EDITOR'S NOTE: At the beginning of the 1980s, the Philippines, in trying to offset the unfortunate effects of three decades of protection, embarked on a program of gradual liberalization of trade policy. The elimination of quantitative import restrictions and the reduction and rationalization of tariff protection were the principal elements of the program. Some success was noted during the first phase of tariff reform (1981-1985) but much of the momentum was lost due to the onset of the balance of payments crisis in the latter half of 1983.

Beyond the prime goal of recovery, achieving sustained growth at the full potential of the economy remains as important. Realizing now that this potential was frustrated in the past by overly protective policies, Philippine policymakers are now looking at the free market to correct the investment and resource allocation priorities that have supported inefficient patterns of production in the past.

A serious option is IMPORT LIBERALIZATION. Complemented with other trade policy measures, the program is envisioned to encourage industries to produce in areas where the country has obvious comparative advantage, and to turn out high quality goods for both local and foreign consumption at competitive prices.

Our guest writer for this issue is Dr. Erlinda Medalla, a Research Fellow at the Philippine Institute for Development Studies (PIDS). In her article, she discusses the rationale for, and the concept of, import liberalization and the other issues related to it. Dr. Medalla has likewise been involved in many studies regarding improvements in trade policy, as evident by her involvement in projects supported by either the Institute or the Tariff Commission. Together with Dr. John Power, her latest research appears as a PIDS staff paper on the “Methodology for Measuring Protection and Comparative Advantage” (S.P. #8504). She has also recently concluded a joint PIDS-Tariff Commission Project on “Trade Liberalization in the Philippines.”

On another matter, some of the highlights of the PIDS-Media Forum on Import Liberalization held on September 17, 1986 at the NEDA Makati Building are presented immediately after Dr. Medalla’s article in this issue.

Introduction:

This article is an attempt to further clarify and explain the rationale for, and the concept of, import liberalization and related issues surrounding its implementation.

Let us consider first a scenario where there are minimal import controls, (i.e., there is a relatively free flow of goods between the rest of the world and the home markets). However, this does not exclude the possibility of some uniform tariff for revenue purposes.

The scenario, as presented in Figure 1, focuses on the three general stages of production which are: a) primary inputs (PI); b) intermediate inputs (II); and c) final output (FO).

Consumers benefit from industry competition in terms of better prices and better quality of products. On the other hand, industries also benefit in terms of equal treatment across all sectors of the economy. If desired and necessary, the government could grant real protection (via direct subsidies) to a few selected industries considered socially desirable yet not commercially viable because of genuine market failures (e.g., the case of infant industries, externalities, etc.).
Industries that would emerge from a setting of minimum import controls would be producing goods in areas where the country has obvious comparative advantage. Production for exports and domestic consumption will be carried out in selected areas where it is relatively more advantageous (cheaper) to do so. In cases where they are not, goods which are relatively cheaper abroad will be imported.

Let us now introduce restrictions on imports of final products, as represented in Figure 2. Note the broken line separating domestic consumers from the final output produced by the rest of the world.

Import restrictions on final products means less supply, more expensive foreign goods and in general, less competition. This allows local producers to charge higher prices for goods or produce lower quality products, or some combination of both, given the captive domestic market. To some extent, local production is developed, but this is confined to the limited domestic market. Moreover, the higher price charged by producers damps total domestic demand so that full potential of the domestic market is not reached.

An argument in favor of restrictions states that the system of import restrictions defends a relatively lower peso price of foreign exchange.

Foreign exchange is thus artificially cheapened. This has at least two major and adverse consequences. For one, imports allowed to come in at low duties are artificially made cheap. This is the case for capital and intermediate inputs. Domestic producers of capital goods and intermediate inputs are thus unable to compete. Backward linkages are impeded and domestic production of intermediate inputs is not developed. Furthermore, there is a bias towards using imported (artificially cheap) capital. Necessarily, the import substitution process becomes import dependent. Second, exports are penalized by the artificially lower peso rate of foreign exchange.

Hence, contact with the export market is weakened (break in the arrow from Final Output to Exports.) Only in those export activities where there is substantial comparative advantage could firms survive, namely, in the exports of primary products (coconut, sugar, abaca, etc.).

This is indeed what happened in the first stage of import substitution during the 1950s and 1960s. The manufacturing industries that developed were mainly packaging and assembly types and were heavily dependent on imports. Compounding the problem is the country's dependence on primary products for exports.

Suppose now that in the second stage of import substitution, even imports of intermediate inputs (II) are restricted, as shown in Figure 3.

With import restrictions, local production of intermediate inputs is now encouraged and producers are able to charge higher prices in the domestic market. The higher price of the protected intermediate input is passed on to industry users (downstream industries) and ultimately to domestic consumers. However, the higher cost of protected inputs limits the growth of downstream industries, in turn, limiting its own growth potential. Thus, the system of protection has an inherent bias against forward linkages.

With import restrictions applying on a wider range of products (both intermediate inputs and final output), the general equilibrium effect on the price of foreign exchange becomes even more pronounced. As in the previous case (see Figure 2), with a lower peso rate of foreign exchange, protected domestic industries would not be able to compete in the world market (unless it is very efficient relative to the rest of the world, thus offsetting the penalty from the
lower price of foreign exchange. If this is the case, the industry does not really need the protection at all. Protection only enables the producer to reap excess profits. Moreover, the system of import restrictions creates a bias against exports because the link to the export market is weakened.

After more than 3 decades of experimentation with excessive protection through escalated tariff and import controls, the possibilities for growth from such a strategy have been exhausted. The system of protection created a bias against exports, which until now makes the Philippines heavily dependent on primary exports. Combined with an inherent bias against forward linkages, the long-run growth of the industrial sector has been limited. Furthermore, it created a bias towards capital intensity. All these contributed to slow down industrial labor absorption so that agriculture, petty trade and services had to absorb more than their share of the rapidly growing labor force.

Import Liberalization:

As illustrated in Figure 4, the price structure before import liberalization is indicated by the figures in the first box. The import ban or restriction allows domestic producers to charge a higher price (quality-adjusted) than what would have been without the restriction. This higher cost to consumers, however, may not be visible, as there may not be an occasion to compare prices. The first phase of import liberalization calls for a removal of import controls and replacing these with tariff. This means that imports are now allowed but are imposed a tariff which would allow local producers to maintain its former protected price differential. There are no benefits yet to consumers as prices are maintained. The impact of the first phase of import liberalization transferred the rent from the import licensee to the government.

The rent that was transferred to the government could be quite substantial as seen in the case of mackerel and sardines. The domestic price of mackerel and sardines have been estimated to be at least 33 percent and 21 percent more expensive than border (world) prices, respectively. Imports of mackerel and sardines in 1983 were valued at $0.852M and $4.434M, respectively. Had equivalent measures been imposed as price differentials, instead of the 10 percent tariff, government revenue would have been around P24.2M. Before import liberalization, the government and the import licensee shared this. The 10 percent tariff went to the government (around P10M) while the rest went to the import licensee (around P14M). With import control replaced by tariffs, as in the first phase of liberalization, all of the P24.2M would go to the government, thus increasing the revenues gained from mackerel and sardines alone to P14M. The (increased) revenue could be used to improve the industry itself or to finance other government expenditures (e.g., social services) which would eventually benefit consumers.

The second phase of import liberalization completes the process by gradually lowering tariff protection over a period of time to some uniform level, mainly for revenue purposes. The first phase gives industries initial time to adjust. The second phase provides a longer adjustment period.

Let us then explore the case of a downstream industry as we determine the possible impact of import liberalization on unit price, output and employment.

As illustrated in Figure 5, the unit cost variables of the firm before is represented by the first bar. The cost of the raw materials is the protected price (i.e., it includes the increased cost due to protection on the local input). After import liberalization, the cost of the raw material input goes down (the increased cost due to protection received by local input producer is removed).
Hence, the total unit cost of the firm goes down and the firm could afford to offer a lower price to consumers. This would create increased demand and eventually encourage the expansion of the firm (and the downstream industry as a whole).

What the process implies is that while the intermediate input production could contract, the downstream industry would expand so that the over-all level of employment and output need not suffer because of import liberalization. Indeed, if the downstream industry is relatively more labor-intensive, or if the expansion in the downstream industry is greater than the contraction in the protected upstream industry, employment and output could even rise.

**Effects of Import Controls:**

The series of diagrams presented show how import controls distort the market which eventually defeats the intended goals of growth and employment generation. Still, protection retains an appeal even to policy makers. This partly explains why import liberalization remains to be one of the most difficult reform programs to implement.

Controlling imports, directly or indirectly, through tariff walls not only constrains the demand for foreign exchange but also provides protection from foreign competition to local producers of substitutes for controlled imports. Three things seem to occur simultaneously. First, in the case of tariffs, government revenue is generated. Second, balance-of-payments pressure is temporarily relieved. And third, with less or no competition from foreign goods, affected domestic industries are promoted by providing secure and distinct advantages in the domestic market. All these are immediate consequences of tariffs and import controls which are more easily understood by many. What is not always realized is that these also bear a cost to society—often even more burdensome than a direct subsidy. Hence it is not difficult to see why tariffs and import controls are very convenient policy tools. In much the same way, it is logical to expect resistance to any program to liberalize imports. (This is aside from the fact that the protected sector is more organized than consumers and other beneficiaries of import liberalization.)

While these “benefits” of protection are easily recognized, costs hidden behind tariffs and import controls are not. Consumers and other industrial users are paying more for the protected local product, in most cases, without even being aware of it because no additional nominal taxes are actually imposed nor actually disbursed. The reality remains that they are taxed and the costs to them are as real. If local producers are able to raise their prices due to protection from imports by, say, 50 percent (or sell lower quality products) then, that is exactly the cost of protection to society.

Further, the increased cost goes to the local producer (and import licensee). Import duties are government revenues which should eventually revert to society in terms of other hopefully more beneficial public expenditures. But the increased cost due to protection is effectively an implicit subsidy to the concerned industry.

It is true that, in many instances, such a subsidy would be used by the industry to cover a higher real cost of production (relative to the rest of the world). However, this only points out more obviously the misallocation of resources which the system of protection inevitably created. Due to protection, we have invested in the “wrong” industries (i.e., in industries where there is no comparative advantage). If producing an import substitute locally requires P30 worth of resources for every dollar saved, while an exporting activity needs only P15 worth of resources to earn a dollar, then there is obviously a misallocation of resources. Society would maximize benefits if resources were reallocated so that we would produce less of the former and more of the latter. This represents the dead weight losses from protection arising from allocation inefficiencies.

In other cases, it could be equally true that protection simply allowed firms to be less efficient. And still in other cases, it could also be true that we are subsidizing relatively efficient industries, and this allows them to reap excess profits. Seemingly, it should not matter if protection is removed. The issue of protection via tariffs, import controls and import liberalization is thus less simple than trying to promote domestic industries, generating revenues and saving foreign exchange. There is a question of costs and efficiency. Is industry being promoted at all? And at what cost? Do these industries deserve the protection in the first place? Foreign exchange is saved with import controls, but, again, at what cost? If the cost of balancing the foreign exchange budget is increased, then the protection system would not help at all in solving our balance-of-payments problem in the long run. (The increased cost is due to the misallocation of resources created by the protection system which favors...
saving a dollar at a much higher cost than earning it.)

Still import liberalization remains to be a controversial issue, and as pointed out earlier, this is not really unexpected. The costs of protection are hidden, being so far removed from the source, that these are difficult for non-economists to realize. On the other hand, sectors which will be hurt by import liberalization are very organized and visible and often sensitive to the short-run adjustment costs that surely follow import liberalization. However, these adjustment costs would not be too much to pay for the dynamic and long-run gains achieved from a freer trade regime, including the macro benefits derived from the removal of the cost of protection that the Philippine economy has borne for the past three decades.

Additional Notes on Import Liberalization (Based on the PIDS-Media Forum Series)

As part of the Institute's dissemination program, a new project called the PIDS-Media Forum Series was launched on the 17th of September 1986. Held at the NEDA Makati Building, the Forum Series aims to discuss and clarify critical points of specific economic issues of national interest so as to better inform the general public.

For its launching session, the Forum Series focused on import liberalization. A panel of economists from the U.P. School of Economics (UPSE), U.P. Los Baños, the National Economic and Development Authority (NEDA), and the Philippine Institute for Development Studies (PIDS) was invited to present their views on the rationale and potential effects of import liberalization.

The participants and the aspects they discussed during the forum are as follows:

1. Dr. Florian Alburo
   Deputy Director-General (NEDA)
   General “Non-Issues” of Import Liberalization

2. Dr. Erlinda Medalla
   Research Fellow (PIDS)
   Impact on Industry

3. Dr. Cayetano Paderanga, Jr.
   Associate Professor (UPSE)
   Impact on Regional Development

4. Dr. Agnes Quisumbing
   Assistant Professor (UP Los Baños)
   Impact on Agriculture

5. Dr. Lourdes Adriano
   Assistant Professor (UP Los Baños)
   Impact on Agriculture

6. Dr. Raul Fabella
   Professor (UPSE)
   Effects on Income Distribution

7. Dr. Mario Lamberte
   Research Fellow (PIDS)
   Development Finance and Import Liberalization

Some of the points raised were the general “non-issues” of import liberalization. In this discussion, Dr. Alburo noted that a common misconception about the country’s proposed import liberalization program is that it is something being imposed on the country by the International Monetary Fund (IMF) and the World Bank. In addition, he noted that another misconception is the belief that any kind of openness of the economy will lead to vice, fuelling further the Filipinos’ penchant for imported goods (i.e., the so-called colonial mentality of the Filipinos will be further encouraged).

As rational consumers, Dr. Alburo believes that Filipinos are no less demanding of the optimal price-quality mix than their Asian counterparts, or for that matter, anyone else in the world. As to the perception that Filipino businessmen cannot come up to the standards of international business, Dr. Alburo noted that there are many enterprising Filipino exporters who have successfully penetrated highly competitive areas of business abroad.

Dr. Raul Fabella commented further on the concept of colonial mentality. He said the fear of encouraging colonial mentality among Filipinos, or alternatively, giving unfair advantage to foreign brands, is somewhat exaggerated. He observed that in the late 50s and early 60s, Japanese products were considered very much inferior to European or American products. However, the later decades altered this impression. The Japanese proved to the world that they can produce highly competitive goods that are also of high quality. Relating this to the Filipino’s attitude towards Philippine products, Dr. Fabella said that colonial mentality endures precisely because of the protection inherent in the system which allows the production of high-priced low-quality goods.

In terms of industry effects, several of the discussants agreed that because of the existing structure, import-substituting industries were protected, to the prejudice of export industries and the agricultural sector. This, of course, does not blend very well with the avowed policy to boost rural incomes and develop the countryside. As the three-decade protection experience has proven, incentives to agriculture had been severely depressed, and manufactured inputs, as well as consumer goods, have become progressively more expensive for agricultural producers.

To the extent that industries located in either Metro Manila or in the regions must be accorded the same tariff treatment, the first step, according to panelist Dr. Erlinda Medalla, is to make protection transparent so that policymakers can more definitely move towards applying uniform tariffs to industries, irrespective of location.

To be sure, the import liberalization program must be given serious consideration before anything is implemented. Much is demanded of policymakers — the timing, sequencing, concrete steps, modifications and effects of the liberalization plan need to be programmed and regularly monitored. The government will need to exercise discretion and flexibility, and wherever necessary, stabilization measures will have to be instituted. Since the liberalization plan is but part and parcel of an even bigger structural reform program, supplementary measures will have to be adopted also. This may be in the areas of foreign exchange, external debt or artificial barriers to more aggressive trade.
**UPDATE:**

**COMPLETED PROJECTS**

Bicol Multi-Purpose Survey Data Improvement Activity (BMSDIA) – Phase I

by: Sonia S. Imperial
Research and Service Center
Ateneo de Naga

The Bicol Multi-Purpose Survey Data Improvement Activity — Phase I represents the preliminary activities conducted by the BMS Data Generation Staff of the Research and Service Center (RSC) to identify the nature and extent of the problems that exist in the BMS data sets. The activity was developed primarily to assess the impact of the Bicol River Basin Development Program (BRBDP) and other public projects in the Bicol region. In 1978, a baseline survey was conducted by the Institute of Philippine Culture of the Ateneo de Manila. This was followed by another survey done in 1983, with the assistance of the National Computer Center (NCC) and the Agricultural Resource Center (ARC). The major tasks completed in Phase I include verification and checking of both the 1978 and 1983 data; determination of the source of problems related to both data sets and the nature of errors that have found their way in the final data; and the drawing up of a work schedule for the improvement activities.

The problems were traced mainly to discrepancies which occurred in almost all stages of the project, namely: a) error in encoding the data on the response forms which remained undetected in the final output; and b) inconsistent data that were not checked at all. Of the problems identified, the most serious pertain to consistency errors, affecting largely the income and employment variables. To the extent that the BMS is essentially designed to evaluate the development projects in the Bicol region,
a substantial improvement addressing the major problems is necessary to enhance the quality and usefulness of the BMS data for accurate analysis.

Population Pressure And Migration: Implications For Upland Development In The Philippines

by: Concepcion J. Cruz, Imelda Z. Feranil and Cristela L. Goce. Ms. Cruz is an Assistant Professor at the College of Development Economics and Management, and Chairperson of the Graduate Program on Environmental Studies, U.P. Los Baños. Ms. Feranil is Assistant Professor at the Population Institute of the University of the Philippines, while Ms. Goce is an Instructor at the College of Development Economics and Management, also at U.P. Los Baños.

The report is a demographic analysis of upland communities to help the government and other concerned sectors in understanding the nature and extent of population pressure in the uplands. More specifically, the study aims to arrive at a reliable estimate of current population in the uplands and the extent of migration to upland areas. There is also reference to the socio-economic and environmental determinants and consequences of upland migration and the dynamics of migration behavior. This may serve as an input to devise appropriate measures to control rapid upland population growth and to help in the development of social forestry-related programs. There is evidence of impending demographic stress as uncontrolled encroachment of populations into interior forest land continues. This has resulted in the progressive and widespread degradation of the uplands. Estimates as of 1980 show that over 14.4 million (or 30% of total Philippine population) reside in communities classified as upland. In terms of interregional flows, destinations are mostly the uplands of Laguna, Batangas and Mindanao, while source migrants come from Metro Manila and Central Visayas.

The macro-migration analysis indicates that the attractiveness of upland areas, especially the land availability factor, is more significant in explaining most of the variations in migration flow than factors associated with the area of origin. Other significant variables include population density, age at time of movement, and education. The case study of three villages in Laguna provides information on migration circumstances, socio-economic characteristics of migrants and a description of the adjustment process.

**ON-GOING PROJECTS**

Prescription of Ceilings on Certain Business Deduction and Standard Deduction Ratios

by: Angel Q. Yoingco
Executive Director
National Tax Research Center

Recent empirical studies have shown that the present system of income taxation of individuals and corporations permits considerable discretion on the part of both taxpayer and tax examiner. Hence, reported incomes can be grossly undervalued and deductions, abused. In many instances, overstatement of deductions has eroded the tax base and impaired the horizontal and vertical equity of the income tax system.

The objective of the study is to prescribe reasonable ceilings on the most commonly abused deductions claimed by businessmen and corporations on such expenditure items as representation, travel and advertising. Through this effort, there will be increased reliance on direct taxes as a source of government
The Empirical Magnitudes of Labor Supply and Interregional Migration

by: Cayetano Paderanga, Jr.
Associate Professor,
U.P. School of Economics

The study aims to contribute to the efforts towards analyzing the impact of rural investments and government interventions in the agricultural sector. As the sector develops, significant changes are noted in the magnitude and structure of production and labor supply. Moreover, changes in labor decisions to participate in either farm or non-farm sectors are seen to affect migration flows between urban and rural areas.

The main output of the study are coefficient estimates of the important variables that influence the decision to engage in farm or off-farm occupations, and to look into the effects of the factors that determine interregional and rural-urban migration. In addition, the impact of agricultural policy on nutrition and health, fertility, agricultural price and other variables are also examined.

PIDS-NEDA Roundtable Discussion on Devaluation and Related Policies

A roundtable discussion on "Devaluation and Related Policies" was held on Thursday, September 11, 1986 at the Operations Room of the NEDA Makati Building, under the sponsorship of the PIDS, NEDA and the United States Information Service (USIS). The guest speaker for the occasion was Dr. David B. H. Denoon who is also the author of a new book entitled "Devaluation under Pressure: India, Indonesia and Ghana." Dr. Denoon is currently Associate Professor of Politics and Economics at the New York University.

The main point that was stressed in the discussion was the necessity of developing a comprehensive reform package attendant to devaluation if the devaluation measure is to have significant positive effects on the economy and a minimum of negative ones. This entails working at structural reforms in the broader socio-economic and political framework in order to make the economic environment stable and attractive for domestic as well as foreign investments to thrive.

PIDS-Media Forum on Import Liberalization

The first in a series of fora between the media and representatives of the Institute was held on September 17, 1986 at the NEDA Makati Building. The objective of this exercise is to allow active discussion on major economic issues by bringing together a group of economists and print media representatives. This will, in turn, provide the general public basic information on current affairs of national interest. In its launching session, the Forum Series focused on import liberalization. Seven (7) economists from PIDS, the NEDA, the U.P. School of Economics (UPSE) and U.P. Los Baños discussed with several print media members the various aspects of the import liberalization program.

Seminar on Upland Development

A seminar on "Population Pressure and Migration: Implications for Upland Development in the Philippines" was held on Tuesday, October 7, 1986 at the NEDA Operations Rooms in Makati, under the auspices of the PIDS, the Center for Policy and Development Studies (CPDS) of the U.P. Los Baños, and the International Development Research Centre (IDRC). The seminar presented the findings of a joint research effort of Ms. Concepcion J. Cruz, Imelda Z. Feranil and Cristela L. Goece. Ms. Cruz and Ms. Goece are Assistant Professor and Instructor, respectively, at the College of Development Economics, U.P. Los Baños, while Ms. Feranil is Assistant Professor at the U.P. Population Institute.

Sponsored by the PIDS and the International Development Research Centre (IDRC), the research makes a demographic analysis of upland communities and determines the influence of destination and source variables in the migration decision. Moreover, the study also looks into the dynamics of migration behavior in order to recommend measures to policy makers on how to better control rapid upland population growth.
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