

**THE PHILIPPINE INDUSTRIAL SECTOR:
POLICIES, PROGRAMS
AND PERFORMANCE**

Filologo Pante, Jr. and Erlinda M. Medalla

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TABLE OF CONTENTS

I.	Introduction	1
II.	Overview of Economic and Industrial Performance	2
	A. Economic Performance	2
	B. Industrial Performance	10
III.	Review and Assessment of Industrial Policies and Programs	18
	A. Macroeconomic Policies	20
	B. Trade Reform	25
	C. Investment Incentives Reform	30
	D. Export Promotion Program	34
	E. Program for the Regional Dispersal of Industries ...	35
	F. Program for the Development of Small and Medium-Scale Industries	45
	G. Program for Technology Upgrading and Development	52
	H. Privatization	56
	I. Financial Sector Reform	60
IV.	Summary and Conclusion	62
	A. Economic Performance	64
	B. Industrial Performance	64
	C. Assessment of Industrial Policies and Programs	65
	References	72

LIST OF TABLES

1	National Income Indicators	4
2	Selected Economic Indicators	5
3	Balance of Payments, 1983-1989	9
4	Structure of Value Added (VA) and Employment (E) by Industry	11
5	Total Factor Productivity Growth in Philippine Manufacturing	12
6	Structure of Manufacturing Value Added	13
7	Regional Distribution of Firms by Number and Size, 1983..	15
8	Regional Distribution of Firms by Output, Employment and Fixed Assets	15
9	Percentage Shares of Traditional and Nontraditional Exports in Total Exports	17
10	Percentage Distribution of Nontraditional Manufactured Exports	17
11	Indicators of Capital Intensity and Labor Productivity in Manufacturing	19
12	Money Supply and Interest Rates (End-of-Year)	22
13	Effective Exchange Rate Indexes (1972-1989)	23
14	Number of Items Regulated, Liberalized and Newly Regulated by Year, 1977 to 1988	27
15	NTM Coverage by Major Groups (1984-1988)	28
16	(1+EPR) Index by Major Groups - 1985, 1986, 1988 Using price comparison	29
17a	Selected Statistics on New and Expansion Projects Approved Under P.D. 1789 (with Incentives-Nominal Cost)..	32
17b	Selected Statistics on New and Expansion Projects Approved Under P.D. 1789 (with Incentives-Real Cost)	33
18	Basic Information on Philippine EPZs, 1988	40
19	Comparative Statistics on Firm Size: BOI-Registered Firms vs. National Average, 1981-1988	48
20	Loans Granted by the Central Bank to Commercial Banks ...	63

THE PHILIPPINE INDUSTRIAL SECTOR: POLICIES,
PROGRAMS AND PERFORMANCE

Filologo Pante, Jr. and Erlinda M. Medalla*

I. INTRODUCTION

Unable to adjust adequately to external shocks, the Philippines experienced the most severe economic and financial crisis in its postwar history in 1983. The country's economy was particularly vulnerable because the pattern of development which had been pursued in the past was characterized by a distorted incentive structure, inefficient investments and heavy dependence on foreign borrowings.

After managing to grow by 1.1 percent in 1983, the economy contracted by 7.0 percent in 1984 and by 4.1 percent in 1985. Industrial and manufacturing growth rates collapsed during the period. Domestic investments were the hardest hit, their growth plummeting by as much as 43.1 percent in 1984 and 21.7 percent in 1985. Open unemployment swelled to 25.0 percent in Metro Manila and 12.5 percent nationwide. The inflation rate accelerated to an average of 50.3 percent in 1984 before it somewhat cooled down to 23.1 percent in 1985.

Shortly after the new government under President Corazon C. Aquino took over in 1986, it instituted a wide-ranging set of socio-economic and political reforms. The economic reforms were primarily aimed at increasing efficiency in the economy through the elimination of distortions in the incentive structure, the revitalization of private sector initiative and greater reliance on market forces.

*The authors are President and Research Fellow of the Philippine Institute for Development Studies (PIDS), respectively.

The major policy reforms in the area of trade and industry which have been instituted by the Aquino government include: (1) trade policy reform, which continued and expanded the import liberalization program started in the early 1980s; and (2) investment incentives reform, which involved changes in the country's investment laws as well as the streamlining of the process of investment incentives availment. Other measures such as privatization, tax reform and financial sector reform are expected to have a significant impact on the development of the Philippine industrial sector.

The purpose of this paper is to evaluate the ongoing program of industrial restructuring and development in the Philippines. The main developments in the economy in the 1970s and 1980s will be briefly reviewed to locate the place of industry in the overall economy. The performance of industry as well as changes in industrial structure will also be discussed to serve as the point of departure for the subsequent assessment of trade and industrial policy reforms and programs. Within the industrial sector, the main focus will be on the manufacturing sector.

The paper is structured as follows:

Section II provides an overview of the main developments in the economy in the 1970s and the 1980s, and reviews the performance of the manufacturing sector during the period.

Section III assesses the government's progress in the implementation of major policies and programs of industrial restructuring and development, with emphasis on the period after 1985. The policies and programs to be covered are the following: macroeconomic policies; trade reform; export promotion program; program for the regional dispersal of industries; program for technology upgrading and development; privatization; and financial sector reform.

Section IV summarizes and concludes the paper.

II. OVERVIEW OF ECONOMIC AND INDUSTRIAL PERFORMANCE

A. Economic Performance

On the whole, the pattern of development pursued in the country up to 1983 had led to an economy characterized by a distorted incentive structure, inefficient investments and heavy dependence on foreign borrowings. The weaknesses in macroeconomic management which resulted in delayed, inadequate and, in some instances, inappropriate policy responses, exacerbated the situation. Accordingly, unable to adjust adequately to external shocks, the Philippines faced the most severe economic and financial crisis in its postwar history in 1983.

The Philippine economy grew by 6.2 percent per year in the 1970s, as compared to its growth of 4.8 percent per year in the 1960s (Table 1). Even without 1973 when the world commodity boom raised economic growth to 9.3 percent, the Philippine economic performance would still be better in the 1970s than in the 1960s.

At first glance and by itself, this is indeed a remarkable performance, considering that the international economic environment was more hospitable in the 1960s. A closer analysis, however, will show that growth in the 1970s was achieved at a great cost to the economy, a matter which became evident starting in 1980. This is not meant to downplay the importance of the external shocks which the Philippine economy had to absorb in the 1970s nor to ignore the policy reforms which were initiated during the period.

To be sure, the two oil shocks in the 1970s and the world recessions that followed certainly took their toll on the economy. With 1972 as the base year, the terms of trade index for the Philippines fell from 114.5 in 1974 to 71.0 in 1977 (Table 2). It recovered in 1978 and 1979 but fell again in 1980. In 1983, the terms of trade index stood at 61.3. In the case of crude oil, the Philippines was importing only an average of \$142.5 M per year of the product in 1971-1973, representing 10.7 percent of total imports during this period. In 1974, the value of oil imports rose four times, their share in total imports rising to 18.2 percent in a single year. The share of oil in the import bill further increased to 24.0 percent, as oil prices nearly tripled in 1979-1980. Accompanied by the unchecked growth in non-oil imports, the overall result was a rapid build-up in current account deficits after 1974. The current account deficit increased from 1.2 percent of GNP in 1974 to an average of 5.1 percent in 1975-1981 and 8.0 percent in 1982-1983. Higher oil prices also propelled domestic inflation to 34.2 percent in 1974, 16.5 percent in 1979, and 17.6 percent in 1980.

The government's response to the oil price shocks consisted mainly of efforts to promote domestic and foreign investments, expand exports and reduce the country's dependence on imported oil. Recognizing that the highly protected trade and industrial regime which date back to the 1950s strongly favored the import-dependent manufacture of consumer goods for the domestic market at the expense of exports and agriculture, attempts were made to correct the situation through the grant of liberal fiscal incentives to exporters. Furthermore, the government embarked on a more active export promotion program involving not only the expansion but also the diversification of exports in terms of commodities and markets. A Department of Tourism was created to boost the tourist industry, and foreign investments were encouraged by a series of presidential decrees liberalizing the rules covering the remittance of profits and repatriation of investments and providing tax incentives. The government also launched an energy development program to complement the energy conservation measures it had put in place.

Table 1
NATIONAL INCOME INDICATORS

	1961-70	1971-80	1981-83	1984	1985	1986	1987	1988	1989 a/
I. Real GDP by Industrial Origin (% change)									
A. Agriculture	4.0	4.6	2.4	2.3	3.3	3.3	-1.0	3.5	3.6
B. Industry	5.3	7.8	3.0	-10.2	-10.2	-2.1	7.7	8.5	7.3
Manufacturing	5.6	6.7	3.1	-7.1	-7.6	0.8	6.7	9.0	6.7
Mining	7.5	8.6	-1.9	-10.7	0.7	-11.0	-1.7	4.4	-3.0
Construction	3.2	13.4	3.4	-23.7	-27.4	-20.6	17.3	9.5	14.0
Utilities	5.4	9.2	9.1	12.5	6.8	20.2	10.7	4.6	7.1
C. Services	4.9	5.7	4.1	-7.4	-4.4	2.9	6.6	6.8	6.6
GDP	4.8	6.1	3.3	-6.8	-4.3	1.4	4.7	6.4	6.0
II. Real GNP by Expenditure Category (% change)									
A. Personal Consumption Expenditures	4.7	4.5	3.6	1.0	-0.1	0.9	5.7	6.0	4.8
B. Government Consumption Expenditures	5.8	7.0	2.5	-6.1	-0.4	-0.4	7.2	11.3	8.1
C. Gross Domestic Capital Formation of which Fixed Investments	5.2	9.4	-0.3	-43.4	-21.7	-9.1	30.3	19.2	16.2
D. Exports of which: Merchandise	5.9	9.0	5.5	8.2	-7.2	21.8	-1.3	16.0	16.4
E. Imports	5.8	5.8	3.9	-16.4	-23.0	12.9	26.5	34.8	26.7
GNP	4.8	6.2	2.9	-7.1	-4.1	1.9	5.9	6.6	5.6

a/ Advanced estimates as of 31 December 1989.

Sources: National Economic and Development Authority (NEDA); National Statistical Coordination Board (NSCB).

Table 2
SELECTED ECONOMIC INDICATORS

	Gross Investment as Percent of GNP	Foreign Saving (I-S gap) as Percent of GNP	Incremental Capital Output Ratio	Budget Deficit (Surplus) as Percent of GNP	Liquidity (M3) Percent Change	Real GNP Growth Rate (%)	Terms of Trade (1972 = 100)	Inflation Rate
:1960-70								
Average	19.8	-1.7	3.3	1.1	13.6	4.8		
1971	20.1	0.0	3.4	(1.0)	11.8	5.8	110.6	21.9
1972	19.5	0.1	3.8	0.7	13.1	4.9	100.0	8.2
1973	19.8	5.0	2.3	0.5	52.2	9.6	113.3	16.5
1974	23.0	-1.2	3.9	0.7	34.2	6.3	114.5	34.2
1975	26.8	-5.6	3.6	1.2	19.2	5.9	87.8	6.8
1976	28.8	-5.8	3.3	1.8	24.3	6.1	77.7	9.2
1977	27.1	-3.6	4.7	1.9	22.4	6.9	71.0	9.9
1978	29.5	-4.6	4.9	1.2	18.0	6.2	78.2	7.3
1979	31.2	-5.1	4.4	0.2	10.7	7.5	81.6	16.5
1980	30.7	-5.4	5.5	1.3	18.2	4.4	68.6	17.6
1981	30.7	-5.4	7.3	4.0	21.1	3.7	60.4	12.4
1982	28.9	-8.1	9.7	4.3	16.1	2.8	58.7	10.2
1983	27.1	-8.1	28.5	2.0	18.6	1.4	61.3	10.9
1984	17.4	-3.5	-	1.9	7.3	(7.1)	59.8	50.3
1985	14.3	-0.3	-	1.9	9.6	(4.1)	55.9	23.1
1986	13.2	3.3	8.7	5.6	6.2	1.9	82.1	0.8
1987	15.7	-1.6	2.4	2.3	12.8	5.9	89.7	3.8
1988	17.4	-1.0	2.2	2.4	22.4	6.6	99.6	8.8
1989	18.7	-3.5	2.7	2.3	27.4a/	5.6	95.8	10.6

a/ Basic data revised to reflect expanded coverage of DMBs (Deposit Money Banks) and other changes in classification of accounts.

Sources: National Economic and Development Authority, Central Bank of the Philippines and Department of Finance.

The abovementioned measures appeared to have had some perceptible impact, at least up to 1979-1980. Exports grew by 20.7 percent annually from 1970 to 1980, as compared to their growth of 7.1 percent per year during the 1960s, with the share of nontraditional exports in the total increasing from 7.5 percent in 1970 to 38.0 percent in 1980. The manufacturing sector also improved its performance in the 1970s, growing by 6.5 percent annually as compared to 5.9 percent in the 1960s. Tourist receipts increased from \$59 M in 1974 to more than \$300 M by 1980. Net direct foreign investments rose from an average of \$46 M in 1973-1974 (they were negative in 1971 and 1972) to an average of \$125 M in 1975-1979. And the share of imported oil in total energy requirements were reduced from 87.2 percent in 1973 to 75.0 percent in 1981. However, the adjustments taken were not enough to significantly mitigate, much more so, to compensate for the impact of the external shocks.

Power (1983) examined how and to what extent Philippine domestic policies accommodated the external shocks of 1974 and 1979-1980. He decomposed the adjustment or accommodation process into export expansion, import substitution and slower output growth. The difference between total shocks and total adjustments represents that part of external shocks which must be financed by additional external capital inflows. He found that the Philippines adjusted in such a way as to accommodate only one-fourth of the external shocks, leaving 75.0 percent to be covered by additional external financing. Export expansion was the most important element in this adjustment process, followed by import substitution. The rate of growth of output had a negative accommodation effect; in other words, it exacerbated the imbalances generated by the external shocks.

Despite the unfavorable international economic environment which followed the second oil shock, the government continued to pursue its "countercyclical" strategy. A number of factors prevented a repeat of the relatively effective use of such strategy after the first oil shock. First, the prolonged recession following the second oil shock had a double-edged effect: it increased the debt service burden (via higher interest rates) on a level of debt which by that time had risen sixfold and at the same time, led to lower export receipts. Second, the country was not able to translate large doses of investments into higher economic growth because of the relative inefficiency of investments, as indicated by the high incremental capital-output ratios in Table 2.

Furthermore, while measures were taken to move towards a more outward-looking strategy as opposed to import substitution, the biases of the system of protection remained. It was only in 1980 that a program of trade and financial liberalization and fiscal incentive rationalization was initiated with assistance from the World Bank. By that time, however, it was too late. As will be pointed out later in this paper, the import

liberalization program would in fact suffer a reversal three years after its initiation. Mention must also be made of the growth of both direct and indirect government intervention in the economy during the 1970s and early 1980s, grossly undermining the market mechanism and discouraging private sector initiative.

The ease by which the Philippine government was able to avail of foreign loans in the 1970s led to the postponement of adjustments in the exchange rate which were clearly called for by the large and growing trade and current account deficits. While the Philippines adopted a flexible exchange rate system in 1970 and has maintained it since then, there is ample evidence that exchange rate policy was not used effectively to adjust to imbalances in the country's external accounts. From 1974 to 1982, nominal exchange rates exhibited a generally depreciating trend, but the rate of depreciation was kept at about 3.0 percent per year. Meanwhile, the Philippine inflation rate accelerated from 5.3 percent annually in the 1960s to 14.0 percent per year from 1973 to 1983. Although the Philippines' major trading partners also experienced a relatively higher rate of inflation after 1973-1974, these were not as high as those in the Philippines. Thus, the limited nominal adjustments in the peso/dollar exchange rate resulted in real effective exchange rates that were appreciating at the same time that trade and current account deficits were rapidly building up.

It is, therefore, not surprising that after 1979, the economy began to falter. Real GNP growth progressively slowed down from 7.5 percent in 1979 to 4.4 percent in 1980, 3.7 percent in 1981, 2.8 percent in 1982 and 1.1 percent in 1983. Industrial and manufacturing growth rates followed the same pattern. The real squeeze came in the second half of 1983 when unsettling political events triggered by the assassination of the late Senator Benigno Aquino led international banks to halt further lending to the Philippines and call their short-term loans. The situation swiftly turned into a full blown debt and balance of payments crisis.

The immediate policy responses of the government were directed at the external sector. The peso was devalued three times between June 1983 and June 1984, resulting in a 46.1 percent depreciation of the peso from 1983 to 1984. The exchange rate adjustments were accompanied by severe foreign exchange restrictions, wide-ranging import controls and additional import duties and export taxes. The latter measures were clearly not consistent with the long-run goal of rationalizing the protection structure as embodied in the trade reform program the government initiated in 1980. In any case, these ad hoc measures were abandoned towards the end of 1984 in favor of the more orthodox expenditure switching and expenditure reducing policy instruments, which included, among others, the tightening of monetary policy, the reduction of budget deficits and a more flexible exchange rate policy.

The severe reduction in aggregate demand succeeded in quickly improving the current account balance mainly due to large cutbacks in imports which went down by 19.0 percent in 1984 and 15.8 percent in 1985 (Table 3). However, the cost of the adjustment program was high in terms of decreased output and higher unemployment. The economy contracted by 7.0 percent in 1984 and by 4.1 percent in 1985. Industrial and manufacturing growth rates plummeted by 10.0 percent per year and 7.0 percent per year in 1984 and 1985, respectively. Construction activities suffered declines of 23.7 percent in 1984 and 27.4 percent in 1985. Only agriculture and utilities managed to post positive growth rates during this period. On the expenditure side, personal consumption expenditures declined on a per capita basis in 1984 and 1985. Government consumption also took a beating, experiencing a negative growth rate of 6.1 percent in 1984 and 0.40 percent in 1985. Gross capital formation was the most adversely affected item, contracting by as much as 43.1 percent in 1984 and 21.7 percent in 1985. Open unemployment swelled in 1985 to 25.0 percent in Metro Manila and 12.5 percent nationwide. The inflation rate accelerated to 50.3 percent in 1984 before it cooled down somewhat to 23.1 percent in 1985. The import restrictions and high interest rate policy pursued at the height of the crisis virtually became supply shocks that adversely affected output and the prices of final goods during the period.

After the new government under President Corazon C. Aquino took over in February 1986, it instituted a wide-ranging set of socio-economic and political reforms. The economic reforms were primarily aimed at increasing efficiency in the economy through the elimination of distortions in the incentive structure, the revitalization of private sector initiative and greater reliance on market forces. These reforms included the adoption of a simplified and more efficient tax system, the dismantling of monopolies in the marketing of agricultural outputs and inputs, the abolition of export taxes, the elimination of a large number of import restrictions, the restructuring and strengthening of the major government banks, the refocusing of the public investment program, privatization, deregulation and decentralization. At the same time, prudent fiscal and monetary policies were pursued.

As a result, the economy achieved a remarkable recovery. After posting a small positive growth in 1986, real GNP grew by 6.0 percent in 1987, 6.6 percent in 1988 and 5.6 percent in 1989. Economic recovery was propelled mainly by the significant rebound of domestic demand since 1987, with consumer spending increasing by 5.8 percent per year from 1987 to 1989. There was also a strong recovery in investment activities. Gross investments rose by 21.7 percent annually from 1987 to 1989. External demand factors also assisted the recovery, with merchandise exports growing by an average of 13.7 percent per year in real terms during 1986-1988.

Table 3
BALANCE OF PAYMENTS, 1983-1989
(In US\$ M)

	a/						
	1983	1984	1985	1986	1987	1988	1989
I. Current Transactions							
A. Merchandise Trade	-2482	-679	-482	-202	-1017	-1085	-2598
Exports	5005	5391	4629	4842	5720	7074	7821
Imports	7487	6070	5111	5044	6737	8159	10419
B. Nonmerchandise Trade	-740	-823	0	715	0	-93	369
Inflows	3127	2626	3288	3791	3454	3690	4506
Outflows	3867	3449	3288b/	3076b/	3454	3683	4217
C. Transfers	472	386	379	441	573	789	675
Current Account, Total	-2750	-1116	-103b/	954b/	-444	389	-1554
II. Nonmonetary Capital							
D. Long-term Loans	1392	478	2787	732	159	-329	367
E. Foreign Investments	112	17	17	140	326	986	854
F. Short-term Capital (net)	-618	549	-1731	-824	80	-205	33
G. Errors and Omissions	-387	161	638	33	-144	190	425
Nonmonetary Capital, Total	499	1205	1711b/	81b/	421	642	1613
H. Monetization of Gold	183	169	221	279	365	314	288
I. Allocation of SDR	-	-	-	-	-	-	-
J. Revaluation Adjustment	-50	-15	-88	-72	-78	83	101
Debt Reduction			-	NA	-	73	223
III. Overall Surplus/Deficit (+)	-2118	243	2301	1242	264	650	448

a/ Data from 1983-1985 are adjusted for arrears per official concept.

b/ Revised due to reclassification of cost recovery accounts from the "Capital Withdrawn from the Philippines" to the "Other Service Payments."

Sources: Treasury, Management of External Debt Department, Department of Economic Research-Domestic and Department of Economic Research-International, Central Bank of the Philippines; and National Statistics Office.

After experiencing absolute declines in real value added for three consecutive years, the Philippine industrial sector recovered strongly in 1987, posting a growth rate of 7.7 percent. The sector's recovery was sustained in 1988 and 1989, with real industrial value added growing by 8.6 percent and 7.1 percent, respectively. The recovery in the manufacturing sector started in 1986 with a modest growth in real value added of about one percent. The turn-around accelerated in 1987 and 1988 with a 6.7 percent and 9.0 percent increase in manufacturing value added, respectively, and was carried through to 1989 with a growth rate of 7.0 percent.

B. Industrial Performance

The postwar development of the Philippine manufacturing sector is well documented.^{1/} There is unanimity in past studies of industrialization in the Philippines that the nature of government policies adopted since the 1950s to promote industrialization in the country, i.e., import substitution through import controls in the 1950s; high tariffs and quantitative restrictions in the 1960s and 1970s, accompanied by liberal financing and investment incentives favoring large and capital intensive industries, particularly in the 1970s; overvalued exchange rates; and increasing direct government participation in industrial production, has led to an industrial structure that is characterized by a poor record of productivity growth and failure to significantly help in the alleviation of unemployment, underemployment and poverty in the country. The performance and structural characteristics of the manufacturing sector are discussed below.

Limited Labor Absorption

The share of manufacturing value added in GDP increased from 22.5 percent in 1960 to about 25.0 percent in the 1980s (Table 4). On the other hand, the share of manufacturing employment in total employment has been declining from 12.1 percent in 1960 to 11.5 percent in 1970, 11.0 percent in 1980 and 9.7 percent in 1985, implying that, on average, overall employment growth in manufacturing since 1960 has lagged behind that in the economy as a whole. This phenomenon has been largely attributed by past studies on the Philippine manufacturing sector to the capital bias of the industrial incentive system, as well as to its bias against small and medium scale industries.

^{1/} See for instance, Power and Sicat, 1971; Ranis et al., ILO, 1974; Baldwin, 1979; Bautista, Power, and Associates, 1979; World Bank, 1979 and 1987c.

Table 4
STRUCTURE OF VALUE ADDED (VA) AND EMPLOYMENT (E) BY INDUSTRY a/
(%)

Sector	1960		1970		1980		1985		1988	
	VA	E								
Agriculture	31.1	61.2	29.2	50.4	25.5	51.4	29.2	49.0	27.3	47.0
Industry	28.5	38.8	30.7	15.7	36.2	15.5	32.3	14.2	32.7	15.4
Manufacturing	22.5	12.1	24.4	11.5	25.0	11.0	24.0	9.7	24.9	10.3
Mining	1.6	0.3	2.1	0.5	2.4	0.6	2.0	0.7	1.6	0.8
Construction and utilities	4.4	3.0	3.4	3.8	7.7	4.0	4.7	3.8	2.0	4.3
Services	40.4	23.5	40.1	33.9	38.3	32.7	38.5	36.8	40.0	37.6
<u>Total</u>	<u>100.0</u>									

Source: NEDA; NSCB

a/ Totals may not add up to 100 due to rounding off.

Declining Total Factor Productivity

From 1956 to 1970, total factor productivity in manufacturing was estimated by Hooley (1985) to have increased by 0.56 percent annually, while from 1971 to 1980, total factor productivity was estimated to have declined at the rate of 1.2 percent per year. Over the whole period 1956 to 1980, total factor productivity growth was a negative 0.15 percent per year. Within individual industries, however, total factor productivity increased throughout the whole period. The negative productivity growth across industries accompanied by positive productivity growth within industries suggests a shift from industries with high productivity to industries with low productivity during the 1950s through the 1970s (Table 5).

Little Change in Structure

The structure of production within manufacturing has not changed much since 1970, with the production of consumer goods accounting for the largest share of about one-half of manufacturing value added on the average, followed by the production of intermediate goods and capital goods (Table 6). Among consumer goods, the manufacture of food products alone represented 40.0 percent of manufacturing value added in 1985. The share of intermediate goods in manufacturing value added rose to 31.1 percent in 1975 from 27.9 percent in 1970 mainly on account of the increase in the production of chemical products, but this has settled down to an average of 25.0 percent in 1980 and 1985. Capital goods production has accounted for an average share of about 20.0 percent of value added in the manufacturing sector since 1970.

Table 5
TOTAL FACTOR PRODUCTIVITY GROWTH
IN PHILIPPINE MANUFACTURING
(%)

	1956-80	1956-70	1971-80
<u>All Manufacturing</u>	-0.15	0.56	-1.23
Within Industry	0.49	0.77	0.34
Across Industries	-0.64	-0.21	-1.57

Source: Hooley (1985)

Table 6
STRUCTURE OF MANUFACTURING VALUE ADDED

Sub-sectors	Percentage Shares				
	1970	1975	1980	1985	1988
Consumer Goods	50.6	49.1	48.9	54.5	52.4
Food	39.4	36.0	36.3	40.1	39.6
Beverage	3.0	2.9	3.2	3.7	3.3
Tobacco	3.6	5.5	4.5	4.5	2.8
Footwear & Wearing Apparel	3.8	4.2	4.4	5.6	6.2
Furnitures & Fixtures	0.8	0.6	0.6	0.5	0.6
Intermediate Goods	27.9	31.1	29.8	25.1	24.9
Textiles	5.5	5.1	4.5	3.4	4.0
Wood & Cork	3.1	2.5	2.9	2.5	1.8
Paper	0.8	0.9	0.8	0.7	0.9
Publishing & Printing	1.3	1.5	1.4	1.8	2.0
Leather	0.4	0.3	0.3	0.3	0.3
Rubber	1.5	1.7	1.3	1.3	1.4
Chemicals	5.6	8.6	10.2	7.9	7.2
Petroleum and Coal	7.0	7.7	5.9	5.4	5.4
Nonmetallic Minerals	2.8	2.7	2.5	1.7	1.9
Capital Goods	20.2	18.6	20.1	18.4	20.8
Basic Metals	3.4	3.3	3.7	5.0	5.2
Metal Products	5.2	4.2	4.5	3.5	3.5
Machinery, except Electrical	3.7	3.0	3.1	1.9	2.1
Electrical Machinery	4.4	3.9	5.0	7.4	9.2
Transport Equipment	3.6	4.2	3.8	0.6	0.7
Miscellaneous Manufacturers	1.3	1.2	1.1	2.1	1.9
Total Manufacturing	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>
Memo item:					
(GDP in millions at constant 1972 prices)	11,823	16,537	23,175	21,541	

Source: NEDA; NSCB

Production Structure Concentrated in Metro Manila

By all measures, whether in terms of number of firms, employment, value added or fixed assets, there is a strong degree of concentration of manufacturing activities in Metro Manila and the surrounding core regions (Ranis et al., ILO 1974; Pernia, Paderanga et al. 1983; Asian Development Bank 1986; World Bank 1987c).

In 1983, 41.4 percent of all firms were located in Metro Manila. If Regions III and IV are included, the proportion goes up to 65.0 percent of all firms. The concentration increases with the size of firms, with 62.0 percent of firms with 50 or more workers being in Metro Manila as compared to only 35.0 percent of firms with less than 10 workers (Table 7). The degree of concentration becomes even more pronounced when output and employment are used as the indicators of concentration. Metro Manila employs about one-half of all workers in manufacturing, the employment concentration rising with the size of firm (Table 8). In terms of output, Metro Manila contributes 56.5 percent of the total output in manufacturing.

Since the import substitution drive of the 1950s and 1960s was heavily dependent on imported materials and intermediate and capital goods, the industries established were located near their source of supply which is the port of Manila. Moreover, the structure of financial and government institutions, as well as the availability of infrastructure facilities, favored Metro Manila and its environs. Despite fiscal incentives offered to firms locating outside of Metro Manila, the net effect of the incentives system worked against the dispersal of industries outside of the National Capital Region.

Structure Is Biased Against Small and Medium Scale Industries (SMIs)

While SMIs accounted for 80.0 percent of the total number of firms with at least 10 workers in 1983, they only accounted for less than a fourth of total employment and a tenth of value added of such firms (Tecson, Valcarcel and Nuñez 1989). These shares of employment and output are considerably below their levels in 1972.

The discrimination against SMIs has taken on many forms. The import and exchange controls of the 1950s and, later, the import restrictions of the 1960s and 1970s undoubtedly favored large enterprises which had both the economic and political power to influence the allocation of import licenses and foreign exchange. Moreover, the tax exemptions for "new and necessary" industries, replaced later by different versions of investment incentives packages, have not benefited small enterprises. Larger firms had the advantage over SMIs in terms of their ability to transact business with the Board of Investments (BOI)

Table 7
REGIONAL DISTRIBUTION OF FIRMS
BY NUMBER AND SIZE, 1983

Size of Firm in Terms of No. of Employees	Metro Manila	Regions III & IV	Other Regions
Less than 10	35.4	24.5	40.1
10-19	49.1	16.8	34.2
20-49	54.2	16.5	29.3
More than 50	62.3	15.8	21.9
Total	40.0	22.6	37.4

Source: National Statistics Office (NSO).

Table 8
REGIONAL DISTRIBUTION OF FIRMS
BY OUTPUT, EMPLOYMENT AND FIXED ASSETS

Size of Firm in Terms of No. of Employees	Metro Manila	Regions III & IV	Other Regions
<u>1. Percentage of Output (1978)</u>			
1-9	34.5	26.7	38.4
10 +	57.0	26.3	16.7
Total	56.5	26.4	17.1
<u>2. Percentage of Employees (1979)</u>			
1-4	14.4	25.6	60.0
5-9	23.8	31.7	44.5
10-19	37.9	25.8	36.3
20-49	59.5	14.2	26.3
50-99	65.4	12.4	22.2
100 +	61.1	17.0	21.9
Total	50.2	19.3	30.5
<u>3. Percentage of Fixed Assets (1980)</u>			
Total	39.1	25.5	35.4

Source: NSO Census of Establishments, 1978 and Annual Survey of Establishments in Manufacturing, 1980; taken from Asian Development Bank (1986).

for the registration and availment of incentives. With respect to technology, large industries have had access to foreign technologies through licensing agreements or equity participation by foreign firms. On the other hand, SMIs have had to be content with obsolete and low productivity technology, the upgrading of which has received inadequate government support. Export promotion measures have also not been neutral as to size of firm, especially because of the cost of incentive availment and the late release of imported inputs for exports. (See Section III.E for related discussion.)

Increasing Share of Nontraditional Exports in Total Exports
But Nontraditional Manufactured Exports Concentrated in Only
Three Products

There was little perceptible change in the Philippine trade structure between 1950 and 1970 (Albuero, Medalla and Pante 1988). The top ten principal exports composed of primary products (copra, sugar, bananas, logs, lumber, desiccated coconut, coconut oil, abaca, copper concentrates and gold) accounted for 75.0 to 85.0 percent of all exports. Since the early 1970s, however, there have been significant shifts in the structure and pattern of trade, partly due to the external shocks that affected almost all open economies, and partly due to the conscious policy shift towards the exports of manufactures and the incentives provided to promote them. In particular, the Philippines benefited from the measures it took to place export firms on a free-trade basis (World Bank 1979).

The share of the ten principal (traditional) exports fell dramatically to 28.4 percent in 1985 and 23.0 percent in 1988 (Table 9). Conversely, the share of nontraditional manufactured exports, such as electronic components, garments, handicrafts, chemicals, leather and footwear products, furniture and fixtures, in total exports rose from only 8.3 percent in 1970 to 71.6 percent in 1985. In 1988, nontraditional manufactured exports accounted for a little over three-fourths of total exports. The growth of nontraditional manufactured exports was certainly the most dynamic component of export growth since the early 1970s, growing by an average of 32.0 percent per year since 1972.

Despite the notable performance of nontraditional manufactured exports since the early 1970s, a fundamental weakness in the export structure remains, because nontraditional exports of manufactures have been concentrated in just three products, namely semi-conductors, garments and handicrafts (Table 10). In 1985 and 1988, exports of garments and semi-conductors accounted for almost two-thirds of all nontraditional manufactured exports. Moreover, as compared to the processing of primary commodities, nontraditional manufacturing is considerably dependent on imported inputs and has limited linkages with the domestic manufacturing sector. As a result, the rapid growth in

Table 9
 PERCENTAGE SHARES OF TRADITIONAL AND
 NONTRADITIONAL EXPORTS IN TOTAL EXPORTS
 (%)

	1960	1970	1980	1985	1988
Traditional Exports	91.7	92.0	53.7	28.4	23.0
Nontraditional Exports	8.3	8.0	46.3	71.6	77.0
TOTAL EXPORTS ^{a/}	100.0	100.0	100.0	100.0	100.0

^{a/} Excluding Special Transactions and Re-Exports

Source: DER, Central Bank of the Philippines.

Table 10
 PERCENTAGE DISTRIBUTION OF
 NONTRADITIONAL MANUFACTURED EXPORTS
 (%)

	1970	1975	1980	1985	1988
Garments	--	27.3	25.0	22.5	28.2
Electrical and Electronic Components	--	12.8	33.5	38.2	31.6
Handicrafts	6.9	12.5	7.4	4.9	5.3
Others	93.1	47.4	34.1	34.4	34.8
<u>Total</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>

Memo items:

Total exports of nontraditional manufacturers (in US\$ M)	72	367	2,005	2,765	4,667
---	----	-----	-------	-------	-------

-- Less than one percent

Source: DER, Central Bank of the Philippines.

nontraditional manufactured exports has led neither to an acceleration in overall manufacturing growth nor to any substantial change in the structure of the manufacturing sector.

Incentive Structure Biased in Favor of Capital Intensity

Fiscal incentives in the form of tax and duty exemptions and subsidized industrial credit, as well as the government's own initiatives in establishing large-scale capital intensive industrial projects in the 1970s, have all tended to promote capital intensity in the manufacturing sector. Capital deepening can be observed in many subsectors of manufacturing, most notably in food, beverages, chemicals, cement, iron and steel, fabricated metals and transport equipment, wherein capital labor ratios increased significantly between 1960 and 1980 (Table 11). Moreover, except in the case of chemicals and iron and steel, the increase in capital labor ratios was not accompanied by corresponding increases in labor productivity (World Bank 1987c).

III. REVIEW AND ASSESSMENT OF INDUSTRIAL POLICIES AND PROGRAMS

A new Philippine Development Plan was prepared shortly after the Aquino government took over in 1986, covering the period 1987 to 1992. The role of industrial restructuring and development in the country's overall development is stated as follows (p. 145):

The industrial and trade sectors shall be mobilized to contribute to the attainment of economic recovery in the short and medium term, and sustained growth in the long term. Consistent with the overriding objectives of employment generation, poverty alleviation, and an equitable distribution of the fruits of development, industrial concerns shall focus on the revitalization of existing industries that are economically viable and on the development of world-competitive industries which shall complement the growth in both agricultural output and rural income. Increases in foreign exchange earnings shall likewise be pursued to finance imports and augment the requirements for industrial expansion and to meet foreign debt obligations.

The industrial sector as a whole is targeted to grow at an average annual rate of 8.8 percent during the Plan period. This increase in industrial output is expected to be translated into a growth in industrial employment of 8.3 percent per year. Within the broad industrial sector, manufacturing is targeted to post a growth rate of 7.6 percent per year, reflecting a better performance as compared to the sector's performance in the 1960s

Table 11
INDICATORS OF CAPITAL INTENSITY AND LABOR PRODUCTIVITY
IN MANUFACTURING

Code	Industry Group	1960		1980		a/
		FA/L	VA/L	FA/L	VA/L	
311/312	Food	6.52	9.88	10.98	7.40	
313	Beverage	5.41	15.20	12.31	14.63	
314	Tobacco	2.70	6.53	3.12	18.85	
321	Textiles	6.99	4.17	8.80	4.17	
322	Wearing apparel except footwear	1.33	2.44	1.26	2.03	
323	Leather and products	4.01	4.78	3.13	2.67	
324	Footwear	1.48	2.55	1.78	1.57	
331	Wood products	4.77	4.01	5.11	13.98	
332	Furniture and fixtures	1.75	2.72	1.52	1.83	
341	Paper and products	14.12	10.11	17.88	11.09	
342	Printing/Publishing	3.61	5.29	5.59	4.60	
351	Industrial chemicals	17.56	7.82	23.48	30.08	
352	Other chemicals	6.29	16.72	6.46	14.34	
353	Petroleum refineries	62.62b/	132.18b/	68.89	207.00	
355	Rubber products	9.35	11.27	5.24	8.11	
356	Plastic products	4.72	6.04	4.90	4.73	
362	Glass products	8.54	9.77	8.96	5.79	
368	Other non-metallic	12.97	8.76	16.29	8.82	
371	Iron and steel basic	9.34	7.48	14.67	35.35	
372	Non-ferrous metal	6.77	6.77	5.69	9.13	
381	Fabricated machinery	0.06	7.56	3.35	4.10	
382	Machinery	4.95	9.07	5.43	4.45	
383	Electrical machinery	4.17	8.40	3.26	6.02	
384	Transport equipment	4.95	9.07	8.05	9.09	

a/ The 1980 data have been deflated by an index of 700% which is the approximate price increase for manufactures between 1960 and 1980.

b/ 1962.

FA/L - value of fixed assets per employee in thousand constant 1960 pesos.

VA/L - census value added per employee in thousand constant 1980 pesos.

Source: Hooley (1985) and World Bank (1987c).

and 1970s. Nontraditional manufactured exports are expected to increase by 16.5 percent per year as compared to traditional exports which are seen to grow at 12.8 percent annually. As a result, the share of nontraditional exports of manufactured products is envisioned to reach approximately three-fourths of total exports by 1992.

In order to achieve these goals, the following policy and program thrusts would be pursued: promotion of resource-based, labor-intensive, small and medium scale industries; reduction of government intervention in business through privatization and deregulation; continuation of the trade reform program initiated in 1980; rationalization of investment incentives; promotion of exports and foreign investments; promotion of the regional dispersal of industries; maintenance of a competitive exchange rate; the provision of adequate infrastructure support; and maximization of gains from international cooperation.

The Philippine Government's progress in the implementation of major policies and programs of industrial restructuring and development is reviewed and assessed in this section, with emphasis on the period after 1985. The policies and programs to be covered are the following:

- (1) Macroeconomic policies;
- (2) Trade reform;
- (3) Investment incentives reform;
- (4) Export promotion program;
- (5) Program for the regional dispersal of industries;
- (6) Program for technology upgrading and development;
- (7) Privatization; and
- (8) Financial sector reform.

A. Macroeconomic Policies

By and large, the government has pursued conservative fiscal and monetary policies since 1986. After rising to 5.1 percent of GNP in 1986 from 2.0 percent in 1984-1985, the budgetary deficit was limited to 2.8 percent of GNP in 1987 and 1988, and to 2.0 percent in 1989. ^{2/} The tax effort improved from 10.6 percent in 1986 to 12.2 percent in 1987 but there was a setback in 1988 when the tax effort went down to 11.0 percent on account mainly of the problems encountered in the introduction of the value added tax and the lower collections from ad valorem taxes on petroleum products. The tax effort, however, rose to

^{2/}

The primary fiscal balance, defined as being equal to the overall fiscal balance less interest payments, was found by Manasan (1990) to have registered deficits of 2.4 percent of GNP in 1980-1982 as compared to surpluses of 1.6 percent of GNP in 1986-1988.

12.8 percent in 1989 following improvements in the implementation of the 1986 tax reform package, particularly the value added tax.

Monetary policy was pursued cautiously in 1986 and 1987, with money supply (M3) growing by 7.3 percent and 12.1 percent, respectively (Table 12). However, in 1988, money supply growth accelerated to 22.6 percent. In March 1989, domestic liquidity rose by 26.6 percent from its year-ago level. In order to rein in the growth in liquidity, the monetary authorities adopted a number of measures which included: (a) intensified open market operations through the increased issuance of treasury bills; (2) increase in the Central Bank's rediscount rate from 10.0 percent to 12.0 percent; and (3) unification of the reserve requirement to 20.0 percent for all types of deposits and deposit substitute liabilities of commercial banks and nonbank financial institutions. The growth in M3 decelerated to 22.1 percent in September 1989 but picked up speed again in the next three months.

Accompanied by declining oil prices for most of the period, fiscal and monetary policies have helped in containing inflation to a single digit level up to 1988. The inflation rate, as measured by percentage changes in the Consumer Price Index (CPI), increased by less than one percent in 1986, 3.8 percent in 1987 and 9.0 percent in 1988. In 1989, the increase in consumer prices accelerated to 10.8 percent on account of cost push factors like the upward adjustment in domestic oil prices and power rates, the legislated 39.1 percent increase in the minimum wage of workers in the private sector and the standardization of salaries in the public sector which also had the effect of raising wages within the sector.

The peso depreciated vis-à-vis the US dollar by only 4.4 percent between February 1986 and February 1989. From the latter month to the end of 1989, the exchange rate depreciated by 4.6 percent. In terms of annual averages, the exchange rate depreciated by only 6.6 percent from 1986 to 1989 (Table 13). Despite the minimal changes in the nominal exchange rate, the effective exchange rate (EER) depreciated by 16.7 percent from 1986 to 1988 due to the direction of changes in the currencies of the country's major trading partners. The EER hardly moved at all in 1989. Furthermore, the relatively favorable price situation resulted in the depreciation of the real effective exchange rate (EER) up to 1988 despite the minimal change in the official exchange rate. In 1989, however, the real EER appreciated.

A key factor in the country's exchange rate policy has been the monetary authorities' concern for maintaining a stable exchange rate, allowing only small changes in the official rate over time. They have been particularly concerned with preventing speculative swings in the exchange rate. For instance, after the August 1987 coup attempt, the Central Bank supported the peso,

Table 12
MONEY SUPPLY AND INTEREST RATES
(End-of-Year)

	M3 (Growth Rates)	91-T-bill Rate (percent p.a.)
1983	19.90	14.03
1984	7.20	15.38
1985	9.87	42.17
1986	7.31	16.56
1987	12.12	13.59
1988		
Jan.	13.53	13.52
Feb.	16.42	11.58
Mar.	16.06	13.88
Apr.	19.30	14.94
May	21.37	15.10
June	20.96	14.36
July	19.18	14.74
Aug.	19.82	14.55
Sept.	21.00	14.66
Oct.	21.31	15.59
Nov.	23.25	16.36
Dec.	22.61	16.74
1989		
Jan.	23.48	17.00
Feb.	23.18	15.63
Mar.	26.59	15.50
Apr.	25.61	16.70
May	24.75	16.54
June	24.27	17.11
July	28.20	17.56
Aug.	26.87	19.20
Sept.	22.12	22.68
Oct.	25.67	23.16
Nov.	28.88	23.25
Dec.	27.47	20.00

Source: Department of Economic Research,
Central Bank of the Philippines

Table 13
EFFECTIVE EXCHANGE RATE INDEXES (1972-1989)

Year	P/\$ Exchange Rate	Effective Exchange Rate Index (%)	Real Effective Exchange Rate Index (%)
1972	6.67	100.00	100.00
1973	6.76	108.89	105.01
1974	6.79	107.67	87.88
1975	7.25	114.71	96.79
1976	7.44	115.78	100.43
1977	7.40	119.00	102.94
1978	7.37	130.01	110.60
1979	7.38	130.03	98.41
1980	7.51	131.52	92.51
1981	7.90	133.91	90.21
1982	8.54	136.18	87.30
1983	11.11	174.27	107.49
1984	16.70	254.57	105.04
1985	18.61	276.93	92.80
1986	20.39	348.12	117.64
1987	20.57	373.49	124.76
1988	21.09	406.36	128.67
1989	21.74	406.24	122.11
Jan.	21.34	412.38	125.64
Feb.	21.36	411.12	125.45
March	21.34	407.43	124.68
April	21.41	407.19	125.03
May	21.58	403.38	123.01
June	21.68	398.96	119.13
July	21.89	407.51	121.07
Aug.	21.88	406.29	119.23
Sept.	21.97	403.78	118.05
Oct.	21.96	-	-
Nov.	22.10	-	-
Dec.	22.34	-	-

Sources: Central Bank of the Philippines; International Financial Statistics, International Monetary Fund. Key Indicators of DMCs, Asian Development Bank.

resulting in a \$500 M decline in the country's gross international reserves (GIR).

As the inflation rate accelerated and the GIR dwindled, the pressure on the exchange rate mounted in 1988. Since the GIR was already at a low level, the Central Bank tightened interest rates in 1988 to reduce the speculative pressure on the peso by making foreign exchange holdings unattractive. Consequently, the 91-day Treasury bill (T-bill) rate jumped from 9.1 percent in January 1987 to 16.7 percent in December 1988. Prior to 1988, interest rates had actually been declining from an average of 41.0 percent (91-day T-bill rate) in 1984 to 11.4 percent in 1987. In 1989, the Central Bank continued to pursue a high interest rate policy in order to defend the exchange rate and siphon off "excess liquidity." The 91-day T-bill rate soared to 23.25 percent per annum in November 1989 and settled at 20.0 percent per annum at the end of the year. The use of monetary policy indeed enabled the monetary authorities to shore up the peso in 1988 and 1989.

There are indications, however, that the use of monetary policy to defend the peso can no longer be sustained. First, real interest rates are already high; a further increase will have a dampening effect on investments. Second, the rapid build-up in the country's trade and current account deficits in 1989 is symptomatic of an overvalued domestic currency, requiring a major realignment in order to maintain the rate's competitiveness and arrest the unabated large increases in the country's imports.

The current account developments in 1989 clearly demonstrate that the peso is overvalued. The current account deficit more than quadrupled from \$373 M or 1.0 percent of GNP in 1988 to \$1.5 B or 3.5 percent of GNP in 1989 (Table 3). Moreover, the trade balance more than doubled from \$1.1 B in 1988 to \$2.6 B in 1989. Merchandise exports grew by only 10.6 percent, lower than the target of 13.6 percent. On the other hand, imports increased by 27.7 percent, higher than the programmed 17.2 percent. Actually, imports in US dollar terms increased by 33.6 percent in 1987 and 21.1 percent in 1988 after declining by 18.9 percent in 1984, 15.8 percent in 1985 and 1.3 percent in 1986. Export receipts dropped by 14.1 percent in 1985 but recovered in the succeeding years with growth rates of 4.6 percent, 18.1 percent and 23.7 percent in 1986, 1987 and 1988, respectively. Export growth has been led by electronics, electrical equipment and garments. Imports have been principally composed of raw materials and intermediate and capital goods. Imports of finished consumer goods have accounted for only about 10.0 percent of total imports.

The government's target of 6.3 percent annual average growth rate in real GNP for 1990-1992 calls for a substantial rise in investments from 18.9 percent of GNP in 1989 to 24.7 percent in 1992. Considering the relatively high import intensity of investments, the implementation of the government's development

program can be expected to continue to exert pressure on the country's external accounts. This problem is made doubly difficult by the heavy external debt problem that the country has to bear. While the debt to GNP ratio has been reduced from 94.0 percent in 1986 to 62.8 percent in 1989, and the debt service ratio, from 34.0 percent in 1986 to 29.0 percent in 1989 (prior to adjustments for debt conversions), the net transfer of resources abroad is estimated to remain at about \$2 B per year up to 1992. Accordingly, greater efforts are necessary to expand exports, promote foreign investments and obtain substantial debt relief.

The government's latest projections (as of March 1990) show that a total external resource inflow of \$9 B or \$3 B per year will be required during 1990-1992, assuming export growth to be 15.0 percent per year (18.8 percent in the case of manufactured exports), import growth to be 12.5 percent per year, net inflows of foreign investments to be a little less than \$1.0 B during the three-year period, and disbursements of medium and long-term loans to average about \$2.3 B annually from 1990 to 1992.

B. Trade Reform

Trade policy is very much intertwined with industrial policy. With its pervasive effects on the relative price and incentive structure, it has a direct bearing on industrial structure and industrial development. Indeed, trade policy has been one of the major tools for development.

The Philippines, in particular, has employed a restrictive trade regime to promote import-substituting industries, starting as early as the 1950s. There were short periods of decontrol but on the whole, the import-substitution bias has persisted until now. It was only in the 1980s that major trade reforms were undertaken.

The trade reforms started in 1981 contained three components: (1) the 1981-85 Tariff Reform Program (TRP); (2) import liberalization; and (3) indirect tax realignment. The TRP proceeded as planned. The indirect tax realignment was implemented in the latter part of 1985. The second component was shelved in view of the balance of payments crisis which erupted in August 1983.

Amid some degree of controversy, the present government continued the trade reforms started. Many more items were liberalized. In addition, one of its priority acts was the removal of all export taxes, except for logs, which imposed a heavy burden on the agricultural sector.

1,477 PSCC Lines Liberalized from 1986 to 1989

The import liberalization program resulted in the lifting of import restrictions on around 1,477 PSCC lines from 1986 to 1989.

This reduced the number of regulated items as a percentage of the total number of PSCC lines from around 34.1 percent in 1985 to only 8.0 percent by the end of 1989 (Table 14).

The Tariff Commission constructed a frequency index of regulated items by sector and by year. The number of PSCC lines in a still-regulated sector were tabulated (referred to as PSCC lines with NTMs or nontariff measures) by year and then divided by the total number of lines in the sector to estimate the NTM coverage. The results are presented in Table 15. In 1985, the NTM coverage for agriculture and fishing was around 30.6 percent, close to that for manufacturing with 32.1 percent. The NTM coverage went down to only 1.6 percent for agriculture while that for manufacturing went down to 9.4 percent in 1988. Thus, based on frequency index alone, there seems to have been a greater liberalization in agriculture.

The different sectors within the manufacturing sector have not been uniformly affected. There was virtually no liberalization in electrical machinery and transport equipment. In 1988, this sector had the second highest NTM coverage at around 20.8 percent. (Fishing had the highest index at 34.8 percent.) Non-metallic mineral products and food processing were two other sectors with higher than average NTM coverage.

Admittedly, such a frequency index has inherent shortcomings. Still, these figures give an indication as to what industrial structure is favored and encouraged by trade policy. The uneven treatment is brought out more clearly by the effective protection rate (EPR) estimates computed by the Tariff Commission-PIDS joint research project.

EPR Variation Reduced But Biases Remain

The EPR estimates, whether using book rates or price comparisons, show large variation in protection across sectors. The import liberalization episodes brought down steadily the average EPR from 49.0 percent in 1985 to 36.5 percent in 1988. (These estimates made use of price comparisons whenever feasible and applicable.) The decline was exhibited in all importable sectors while the EPR for exportables improved with the removal of export taxes in 1986. The gap between the importable and exportable sectors, thus, narrowed down.

To illustrate more clearly the movement in EPR in relative terms, the $(1+EPR)$ index by sectors was computed (Table 16). With agriculture set to 100, the index for manufacturing declined from 143.6 in 1985 to 135.1 in 1988. At the same time, the index for exportables rose, from 77.1 in 1985 to 83.3 in 1988.

The average and aggregate figures can hide large variations and contrary movements. Still, the study shows that the import liberalization episodes from 1986 to 1988 reduced the disparities

Table 14
NUMBER OF ITEMS REGULATED, LIBERALIZED
AND NEWLY REGULATED BY YEAR
1977 TO 1988

	Total Number Regulated	Newly Regulated	Liberalized	No. of Regulated Items as a Percent of Total Number of PSCC Lines (%)
1977	1892	47	-	33.5
1978	1926	34	-	34.2
1979	2031	104	-	36.0
1980	2032	1	-	36.0
1981	1771	2	263	31.4
1982	1438	277	610	25.5
1983	1988	598	48	35.3
1984	1994	6	-	35.4
1985	1924	-	70	34.1
1986	973	-	951	17.3
1987	802	-	171	14.2
1988	579	-	223	11.9
Apr. 1988			129	
Dec.	579	-	94	10.2
1989	453	-	126	
March			3	
July			54	
September			13	
October			17	
December	453		39	8.0

Source: National Economic and Development Authority, Tariff Commission.

Table 15
 NTH COVERAGE BY MAJOR GROUPS
 (1984-1988)

RATIO OF PSCCs WITH NTHs TO TOTAL PSCC

I/O	S E C T O R	1984		1985		1986		1987		1988		
		Total No. of PSCCs in Sector	PSCCs w/ NTHs Coverage (%)									
03-96	ALL SECTORS	5,498	1790	32.56	1720	31.28	783	14.24	614	11.17	485	8.82
03-22	AGRICULTURE, FISHING AND FORESTRY	406	122	30.05	118	29.06	33	8.13	30	7.39	14	3.45
03-13	Agriculture	323	87	26.93	84	26.01	24	7.43	21	6.50	5	1.55
19-20	Fishing	23	22	95.65	22	95.65	8	34.78	8	34.78	8	34.78
21-22	Logging & Others	60	13	21.67	12	20.00	1	1.67	1	1.67	1	1.67
23-27	MINING	108	1	0.93	1	0.93	1	0.93	1	0.93	1	0.93
28-96	MANUFACTURING	4,984	1667	33.45	1601	32.12	749	15.03	583	11.70	470	9.43
28-45	Food Processing	536	268	50.00	240	44.78	82	15.30	80	14.93	65	12.13
46-50	Beverages and Tobacco	57	52	91.23	48	84.21	7	12.28	2	3.51	0	0.00
51-55	Textile and Footwear	706	276	39.09	268	37.96	149	21.10	77	10.91	1	0.14
56-58	Wood and Wood products	164	18	10.98	15	9.15	0	0.00	0	0.00	0	0.00
59-66	Paper, Rubber, Leather & Plastic Prod.	491	216	43.99	203	41.34	73	14.87	15	3.05	15	3.05
67-75	Chemicals and Chemical Products	676	129	19.08	129	19.08	70	10.36	66	9.76	60	8.88
76-79	Nonmetallic Mineral Products	234	81	34.62	79	33.76	50	21.37	40	17.09	30	12.82
80-82	Basic Metals and Metal Products	605	209	34.55	207	34.21	26	4.30	11	1.82	7	1.16
83-91	Mach. incl. Electr. & Transp. Eqpt.	1,008	213	21.13	213	21.13	210	20.83	210	20.83	210	20.83
92-96	Miscellaneous Manufactures	507	205	40.43	199	39.25	82	16.17	82	16.17	82	16.17

Note: The count is not exhaustive as certain I-O sectors considered nontraded were left out.

Source: Tariff Commission

Table 16
 (1+EPR) INDEX BY MAJOR GROUPS
 1985, 1986, 1988
 Using price comparison

	1985	1986	1988
ALL SECTORS	123.45	121.09	118.58
Exportables	77.11	83.31	83.28
Importables	167.53	157.01	152.16
AGRICULTURE, FISHING & FORESTRY	90.28	91.25	91.41
Exportables	75.80	81.93	81.93
Importables	148.78	128.87	129.70
AGRICULTURE	100.00	100.00	100.00
Exportables	77.34	86.27	86.27
Importables	150.95	130.85	130.85
FISHING	89.10	90.61	91.08
Exportables	81.36	86.06	86.05
Importables	143.96	122.89	126.70
FORESTRY	64.91	67.54	67.54
Exportables	62.29	65.33	65.33
Importables	130.61	122.80	122.80
MINING	82.66	85.15	85.15
Exportables	75.81	79.08	79.08
Importables	102.87	103.05	103.05
MANUFACTURING	143.58	139.16	135.09
Exportables	79.14	85.85	85.77
Importables	171.68	162.41	156.59

Agriculture = 100

in EPRs across sectors. However, although not insignificant, the impact was not large enough to substantially alter the inherent biases of the protection structure.

On the whole, the trade reform program has been successful in bringing down nominal and effective rates of protection and in reducing variation in the latter across sectors. They have certainly been in the right direction. Nonetheless, the reforms which have been implemented so far have not been enough to alter the biases of the protection system against exports and agriculture. Accordingly, further reforms are needed to lower the level and dispersion of effective protection. Moreover, it is important for the government to sustain the implementation of the import liberalization program, in order to give a consistent policy signal to the private sector. Finally, to obtain the full benefits from trade reform, the latter should be complemented by the appropriate fiscal, monetary and exchange rate policies.

C. Investment Incentives Reform

The Philippines institutionalized the system of investment incentives with the Investment Incentives Act of 1967, later supplemented in 1970 with the enactment of the Export Incentives Act (RA 6135). Since then, it has been amended and codified three times, culminating with Executive Order No. 226 (EO No. 226) otherwise known as the 1987 Omnibus Investment Code (OIC). EO No. 226 superseded Batas Pambansa 391 (BP 391) passed in 1983 which introduced innovative forms of incentives.

Fiscal incentives for investment, as offered by the Board of Investments (BOI), make up another policy tool for influencing industrial activity. Some view BOI incentives as primarily a means to promote "infant" industries. While a case could be made for assisting infant industries, the implementation of such a program is administratively difficult, with large probabilities of committing mistakes. From deciding on the process of selection to the actual selection process which could cover a gamut of industries, and so forth, the administrative problems are daunting. This arises mainly from the extreme difficulty in predicting which "infants" have potential comparative advantage. Government intervention could only very likely introduce more distortions, further increasing the probability of choosing the "wrong" industries. In order to be more manageable, then, and if the government is to grant incentives to "infant" industries, it should choose very judiciously only a few industries at a time, using the most neutral policy measures.

BOI incentives can be more easily justified as a means to provide compensating adjustments to counteract the bias against exports of the prevailing trade regime. Additionally, given the imperative for employment generation, BOI incentives could seek to promote relatively more labor-using industries. It is thus important to know how the investment incentives system fares on

these two counts, i.e., promoting exports and labor-using industries.

A rationalization for the reform of the investment incentives implemented under EO 226 is to make the incentive package competitive with those offered by other ASEAN countries. Whether the intention is to attract more foreign investment or to promote "infant" industries deemed necessary for industrial development, the fact remains that the investment incentives unavoidably would have an industrial policy bias, particularly with regard to domestic vs. export producers, and labor-intensive vs. capital-intensive industries (not to mention industry vs. agriculture). Thus, a review of the investment incentive system would necessarily entail an assessment of how it affects factor prices (capital vs. labor) and exports.

BP 391 Superior to EO 226 in Terms of Promotion of Labor-Intensive and Export Industries

BP 391 introduced an innovative form of incentive, i.e., a tax credit equivalent to a certain percentage of net value earned and net local content (10.0 percent for exports). This was replaced in the 1987 OIC by the income tax holiday for a duration ranging from three to eight years. Manasan (1989) estimated the impact on the internal rate of return (IRR) of the important provisions of BP 391 and EO 226 on a hypothetical BOI registered firm. Her results show that the increment on the IRR of exporters is three to four times as large as that of non-exporters under BP 391 while EO 226 differentiates only between pioneer and nonpioneer enterprises. Consequently, the inducements given to exporters were reduced by half while benefits made available to non-exporters almost doubled under the new OIC.

The impact of EO 226 could also be deduced from selected statistics on BOI-approved projects from 1981 to 1988 under the successive versions of the Investment Incentives Act - P.D. 1789, amended by BP 391 in 1983, then superseded by EO 226 in 1987. The statistics are very revealing (Tables 17a and 17b). The number of firms rose and fell with the state of the economy. Most interesting, however, are the figures for the capital-labor ratio (K/L), which is estimated by project cost divided by employment, and average cost per firm, which could indicate size. The K/L ratio fell drastically during the period 1983 to 1986 when BP 391 was effective, from ₱512,740 per employee in 1982 to ₱83,660 in 1986. Then, the ratio started to pick up in 1987 with EO 226, more than doubling in 1988 to ₱224,290 per employee. Deflating by the GNP deflator did not alter the results. A similar trend is also apparent for average cost per firm.

These results clearly indicate the capital bias of the investment incentive system prior to 1983, which to some extent seems to have been reinstated in 1987 with EO 226. The figures

Table 17a
 SELECTED STATISTICS ON NEW AND EXPANSION PROJECTS
 APPROVED UNDER P.D. 1789 (WITH INCENTIVES)
 (1981-1988)
 (In P000 Nominal Cost)

YEAR	No. of Firms	Project Cost (Nominal)	Employment	K/L	Average Cost per Firm
	(1)	(2)	(3)	(2)/(3)	(2)/(1)
1981	193	11,364,366	53,110	213.98	58,882.73
1982	143	14,497,342	28,274	512.74	101,380.01
1983	143	7,437,044	27,980	265.80	52,007.30
1984	121	7,203,588	37,830	190.42	59,533.79
1985	136	2,742,089	23,961	114.44	20,162.42
1986	114	2,191,961	26,201	83.66	19,227.73
1987					
P.D. 1789	230	5,369,942	48,782	110.08	23,347.57
E.O. 226	181	4,474,199	33,319	134.28	24,719.33
1988 *	616	28,720,161	128,052	224.29	46,623.64

* E.O. 226

Source: Department of Trade and Industry.

Table 17b
 SELECTED STATISTICS ON NEW AND EXPANSION PROJECTS
 APPROVED UNDER P.D. 1789 (WITH INCENTIVES)
 (1981-1988)
 (In P000 Real Cost)

YEAR	No. of Firms	Project Cost a/ (Real)	Employment	K/L	Average Cost per Firm
	(1)	(2)	(3)	(2)/(3)	(2)/(1)
1981	193	11,364,366	53,110	213.98	58,882.73
1982	143	13,371,779	28,274	472.94	93,508.94
1983	143	6,142,534	27,980	219.53	42,954.78
1984	121	3,970,818	37,830	104.96	32,816.68
1985	136	1,278,566	23,961	53.36	9,401.22
1986	114	1,005,223	26,201	38.37	8,817.75
1987					
P.D. 1789	230	2,283,490	48,782	46.81	9,928.22
E.O. 226	181	1,902,588	33,319	57.10	10,511.54
1988 *	616	11,187,537	128,052	87.37	18,161.59

* E.O. 226

a/ Deflated by GNP deflator (1981=100)

Source: Department of Trade and Industry.

also tend to confirm the bias of the system in favor of larger firms. There is, therefore, a need to reform the investment incentives package. In particular, more factor neutral incentives should be adopted and the larger inducement to exporters as compared to non-exporters should be restored. Moreover, there is ample room for further simplifying the administrative requirements in incentives availment and in reorienting the Board of Investments' functions from investment regulation to promotion.

D. Export Promotion Program

Aside from BOI export incentives provided under the OIC, there are other export promotion measures which are aimed at granting exporters access to intermediate inputs at world market prices, thereby putting exports under a "free trade" status. Tax and duty-free access to intermediate inputs is extended through outright tax and duty exemptions, or the tax and duty drawback mechanism.

Exporters may avail themselves of tax and duty exemption on imported inputs through any one of the following:

- (1) Locating in an export processing zone (EPZ),
- (2) Using bonded manufacturing warehouse (BMW) facilities; and
- (3) importing under Customs Administrative Order 3-78 (CAO 3-78).

On the other hand, tax and duty drawback on imported intermediate inputs used in export production may be availed of under the following:

- (1) individual drawback scheme of the Bureau of Customs (BOC); and
- (2) fixed drawback scheme of the BOI.

Manasan (1989) made an inventory of the documentary and other requirements for availing of the incentives under these various export promotion programs. Her findings show that there are still too many requirements. The procedures remain long and tedious. For example, the documentary requirements for the establishment of a BMW add up to at least 15. Foremost of these are (1) a "formula of manufacture"; and (2) a feasibility study. There are also fees which make BMWs costly to operate.

Judging from the number of requirements and the complexity of procedures, the availment of export incentives, primarily tax and duty-free importation of intermediate inputs, is still far from being automatic. Furthermore, all exporters, except those

located in an EPZ, are still required to get BOI certification of non-availability of domestic substitute for the imported raw materials. With these limitations, it is not difficult to comprehend that the current export promotion programs are not as far reaching as desired. The largest improvement in the export promotion program would involve the increasing automaticity of export incentives availment. The first-best solution is, of course, trade liberalization. However, because this is not feasible in the immediate period, the more extensive application of standard duty drawback, common bonded warehouses and the like, should be pursued.

One other aspect of the export promotion program that needs attention is that of export financing, more specifically pre-shipment export financing, which currently seems to be weak and ineffective. Among the measures which can be considered are: the development of a domestic L/C system, the provision of equal access by indirect exporters to the Central Bank's refinancing facility and the strengthening of pre-shipment export finance guarantee schemes.

E. Program for the Regional Dispersal of Industries

The current government's objective and strategy in the area of regional dispersal of industries are spelled out in the Medium Term Philippine Development Plan, 1987-1992 as follows:

The dispersal of industries to the regions shall be pursued to create employment and income opportunities in the countryside and to slow down rural out-migration. Towards this end, emphasis shall be given to labor-intensive, rural-based industries that are consistent with the region's natural and human resources. Specifically, the development of micro, cottage, small and medium resource-oriented and agro-based types of industries shall be supported.

Efforts in industrial dispersal shall focus on the promotion of rural credit, the selective decentralization of government services to facilitate administrative processes and procedures, and the provision of better and more reliable industrial support services such as infrastructure, access to markets and technology, product development and skills upgrading. (p. 62)

To be sure, the concern for a more balanced regional distribution of industries in the country has been articulated in various Philippine development plans prepared since the early 1960s. Among the major instruments which have been utilized by the government for industrial dispersal are (Louis Berger International Inc. 1986): (1) fiscal incentives; (2) development

of industrial estates and export processing zones; (3) credit and financial policies, particularly those supporting small and medium scale industry development; and (4) zoning regulations. While infrastructure expenditure policy has been recognized as a potentially effective tool for the regional dispersal of industries, this has not been pursued actively (Javier 1975). In fact, the allocation of public investments has continued to be skewed in favor of the National Capital Region, Central Luzon and Southern Tagalog. Public investments in these regions represent about 30.0 percent of total region-specific public investments, based on the Medium Term Public Investment Program for 1989-1992. On the other hand, the shares of most other regions in the total region-specific public investments range from only 2.0 to 4.0 percent: Region I, 2.0 percent; Region II, 2.4 percent; Region IX, 2.8 percent; Region X, 3.0 percent; Region XI, 3.6 percent; and Region XII, 3.7 percent.

Fiscal Incentives

The use of fiscal incentives to promote industrial dispersal started in 1973 with the amended Export Incentives Act (PD 6135 as amended). If a registered export producer located its plant in a BOI-designated area, the following additional incentives were extended: (1) increased deduction from taxable income through the doubling of its direct labor costs permissible up to 25.0 percent of export revenues; (2) a tax credit equivalent to 100.0 percent of the cost of such necessary infrastructure facilities as portworks, waterworks and roads put up by the export producer.

In a study of the effects of Philippine fiscal incentives for industrial promotion, Gregorio (in Bautista, Power and Associates 1979) pointed out that the additional tax deduction for direct labor costs does not make any difference to firms with relatively high direct labor and raw material costs as indicated by their having reached the 25 percent ceiling, since they would be enjoying the same level of incentives regardless of where they locate their firm. On the other hand, firms with low local raw material and direct labor costs would obtain high marginal benefits from operating in a government-preferred location. Thus, even if the incentive had any impact at all, it would have worked at cross purposes with other objectives inasmuch as it favored the dispersal of firms with relatively fewer backward linkages to the regions as well as of those which are relatively less labor-intensive.

With respect to the tax credit for the cost of necessary infrastructure which the firm undertakes, it would not have attracted, by itself, a firm to prefer a less developed area over a more developed one. In the first place, it would still be necessary for the firm to incur additional costs up-front, a factor which would adversely affect the firm's cash flow position at a critical stage of operations. Moreover, since the refund is

granted in the form of a tax credit, the benefit which the firm eventually obtains is limited by the firm's liability which is usually small or zero at the early stages of the firm's life. It is, therefore, not surprising that only five (5) out of a total of 1,537 BOI-registered firms availed themselves of the tax credits for infrastructure works between 1975 and 1980.

In 1979, a special legislation was enacted to promote the development of lagging areas. This was BP 44, the "Investment Promotions Act for Less Developed Areas," under which all BOI-registered enterprises locating in "less developed areas" designated by the BOI could avail themselves of all incentives previously granted only to pioneer enterprises, with the exception of the exemption from the payment of the sales tax. The net impact of BP 44 incentives on the firm's rate of return was estimated to be anywhere from zero percent to 3.5 percent, hardly sufficient to offset the advantages of more developed areas, particularly Metro Manila, over less developed areas as an investment destination (Louis Berger International, Inc. 1986). Accordingly, from 1980 to 1982, out of a total of 17 projects which were approved under BP 44, only three were in manufacturing. The 14 other projects were all in agriculture. Even if all the 17 BP 44 projects were counted, they would still fall considerably short of the 998 projects registered under RA's 5186 and 6135, P.D. 1789 and BP 391 during the same period.

Under EO 226, otherwise known as the "Omnibus Investments Code of 1987" another attempt was made to provide fiscal incentives for industrial dispersal. What was actually done was to combine the incentives available under BP 44 with those provided for in the 1973 Export Incentives Act, i.e., tax deduction of up to 100.0 percent of the cost of necessary and major infrastructure works undertaken by the investor. For reasons already mentioned above, the prognosis on the impact of such incentives for the regional dispersal of industries is not too encouraging.

Development of Industrial Estates (IEs) and Export Processing Zones (EPZs)

One of the mechanisms which has been utilized by the Philippine government to promote the regional dispersal of industries is the development of industrial estates and export processing zones. As a generic concept, the term "industrial estate" refers to a piece of land which is subdivided and developed for the use of a group of industries according to a comprehensive plan, and provided with the necessary infrastructure, utilities and business services, in some instances with prebuilt factory buildings and common service facilities, under a unified management. An industrial estate (IE) may take the form of a regular IE or an export processing zone (EPZ).

In the case of export processing zones under the Export Processing Zone Authority (EPZA), a host of fiscal incentives are provided. These include: (1) exemption from customs duties and internal taxes of capital equipment, raw materials and supplies, local taxes and licenses, except real estate taxes, contractor's tax, wharfage dues and export tax; (2) deduction of labor training expenses, organizational and pre-operating expenses; (3) tax credit in taxes paid on supplies and raw materials; and (4) net operating loss carry-over and accelerated depreciation.

There are now four EPZs operating in the country, one each in Baguio, Bataan, Cavite and Mactan, Cebu. There have also been a number of industrial estates operated by the government, including those under the PHIVIDEC Industrial Authority (Resources-Oriented), the National Housing Authority (Navotas, Cavite, Bulacan, Cagayan de Oro), National Development Company (Cavite) and various units under the defunct Ministry of Human Settlements. Like the firms under EPZA, those under the PHIVIDEC Industrial Authority (PIA) are also extended a number of fiscal incentives such as the exemption of capital equipment, raw materials and supplies from customs duties and internal taxes, local taxes and license and wharfage dues.

Past studies of the performance of EPZs and IEs in the Philippines (COWIConsult 1983; Louis Berger International, Inc. 1986) concluded that on the whole, they have not been effective instruments in the regional dispersal of industries. One indicator of the problems besetting EPZs and IEs is the substantial unused capacity in the existing EPZs and IEs. Obviously, the set of fiscal incentives provided in the EPZs has not been sufficient to offset the advantage which Metro Manila has over less developed regions in the country. In fact, EPZA and PHIVIDEC incentives are even less liberal than BOI incentives, especially in the case of export firms. Moreover, the distribution of EPZs and IEs in the country has been characterized by a concentration of such estates in and within the periphery of Metro Manila. The Louis Berger study (1986) reported that out of the 15 government operated EPZs/IEs, only four are operating outside of the core region composed of Metro Manila (NCR), Region III and Region IV. The IE program has also been characterized by deficiencies in the institutional set-up, exemplified by the multiplicity of agencies involved in IE development and by the lack of coordination among them. The situation has not really improved after the abolition of the Ministry of Human Settlements because the IEs which used to be operated by the defunct Ministry were placed under the Office of the President rather than the Department of Trade and Industry. COWI Consult (1983, p. 114) aptly concluded that:

The totality of these individual programs does not seem to reflect a rational system of industrial estates -- in terms of location, size and type, resulting in an over concentration of estates in

or near Metro Manila, over-emphasis on export processing zones, and over-investment in estates (resulting in excess capacity in IEs).

Finally, by the very nature of EPZ operations, EPZ companies tend to be import-dependent, resulting in minimal backward linkages with the rest of the economy. This provides quite a narrow foundation for a broad-based and self-sustaining growth. Their reliance on the export market also adds a measure of vulnerability to adverse developments in world market conditions.

The case of the Bataan Export Processing Zone (BEPZ) has been well-researched.^{3/} By and large, these studies are critical of its location, design and socio-economic impact, the major conclusion being that the benefits derived from the BEPZ do not outweigh its costs, resulting in an excessive and wasteful public expenditure in a remote area in the country. Moreover, from the viewpoint of one of the major objectives of the Zone, Castro (1984) concluded that the record of the BEPZ has thus far been modest: more than one-fourth of the firms in the Zone are wholly Filipino owned and a good proportion of the foreign firms were found to have relied on local borrowings to finance their investments. The problem with this undertaking was that the basis for the decision as to its location was largely a political one. When the feasibility study was prepared in 1974, the assumption had to be of heroic proportions to provide economic justification for the project. Thus, the 1974 project analysis assumed that: (1) the BEPZ would reach full capacity by CY 1976-1977; (2) it would cost ₱840 M to develop 329 hectares of the zone area; (3) it would create 38,000 jobs; and (4) by 1980, annual exports from the zone would reach \$1.7 B. All of these assumptions were not realized as shown by the following: (1) by 1984, investment costs had exceeded ₱1.2 B at constant 1974 prices; (2) less than one-third of the Zone area had been developed, and occupancy was only one-half of what was projected; (3) only 20,000 factory workers were employed; (4) actual exports represented only 8.0 percent of the targeted level of exports.

The lessons from the BEPZ were not unheeded, and the subsequent choice of locations for an EPZ considered carefully the amount of new investments in infrastructure required to make the zones operational as well as the availability of manpower in the general area of the zone. However, Table 18 shows that as of 1988, even the new EPZs have not contributed significantly to the achievement of the objectives of industrial dispersal, foreign exchange generation and employment creation. In view of the campaign launched by the Aquino government to attract more

^{3/}

See for instance Ron Bergsdorff *et al.*, 1982, and Warr, 1984, also cited in Louis Berger International, Inc., 1986.

Table 18
BASIC INFORMATION ON PHILIPPINE EPZs, 1988

INDICATOR	BATAAN EPZ	MACTAN EPZ	BAGUIO EPZ	CAVITE EPZ	TOTAL
Initial Year of Implementation	1972	1979	1980	1983	
Total Area Reserved/Declared (ha.)	1600	119	66.06	275	
Developed Net Industrial Area (ha.)	172.49	35.16	16.02	30.89	254.56
Occupied Net Industrial Area (ha.)	62.24	13.85	12.99	20.71	109.79
Number of Operating Firms	26	15	12	5	58
Employment (000)	15.23	5.389	4.340	0.323	25.282
Exports (\$M)	70.6	110.1	223.2	2.8	406.732
Net Trade Balance (\$000)	21.096	15.090	54.669	46.0	30.3
Degree of Local Resource Utilization (%)	4.58	1.08	.71	0	1.59

Source: Export Processing Zone Authority.

foreign investments, the situation has improved somewhat, particularly in the case of the Cavite EPZ. In January 1989, EPZA reported that in addition to the five firms already operating in the zone, there were 23 manufacturing firms which were in the process of putting up production facilities in the zone. EPZA's projection is that by 1994, the number of firms in the CEPZ would reach 90. Based on past experience, this number seems to be over optimistic.

Credit and Financial Policies

The majority of the special credit programs devised and implemented by the government were aimed at promoting the development of small and medium scale enterprises. (See section on SMI development.) The same credit programs were utilized to provide credit support for the regional dispersal of industries at one time or another. For instance, the Development Bank of the Philippines (DBP) launched in 1974 a special credit program focused on SMI development, particularly in the rural sector. The following year, the government directed the DBP and Industrial Guarantee and Loan Fund (IGLF) to channel 60.0 percent of their loan portfolios to areas outside of Metro Manila. In 1976, the Central Bank (CB) required commercial banks and thrift banks to invest 75.0 percent of the total deposits of their branches in the areas where these were located.

The results of these lending programs show that they have not been effective in encouraging the regional dispersal of industries (Tecson, Valcarel and Nuñez 1989). Metro Manila remained the major beneficiary of the special credit programs implemented by the government to promote SMI development and, purportedly also, regional industrial dispersal. For example, between 1981 and 1987, the share of Metro Manila in IGLF funding increased from 63 to 73.0 percent. In 1987, the share of IGLF lending of the core region composed of Metro Manila and Regions III and IV reached 86.5 percent. Finally, as experienced in the mandatory requirements for lending to agriculture and agrarian reform, the expected increase in credit resources in areas outside of Metro Manila did not materialize.

Some of the reasons for the heavy concentration of special lending operations in Metro Manila and adjoining Regions III and IV are the following: (1) centralization of the credit decisionmaking process in the head offices of participating institutions; (2) almost exclusive reliance, particularly in the case of IGLF, on accredited commercial banks whose branches are generally located in cities and whose head offices are usually in Metro Manila, as conduit of funds; (3) lack of information on the availability of special credit programs, particularly in the remote regions of the country.

Zoning Regulations

Zoning is a more direct way of addressing the problem of overconcentration of industry in a particular area. In December 1973, the government banned the establishment of all new plants and factories within a 50-kilometer radius of Metro Manila. In order to implement this directive, all new industrial projects were required to secure a locational clearance from the Human Settlements Regulatory Commission (HSRC). Subsequently, the Commission formulated and issued a comprehensive zoning ordinance which formed the basis for the zonal plan in Metro Manila.

The 50-kilometer ban and related zoning regulations issued by the government were not effective in easing the concentration of industries in Metro Manila because enforcement was very weak (Pernia, Paderanga, Hermoso *et al.* 1983). The implementation of the regulations was characterized by the liberal grant of exemptions and grace periods. Moreover, the result was a tendency for industrial plants to cluster around the periphery of Metro Manila. About 30.0 percent of the locational clearances issued by the HSRC between August 1974 and February 1978 were in the urban centers in Central Luzon and Southern Tagalog. About 17.0 percent of the clearances were in the form of exceptions under which new firms were given permits to locate their plants in Metro Manila. Thus, around half of all the locational clearances extended by the HSRC were for the core area composed of Metro Manila and Regions III and IV.

Recent Measures

New strategies and measures have recently been considered to facilitate the regional dispersal of industries. The Department of Trade and Industry (DTI) has proposed an industrial dispersal program involving the development of identified alternative industrial locations outside of Metro Manila into attractive and viable industrial centers. The developmental activities in the identified areas consist of "(1) decentralization and strengthening of trade and industry-related services and facilities; (2) improvement of infrastructure facilities, utilities and credit delivery system; and (3) adoption of a more competitive and rational pricing of transport and utilities."

According to DTI, priority in the program's implementation shall be accorded to cities/municipalities with strong industrial potential and with fairly developed infrastructure and utilities. More specifically, DTI's set of criteria for the selection of industrial centers is composed of seven factors, namely "(1) market size, including the export market; (2) availability of labor; (3) manufacturing base; (4) business services; (5) social amenities; (6) infrastructure and utilities; (7) other considerations such as availability of raw materials, peace and order situation, distinct comparative advantage, and business

dynamism in the locality. The exact manner by which the abovementioned set of criteria was applied could not be ascertained, but in any case, DTI identified the following regional centers as the focal points for industrial dispersal efforts:

REGION I	-	SAN FERNANDO, LA UNION
CAR	-	BAGUIO EPZ
REGION II	-	CAUAYAN, ISABELA
REGION III	-	BATAAN EPZ
REGION IV	-	CAVITE EPZ / BATANGAS CITY
REGION V	-	LEGAZPI CITY
REGION VI	-	PAVIA, ILOILO
REGION VII	-	MACTAN EPZ
REGION VIII	-	TACLOBAN CITY
REGION IX	-	ZAMBOANGA CITY
REGION X	-	PHIVIDEC INDUSTRIAL ESTATE, TAGOLOAN, MISAMIS ORIENTAL
REGION XI	-	DAVAO CITY / GEN. SANTOS CITY
REGION XII	-	ILIGAN CITY / PARANG, MAGUINDANAO

For the identified industrial centers, DTI has formulated an "Infrastructure Support Program" which is simply a list of one to three infrastructure projects for each industrial center. Except perhaps in the case of the CALABAR (Cavite - Laguna - Batangas - Rizal) area, General Santos, and the PHIVIDEC industrial estate in Misamis Oriental, no integrated area plans for the other areas are available. Accordingly, the project list seems to hang rather "loosely," in the sense that one cannot see how the projects identified relate to other infrastructure requirements within an industrial center. Moreover, except for the industrial centers which simultaneously serve as EPZs, DTI has not yet defined the institutional set-up it has in mind regarding the coordination of various activities to be implemented for the development of the identified industrial centers.

The NEDA Secretariat has formulated a framework for countryside agro-industrial development which can complement and help refine the DTI proposal (NEDA 1989). Essentially, the proposal is to delineate four areas within the country based on the available information on resource endowments, infrastructure and potentials. The four areas proposed are the following:

(1) Metro Manila and the Industrial Areas of Regions III and IV: This area will be the primary industrial core, with Metro Manila continuing to be the dominant political, administrative, commercial and industry center of the country and wide segments of Central Luzon and Southern Tagalog experiencing the spillover of population and economic activities, especially industry, from the rapidly expanding metropolis.

(2) CAR, Regions I, II, V and the Rest of Regions III and IV: This group of regions will primarily be the main food

producing area in the country, supplying the country, particularly, the primary industrial core, with cereals, fruits and vegetables, meat, fish, dairy products and other staples. However, urban centers in the area such as Legazpi City, Tuguegarao, La Union, and Cabanatuan can be minor industrial cores with small and medium industries processing agricultural products and producing certain types of consumer goods.

(3) The Southern Industrial Core: A secondary industrial core can be developed in the South consisting of the Iligan - Cagayan de Oro and Cebu network of cities. Industries similar to those in Metro Manila can be located in this core. At the same time, a number of small and medium scale industries can be encouraged to cluster around the larger industries/enterprises in the area. Metro Cebu is expected to continue to serve the crucial role of commercially linking Visayas and Mindanao to the rest of the economy and to world markets. While the development of footloose industries and industries processing the agricultural surplus of other regions is the logical choice of industries in Metro Cebu, it has the potential for branching out into shipbuilding and a number of engineering industries.

(4) Regions VI, VIII, IX, XI and the Rest of Regions VII, X and XII: For Western Visayas, the strategy calls for the diversification of exportable and import substitute crops, and the encouragement of the growth of more agro-processing industries in its urban centers. The urban centers of Eastern Visayas can also be sites of industries processing abaca, rootcrop and coconut produced in the region. In the case of Western Mindanao, agriculture, including fishery and forestry, will be the dominant sector. For Northern, Central and the rest of Northern Mindanao, the vast tracts of land available make them suitable for the production of a variety of traditional and nontraditional food and cash crops. The cities of Davao, General Santos and Zamboanga can continue to be the principal processing centers for the area. The rest of Visayas and Mindanao can increasingly provide the food and processed as well as unprocessed raw material requirements of the secondary industrial core in Cebu, Iligan and Cagayan de Oro, and the primary industrial core in Luzon.

The implementation of the strategy outlined above requires close coordination both horizontally and vertically. At present, there is no institutional machinery in place which is tasked with such coordination. However, the NEDA Secretariat has proposed that the existing CORD-RDC-Cabinet set-up be modified to serve this purpose. For instance, the RDCs in Luzon and those in the Visayas and Mindanao can meet monthly; all the RDCs can meet once every quarter. The agenda can be focused on interregional plans, aside from implementation issues.

Both the DTI and NEDA Secretariat proposals have been approved by the President and Cabinet. While the proposals are

not mutually exclusive, there is a need to harmonize the proposed approaches, so that inconsistencies are resolved and eliminated. Exactly how the two approaches are going to be operationalized remains to be seen.

A piece of legislation intended to promote the development of enterprises in the countryside was signed into law by President Aquino on December 14, 1989. This is Republic Act No. 6810 entitled: "An Act Establishing the Magna Carta for Countryside and Barangay Business Enterprises, Granting Exemptions From Any Government Rules and Regulations and Other Incentives and Benefits Therefore, and For Other Purposes," otherwise known as "Kalakalan 20."

Republic Act No. 6810 provides that all Countryside and Barangay Business Enterprises (CBBEs), defined as those whose employees do not exceed twenty (20), with assets not exceeding ₱500,000 before financing, and located in the "countryside" (to be defined in the rules and regulations to be issued by DTI), shall be exempted from all taxes (local and national), license and building permit fees and other business taxes, except real property and capital gains taxes, import duties and other taxes on imported articles. They shall also be exempt from any and all "government rules and regulations covering assets, income, and other activities" connected with the business of the enterprise. These exemptions are applicable for a period not exceeding five (5) years from the date of registration of the CBBE. The CBBE, however, shall pay a registration fee of ₱250.00 and some form of a license fee starting on the second year of operations which ranges from ₱1,000.00 to ₱5,000.00 per annum depending on the net assets of the CBBE before financing. It is too early to project the possible impact of Kalakalan 20.

Future efforts to promote the regional dispersal of industries should focus on removing or at least mitigating the major constraints faced by firms in the regions, e.g., provision of basic infrastructure like power, telecommunications and roads, and facilitating access to credit, particularly long-term credit. The management of IEs and EPZs can be improved and their operations rationalized. Less emphasis should be given to more direct forms of government intervention to promote industrial dispersal since studies have demonstrated their ineffectiveness in this regard. Finally, industrial dispersal policies should not be considered separately from the overall economic development strategy of the country since rural development, trade reform, export promotion, decentralization, small and medium scale industry development, among others, are all supportive of the regional dispersal of industries.

F. Program for the Development of Small and Medium-Scale Industries

The development of small and medium-scale industries (SMIs) has been one of the stated goals of the government for various

reasons. The first, and most obvious reason, is job creation. This hinges on the presumption that SMIs are relatively more labor-intensive than their larger counterparts. The second is the contribution of SMIs in creating general and entrepreneurial skills. The human capital that is developed does not depreciate in later years but rather tends to spill over to other sectors and generally stimulates greater economic activities. Such potential dynamic external economies from SMIs represent a forceful rationale for their development, perhaps even more than the first reason. Third is SMIs' important role in the regional dispersal of industries. A fourth reason relates to the assistance that SMI development can provide to address the problem of income inequality.

There are many other reasons and objectives that could be cited. It is thus unfortunate that some of the major distortions which create biases against SMIs are policy induced. These are, primarily, in the areas of trade policy and the investment incentive system.

Trade Policy Bias Against SMIs

Among the trade policy tools, foreign exchange and import controls impose a direct bias against SMIs. The bias is built-in such that even if quotas were allocated efficiently by auction, large firms would have inherent advantages over smaller ones as they have greater access to resources. Even such a seemingly objective criteria as a firm's track record carries such a bias. The problem is magnified if quotas are allocated in a less transparent manner, where access to financial resources and political connections become even more important.

The overall protection structure has been found to be biased against SMIs. Regressions by Tecson *et al.* (1989) show a significantly negative relationship between EPR and the share of the 10-99 employee-enterprise in industry employment or value-added. This result, as pointed out, could be expected as industrial sectors dominated by smaller firms have a weaker bargaining power in obtaining greater protection. After the 1981-1985 TRP, the relationship became insignificant, implying a reduction in the firm-size bias in the protection structure.

The OIC Bias Against SMIs

The discussion in Section III.C of this paper on the investment incentive system has highlighted the bias against SMIs in the availment of BOI incentives. In particular, Table 17a showed that the average project cost per firm, even at its lowest level in 1986, was still more than ₱19 M. The average project cost per firm declined from around ₱101.38 M in 1982 to ₱19.23 M in 1986 (unadjusted for inflation) under BP 391 and then more than doubled to ₱46.62 M in 1988 under EO 226 (with parallel movements in the K/L ratio).

Table 17b also indicated that BP 391 reduced the capital and scale biases of the previous investment incentive package, and that EO 226 seems to have reinstated some of these biases. However, it did not reveal how BOI-registered firms compare with the national average. For this purpose, Table 19 presents comparative statistics on the manufacturing sector. In terms of asset (project cost for BOI firms and book value using the NSO Annual Survey of Establishments), BOI firms appeared to be more than ten times larger than the average manufacturing firm before 1983. The gap diminished continuously until 1986 to around 36.0 percent. The gap started to widen again in 1987. Although figures are unavailable for 1988 from NSO, the trends indicate that BOI firms could be around twice as large as the average firm in 1988. Questions on the comparability of data can of course be raised. However, given that the sample data from NSO cover only "large" establishments with more than 10 employees, a great deal of confidence can be placed on the earlier conclusions, particularly with regard to the bias against SMIs in the availment of BOI incentives. The same observations can be gleaned from comparing firm size in terms of employment.

These findings are not surprising. In the first place, there is a built-in bias in the way the investment incentive system is administered. For example, complex rules and procedures need to be complied with to be registered with the BOI and to be able to avail one's self of incentives. In the second place, some of the provisions in the OIC may in itself be biased against SMIs. A specific example is the granting of 100 percent tax credits for infrastructure undertaken outside Manila -- this is obviously outside the reach of SMIs. Another is the requirement that foreign exchange earnings be at least US\$5 M annually during the first three years of operation for incentives to be extended. Other examples can be found. In general, however, a capital bias in the OIC has already been noted.

For similar reasons, the major export promotion programs are also biased against SMIs. The documentary and other requirements ("formula" of manufacture, export bonds, etc.) virtually excludes SMIs. Only large establishments can afford to set up Bonded Manufacturing Warehouses. The Common Bonded Manufacturing Warehouses which allow a sharing of facilities is a vast improvement for SMIs. Still, in general, SMIs are often at a disadvantage, lacking resources and the capability to deal with all the bureaucratic red tape.

Assistance to SMIs

In view of the potential role of SMIs in stimulating economic development, as well as of various distortions, policy-induced or otherwise that inhibit SMIs from effectively discharging this role, assistance to SMIs can be justified. Ideally, the removal of the distortion at the source is the first-best solution. In the real world, however, very little can

Table 19
 COMPARATIVE STATISTICS ON FIRM SIZE: BOI-REGISTERED FIRMS vs. NATIONAL AVERAGE
 1981-1988
 (Asset and Cost in P000)

YEAR	BOI-RATIO			NSO-RATIO		
	PC/FIRM	Worker/Firm	K/L	BVFA/FIRM	Worker/Firm	K/L
1981	58,882.73	275.18	213.98	5,154.45	101.96	50.55
1982	101,380.01	197.72	512.74	5,828.39	102.06	57.11
1983	52,007.30	195.66	265.80	8,585.14	122.26	70.22
1984	59,533.79	312.64	190.42	10,515.59	118.77	88.54
1985	20,162.42	176.18	114.44	11,116.91	116.16	95.70
1986	19,227.73	229.83	83.66	14,253.10	119.99	118.79
1987	23,951.68	199.76	119.90	16,806.99	135.27	124.25
P.D. 1789	23,347.57	212.10	110.08			
E.O. 226	24,719.33	184.08	134.28			
1988 *	46,623.64	207.88	224.29	a/		

* E.O. 226

a/ Data for 1988 not available.

Note:

PC - Project Cost

BVFA - Book Value of Fixed Assets

NSO-RATIO - National Statistics Office (Annual Survey of Establishments)

K/L - Capital-labor ratio where capital represents Project cost in the case of BOI-figures and Book Value in the case of NSO.

Source: Department of Trade and Industry (DTI).
 National Statistical Coordination Board (NSCB).

be done in this direction. Assistance, in terms of technical and financial support programs, offers second- and third-best solutions. Tecson et al. (1989) reviewed and evaluated the major SMI promotion programs in the country. The discussion below draws heavily on the findings of this study.

Financial Assistance

There are a number of existing financial assistance programs designed specifically for cottage, small, and medium scale enterprises. In general, they are intended to serve either or both of two functions -- (1) as a lending mechanism, and (2) as a guarantee mechanism.

Under (1), the more important programs include the Industrial Guarantee and Loan Fund (IGLF), The Development Bank of the Philippines (DBP) SMILE Program (Small and Medium Industries Lending), and the various programs under the Technology and Livelihood Resource Center (TLRC), formerly the Technology Resource Center (TRC).

The IGLF is a revolving fund administered by the Central Bank to cater to the financing needs for working capital and acquisition of fixed assets of SMIs. It also offers a guarantee scheme although there have been no takers since 1973 due to difficult requirements from participating banks before they are able to call on the guarantee. They are first to exhaust all possible means of collection before they could turn to IGLF. The IGLF has thus been mainly a refinancing scheme, with commercial banks as the main conduits. In 1988, the IGLF granted around 556 loans amounting to a total of around ₱1,499 M, heavily concentrated in the manufacturing sector, especially footwear and garments, and iron and steel. There is also heavy concentration in the National Capital Region and the larger segments of the SMI sector.

The DBP SMILE program is intended to offer the wide array of DBP lending facilities to SMIs. In 1986, it granted around ₱53.5 M (compared to ₱196.6 M in 1982). Like IGLF, the program is heavily concentrated in the NCR.

The TLRC manages six major lending programs to SMIs, namely: (1) Agro-Industrial Technology Transfer Program; (2) Export-Industry Modernization Program (EIMP); (3) Enterprise Development Funding Scheme (EDFS); (4) Purchase Order Financing Program (POFP); (5) Bagong Balikatan sa Kabuhayan Program (BSKP); and (6) Technology Utilization Financing Program (TUFFP). These programs are suited to serve certain specific purposes as implied by their titles. In general, however, they are all concerned with the more effective use of appropriate technology and the promotion of livelihood opportunities. The TLRC is a government nonfinancial institution that has been criticized in its management of a huge amount of loanable funds. Its disadvantage lies in its lack of

expertise in credit evaluation and supervision. Indeed it had high arrearages especially at the start of its operation. However, over the years, it seems to have achieved some expertise, as the arrearages rate has reportedly declined. Moreover, perhaps due to its nonfinancial character, TLRC has developed innovative approaches to lending which improved access to credit by SMIs. For example, it allowed personal properties and unencumbered assets obtained from the loan as part of collateral. It also developed an anchor chain type loan system whereby smaller borrowers can obtain loans through an anchor firm. Nevertheless, with scarce manpower and numerous programs, it tended to spread itself thinly, resulting in concentration of lending in the NCR. Moreover, the same tendency towards the larger segment of the SMI sector is exhibited.

Under the guarantee schemes, there are three major programs -- Guarantee Fund for Small and Medium Enterprises (GFSME), the Export Credit Guarantee Program for Small and Medium Industries under the Philippine Export and Foreign Loan Guarantee Corporation (PHILGUARANTEE) and the Quedan Fund. The GFSME and the Quedan Fund deal exclusively with the agricultural sector. Philguarantee covers export credit risks of SMIs. The IGLF is supposed to deal with industrial loans but as mentioned earlier, there had been no takers since 1973 due to its stringent requirements. The Philguarantee, in contrast, is able to release the amount of guarantee automatically once the notice of default is served, although there had been no incidence of defaults since 1985.

Overall, two main weaknesses were identified in the various financial assistance programs -- the tendency to cater to the larger segment of the SMI sector and the concentration in the NCR. To this end, one recommendation is to reduce reliance on commercial banks as conduits and to make greater use of rural banks (with improved selection process) as conduits of SMI finance. Another is the more extensive dissemination of information on the available SMI lending programs.

Technical Assistance

The survey by Tecson et al. (1989) found that the majority of SMIs acquired technology through on-the-job training. Most entrepreneurs prefer to train their own workers although lack of skills is one of their main problems. Many respondents did not consider government institutions as an important source of technology, suggesting a need on the part of the different government agencies involved to be more active in extending technological assistance to SMIs. Accounting, financial planning and control were indicated areas of deficiency. Lack of up-to-date market information and export opportunities, poor product design, lack of exposure to foreign market requirements, etc., were other deficiencies cited.

To be sure, there are numerous government and nongovernment technical assistance programs to SMIs. If these support programs function as intended, they seem to be adequate enough to meet the needs of the SMIs. But as generally known, the implementation of these technical assistance programs in the field is quite weak and deficient.

Recent Measures: Proposed Magna Carta for Small Enterprises

There are two major bills in Congress which have a direct bearing on SMIs. One was signed into law by the President on December 14, 1989 -- Kalakalan 20, more formally known as RA No 6180. As mentioned in Section III.D of this review, Kalakalan 20 is primarily intended to promote enterprises in the countryside. Moreover, as pointed out earlier, it is too early to assess its impact. Nonetheless, SMIs can be expected to benefit from the provisions of the Act. Since many establishments affected would probably belong to the informal, unorganized sector and pay minimal taxes, Kalakalan 20 would at least level the playing field between honest and dishonest taxpayers, and encourage the integration of the sector into the formal system by doing away with much of the bureaucratic requirements. It should be cautioned, however, that the Act could create a tax loophole for establishments at the margin.

The other bill, which is probably much more potent, is Senate Bill No. 743. At the time of this writing, this bill was on second reading in the Senate. Also known as the Magna Carta for Small Enterprises, the bill proposes "to rationalize and promote small enterprises, establish a credit and guarantee corporation, provide funds therefore, and for other purposes."

There are vast differences between the two measures. The first is in the target beneficiaries. Kalakalan 20 addresses the smaller enterprises with fixed assets of ₱500,000 or less which are located in the countryside, while the pending bill would serve those with ₱5 M asset or less regardless of location. The second difference is in the incentive package itself. Kalakalan 20 grants purely fiscal incentives in the form of exemption from a number of taxes while the pending bill combines fiscal incentives with financial assistance, in terms of providing both loanable funds (at "preferential" rates) and a guarantee mechanism.

As regards the first point, Kalakalan 20 is easier to justify as it applies directly to one of the most disadvantaged sectors of the economy. The pending bill, on the other hand, seems to address the entire SMI sector, i.e., it seeks to support enterprises simply for reasons of size, within a larger range at that, making its goals more questionable. In the first place, what should really be the cut-off size? In the second place, to the extent that the distortion (the bias against SMIs) is inherent and natural, i.e., neither policy-induced nor caused by

market failures, many would question the validity of government intervention. In the third place, the entire SMI sector is not uniformly affected by distortions.

This leads to the second point. Granted that government intervention is justified, what form of intervention is needed? As earlier argued, the first-best solution is the removal of the distortion at the source. With limited options in this regard, second- or third-best solutions need to be resorted to. Still, a general rule in choosing the form of assistance (intervention) is that it should be as nondistortionary as possible.

The pending bill offers a wide range of assistance. As it is only in its second reading, it is difficult to judge how it is meant to be implemented and, if approved, how it would actually be implemented. Accordingly, the views indicated below are only initial impressions on the provisions of the bill.

The proposed Magna Carta for Small and Medium Enterprises introduces so many additional distortions that it becomes doubtful whether the economy would derive positive net benefits. In many cases, the provisions represent a retrogression in policy. The most serious is in the credit/financial area. One, it goes back to the credit allocation scheme similar to the agrifin scheme -- a severely distortional policy that would affect not only the SMI but the entire financial sector and the economy as a whole. Second is credit subsidization, which is definitely a move away from market-determined interest rates. The third is the creation of the SMI credit and guarantee corporation itself where the government would infuse an additional ₱500 M. The fiscal incentives have capital bias as they grant duty-free importation of capital equipment.

There are other questions which are quite important. One is the graft and corruption that would very likely ensue given the awesome incentives in the hands (and discretion) of the implementor. Another possible problem is the large potential loss in government revenues. In view of these concerns and considering the host of existing assistance to SMIs, the delivery of which probably only needs to be improved, the necessity and practicability of the proposed measure can be questioned.

G. Program for Technology Upgrading and Development

In an analysis of the record of technological development in the Philippines using such indicators as the ratio of R and D expenditures to GNP, capital-output ratios, total factor productivity in manufacturing and the number of scientists and engineers in R&D relative to the total population, the World Bank (1987c) concluded that the Philippines "has a low level of technological development as compared to other developing countries and that it has not paid enough attention to

technological capability." Among the reasons cited for this state of affairs are the following:

(1) The industrial incentive system, particularly, the overly protective trade regime and various other government interventions limiting competition, has not provided enough motivation to manufacturers to search for and utilize the most appropriate technology.

(2) There is too much emphasis on innovation capability, i.e., the creation and use of new technological possibilities, when the critical need at this stage of technological development in the country is the choice of the appropriate technology, the effective and efficient use of that technology and its modification to suit changing local conditions and keep up with technological advances in the rest of the world.

(3) There is very little linkage between the activities in R and D centers and production and investment, private sector participation in various R and D boards and councils notwithstanding.

(4) There is a lack of effective coordination among S and T agencies and between the latter and agencies overseeing developmental activities in the other sectors of the economy such as agriculture, industry and education.

This is not to say that the government has not recognized the importance of science and technology in its development. Starting with the Philippine Development Plan for 1983-1987, a separate chapter has been devoted solely to science and technology concerns. Moreover, some progress has been made in R and D efforts in agriculture, natural resources and industry. ^{4/} The National Science and Technology Authority (NSTA) was reconstituted into a government department in 1987. Finally, with respect to policy formulation and decisionmaking, the Secretary of Science and Technology was made a regular member of the NEDA Board earlier in 1989, in order to ensure that S and T considerations are adequately addressed in the discussion of economic policies.

The primary objective of the S&T plan, as enunciated in the Philippine Development Plan for 1987-1992, is to provide scientific and technological inputs to the country's efforts to reduce poverty and inequity, expand employment opportunities and achieve sustainable economic growth. R&D expenditures as a percentage of GNP are targeted to increase from 0.2 percent in 1987 to 0.9 percent in 1992, with the private sector accounting

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See chapter on Science and Technology (Chapter 11) of the Medium Term Philippine Development Plan, 1987-1992, pp. 335-337.

for 30.0 percent of total expenditures for R&D. The number of S&T professionals engaged in R&D is expected to increase by 32.0 percent to attain a ratio of 380 professionals per million population.

In order to achieve the national S&T objectives, the Development Plan sets forth the following strategies and policies:

- (1) Generation and active diffusion of technologies which can increase the absorption of labor in the economy.
- (2) Identification and development of commercial use of local materials and improvement of indigenous technologies both for the production of import substitutes and exports.
- (3) Greater emphasis on the commercialization of R&D results.
- (4) Promotion of private sector participation in R&D activities.
- (5) Proper selection and acquisition of essential and appropriate technologies.
- (6) Adaptation, absorption and mastery of imported technology.
- (7) Dissemination of appropriate technologies and increase in the accessibility to S&T information and services.
- (8) Development of high quality S&T manpower in areas which offer vast growth opportunities in the near future.
- (9) Expansion of S&T education and training.

In the absence of updated figures on R&D expenditures as a percentage of GNP as well as the number of S&T professionals engaged in R&D, it is not possible to assess the actual accomplishments in S&T efforts vis-à-vis the targets in the Philippine Development Plan. However, the Philippine Development Report for 1988 (NEDA 1988) cites a number of accomplishments in various areas in the S&T sector. In industry in particular, the Report lists the efforts taken toward the conversion of local materials into higher value products to substitute for imports and expand exports. Ferro-cement components for low-income houses were developed as an alternative to conventional ones. The Forest Products Research and Development Institute (FPRDI) completed its work on handmade paper technology using rice straw, sodium hydroxide, sodium hypochlorite, alum and cheese cloth. Locally fabricated cocowood pallets were distributed to three local softdrink companies for testing and were found to perform

better than those which are currently being used. The pilot-scale production of USP grade dextrose and sodium chloride from starch for intravenous fluids was undertaken successfully. Finally, to determine the commercial viability of producing citric acid locally, the Industrial Technology Development Institute (ITDC) started producing citric acid on a pilot basis.

The Report also touched on activities directed towards the commercialization of technology, including the establishment of linkages with the Philippine Chamber of Commerce and Industry, the intensification of the commercialization of the technology for the production of refined agar, and the initiation of the commercialization of the process technology for the production of rice-soy-based baby food and rice-soy curls. In the area of institutional support the Report highlighted the creation by President Aquino on August 11, 1988, of a Presidential Task Force on Science and Technology Development. The Task Force was specifically established to help in harnessing S and T for greater economic growth through the attainment of superior product quality and higher productivity.

Looking at the wide range of R&D activities going on in many research centers and institutes, it appears that greater impact can be obtained with the limited resources available if research priorities were more clearly established and if research efforts were more closely coordinated. Concluding its discussion of accomplishments in the field of S&T, the 1988 Philippine Development Report states that:

... compared to neighboring countries in Asia, the growth and development of the S&T sector is still sluggish. This can be attributed primarily to the following causes: (a) under-utilization of S&T results; (b) under-investment in S&T development; and (c) weak linkage between the technology generators and end-users. (p. 391)

What can be done? The World Bank (1987c) has proposed a number of measures to improve the contribution of S&T to the achievement of the country's development goals, namely:

(1) Integrating technology policy into the national development strategy, through, among others, a commitment of the country's leaders to the improvement of its technological performance and greater coordination among government agencies concerned with industrial technology policy.

(2) Development of the country's technological infrastructure through the strengthening of the technological information system, the promotion of closer linkages between publicly funded research centers and the productive sector, further development and diffusion of product standards and

testing services throughout the country, and the strengthening of the Philippine Patent Office.

(3) Promotion of technology-enhancing activities through greater stimulation of private sector spending for R&D, more emphasis on the dissemination of existing technology, particularly to small and medium scale industries, the encouragement of the development of consulting firms, and the monitoring of technological trends and the promotion of local efforts to acquire capability in new technologies.

Within GOP, the Presidential Task force on Science and Technology Development mentioned above has submitted its own recommendations to more effectively harness science and technology for the development of the country. The most important recommendations cover the areas of: (1) human resource and infrastructure development; and (2) incentives, financial and other support. The recommended measures under the first area include: the strengthening of key secondary schools and the initiation of science-honors programs in these schools; the establishment of a Ph.D. Engineering program and the offering of a more attractive compensation package for engineers; the strengthening of higher level scientific manpower programs in different universities and the upgrading of their facilities; and the development of a program to provide incentives to Filipino scientists abroad to return and pursue a scientific career in the Philippines. The measures recommended under the second area include mostly the extension of various tax exemptions and incentives to R&D activities; the establishment of a loan fund for S&T enterprises; the provision of a larger budgetary support to S&T development programs; and the channeling of more external assistance funds to S&T development.

H. Privatization

The primary objectives of the Philippine Government's privatization program are: (1) to reduce the budgetary burden imposed by state enterprises on the national government; (2) to create an investment climate that promotes and strengthens private sector initiative; and (3) to improve overall efficiency in the economy.

In order to achieve these objectives, the program aims to:

- (1) substantially reduce the size of the government corporate sector by limiting the use of the government corporate form to areas generally considered as natural monopolies, those that require large and physically indivisible capital investments and long gestation periods, and those that are essential from the viewpoint of national welfare, security and defense;
- (2) dispose of existing government corporations that do not meet the criteria in (1) above, as well as the nonperforming assets transferred by the Philippine National Bank (PNB) and the Development Bank of the Philippines (DBP) to the national government;
- (3) establish

an integrated system of performance evaluation for the government corporations that will be retained; and (4) improve the system of supervision and control of government corporations.

The privatization program has two major components, namely: the government corporate sector component and the nonperforming asset component. The former calls for five alternative actions on government corporations, namely: (1) retention; (2) merger with another government corporation; (3) conversion into a regular government agency; (4) dissolution or liquidation; and (5) total or partial divestiture. It also involves the financial restructuring and rehabilitation of the Philippine National Bank and the Development Bank of the Philippines, and the tighter monitoring and evaluation of the performance of government corporations that are retained as government corporations, particularly the 11 nonfinancial government corporations under the purview of the Government Corporate Monitoring and Coordination Committee (GCMCC). The second component covers the disposition of the nonperforming accounts of PNB and DBP which have been transferred to the national government. This consists of a total of 399 accounts with a total booked exposure of ₱108 B plus contingent exposure of ₱33.8 B.

Following the objectives and broad policy directions set in the government's privatization program, President Aquino issued Proclamation Nos. 50 and 50A on December 8 and 16, 1986 respectively, defining the basic policies, role and framework for improving the performance of government corporations, and creating the Committee on Privatization (COP) and the Asset Privatization Trust (APT). The COP is the policymaking body for the rehabilitation, conservation, take-over and disposition of government corporations, including the national government-held nonperforming assets, while the APT is the implementing arm of the COP. The APT was initially tasked with the disposition of nonperforming assets, but was subsequently also directed to handle the disposition of a number of government corporations which have been earmarked for privatization. Two other legal issuances affecting the privatization program were made: Executive Order No. 236 issued on July 22, 1987 and Administrative Order No. 59 issued on February 16, 1988. The first strengthened the powers and functions and organization of the GCMCC, while the second supplemented and refined the directions already set forth under Proclamation Nos. 50 and 50A.

So far, 121 government corporations have been approved for privatization. Four of these corporations were privatized prior to the issuance of Proclamation No. 50. In addition, 58 corporations have been recommended for abolition, 17 for regularization, and 18 for consolidation with other government corporations. COP has designated 12 disposition entities (DEs) to draw up and carry out the privatization plans of the government corporations up for privatization. The DEs include, aside from APT, the National Development Company (NDC), the

Philippine National Oil Company (PNOC), the Government Service Insurance System (GSIS), the Social Security System (SSS) and the Department of Agriculture (DA).

Of the 121 government corporations approved for privatization, 30 have been disposed of with an aggregate sales value of ₱6.2 B as of November 1989. This number includes the four government corporations which were privatized prior to the issuance of Proclamation No. 50. The other government corporations to be privatized are in various stages of divestment proceedings, with 39 having been already offered for sale.

With respect to the sale of nonperforming assets transferred to the national government, APT (1987 and 1988) reported that as of the end of 1988, 152 accounts have been sold, of which 104 accounts were fully sold and 48 accounts, partially sold. On a cumulative basis, proceeds of the APT sales of nonperforming assets, including sales directly handled by government financial institutions (GFIs) amounted to ₱7.7 B. The latest report of APT indicates that only ₱2.0 B has been realized from the sale of assets under its trust in 1989, very much short of its target of ₱8.0 B for 1989 and the ₱4.0 B proceeds in 1988. APT attributes the poor performance to the complications that arose in the sale of big ticket items, in particular, the Nonoc Mining and Industrial Corporation and the Paper Industries Corporation of the Philippines. As of December 31, 1988, APT has registered a recovery rate of 43.0 percent and 69.0 percent based on booked exposure and appraised value, respectively.

By all indications, the government's privatization program seems to be proceeding much slower than anticipated when the program was launched in 1986. There is a real danger here because further delays in the disposition of government corporations and nonperforming assets could provide enough time to parties with vested interest to mobilize a sufficiently strong opposition to the program to effectively derail it. Moreover, such delay gives the impression that the government may be wavering in its resolve to implement the program, particularly the divestiture of major corporations like the Philippine Airlines and Manila Hotel, among others.

Several reasons have been mentioned to explain the rather slow process of privatization. Foremost among these are legal and procedural problems. In the case of government corporations, converting the corporations into vendible form has many requirements such as the settlement of creditors' claims, perfection of the title of assets, completion of assets inventory, appraisal and financial evaluation of the corporation. With respect to the sale of nonperforming assets, the main problem is that only about 100 of the 399 nonperforming accounts have been transformed into physical assets acquired through foreclosure, i.e., most of the assets are not in conveyable form. Even among the 100 acquired assets, several of the big ticket

items remain tied up in litigation, and are thus not readily conveyable. In an effort to dispose of the assets in financial form without being held up by long and costly litigation, APT has devised alternative disposal modes, such as compromise foreclosures outside of the judicial system and direct debt buy-outs.

The bidding and approval process has also caused some delay in the sale of the nonperforming assets under APT. For example, the COP requires that an independent appraisal of the assets in question be made available to it first before it approves any sale recommended by APT. Moreover, negotiated sales are only allowed after two failed biddings. Needless to say, the requirements have been imposed in the interest of transparency to protect the public interest. There is no quick fix to this dilemma, for as Berg and Shirley (1987) note in their review of divestiture experience in developing countries, there is a real risk that the government will make a poor bargain and that the issues of whether or not to sell, in what form, or to liquidate are usually ambiguous. In any case, in order to facilitate the disposition of APT-held assets, the COP has delegated to APT in 1989 the authority to approve the disposition of assets whose transfer price does not exceed ₱300 M, regardless of whether the transactions are made through direct debt-outs or sale through public bidding.

Other reasons have been cited. For instance, bureaucrats managing some of the more saleable government corporations may be reluctant to facilitate divestiture or to divest at all. In fact, the wisdom of allowing supervising departments or some of the corporations themselves to handle their own privatization plans has been questioned, in light of the relative speed of APT-initiated privatization as compared to that of other agencies which have been designated as divestiture entities.

The general conclusion that can be made from this brief review of the progress of implementation of the Philippine privatization program is that while the Aquino government remains committed to privatization in the main, the pace at which the program has been carried out so far has been and can be realistically expected to be rather slow. Accordingly, from the viewpoint of the private sector, what is important at this point is that the government corporations which are in operation are not extended any competitive edge over private companies through government fiat. Moreover, it is imperative for the government to be unequivocal and decisive about the disposition of major government corporations which have been previously identified for privatization but on which the government seems to have moved with hesitation.

I. Financial Sector Reform

The objectives of the government's reform program in the financial sector are: (1) improvement of the financial structure through the strengthening of Central Bank (CB) supervision and regulation of financial institutions, freer entry into all areas of banking and finance to encourage competition and enhance the efficiency of financial intermediation, rehabilitation and rationalization of the operations of the Philippine National Bank (PNB) and the DBP, and divestiture of at least the majority stockholdings of government-acquired banks by the end of 1988; (2) improvement of the rural credit market through the rationalization and strengthening of the rural banking system; (3) rationalization of government regulations affecting intermediation cost, including the gradual reduction in reserve requirements when circumstances so warrant, repeal of the agrifin requirements and abolition of the gross receipts tax; (4) continued adoption of a market-determined interest rate policy through the elimination of all remaining forms of interest rate subsidies to specific sectors, among others; and (5) development of the domestic capital market through the strengthening of the securities market and the development of a secondary market for government securities. 5/ A \$300 M Financial Sector Adjustment Loan has been extended by the World Bank to the Philippines to assist the government in the implementation of its reform program covering the financial sector.

Improvement of Financial Structure

The major actions which have been taken by the government to achieve this objective are the following: (1) expansion of the coverage of the single borrower's limit to include contingent liabilities in the determination of the limit; (2) imposition of ceilings on outstanding guarantees that a bank can issue; (3) adoption of the policy whereby the CB will refrain from sustaining weak banks except in times of general financial emergency or when specific banks face problems of liquidity rather than of solvency; (4) relaxation of barriers to entry by terminating the moratorium on new bank licenses and eliminating the prerequisite investment in government securities for purposes of opening bank branches; (5) completion of the rehabilitation of PNB and DBP; and (6) divestiture of government stocks held in acquired banks. Aside from these measures, the CB has proposed major amendments to the General Banking Act, most of which are focused on curbing insider abuse.

5/

See Lamberte and Relampagos (1990) for a more detailed discussion of reforms in the financial sector during the period 1986-1988.

Improvement of the Rural Credit Market

In order to improve the rural credit delivery system, the CB launched the rural bank rehabilitation program in 1987. The program aims to strengthen the rural banking system through a capital build-up and conversion scheme and/or a plan of payment covering rural banks experiencing financial difficulties. The former involves the conversion of arrearages into paid-in capital of the government in the form of shares of stock issued in the name of the Land Bank of the Philippines (LBP), while the latter involves an arrangement with the Central Bank whereby the rural bank would amortize its arrearages with the CB within a period not exceeding ten years.

As of the end of 1988, 522 applications have been received by the CB. Of this number, 476 have been approved, while 27 have been denied, withdrawn or disqualified. Close to 62.0 percent or 295 of the approved applications have fully complied with the rehabilitation program requirements, with 224 opting to avail of the fresh capital infusion and 71 choosing to amortize their arrearages with the CB. Fifty-one more rural banks have partially infused capital, bringing the total number of banks which have decided to put in fresh capital to 275 banks or 58.0 percent of all approved applications.

Rationalization of Government Regulations Affecting Intermediation Cost

During the period 1986-1988, the monetary authorities reduced the required reserves against deposit liabilities with original maturities of 730 days or less from 23.0 percent to 21.0 percent. For deposits with maturities over 730 days, the reserve requirement was reduced to 5.0 percent from 6.0 percent in 1986. However, in 1989 the reserve requirement for long-term deposits were unified with those having shorter maturities, in effect raising the overall reserve requirement against deposit liabilities. The objectives of promoting long-term capital funds and reducing intermediation costs were sacrificed by the monetary authorities in favor of liquidity control. No progress has been made to abolish the agri-agra requirement and the gross receipts tax, although proposed legislation to put these into effect has been filed in the Philippine Senate.

Continued Adoption of a Market-Determined Interest Rate

Prior to 1985, the rediscounting facility of the CB was used to allocate credit to high priority sectors. The rediscount rate for the priority sectors ranged from 3.0 to 8.0 percent per annum with a prescribed ceiling on the banks' lending rate ranging from 12.0 to 14.0 percent per annum. The rediscount value was between 50.0 to 100.0 percent. In November 1985, the CB started to use its rediscount window more for stabilization purposes rather than for the allocation of credit.

This policy has been maintained, its special features being the standardization of the proportion of the loan value eligible for rediscounting at 80.0 percent and the application of a uniform rediscount rate aligned with the market rate. The latter is based on the Manila Reference Rate (MRR) 90 which, in turn, is determined on the basis of the weighted average of interest rates on promissory notes and time deposits with a 90-day maturity.

Nonetheless, the CB seems to be pursuing an export-oriented rediscounting policy, which is understandable considering the magnitude of the balance of payments problem the country is facing. Accordingly, it is easier for banks to obtain rediscounting on export loans than on non-export loans. Moreover, based on the amounts of rediscounts which have been made available by the CB, the nontraditional export sector is accorded higher priority over the traditional sector (Table 20). The CB also sees to it that the export sector's access to the rediscount window is not affected by any change in monetary policy.

As regards special credit programs, 20 out of 46 separate loan funds were merged in 1986 to create the Comprehensive Agricultural Loan Fund (CALF) which is being used to beef up the resources of various guarantee programs of the government. The other separate loan funds cannot be merged with CALF because they are covered by loan covenants between the government and external funding agencies. It is interesting to note that most of the non-CALF lending programs carry nonmarket interest rates while the lending programs covered by CALF follow market rates.

On the whole, the financial sector reform program is progressing well, despite some problems in a few key areas. The areas where reform efforts are lagging behind are those aimed at reducing intermediation costs, e.g., abolition of agri-agra requirement and the gross receipts tax, and the development of the domestic capital market, in particular the strengthening of the securities market. It is also about time that the government consider the rationalization of the operations of the GSIS and the SSS.

IV. SUMMARY AND CONCLUSION

The main developments in the economy in the 1970s and 1980s were initially reviewed to locate the place of industry in the overall economy. The performance of industry as well as changes in industrial structure were then discussed to serve as the point of departure for the subsequent assessment of trade and industrial policies and programs.

Table 20
LOANS GRANTED BY THE CENTRAL BANK TO COMMERCIAL BANKS
(In ₱M)

	(a) 1/ Total	(b) Traditional Exports	(c) Nontraditional Exports	b + c ----- a	b ----- c	c ----- a
1980	38,707	20,000	11,607	0.82	0.52	0.3
1981	46,096	19,571	13,884	0.73	0.42	0.3
1982	39,121	15,459	10,833	0.67	0.40	0.2
1983	28,229	8,256	12,028	0.72	0.29	0.4
1984	14,392	1,568	10,805	0.86	0.11	0.7
1985	7,040	575	5,787	0.90	0.08	0.8
1986	9,696	2,251	6,322	0.88	0.23	0.6
1987	5,173	1,485	3,493	0.96	0.29	0.6
1988	9,582	2,150	6,959	0.95	0.22	0.7

1/ Includes other loans.

Source: Central Bank of the Philippines; in M. Lamberte, "An Assessment of Policies Affecting the Financial Sector, 1986-1988," PIDS Working Paper No. 90-05.

A. Economic Performance

On the whole, the pattern of development pursued in the country up to 1983 had led to an economy characterized by a distorted incentive structure, inefficient investments and heavy dependence on foreign borrowings. The weaknesses in macroeconomic management, exemplified by the continued overvaluation of the peso in the face of mounting trade and current account deficits, exacerbated the situation. Accordingly, unable to adjust to external shocks, the Philippines faced the most severe economic and financial crisis in its postwar history in 1983.

The economy contracted by 7.0 percent in 1984 and by 4.1 percent in 1985. Industrial and manufacturing growth rates collapsed during the period. Domestic investments were the hardest hit, their growth plummeting by as much as 43.1 percent in 1984 and 21.7 percent in 1985. Open unemployment swelled to 25.0 percent in Metro Manila and 12.5 percent nationwide. The inflation rate accelerated to an average of 50.3 percent in 1984 before it cooled down somewhat to 23.1 percent in 1985.

Shortly after the new government took over in 1986, it instituted a wide-ranging set of socio-economic and political reforms. The economic reforms were primarily aimed at increasing efficiency in the economy through the elimination of distortions in the incentive structure, the revitalization of private sector initiative and greater reliance on market forces.

As a result, the economy achieved a remarkable recovery. After posting a small positive growth in 1986, real GNP grew by 6.0 percent in 1987, 6.8 percent in 1988 and 5.6 percent in 1989. Economic recovery was propelled mainly by the recovery in domestic demand, although external demand factors also helped at least up to 1988. After experiencing absolute declines in real value added for three consecutive years, the Philippine industrial sector recovered strongly in 1987 and sustained a growth of 7.0 to 8.0 percent per year in 1988 and 1989. The recovery in the manufacturing sector started in 1986 with a modest growth of about one percent. The turnaround accelerated in 1987 and 1988 with a 6.7 percent and 9.0 percent increase in real value added, respectively, and was carried through to 1989 with a growth rate of 7.0 percent.

B. Industrial Performance

There is unanimity in past studies of industrialization in the Philippines that the nature of government policies adopted since the 1950s to promote industrialization in the country has led to an industrial structure that is characterized by a poor record of productivity growth and failure to significantly help in the alleviation of unemployment, underemployment and poverty in the country. More specifically, the performance and

structural characteristics of manufacturing can be summarized as follows:

(1) Limited labor absorption. While the share of manufacturing value added in GDP increased from 22.5 percent in 1960 to 25.0 percent in 1988, the share of manufacturing employment in total employment declined from 12.1 percent to 10.3 percent over the same period.

(2) Declining total factor productivity. Over the whole period 1956 to 1980, total factor productivity in manufacturing was estimated by Hooley (1985) to have declined by 0.15 percent per year.

(3) Little change in structure. The structure of production has not changed much since 1970, with the production of consumer goods accounting for the largest share of about one-half of manufacturing value added on the average, followed by the production of intermediate and capital goods.

(4) Production structure concentrated in Metro Manila. By all measures, whether in terms of number of firms, employment, value added or fixed assets, there is a strong degree of concentration of manufacturing activities in Metro Manila and the surrounding core regions.

(5) Structure is biased against small and medium scale industries. While SMIs accounted for 80.0 percent of the total number of firms with at least 10 workers in 1983, they only accounted for less than a fourth of total employment and a tenth of value added of such firms.

(6) Increasing share of nontraditional exports in total exports but nontraditional manufactured exports concentrated in only three products. The share of nontraditional manufactured exports has risen from only 8.3 percent in 1970 to a little over three-fourths in 1988. However, only three products, namely semi-conductors, garments and handicrafts, make up almost two-thirds of all nontraditional manufactured exports.

(7) Incentive structure biased in favor of capital intensity. Capital deepening can be observed in many subsectors of manufacturing, most notably in food, beverages, chemicals, cement, iron and steel, fabricated metals and transport equipment, wherein capital labor ratios increased significantly between 1960 and 1980.

C. Assessment of Industrial Policies and Programs

Macroeconomic Policies

By and large, the government has pursued conservative fiscal and monetary policies since 1986. Accompanied by declining oil

prices for most of the period, fiscal and monetary policies have helped in containing inflation to a single digit level up to 1988. In 1989, the increase in consumer prices accelerated to 10.8 percent on account of cost push factors like the upward adjustment in domestic oil prices and power rates, the legislated 39.1 percent increase in the minimum wage of workers in the private sector, and the standardization of salaries in the public sector which also had the effect of raising wages in the sector.

A key factor in the country's exchange rate policy has been the monetary authorities' concern for maintaining a stable exchange rate, allowing only small changes in the official rate over time. Thus, the peso depreciated vis-à-vis the US dollar by only 6.6 percent from 1986 to 1989. The effective exchange rate (EER) depreciated by 16.7 percent from 1986 to 1988 due to the changes in the currencies of the country's major trading partners, but the EER hardly moved at all in 1989. The real EER likewise depreciated up to 1988 as a result of the relatively favorable domestic price developments up to that year. In 1989, the real EER appreciated.

There is ample evidence that the Central Bank has employed monetary policy, more specifically, high domestic interest rates, to shore up the peso in 1988 and 1989. There are indications, however, that the use of monetary policy to defend the peso can no longer be sustained. First, real and nominal interest rates are already high; a further increase could adversely affect domestic investments and jeopardize economic growth prospects. Second, the rapid build-up in the country's trade and current account deficits in 1989 is symptomatic of an overvalued domestic currency, requiring a major realignment in order to maintain the rate's competitiveness and arrest the unabated large increases in the country's imports.

Trade Reform

The trade reforms started in 1981 had three components: (1) tariff reform, the main feature of which was the reduction of the maximum rate of duty from 100.0 percent to 50.0 percent; (2) import liberalization; and (3) indirect tax realignment which was aimed at eliminating the protective element of local indirect taxes. The tariff reform program and indirect tax realignment measures were implemented as scheduled, but the import liberalization program was shelved in view of the balance of payments crisis which erupted in 1983.

The new government continued and expanded the import liberalization program initiated in the early 1980s. From 1986 to 1989, import restrictions on 1,477 PSSC lines were lifted, reducing the number of regulated items as a percentage of the total number of PSSC lines from around 34.1 percent in 1985 to 8.0 percent by the end of 1989. In addition, all export taxes were abolished, except for logs.

On the whole, the trade reform program has been successful in bringing down nominal and effective rates of protection and in reducing variation in the latter across sectors. They have certainly been in the right direction. Nonetheless, the reforms which have been implemented so far have not been enough to alter the biases of the protection system against exports and agriculture. Accordingly, further reforms are needed to lower the level and dispersion of effective protection. Moreover, it is important for the government to pursue the import liberalization program as scheduled, in order to give a consistent policy signal to the private sector. Finally, to obtain the full benefits from trade reform, the latter should be complemented by the appropriate fiscal, monetary and exchange rate policies.

Investment Incentives Reform

The package of investment incentives in the country has been modified three times since 1970, the latest through Executive Order No. 226 (E.O. No. 226, otherwise known as the 1987 Omnibus Investment Code) which superseded Batas Pambansa 391 (BP 391). While the avowed aim of E.O. No 226 is to make the incentive package competitive with those offered by other ASEAN-member countries, the evidence suggests that the changes adopted have reinstated the capital bias of the incentive system as well as reduced the inducements given to exporters vis-à-vis non-exporters. E.O. No. 226 further eliminated the linkage between incentives availment and performance. Lastly, the bias of the system in favor of larger firms remained under E.O. No.226.

There is, therefore, a need to reform the investment incentives package. In particular, more factor neutral incentives should be adopted and the larger inducement to exporters as compared to non-exporters should be restored. Moreover, there is ample room for further simplifying the administrative requirements in incentives availment and in reorienting the Board of Investments' functions from investment regulation to promotion.

Export Promotion Program

Aside from the export incentives being provided by the government under the Omnibus Investment Code, there are other export promotion measures which are aimed at putting exports under a "free trade" status. More specifically, tax and duty-free access to intermediate inputs is extended through outright tax and duty exemptions or through the tax and duty drawback mechanism.

Judging from the number of requirements and complexity of procedures, the system of tax and duty-free importation of intermediate inputs is still quite cumbersome. Thus, one of the most important measures which can be implemented to expand

exports would involve increasing automaticity in the availment of tax and duty exemptions on the imported inputs of exporters.

One other aspect of the export promotion program that needs attention is that of export financing, more specifically pre-shipment export financing, which currently seems to be weak and ineffective. Among the measures which can be considered are: the development of a domestic L/C system, the provision of equal access by indirect exporters to the CB's refinancing facility and the strengthening of pre-shipment export finance guarantee schemes.

Program for the Regional Dispersal of Industries

Among the major instruments which have been utilized by the government for the regional dispersal of industries are: (1) fiscal incentives; (2) credit and financial policies; (3) development of industrial estates (IEs) and export processing zones (EPZs); and (4) zoning regulations. By all accounts, all of these policies and programs have not been effective in achieving a more balanced regional distribution of industries. The fiscal incentives offered were not enough to offset the advantages of Metro Manila. The credit and financial policies did not lead to more funds flow to the regions because of the highly centralized credit operations of financial conduits, among other reasons. The existing IEs and EPZs remain underutilized. The zoning regulations did not work because enforcement was very weak.

Future efforts to promote the regional dispersal of industries should focus on removing or at least mitigating the major constraints faced by firms in the regions, e.g., provision of basic infrastructure like power, telecommunications and roads, and facilitating access to credit, particularly long-term credit. The management of IEs and EPZs can be improved and their operations rationalized. Less emphasis should be given to more direct forms of government intervention to promote industrial dispersal, since studies have demonstrated their ineffectiveness in this regard. Finally, industrial dispersal policies should not be considered separately from the overall economic development strategy of the country since rural development, trade reform, export promotion, decentralization, small and medium scale industry development, among others, are all supportive of the regional dispersal of industries.

Program for the Development of Small and Medium Scale Industries

While the development of small and medium scale industries has been one of the stated goals of the government, some of the major distortions which create biases against SMIs are policy induced. These are primarily in the area of trade policy and the investment incentives system. As regards the former, the overall

protection structure has been found to be biased against SMIs, although the trade reform program has somewhat reduced that bias. In the case of the investment incentives system, there is a built-in bias in the way the system is administered which involves complex rules and procedures. For similar reasons, the major export promotion programs are also biased against SMIs.

Various assistance programs to SMIs have been implemented by the government to stimulate their development, the major ones being financial and technical assistance. Overall, two main weaknesses have been identified in the different financial assistance programs to SMIs: the tendency to cater to the larger segment of the SMI sector; and the concentration of credit in the National Capital Region. In order to improve the situation, there should be less reliance on commercial banks as conduits. At the same time, it will be necessary to conduct a more extensive dissemination of information on the available SMI lending programs. With respect to technical assistance programs, the main problem is that the implementation of these programs in the field is quite weak and deficient and certainly needs considerable strengthening.

Program for Technology Upgrading and Development

The level of technological development in the country has been observed to be poor as compared to other developing countries. Among the reasons which have been cited are: lack of motivation provided by the system of industrial protection, underutilization of R&D results, underinvestment in R&D development, and weak linkage between technology generators and end-users. In order to promote a higher level of technological development in the country, the following measures have been proposed: (1) integration of technology policy into the national development strategy; (2) development of the country's technological manpower; (3) strengthening of the country's technological infrastructure (information system, linkages, product standards, testing services, etc.); and (4) promotion of technology-enhancing activities (greater private sector spending for R&D and more emphasis on the dissemination of existing technology, particularly to SMIs).

Privatization

The primary objectives of the Philippine Government's privatization program are: (1) to reduce the budgetary burden imposed by state enterprises on the national government; (2) to create an investment climate that promotes private sector initiative; and (3) to improve overall efficiency in the economy. The program has two components, namely; the government corporate sector component and the nonperforming asset component.

By all indications, the privatization program seems to be proceeding much slower than anticipated when it was launched in

1986. There is a danger here because further delays in the disposition of government corporations and nonperforming assets could provide enough time to parties with vested interests to mobilize a sufficiently strong opposition to the program to effectively derail it. A number of legal and procedural bottlenecks have been mentioned as the reasons for the slow process of privatization. Some measures have been taken to resolve these, including the streamlining of the bidding and approval process for the disposition of government corporations and nonperforming assets. At this point, it is imperative for the government to be unequivocal and decisive about the disposition of major government corporations which have been previously identified for privatization but for which the government seems to have moved with hesitation, e.g., the Philippine Airlines and the Manila Hotel.

Financial Sector Reform

The major objectives of the government's reform program in the financial sector are: (1) improvement of the financial structure; (2) continued adoption of a market-determined interest rate policy; (3) rationalization of regulations affecting intermediation costs; (4) improvement of the rural credit market; and (5) development of the domestic capital market.

On the whole, the financial sector reform program is progressing well, despite some problems in a few key areas. For instance, various measures have been implemented to improve the financial structure in the country, the most important of which were the completion of the rehabilitation of the PNB and the DBP, the full or partial divestiture of government shares of stocks in the government-acquired banks, and the relaxation of barriers to entry in the banking system. Interest rates continue to be market-determined, and CB rediscounting has been used primarily for stabilization rather than allocative purposes. The number of special credit programs carrying nonmarket interest rates have been reduced by almost one-half. Moreover, the rural bank rehabilitation program is proceeding largely on track.

The areas where reform efforts are lagging behind are those aimed at reducing intermediation costs, e.g., abolition of agri-agra requirement and the gross receipts tax, and the development of the domestic capital market, in particular the strengthening of the securities market. It is also about time that the government consider the rationalization of the operations of the GSIS and the SSS.

By and large, the policy environment for industrial growth and development in the Philippines has improved since 1986. There are some areas of concern and certainly room for further improvement, but the trade and industrial reform program has

generally been moving in the right direction, albeit slowly. There seems to be one important lacking ingredient, however, and that is, the closer coordination of economic policies. Many separate elements of the reform program have been instituted at different times since the early 1980s, but the full benefits from them are yet to be felt, largely because they were not accompanied by the necessary macroeconomic policies and other complementary measures. Indeed, the reform program must be moved as a package, because otherwise, the weakest link would put a drag on the whole endeavor to improve the contribution of the industrial sector to the country's development objectives.

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