excluded from the benefits of the minimum wage rate. These statistics are derived from various tables from the 1999 Philippine Statistical Yearbook produced by the National Statistical Coordination Board.

required minimum wage) want to seek jobs in these countries as temporary contract laborers if not to migrate to them.

The issue for current policy makers is how to redirect labor market policies so that it is possible to rapidly exhaust the open supply of labor available at very low wage rates. These requires raising the demand for jobs within the economy through a higher level of investments that, at the same time, create job opportunities per peso of additional investment. It is also important to seek policies that make labor highly productive. In such a setting wages the supply of unemployed labor would be absorbed in the productive sector and wage rates would rise fast, as was the experience of many economically successful Asian neighbors.

It would be also useful for the government to help steer organized labor sector leadership to seek policies that help rather than obstruct investment. Actually, the stance of organized labor has improved in recent times, but more work along the lines of creating a national consensus for job growth with industry would still be needed. As long as many laborers do not benefit from advanced labor laws, the gains of labor would be limited. In a more understanding environment of cooperation, the demand to raise the minimum wage among the labor class will become much more realistic.[7]

Fallacy. <u>Price controls or price regulation will make goods affordable and will improve the welfare of the consuming public.</u>

Price controls are often used as the solution for correcting the high prices of basic commodities. In extraordinary times, they might be needed as temporary measures. But whenever they are resorted to, at all, it would be useful to make provision for their temporary character. A definite date for their removal should be part of the policy.

But once in place, price controls are difficult to remove. Why? Price controls immediately create an active constituency of interest groups for their prolongation. The coalition of interest groups to retain price controls and make it a feature of a long range policy include organized groups that are the immediate beneficiaries of controls, social reformers with compassionate concerns (bleeding hearts), and politicians whose gains are populist in nature.

High prices, as already mentioned, are likely to be part of a macroeconomic issue. An anti-inflation policy stance in macroeconomic policy would require balancing aggregate demand with aggregate supply.

What is bad about price controls is that they often have very distorting influences on incentives of market players. For instance, price controls prevent supply incentives of sellers from being realized. Hence,

[7] As an example, recently some legislators have proposed to raise the minimum wage by legislation. For instance, a bill in Congress is said to suggest that the minimum wage be increased by P125 per day, which is an extreme demand, in view of the unemployment problem in the country.

the supply of goods might even become more constricted. Price controls in this sense reduce the natural incentives available to producers to produce more of the goods under control or to bring existing inventory fully to the market.

Oftentimes, price controls would require efforts by the government to import the essential goods. By itself, this could also contribute to macroeconomic imbalances, which then is another problem to deal with.

Fallacy. <u>Rent control enables the poor to enjoy affordable and cheap housing</u>.

Rent control in its present form was introduced when, under martial law and in response to the energy crisis, the president decided to control many types of prices affecting vulnerable groups in the population, including rent for housing. While all price controls were gradually lifted, the one on low rentals has remained. Every time the rent control law was about to lapse, legislators found a way to extend it, by controlling the percentage of rent increases that could be charged.

In the past, retired public officials and school teachers, as well as enterprising businessmen, supplemented their retirement years by investing in apartment dwellings to be rented out. In this way, the supply of dwellings for the poor increased. Nowadays, only the foolish will do such a thing. The private sector has ceased to build apartment dwellings for rent, except those cutting up their existing housing into rooms for rent or to those renting houses for the very rich.

This explains in part the existence of a worsening and serious housing shortage in the country. The housing gap has grown bigger. The government has been forced to play a larger role in housing provision. But its efforts to set up a large low-cost housing program as a means of providing relief for a population facing poor housing availability is constrained by financing problems.

So long as the rent control stays, new private investments in the provision of housing for rent and for sale will be discouraged. In the meantime, the government-provided housing program requires a huge subsidy that is not likely to be sustainable.

The outcome of this is that among the poor middle income public officials and private sector employee who could afford to invest in housing for their own use, the only housing available to them is often in subdivisions that are quite away from their place of work. Their distance from work and the cost of transport in terms of money and time have become either extremely difficult or unsustainable!

In the meantime, the phenomenon of squatting is not only continuing. It has become worse. The country's cities are full of shanties and illegal dwellings.

Fallacies in Macroeconomic Management

Macroeconomic policy is about the management of aggregate expenditure and of aggregate supply of output in the context of relative price stability. Two common fallacies will be discussed.

Fallacy. <u>A strong peso is good for the economy.</u>

This argument used to be mantra for those in charge of foreign exchange policy. At least, this was their public posture.

Essentially, the Philippines has to buy its imports through its export of goods and services. A strong peso makes the price of imports cheaper, but it also has the effect of making it more costly to export. So, a strong peso encourages a balance of payments deficit. In this way, it could become a source of a future balance of payments crisis and therefore hurt the economy.

(The other face of this argument is that <u>a weak peso will be good for the economy</u>. A weak peso surely would make exports attractive to companies, if that was an objective. In fact, economies such as South Korea and Taiwan in the 1960s till the 1970s used this policy to encourage their export industries to grow. It was a correction of their highly protectionist policy regimes to undervalue their currency then. That allowed imports to be unduly more expensive, except those used as inputs to the export industries. The undervaluation of the currency helped these firms to seek an outlet to the world by exporting their products. But the strategy worked as a corrective to the highly protectionist regimes in existence at the time.)

The rate of foreign exchange is a powerful price that could create imbalances in the economy when it goes out of kilter from what appears to be what the market would bear. Stabilizing it is a sound policy, but stabilization means allowing it to seek the correct level.

Fallacy. <u>To keep the fiscal deficit under control, it is adequate to keep watch on the national government's budget.</u>

Keeping watch on the national budget – making sure that expenditures of the government are reasonably covered by tax collections – is very important. But that is only about four fifths of the issue.

The government must watch out how enterprises controlled by the government are being run. To what extent are these enterprises maintaining profitable, or at least viable, operations? These off-the-budget agencies are not truly off-the-national budget indefinitely. If they incur losses all through the years, pretty soon, they are part of the budgetary problem.

If the National Food Authority is required to sell rice below market cost, and to buy palay at a high price, pretty soon, its capital would be wiped out. This even assumes that waste is not happening in the administration of its functions. The agency's credit standing would become ruined. It would not be able to finance its operations, much more pay for its loans, if the capital is impaired. The national budget would then come to the rescue by absorbing the losses or "recapitalizing the agency", which is the same way as absorbing the loss.

This type of story can be multiplied in many ways. A simple review – at one time or other in the past and even today – of the operations of many governmental agencies and that of the instrumentalities of the national government would reveal that many of them had incurred major losses. In the end, the budget had to take care of the problems.

Any good analyst can construct a financial history of the following government agencies, entities, and corporations.

The National Power Corporation has a huge mountain of losses today. That is why it is being privatized and Congress is dealing with the problem of how much "stranded costs" of power generation in the past will be absorbed by the budget.

The Central Bank of the Philippines had to be reinvented in the early 1990s. Its fiscal losses from subsidized credit, guarantees of external debt, and foreign exchange losses over the years had prevented if from effectively supervising financial reforms. Its financial restructuring became a requisite of sound policy.

The Philippine National Bank and the Development Bank of the Philippines were two financial institutions that were designed to help finance economic development. In the process, they became the milking cows of politically induced loans and loans to the import substituting industries of the past, and of bad loans to the sugar sector and other industries. Appropriating new capital to augment their depleted capital from the national budget and transferring their of non-performing assets to a national government instrumentality or to a subsidiary often created the appearance of a strong balance sheet.

The predecessors of the National Food Authority were the NARIC (National Rice and Corn Corporation) and the RCA (Rice and Corn Administration). They had to be reinvented to do the same thing again and again and again after they had lost their capital through subsidy and inefficient operations. Indirect subsidies to keep the prices of basic staples low were a repeat of the quandary that is presently facing the NFA. And the problems afflicting the National Fertilizer Authority are of the same variety.

Over the years since the 1930s, the National Development Company was supposed to engage in pioneer industrial ventures. Many of these ventures have cost a lot of resources for the nation directly and indirectly. A review of the portfolio of this company will reveal that there are many projects that are sustained only by subsidies from its resources, which the government keeps providing.

The Congress is currently (2000) discussing the recapitalization of the Housing Insurance and Guarantee Corporation (HIGC). This corporation was set up to provide guarantees for housing loans so that it could support the low-cost housing projects of the government. The corporation has guaranteed many housing projects that had gone unpaid. Therefore, the HIGC is left with a lot of projects that it had guaranteed with poor prospects of viability, and the guarantees that it had made will eventually fall due. It is losing, if it has not yet lost, the original capital that had been appropriated to start it by the government in an earlier period. The recapitalization of HIGC, a ritual repeated for many other losing public corporations that do not follow prudent business activities, means that the national budget will eventually be refinancing the losses of this corporation. The corporation is seeking new capital of P50 billion from the national government.

Need I continue?