Analysis of Policy Constraints Affecting the Rural Non - Agricultural Sector in the Philippines

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PREFACE

This report was produced under the Employment and Enterprise Policy Analysis Project, which is managed by the Bureau for Science and Technology of the U.S. Agency for International Development. The prime contractor is Harvard Institute for International Development, and the two subcontractors are Michigan State University and Development Alternatives, Inc. (DAI).

The purposes of the project are to:

- Develop approaches for analyzing policy issues related to employment generation and small and medium enterprise development;
- Provide short-term technical assistance to AID missions that wish to address policy issues in this area; and
- Carry out long-term research on factors affecting employment growth and small and medium enterprise development in selected countries.

This report was prepared by a team of two economists provided by DAI in September 1985. During a three-week period, the team reviewed existing data and prior studies, met with government officials and business leaders, and visited small businesses in several regions of the country. This report is intended to be the first step in a policy dialogue on issues affecting rural non-agricultural development in the Philippines. It is expected that the next step will be to gather and analyze data on the major policy issues identified in this report.

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EXECUTIVE SUMMARY

The purpose of this report is to analyze and recommend changes in key policy areas related to the growth and development of the rural non-agricultural (RNA) sector in the Philippines. The major findings can be summarized as follows:

1. The RNA sector in the Philippines is not as large or as developed as in other countries at the same level of development. The main reason for this is the country's import substitution policies, which steered the economy away from the sectors in which it had the greatest comparative advantages. The policies that did the most harm were the overvalued exchange rate and import tariffs and controls. In the long run, the most effective way of achieving sustained growth in the RNA sector is to follow sound trade and monetary policies. The ongoing macro-economic policy dialogue is gradually moving the country in this direction.

2. An analysis of the characteristics of the rural non-agricultural sector indicates that most of the employment is in small businesses that provide consumer goods and services to the agriculture sector. There is a very strong link between growth in agriculture and growth in non-agricultural income and employment. In the medium term, policies to increase agricultural growth will do more to create jobs and increase incomes in the non-agricultural sector than all of the policies that have a direct impact on that sector.

3. However, within the context of improved macro-economic and agricultural policies, certain measures can and should be taken to ensure that the RNA sector can participate in and contribute fully to the overall growth of the country.

POLICY RECOMMENDATIONS

RNA Development Strategy

1. AID should support the stated Government of Philippines policy of giving priority to the RNA sector in the formulation of development policies and the allocation of public sector resources. AID should identify and urge specific actions that could be taken by the government in support of the RNA sector.

2. The government should formulate a rural non-agricultural development strategy that recognizes the wide variation in needs and potentials in the different regions. It is recommended that MTI or NEDA commission a study of each region to identify the constraints and potentials for non-agricultural development. Policies, programs, and resource allocations should then be based on the findings of the study.

<u>Rural Infrastructure</u>

3. The government should direct a greater proportion of infrastructure investments to areas other than Metro Manila. The RNA sector's infrastructure needs in order of priority are: electrical power, telecommunications, roads, coastal shipping, ports, and water supplies.

4. Once the rural share of infrastructure is determined, the government should adhere more closely to the selection and priority of infrastructure investments generated by NEDA. The NEDA list of investments gives greater weight to the needs of the regions and economic feasibility than the lists of the individual ministries.

5. User fees for public services (electricity, ports, and communications) should be restructured so that rural enterprises do not subsidize Metro Manila enterprises. USAID should encourage comprehensive studies of user fees in each sub-sector, especially electricity, to provide a basis for restructurization.

<u>Investment Incentives</u>

7. The Investment Promotion Act for Less Developed Areas (BP 44), which complements the BOI Omnibus Investment Code, should be revised to 1) increase incentives for locating outside of Manila; 2) differentiate between regions based on needs and potentials; and 3) make the incentives available to all BOI-registered firms.

8. Incentives for BOI-registered firms should be focused on regions with the greatest potential for industrialization in the medium term, that is, the incentive system should recognize that there are very few areas of the country that can attract businesses away from Manila.

9. MTI should commission a study of the manufacturing sector in Metro Manila to determine whether industries pay their fair share of the costs of infrastructure and supporting services. Any subsidies identified by the study should be eliminated.

10. An incentive system should be established for small- and medium-scale industries that do not benefit from BOI incentives. This system should be based on a study to determine what types of incentives would be most effective and what the impact of those incentives would be on non-agricultural employment and incomes.

Rural Credit

11. The government should not become involved in direct lending programs for rural SMEs at subsidized interest rates. government-sponsored credit programs for rural SMEs should be administered through private financial institutions.

12. The government must accept that the micro-business sector should not expect to obtain credit from formal financial institutions with no collateral or credit rating, and at highly subsidized rates of interest. The government should not try to fill this gap with programs to provide very small loans to very small firms.

13. The main vehicle for providing credit to the rural SME sector should be the private banking system. USAID and the government should give priority to strengthening the capacity of financial institutions to lend to small businesses in rural areas. Specific steps that could be taken include:

    a. Continue support of the IGLF by ensuring that enough funds are available.

    b. Support studies and pilot projects to make SSE lending more profitable for private sector banks. This effort could include 1) using government interest subsidies as a way of enabling banks to charge higher rates of interest to small and relatively higher risk businesses; 2) providing technical assistance to financial institutions to strengthen their ability to evaluate and supervise loans to SMEs; and 3) evaluating innovative financing mechanisms that reduce the risks of lending to small firms with insufficient collateral.

    c. Support studies and pilot projects to tailor SSE loans more closely to borrower needs, including increased availability of working capital loans and reduced collateral requirements.

Local Government Institutions

14. The government should take steps to decentralize revenue generation authority and responsibility. The decentralization of fiscal powers would be an integral part of AID-financed efforts to improve local resource management and develop rural infrastructure. In the short run, the policy dialogue should focus on 1) improving the capacity of local governments to collect property taxes and 2) reducing the strings attached to the return of revenues from the national government. In the long run, the objective should be to reduce the proportion of budgetary revenues and expenditures controlled by the national government.

15. The Ministry of Local Government should adopt a policy of minimizing the documentation requirements of small businesses in rural areas. To implement this policy, the ministry should issue guidance to provincial, municipal, city, and barangay governments on ways to simplify and expedite regulatory procedures for small businesses.

POLICY DIALOGUE STRATEGY

The 15 recommendations listed above can be summarized into five broad policy objectives:

1. Increase the share of infrastructure investments going to the regions, at least enough to remove the pro-Manila bias.

2. Rationalize utility rates throughout the country.

3. Increase the effectiveness of tax incentives to promote industrial dispersal.

4. Increase the availability of credit to the RNA sector from private banks.

5. Increase the fiscal autonomy of local governments.

If all of these policy objectives were to be achieved, the impact on the RNA sector would be significant. Businesses would be more efficient, more competitive with Manila, and better able to respond to export opportunities. The links with the agricultural sector would also be strengthened. Light consumer goods and some agricultural inputs would be produced locally, although consumer durables and other products requiring economies of scale would continue to be produced in Manila. More important but less quantifiable benefits include a more diversified and dynamic rural economy, and a more broad-based and sustainable development process for the economy as a whole. However, the combined impact of these policy changes on RNA employment and incomes would still be less than the impact of improved policies at the macro level and in agriculture.

If market-oriented macro-economic and agricultural policies are adopted, many constraints identified in the report will be eliminated or significantly reduced. It must be recognized, however, that this will be a slow process. The main reason for pursuing the policy changes recommended in this report is that, in the absence of special efforts, growth and development will continue to be concentrated in the Manila area and large rural-urban gaps will remain. Achieving the five objectives listed above will speed up and facilitate the process of redressing the imbalances.

If AID decides that these policy objectives are important enough to justify a policy dialogue relating specifically to the RNA sector, the following actions will be required over the course of the next year:

1. Generate baseline data on impact indicators to be used in the policy dialogue.

2. Generate baseline data on the characteristics of the RNA sector in each region.

3. Carry out policy-oriented studies in the areas where the issues are not yet clearly defined or AID does not have all of the information necessary to take a policy position.

4. The policy areas where the issues are adequately defined and a policy dialogue can be initiated are: removing urban bias in the allocation of infrastructure investments, removing the credit constraint for rural SMEs, and increasing the fiscal autonomy of local governments. The policy dialogue can be conducted in these areas in the context of projects financed by AID and other donors.

Chapter IV discusses possible approaches to the policy dialogue is greater detail.

I

BACKGROUND

Since 1980, the Philippines has been carrying out macro-economic and sectoral policy reforms to correct the import substitution and capital intensive biases that had been in effect for over 30 years. The adverse effects of these biases on the economy can be listed as follows:

1. The manufacturing sector is high-cost and includes industries that could not survive without import protection.

2. Because of the lack of competitiveness and a heavy dependence on imports (no backward linkages to domestically-produced goods) growth in manufacturing has not been much greater than that of GOP.

3. Employment in manufacturing has remained constant at 10-12 percent of total employment since the 1950s.

4. Infrastructure investment policies combined with dependence on imports has led to a heavy concentration of manufacturing in Manila.

5. The incentive structure led to large investments in inefficient capital intensive industries causing shortages in capital funds available for investments in agriculture.

6. Policies to keep producer prices of food and export crops artificially low combined with high input prices led to steadily deteriorating terms of trade for agriculture since the early 1970s.

The overall result was low economic growth and a classic dual economy characterized by an increasing gap in development and incomes between the modern urban sector and the rest of the country.

The first set of policy changes to address these imbalances are being carried out as part of the World Bank Structural Adjustment Program. The major changes are:

1. A reduced level of import protection through lower tariffs and the liberalization of import quotas.

2. Changes in the incentive system for industry and exports to relate incentives more closely to performance, reduce the bias toward imported capital and intermediate goods, and remove the capital intensity bias.

3. Decontrol of interest rates.

A second set of related policy changes designed primarily to correct structural balance of payments problems were initiated under the IMF Stand-by Agreement signed in November 1984. The key provisions of the agreement call for:

- A floating exchange rate.
- A balanced budget.
- Reduced inflation.
- Elimination of the balance of payments current economic deficit.
- Reduction of foreign exchange exchange arrears and increase in reserves.

Achieving these objectives has entailed and austerity program for the economy and the Government which is still underway.

At the sectoral level the major policy thrust has been in agriculture. The World Bank, IMF and AID have initiated a policy dialogue with the GOP that focuses on (1) the decontrol of agricultural prices, (2) decontrol of fertilizer prices and reduced protection for the domestic fertilizer industry, and (3) removing monopolies from the marketing of agricultural products.

The rural non-agricultural sector has not received much attention in the policy dialogue, although the regional development and the geographic dispersal of industry are stated priority concerns of the GOP as well as donors. If the policy changes discussed above are successfully implemented the rural non-agricultural sector will clearly benefit, primarily from the multiplier effects of higher agricultural growth, but also from improved overall economic performance and the removal of biases against labor-intensive industries. However, as will be discussed in the next section, these benefits will not be sufficient to assure that long-standing rural-urban imbalances will be corrected or that the rural sector can make its full contribution to growth and development in the Philippines.

The purpose of this report is to analyze the constraints and opportunities for growth in the rural non-agricultural sector, identify policy changes that are needed to remove constraints and take advantage of opportunities, and assess the impact of these policy changes on rural non-agricultural employment and incomes.

II

THE RURAL NON-AGRICULTURAL SECTOR

The rural non-agricultural (RNA) sector in the Philippines has been defined in different ways by the various authors and organizations that have studied it. The more restrictive definition of "rural" as used by national census and statistics offices is characterized by recognizable features such as population density, population size, the presence or absence of street patterns, establishments and public places. Typically, towns of population greater than 2,500 are classified as urban. Broader definitions are usually adopted by RNA researchers (Fabella; Gibb) such that towns which primarily serve regional and local markets are included in "rural." The broader definition is preferred in this study, recognizing that the growth of regional cities such as Iliolo and Davao should be promoted to help decentralize the Philippine economy. In general the policy recommendations generated herein pertain to all areas except the National Capital Region and Cebu City -- the two largest urban concentrations in the Philippines.

"Non-agricultural" excludes on-farm production, forestry, and fishing; it includes agricultural-based activities such as food processing, agricultural services, and other forward and backward linkages emanating from agricultural production.

The objectives of this Chapter are to describe the RNA sector in terms of magnitude and importance, describe the linkages with other sectors, and derive conclusions about the scope and relative importance of a policy dialogue between USAID and the Philippine Government.

CHARACTERISTICS OF THE RURAL NON-AGRICULTURAL SECTOR

In 1982 the RNA sector accounted for about one-fourth of total employment in the Philippines, or 4.3 million jobs. According to best estimates three-fourths of RNA employment is agricultural-based via indirect or induced effects. Slightly more than one million peopole -- or 6 percent of total Philippine employment -- are therefore engaged in rural, non-farm and non-agricultural based work. Reworking the figures to account for definitional and numerical differences among sources does not significantly change these estimates.[1] It must be emphasized, however, that there is a significant "underground" economy in the Philippines which avoids counting, so actual RNA employment and income is certainly higher than statistics indicate.

The percentage distribution of rural employment in 1974 by major industry group is shown in Table 1. Primary agricultural production accounted for 75.9 percent, manufacturing 7.4 percent, and commerce 6.1 percent. The remainder is dispursed among remaining sectors.

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1 Calculations for 1982 are as follows:

Total Philippine employment	= 18 million
Total rural employment	= 13 million
RNA employment	= 4.3 million (1/3 of 13 million)
RNA non-ag.-based employment	= 1.1 million (1/4 of 4.3 million)

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TABLE 1

PHILIPPINE RURAL EMPLOYMENT DISTRIBUTION BY MAJOR INDUSTRIAL SECTOR, 1974[a]

Industry Group	Percent of Rural Employment[b]
Agriculture, forestry, hunding and fishing	75.9
Mining and quarrying	0.3
Manufacturing	7.4
Electricity, gas, water and sanitary services	0.1
Construction	1.9
Commerce	6.1
Transport, storage and communication	2.4
Government, community business and recreation	3.6
Domestic services	1.5
Personal services other than domestic	0.7
Industry not reported	0.1
Total	100.0

a Source: Fabella, Table 7-3.

b Includes men and women, wage and salary workers, self-employed workers, and unpaid family workers.

Unemployment and Underemployment

Employment in the Philippines -- particularly in the RNA sector -- diminishes very little in times of general economic decline. An unemployment rate of only 4.1 percent was recorded in the fourth quarter of 1983 -- a time of emerging economic crisis (World Bank, 1985). The apparent reason is that when times are bad more people enter the work force in an effort to maintain minimum household income levels. (World Bank, 1985; NEDA 1984). A more critical indicator of economic distress is underemployment, which reached about 30 percent in the fourth quarter of 1983.

Fabella reports that "on the whole, the impact of RNA is more evident on female than on male workers." His analysis of 1974 data indicates that proportionally more women in the work force are drawn into non-agricultural jobs than men; in absoluate terms the RNA employment split was 52 percent men and 48 percent women.

Income

As would be expected, urban incomes are higher than rural incomes in the Philippines. Furthermore, there was deterioration in the rural-urban income differential between 1975 and 1980-83; the rural-urban per capita income ratio declined from 0.75 to about 0.5 (World Bank, 1985). This increasing rural-urban income difference is corroborated by NEDA (1984) which points out that the faster growth of population in rural areas eroded rural per capita figures.

The World Bank (1985) reports that non-agricultural labor in rural areas was a source of livelihood with relatively low proverty incidence (26%) from 1980-83. However, this group accounted for only a quarter of all rural families.

The evidence is clear that the rural sector and its subset -- the RNA sector -- is poorer than the urban sector and getting relatively poorer. Policy action to reverse the trend appears to be justified.

<u>Sector Linkages</u>

The RNA sector is driven in part by indirect and induced activity originating in the agricultural sector. When agricultural production occurs there are "forward linkages" such as storage, transportation, processing packaging and trade, plus "backward linkages" such as input manufacture and distribution. However, analysis by Gibb (1984, p.2) suggest that rural towns principally serve the agricultural households as consuming units rather than as producing units.

> This interpretation places agricultural income and its distribution at center stage as the prime determinant of agricultural market center growth and suggests that these centers are far more consequences of agricultural growth than causes of it.

In his study at the southern sub-region of Nueva Ecija Province, Gibb estimated the elasticities of demand for forma sector non-agricultural labor with respect to changes in agricultural income.[2] Elasticity coefficients exceed 1.0 in all but two sectors at the Sub-Region level in 1967-71. However, the general result is that each increase of one percent in

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2 Elasticity is the ratio of percentage change in employment to the percentage changes in agricultural income.

agricultural income generated an increase of between 1.23 percent and 2.16 percent in the sectors of retail trade, personnal services, trades, crafts, and light transportation services. In other words, RNA employment is very responsive to changes in agricultural income.

The World Bank (1981) examined the association between agriculture and urban industrial development (both small scale and large scale) in the provinces. It was concluded that the linkage is strong, and that current low crop yields in the Philippines suggest potential for agriculture led industrial growth in the provinces.

> The evidence presented underlines the importance of agriculture as the leading element in urban-industrial development in the provinces. This conclusion is not new. But the strength of the linkages between agriculture and local industry and commerce appear to be even stronger than might have been thought earlier; in the high growth agricultural districts, the emergence of small and large manufacturing establishments in the local urban centers has been very rapid in recent years. (World Bank, 1981, p. 131)

CONCLUSIONS

Available data on the rural non-agricultural sector in the Philippines indicate that most of the employment is in micro-businesses that produce goods and services for farm households. There is a very strong link between changes in agricultural incomes and changes in rural non-agricultural income and employment. Conversely, the proportion of rural non-agricultural sector producing non-agricultural goods for domestic urban markets or for export is very small. Given the present configuration of the rural non-agricultural sector, the single most effective way of increasing employment and incomes is to increase agricultural incomes, i.e., policies to increase agricultural production will have a larger impact on employment in the rural non-agricultural sector than any RNA-specific policies.

It must be recognized, however, that this is a static analysis based on the existing situation in the Philippines. Increasing employment and incomes in the low-productivity micro-enterprises that produce goods and services for farm households is appropriate in the short run, but is inadequate to achieve self-sustaining rural development in the long-run. More developed Asian countries -- Taiwan, Malaysia, Korea -- have more diversified rural economies in which the small and medium scale enterprise sector plays a much larger role relative to agriculture-related cottage industries than in the Philippines. A strategy for the rural non-agricultural sector in the Philippines should look beyond creating jobs in the micro-enterprise subsector that serves agriculture, and address the following issues:

- Ways in which the non-agricultural sector can contribute to agricultural diversification and growth;
- How the multiplier effect of agricultural growth on the rural non-agricultural sector can be increased;
- How the segment of the rural non-agricultural sector that is not related to agriculture, i.e., industries producing for urban and export markets, can develop its own momentum; and
- How to facilitate the transition from cottage industry to small- and medium-scale enterprise in rural areas.

The major policy areas that can have an impact on these objectives are discussed in the next section.

III

POLICY AREAS

INTRODUCTION

Before discussing policy issues that directly affect the rural non-agricultural sector, it is necessary to place them in the perspective of the overall development policy dialogue. The low level of growth and development in the rural non-agricultural sector is due primarily to market-distorting macro-economic policies rather than to any deliberate anti-rural bias. The most harmful of the macro-economic policies were the overvalued exchange rate and import controls. Because of the overvalued exchange rate Philippine exports were non-competitive on world markets thus hampering growth in the sectors where the country had comparative advantages. The import controls resulted in a large import-substitution sector that was protected from market forces and grew in response to incentives that also did not reflect comparative advantages. Less important, but also contributing to the distortions, were artificially low interest rates and minimum wages that exceeded the marginal revenue product of labor. Over time, these policies resulted in urban-based capital-intensive industrialization and a lower rate of rural growth and development than would have occurred under a more free market-oriented development strategy.

Thus, in the policy area, the issues that are most critical to long-term growth in the rural non-agricultural sector are trade and monetary policies. Further, the impact on the rural non-agricultural sector will be felt primarily through improved performance of the agriculture sector. The policy changes discussed in this section impact directly on the rural non-agricultural sector and if implemented, will place it in a better position to participate in the higher rate of economic growth that can be expected as a result of improved macro-economic and agricultural policies.

DEVELOPMENT STRATEGY FOR THE RURAL NON-AGRIUCLTURAL SECTOR

Although the GOP has stated on numerous occasions and in numerous documents that development programs and policies will give special priority to rural areas, there is no development strategy for the rural non-agricultural sector. In the formulation of such a strategy, there are two key issues:

1. The extent to which the rural non-agricultural sector should be given special consideration in policy formulation and resource allocation.

It is generally agreed that, at a minimum, biases in favor of urban areas and capital intensive industries should be eliminated in macro-economic and industrial policies. Most of these policy biases have been removed during the past two years. In the long-run the removal of distortions and biases will lead to more balanced growth and development, both sectorally and geographically but, as noted above, this is likely to be a very slow process.

The issue that concerns us here is whether existing rural-urban disparities *per se* are detrimental to the overall economy over the medium to long term. Would reduced disparities lead to a stronger, more competitive, more dynamic economy? This question cannot be answered empirically in this report, but in a general sense there are certain economic, not to mention obvious social and political advantages to broad-based development. The low level of productivity in rural areas means that there are considerable underutilized labor and natural resources. Also, increased development in the regions would result in a more diverse economic base which is an important factor in bringing about sustained long-term development. In more specific terms, development of the rural non-agricultural sector would tend to increase the share of labor-intensive industries in the manufacturing sector. It would also facilitate agricultural diversification into crops that are potentially profitable but require agro-processing that would be difficult to establish in rural areas under present conditions.

2. The need to formulate a development strategy for the rural non-agricultural sector that reflects the diverse needs and potentials of the different regions.

The characteristics of the rural non-agricultural sector in the Philippines vary greatly from region to region. Perhaps the most useful way to approach the formulation of a strategy is to categorize the regions according to medium-term potential for industrialization. This was done in a recent study of industrialization policy in the Philippines by Louis Berger, Inc. (Berger, 1985). In that study the regions were categorized as follows:

Tier I : Metro Manila which is the most advantageous location for industry because of its well developed infrastructure and institutional base.

Tier II : Regions III (Central Luzon) and IV (Southern Tagalog). These regions are already experiencing industrial growth because of their proximity to Manila and clearly have the most potential for attracting industry outside of the Manila area.

Tier III : Regions I (Ilocos), VI (Western Visayas), VII (Central Visayas), X (Northern Mindanao) and XI (Eastern Mindanao). These regions have large urban areas with some industries, mostly local resource-based. They could have some potential for attracting industries that are not based on local resources but realistically, in terms of number of jobs created, that potential is quite small.

Tier IV : This covers the rest of the country. Virtually all of the non-agricultural sector in these regions is accounted for by businesses that provide goods and services to the agricultural sector. These areas have almost no medium-term potential for industrialization that is not based on local resources.

The rural non-agricultural sectors in categories II, III, and IV each require different development strategies. Efforts in the category IV regions, for example, should be based primarily on growth in agriculture. The bulk of non-agricultural employment is in micro-businesses that provide very rudimentary consumer goods and services. Examples include baking, tailoring, shoemaking, carpentry, welding, bicycle repair, and small-scale commerce. Most of the demand for these goods and services comes from farm households and is, therefore, directly linked to agricultural incomes. The most effective way to increase non-agricultural employment and incomes in these areas is to increase agricultural incomes. The focus of non-agricultural policies and programs in these regions should be on 1) the needs of micro-businesses serving the agriculture sector; and 2) the needs of agro-processing industries associated with agricultural diversification. It would be a wasteful diversion of industrial development resources to treat these areas as if they might compete with the rest of the country for industries that are not based on local resources.

The characteristics of the rural non-agricultural sector in the category III regions are similar to those describe above. The only difference is that they have slightly more potential for industrialization that is not based on local resources.

The main point that needs to be made here is that any strategy for rural non-agricultural development should reflect the different needs and potentials of each region. The next step is to gather data on the characteristics of the non-agricultural sectors of each region. The data should cover 1) the breakdown of the existing non-agricultural sector by type and size of business; 2) constraints that are hampering the growth of this sector; and 3) possible local, national and export markets that could lead to new sources of employment and income. Potentials for new industries should be analyzed from the standpoint of constraints to be overcome and incentives that might be needed to make an investment feasible or to encourage location in the regions instead of Metro Manila. At the same time, a study should be undertaken at the national level to categorize industries according to the likelihood that, with proper incentives and improvements in infrastructure and services, new firms might locate outside of Metro Manila.

It needs to be emphasized that whatever the final strategy turns out to be, it will not lead to rapid industrialization of the regions, with the possible exception of the Tier II regions. The objective should be to gradually bring about balanced and self-sustaining economic growth in the regions that is based on agricultural as well as non-agricultural development.

Recommendation 1

> AID should support the stated GOP policy of giving priority to the rural non-agricultural sector in the formulation of development policies and the allocation of public sector resources. AID should identify and urge specific actions that could be taken by the Government in support of the RNA sector.

Recommendation 2

The GOP should formulate a rural non-agricultural development strategy that recognizes the wide variations in needs and potentials in the different regions. It is recommended that MTI or NEDA commission a study of each region to identify the constraints and potentials for non-agricultural development. Policies, programs, and resource allocations should then be based on the findings of this study.

RURAL INFRASTRUCTURE

Investment in rural infrastructure such as roads, electrical power, telecommunications, ports and water supply directly affects the rural economy by providing access to resources and markets, and by increasing the efficiency of production and marketing activities. Important characteristics of infrastructure investments are that they require large capital investments, last a long time (with proper maintenance), and are "natural monopolies" which require some degree of government control. Government control is necessary to assure suitability in terms of size, quality, cost, coordination with other infrastructure investments, national development objectives, and pricing of services.

The importance of infrastructure to rural economic development in the Philippines is described and estimated by Tippetts, et. al, (1984) in a report to USAID on infrastructure investment and maintenance. Principal findings are:

1. The construction of infrastructure components is estimated to involve about one-third of construction activity in the Philippines.

2. Between 1970 and 1983 the total share of Gross Domestic Product generated by the sectors of electricity, gas and water, transportation, and communications and storage increased from 4.54 percent to 6.5 percent.

3. In 1974, the sectors mentioned above, plus one-third of construction activity, accounted for 3.8 percent of the total value of transactions in the economy of producer prices.

The Tippett report appropriately suggests that numerical indicators do not reflect all the benefits emanating from infrastructure such as the value of developing rural areas by providing access to markets, the improved efficiency of business activities, or the quality of life for rural infrastructure is a critical component of rural development in the Philippines; the more relevant issue addressed in this study is whether or not lack of infrastructure has been a constraint on rural development and, if so, what policy changes can be implemented to rectify the situation.

The Existing Situation

Given that investment capital for infrastructure is not unlimited it is somewhat perfunctory to state that insufficient and inadequate infrastructure is a constraint on rural development in the Philippines. Nevertheless, some first-hand evidence has been collected as part of this study which helps prioritize the deficiencies to be overcome.

The poor reliability and high cost of electrical power are the most common infrastructure constraints mentioned by the rural business community. For example, a resolution to restructure (and therefore lower) electricity prices was passed at the 1985 Bicol Business Conference (for Regions 5 and 8) sponsored by the Philippine Chamber of Commerce and Industry (PCCI). Another PCCI Business Conference for Regions 1, 6, 8, 9, 10, 11, and 12 identified electricity prices as one of the principal issues

(Philippine Chamber of Commerce and Industry, 1985). It was also pointed out that periodic interruption of power supply forces some firms to invest in standby generators, thus raising overhead costs.

A second principal infrastructure constraint is roads. Truck transport costs directly reflect the condition of rural roads, which dictate the time required for travel and the wear and tear on equipment.

Telecommunications is a commonly mentioned constraint. It is reportedly easier to make an international telephone call from rural areas than to call Manila. Service interruptions and poor connections frustrate business communications.

Other infrastructure items mentioned as needing upgrading include ports and water supply. A report by Louis Berger International (1985) for the Asian Development Bank listed the following rural infrastructure categories in order of importance for upgrading: coastal shipping, electrical power, water, telecommunications, ports and roads.

User fees for self-supporting infrastructure such as ports, telecommunications, water and electricity favor Metro Manila.

> In many ways, industry located in the National Capital Region is heavily subsidized. Such subsidies include lower utility rates than would be justified if they were asked to pay their proportionate share. Manila businesses also do not pay their proportionate share for road and port usage or their share of shipping costs. They do not pay their proportionate share of property taxes. (Louis Berger International, 1985, p. 2 of Preliminary Conclusions).

> (Coastal shipping rates) . . . discriminate in favor of long hauls to and from Manila and against short hauls in and between regions. (Op. Cit., p. 1 of Infrastructure).

Field work conducted as part of the present study reveals that industrial electricity rate in Manila are about one-third that of some regions such as Bicol. A significant portion of port user fees are diverted into the National Treasury instead of being retained by the Philippine Port Authority for maintenance and improvement of facilities (Tippets, 1984). The issue of infrastructure pricing warrants thorough investigation if constraints on industrial dispersal are to be mitigated.

Inadequate maintenance of infrastructure is a persistent and well-documented problem in the Philippines. Reference is made to the study by Tippets, et. al. for description and evidence.

The Investment Allocation Process. The Government of the Philippines (GOP) is responsible for selecting nearly all of the infrastructure investments under consideration in this report, namely roads, ports, electrical power, telecommunications, and water supply; exceptions include small investments such as village roads which are financed by municipalities. Selection of the types and locations of infrastructure investments are made by reconciling local requests with national development plans and the availability of funds. The process is at once "bottom up" and "top down", but the latter takes precedent. Steps in the selection process are as follows:[1]

1. The National Economic Development Authority (NEDA) -- the government planning agency -- hosts a workshop at the municipal level to prepare a list of desired infrastructure projects called the Municipal Development Investment Program (MDIP).

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1 A description of NEDA responsibilities and the planning process is in the study by Louis Berger International (1985).

2. NEDA coordinates a workshop at the provincial level to evaluate and integrate the MDIPs. Infrastructure selection is guided to be consistent with national plans and priorities dictated by central government offices.

3. At the regional level, NEDA consolidates and integrates provincial-level infrastructure selections into the Regional Development Plan (RDP) which contains a Regional Development Investment Program (RDIP) -- a five-year prioritized list of investments finalized and recommended by the Regional Development Council (RDC). The Regional Development Council is composed of all regional assemblymen, mayors, and ministry representatives from each infrastucture type.

4. At the national level NEDA combines 12 regional plans into a national infrastructure investment plan which is presented to congress for approval.

5. Congress, the President (who is titular head of NEDS), or the Office of Budget and Management (OBM) can add to, delete or modify the selectioin of items and expenditure levels.

In theory, the investment selection process is systematic and logical, but in practice, it is abused. Politicians reputedly make liberal use of their ability to steer infrastructure investments, and the OBM can terminate or redirect funds after the list has been approved. A feeling of frustration pervades NEDA, which performs the technical tasks of assembling, analyzing, prioritizing, and recommending infrastructure investments only to be overruled. One regional NEDA director said that seven years ago only about 20 percent of recommended investments emanating from his region were approved, but now the figure is up to about 60 percent. There appears to be gradual improvement in adherence to technically-selected investments in response to professed objectives of government decentralization.

Urban Bias. It has been alleged that the GOP favored investment in urban infrastructure for many years -- particularly in Metro Manila -- at the expense of rural areas. Allegations of urban bias in the allocation of infrastructure in the Philippines have been made by various sources. A study by Vreeland, et. al., (p. 318), reports that "...between 1965 and 1972 almost half of government expenditure on infrastructure took place in only two regions: Rizal Province (which includes Manila) and Central Luzon (the provinces of Pampanga and Nueva Ecija)." The World Bank (1984, p. 169) indicates that 66 percent infrastructure investments in 1983 which could be identified as region-specific occurred in the National Capital Region (Metro Manila). According to that report the planned share of expenditures on infrastructure to be allocated to the National Capital Region ranges from a low of one-third in 1985 to one-half in 1987. Additional evidence of urban bias during the past decade has not been obtained in the present study because of the difficulty and time required to do so.[2] However, interviews with government officials and private sector businessmen confirm the impression that urban bias continued during the past decade.

The Impact of Urban Bias. The consequences of urban bias are absolute cost and amenity advantages for firms locating in urban areas, and the inability of rural areas to attract growth-

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2 According to the Director of the Regional Development Staff of the National Economic and Development Authority, a separate investigation would have to be undertaken in each infrastructure subsector (e.g., electrical power), and sorting out the numbers would be a formidable task. For example, actual monetary disbursements do not correspond to budgeted amounts, disbursements made for a specified project are typically spread over numerous years, and separation of new construction from maintenance accounts is not always clear.

inducing, non-agriucltural based industries. The pro-urban policy has been followed for so long and in such great magnitude that the advantages of locating in Metro Manila are virtually permanent. Principal advantages described in secondary sources (Moran, 1979; Berger, 1984; World Bank, 1979) and in personal interviews include:

1. Access to inputs. Users of non-agricultural inputs find it convenient to be located near their suppliers because service is rapid, communication is prompt, and transport costs are low.

2. Access to markets. Metro Manila and world markets are most easily reached at least cost by locating production in Manila itself. Furthermore, Manila is the transportation hub of the country with frequent air and sea transport to all areas of the country.

3. Availability of Skilled Labor. Many of the Philippines' best entrepreneurs, managers, and skilled workers reside in Manila where incomes are relatively higher and the quality of life is perceived as better than other areas. The amenities of Manila -- particularly education -- are frequently mentioned as an important reason why fims and people locate there.

4. The need for communications with government and business. Businesses typically have a continuous and frequent need to communicate with government agencies concerning a myriad of controls, permits, and other issues which are complex and time-consuming. Other businesses (e.g., banks) also tend to be centralized in Manila.

It is clear that one of the most important factors influencing the location of industry is the availability of supporting infrastructure. At a minimum, any serious effort to promote the regional dispersal of industry should include the elimination of the Metro Manila bias in the allocation of infrastructure investments. What is less clear is how far to go in eliminating the bias. The heavy concentration of the modern sector in the Manila area means that this is where most of the infrastructure needs are. Just meeting those needs will require a major portion of infrastructure investments. In addition, there are natural and economically sound growth trends based in Manila which need to be supported with the necessary infrastructure. Therefore, it is very unlikely that the removal of the urban bias alone will result in a large increase in infrastructure investments in the regions.

An allocation system that is based on meeting the legitimate needs of the Manila area while at the same time supporting the development potential of the regions would be a great improvement over the existing system, but it would not be enough to make a significant impact on infrastructure constraints outside Manila. The development of rural infrastructure will also require additional resources, which donors appear willing to provide. It must be emphasized that both the policy shift and the additional resources are needed. It is especially important to guard against using donor-funded projects as a way of freeing up Government funds for investment in Metro Manila.

Policy Recommendations

1. The GOP should adhere to its stated objectives of industrial dispersal by directing a greater proportion of infrastructure investment to areas other than Metro Manila. Priority should be given to electrical power, telecommunications, roads, coastal shipping, ports and water supply.

2. Once the rural share of investment is determined the GOP should adhere more closely to the selection and priority of infrastructure investments generated by NEDA in order to achieve greater economic benefits than is possible with arbitrary selection.

3. User fees for public services (electricity, ports, telecommunications) should be restructured to remove the urban bias. USAID should encourage comprehensive studies of infrastructure user fees in each subsector, e.g., electrical power, to provide a basis for restructurization.

4. Greater emphasis should be placed on infrastructure quality and maintenance than is currently provided.

The Expected Impact of Policy Changes

A change from Metro Manila bias to rural bias in the allocation of infrastructure will increase the relative desirability of locating new enterprise in rural areas. Both new firms and existing firms in rural areas will be able to conduct business more efficiently and cheaply than they can now. Improved maintenance and infrastructure quality will have the same impact.

Restructuring user fees so that rural areas have the same rates as Metro Manila will improve the profitability and attractiveness of rural sites to firms -- paricularly heavy users of electrical power.

Closer adherence to infrastructure investments selected by NEDA using economic feasibility analysis will result in greater economic benefits for the country than investments chosen arbitrarily or politically.

Development of rural infrastructure is a necessary but insufficient condition for employment and income growth in rural areas. If the recommended policy changes are implemented the constraints on rural enterprises will be somewhat mitigated, but additional incentives might have to be provided or additional constraints removed.

Since the infrastructure categories recomm nded for improvement are potentially useable by everyone, it is likely that overall rural economic growth will improve as a result. An increase in agricultural incomes due to better market access, for example, will increase demand for non-agricultural products. Separation of non-agricultural employment growth into that generated by growth in other rural sectors and that generated by better infrastructure for business per se becomes somewhat academic and probably unquantifiable.

INVESTMENT INCENTIVES

The Existing Incentive System

Investment incentives in the Philippines are a major policy tool for influencing the direction and rate of growth of the manufacturing sector. Most of these incentives are exemptions from taxes and import duties. To qualify for incentives, firms must be in industries that produce goods now being imported, or industries that can produce competitively for export. These industries are designated as "preferred areas of investment". Firms in the preferred areas are categorized as domestic or export producers and also as "pioneer" or "non-pioneer". As a general rule, non-pioneer domestic producers receive the lowest incentives and pioneer export producers receive the highest incentives. Analyses of the impact of these incentives on investment decisions have shown that they can increase the rate of return on investments by as much as 15 percent.

In April 1983, the investment incentive system was revised to correct biases against labor-intensive industries and domestically-produced capital and intermediate goods. (The revised incentives are summarized in Annex 1.) In addition, the incentive code has been simplified (7 types of incentives instead of 12) and documentation required by the Board of Investments (BOI) has been substantially reduced. A firm that keeps standard financial records (balance sheet, profit and loss statement, and income tax returns) can apply for incentives and obtain a decision within a maximum of 20 days. Once a firm starts receiving incentives, the BOI requires little more than copies of records that businesses would normally be keeping for other reasons.

It is likely that the revised incentives will have a significant positive impact on economic growth and development in the Philippines. Assuming the continued liberalization of imports, the manufacturing sector will become more export-oriented and, therefore, more efficient and competitive. The reduced bias in favor of imported intermediate and capital goods should contribute to a higher growth rate in manufacturing due to stronger backward linkages to local producers. Finally, factor-neutral incentives should increase the impact of the manufacturing sector on employment.

The Impact of the Investment Incentive System on Industrialization Outside Metro Manila

The main indicator of success for an import substitution-based development strategy is the rate at which imports are replaced by domestically produced goods. The most straightforward way of achieving a high rate of import substitution is to impose import barriers, develop the necessary infrastructure and provide investment incentives to "infant industries". If carried to extremes this strategy invariably leads to concentration of inefficient relatively capital intensive industries in large urban areas, which is what has happened in the Philippines. This could have been avoided with a more market-oriented development strategy, the key elements of which would have been less protection against imports, less capital bias in the incentive system, and more balance between import substitution and export promotion objectives. A market-oriented strategy would have led to economic growth based on comparative advantages which would have meant more labor-intensive and agri-based industries. Industrialization would still have been concentrated in Manila but the regions would have participated to a greater extent than they do now.

The revised incentive system combined with import liberalization has removed the most serious distortions. This should lead to better use of the country's resources including those in rural areas. However, in the absence of special measures to promote regional dispersal of industry, industrial growth will continue to be highly concentrated in Metro Manila with increasing overflow into Regions III and IV. Because of the infrastructure and institutional base, this is where it makes the most economic sense for industries to locate.

The Government, however, has a stated policy of encouraging regional dispersal of industry. The Investment Incentive Code contains three provisions to encourage industries to located outside Metro Manila, two of which apply only to export producers. There is a provision in the investment code which allows exporters to deduct from their taxable income an amount equal to the direct labor and local raw material costs of the export product up to a maximum of 25 percent of the export earning of the producer. This is additional to the normal deduction for income tax purposes. If an export firm located in an area designated by the BOI as necessary for the proper dispersal of industry or in an area which the BOI finds deficient in infrastructure, the firm is entitled to double the labor costs in calculating this deduction as long as the total incentive-related deduction does not exceed the limit of 25 percent of total export earnings. The second incentive for exporters is that if they have to invest in infrastucture as part of their project, they are entitled to a tax credit equal to 100 percent of the cost of the infrastructure investment.

The third incentive, the Investment Promotion Act for Less Developed Areas (BP 44), provided that all BOI registered enterprises located in areas designated as "less developed" are entitled to all of the incentives granted to pioneer industries. Pioneer fims receive no additional incentives for locating in less developed areas, and, since export firms receive all of the incentives of pioneer firms, they do not benefit from this act either. In fact, non-pioneer domestic producers receive only one benefit from BP 44. Pioneer firms receive a tax credit equal to 10 percent of the value added generated from their investments, while non-pioneer firms receive a 5 percent tax credit. Thus, under BP 44 the incentive for a non-pioneer firm to locate in a less developed area is a tax credit equal to 5 percent of the value added generated by the project.

The BOI incentives for locating outside Metro Manila are deficient in several respects. First, none of the incentives are available to all firms. Two are limited to export firms and one is limited to non-pioneer domestic firms. Second, the incentives are not large enough to counteract the attractions of the Manila area. The double labor deduction is particularly ill-conceived. Firms whose deductions are most likely to approach 25 percent of export earnings are labor intensive industries with a high local cost content, while those with low benefits under this provision are likely to be capital intensive and dependent on imports.

Firms that would be most likely to be consider locating outside of Manila because of this incentive are the very firms least likely to benefit from it. Third, BP 44 excludes from its definition of "less developed" most of the areas in the regions most likely to attract industry. Most of the less developed areas under BP 44 are simply not developed enough to attract industry under any reasonably conceived set of incentives.

The impact of these incentives on the regional dispersal of industry has been negligible. It should be recognized, however, that even if these incentives had been increased, they would not have made much difference. In the absence of infrastructural and institutional development in the regions, investment incentives cannot counteract the strong advantages of Metro Manila. However, they can be designed to: 1) swing the balance in favor of areas with an infrastructure and institutional base that can support certain types of industries; and 2) increase the returns of industries that are local resource-based but may be disinclined to invest because of inadequate infrastructure and general low level of development.

Recommended Changes in Incentives for Industries Located Outside Metro Manila

To design an effective incentive system it is necessary to be clear on the objectives to be achieved. In this case, the objective should be to reduce the share of manufacturing value added accounted for by Metro Manila. This, however, is only a proxy indictor for a broader and more basic objective which is to move the Philippines away from the existing dual economy to one which is based on comparative advantages and makes more efficient use of the country's resource base, especially labor and natural resources in the rural areas.

It should also be emphasized that the incentive system must be based on the infant industry argument and only secondarily on equity concerns. In other words, the investment incentives system should not be a subsidy program designed to transfer resources to disadvantaged areas. They should be seen as assistance to private enterprise to initiate activities in rural areas that are economically viable over the long-term, but are relatively unattractive investments due to inadequate infrastructure and weak supporting services. In this connection, it is important that investment incentives and infrastructure development programs be well coordinated. An incentive system in the absence of infrastructure development will have very little impact on the geographic dispersal of industry.

The recommended incentives for regional dispersal of industry fall into two categories: A) incentives for firms that are registered with the BOI; and B) incentives for small and medium scale enterprises that do not stand to benefit significantly from BOI incentives.

<u>Incentives for BIO-Registered Industries</u>

The easiest way to improve the incentives for BOI firms to located outside of Metro Manila is to rewrite the Investment Promotions Act for Less Developed Areas (BP 44). The most important required changes are the following:

- Increase the level of incentives. Existing incentives provide no benefits to many firms, and even when there are benefits they have little impact on the rate of return on the investment. The main incentive at present is the tax credit equal to 5 percent of value added. This type of incentive is effective because it is related to the performance of the enterprise and its contribution to the economy and should, therefore, be retained in the revised system. The appropriate level of incentive cannot be determined without analysis of the disadvantages of locating outside of Manila and of the rate of return on investments that would be needed to compensate for those disadvantages.

- Broaden the geographic coverage and differentiate between geographic areas. Special incentives should not be limited to the least developed areas of the Philippines. In fact, a strong case can be made for focussing the incentives on the Tier II and III regions as described on page 15. Those are the regions that have the most potential for industrialization in the medium term. There is little point in designing incentives that have no chance of contributing to their desired objective.

- Design the incentives so that they benefit all types of firms -- domestic producers and exporters, and pioneer and non-pioneer.

- Keep the 100 percent tax credit on infrastructure investments. This incentive admittedly has no effect on firms that want to locate in Metro Manila because of the infrastructure, but could make a difference for businesses willing to locate elsewhere but unable to make infrastructure outlays. This incentive is even more justified if the firm's infrastructure investment also benefits the surrounding area. The tax credit should cover the entire cost of the infrastructure investment including the costs of capital and management time.

At the same time that incentives for regional location are being improved, a study should be undertaken to determine whether industries in the Metro Manila area are being subsidized through artificially low urban taxes and user fees for public services. There are tremendous advantages to locating in Manila and it may be that in some cases they are not being fully paid for by the beneficiaries.

An important complement to the improved incentives listed above will be the Agricultural Incentives Act. By encouraging agri-business and agro-processing, this bill will contribute to the development of a sector where the Philippines has strong comparative advantages but which has been held back by 30 years of policies and programs favoring the Manila-based manufacturing sector.

In deciding on fiscal incentives to promote industrial dispersal in the Philippines, several issues must be considered. The first is that the possibilities for the geographic dispersal of large industries is quite limited. These businesses not only need supporting infrastructure and services, they also need amenities for their senior personnel. Except for Cebu and certain parts of Region III and IV, there are no locations that can come close to providing the same range of economic and social services as Metro Manila. If the necessary infrastructure is available, tax incentives might induce some businesses to locate outside Manila, but not many. In general, locating outside Manila means paying bonuses to management and senior technical staff, paying higher utility rates, and incurring larger expenses for logistic support. Tax incentives can rarely compensate for these additional costs.

The focus of incentives, therefore, should be on businesses that are not heavily dependent on the advantages that only Metro Manila can offer. Even there, however, there is the issue of whether tax incentives are an effective means of influencing investments, especially in the Philippines where many businesses go to great lengths to avoid paying taxes. It is usually difficult to determine whether incentives make a difference in the investment decision or are simply an additional benefit to a business that would have made the same decision on the basis other more significant considerations. Since tax incentives are in fact tax revenues foregone, it is important to first determine whether they can make a difference and, second, design the incentive system so that there is a strong link between the incentives and the objectives to be achieved.

Incentives for Small and Medium Industries

A second set of incentives is needed for small and medium industries in rural areas. Outside of Metro Manila, most non-agricultural employment is in micro-enterprises, including cottage industries. The objective of the incentives would be to encourage and facilitate the transition from cottage industry to small and medium industry. Aside from management considerations, the main reasons why cottage industries prefer not to become small businesses are 1) increased taxes; 2) the minimum wage requirement; and 3) increased paperwork. However, the costs of remaining small to the firm and the economy are considerable. Cottage industries are very limited in their ability to modernize and achieve significant increases in labor productivity. For middle income countries, development of the rural non-agricultural sector requires a critical mass of small and medium industries that are able to produce for urban and export markets and respond to changing conditions and opportunities. This capacity is critically lacking in the rural areas of the Philippines.

The incentive system for small and medium scale industries outside of Manila should include:

- The same benefits that are available to cottage industries. These would last only for a defined transition period, e.g., five years. The main benefits are exemption from sales taxes, exemption from paying minimum wages, and, in some areas, preferential utility rates.

- A set of incentives similar to those enjoyed by pioneer firms in the BOI system. These include a tax credit related to value added and exemption from taxes and duties on imported and domestically-produced capital and intermediate goods. If these firms are exporting, they should also receive the same benefits as BOI-registered export firms.

- The system should be administered by the MTI, but not the BOI. Documentation requirements should be kept as simple as possible and approvals should be decentralized to the regional level.

Summary of Recommendations

a. Revise BP 44 to 1) increase incentives for locating outside of Manila; 2) differentiate between regions based on needs and potentials; and 3) make incentives available to all BOI-registered firms.

b. Focus the incentives for BOI-registered firms on regions with the greatest potential for industrialization in the medium term.

c. Conduct a study of the manufacturing sector in Metro Manila to determine whether its taxes and user fees constitute its fair share of the costs of infrastructure and public services.

d. Provide incentives for small- and medium-scale industries that do not benefit from the BOI incentives. The incentives should be based on a study of the needs of small and medium scale industries to determine what types of incentives would be most effective and what the likely impact of those incentives would be on non-agricultural employment and incomes.

CREDIT

Enterprises in the rural non-agricultural (RNA) sector are dominated by small scale enterprises (SSE's), sometimes categorized as Micro, Cottage, Small or Medium depending upon the firm's capitalization or number of employees. Such firms account for approximately 90 percent of RNA employment. Among the constraints to their establishment and growth, inaccessbility to formal credit is generally regarded as one of the most important. As pointed out in a study by Louis Berger International (1985), "The framework is in place for institutional lending to regional industries. It is simply not reaching those who need it." As a consequence, those who need credit often turn to informal lenders and pay high interest rates. The obejective of USAID policy should therefore be to help the existing system function better.

The Current Credit Framework

Various funds have been established expressly for SSE's:

- Industrial Guarantee Loan Fund (IGLF). Administered by the Central Bank since 1952 this fund is designed to assist small and medium-scale industries by providing term credit that would otherwise not be available. The IGLF had a shaky start due to low profitability for participating banks, excessive red tape, and a high arrearages. Reforms were implemented to mitigate these problems, and the Fund continues to be the principal source of institutional credit for SSE's. From 1981-83 over 60 percent of the value of loans approved have been located in Metro Manila.

- Small and Medium Industries Lending (SMILE). This program sponsored by the Development Bank of the Philippines was suspended in 1983 due to high arrearages.

- Cottage Industrial Guarantee Loan Fund (CIFLF). Initiated in 1980 as a joint program of various government agencies and banks, this fund for cottage industries was suspended in 1982 due to high arrearages.

- Kilusang Kabuhayan at Kaularan (KKK). The National Livelihood Program was launched in 1981 to support the Small and Medium Industry Sector, but was suspended in 1984 due to high arrearages.

- Guarantee Fund for Small and Medium Enterprises (GFSME).

The GFSME is a new program established to induce banking institutions to support small and medium enterprises by directly lending their own funds to entrepreneurs. The Government supports these banks by assuming 85 percent of the total risks involved in lending to small and medium enterprises engaged in agribusiness. Terms are restrictive and not much action is expected.

Except for the IGLF, the performance of special funds for small business has been dismal. Financial institutions involved in lending to SSE's are briefly summarized.

Commercial banks engage in relatively little long-term lending because (1) short-term lending is at least as profitable given the interest rate difference, (2) they don't want to lock into long-term lending rates in an economy with significant rate fluctuations, and (3) they do not have the institutional expertise necessary to evaluate and make long-terms loans to SSE's. It is common practice to book loans for the short-term with the understanding that they will be rolled over repeatedly --each time resetting the interest rate and generating loan fees for the bank.

The IGLF has not succeeded in encourating commercial banks to voluntarily develop an active lending program to SSE's. Virtually all SSE loans made by commercial banks have been IGLF funds, with minimal use of the banks' own resources. The World Bank (1981, p. 21) concludes that

> Essentially, the effective (interest rate) spreads need to be increased to make lending to small enterprises more financially attractive. This could be done through changes in interest rates, in service charges, or in tax incentives; it need not involve subsidies.

The World Bank report also concludes that commercial banks are not likely to commit privately-raised resources for SSE lending; and change in financial incentives should be seen as a way of enhancing the present program of the government -- not of displacing them.

The Development Bank of the Philippines has a separate department for SSE lending, but it is not profitable due to high arrearages and administration costs. Profits made by lending to large industries offset some of the costs of lending to small industries, but SSE lending is continued purely at the behest of government priority. SSE loan performance has improved with experience.

The Private Development Bank of the Philippines has loaned very little of its own resources to SSE's, but has been a principal mover of IGLF funds. The PDBP has managed to make SSE lending profitable by concentrating on larger loans and using tight appraisal and supervision techniques.

Private Development Banks have experienced high arrears on IGLF loans, but fill an important gap in the banking system. These outlets are among the most promising for SSE loan expansion.

Rural Banks appear to be good potential outlets for SSE laons, but due to low profitability and high arrearages they are not doing the job.

In conclusion, private banks lend specially-sourced and designated funds (IGLF) to SSE's because a small profit is better than none at all, but they do not lend their own money. Government banks lend to SSE's simply because it is mandated. The fundamental reasons why more lending to SSE's does not occur are (University of the Philippines, 1984; World Bank, 1981):

1. Banks do not want to lend because:

   a. Insufficient interest rate (profit) spread due to

   b. High rates of arrears,

   c. High administrative costs per unit loaned,
   d. Lack of compensating business.

2. Potential borrowers canot qualify due to:
   a. Insufficient collateral.
   b. High risk in the particular type of business.
   c. Lack of a business plan or financial records.
   d. Lack of credit history.

3. Loan terms and conditions are unacceptable to borrowers:
   a. High interest rates.
   b. Unable to get long-term or working capital loans.
   c. High real cost of loans considering delays, paper-work.

The main policy issue is how to address the credit constraint for SMEs in rural areas. MTI currently favors a donor-funded subsidized loan program. There are two reasons why this is inappropriate at this time. First, before any credit program can be properly administered, the credit institutions in rural areas need to be strengthened and their roles better defined. For example, commercial banks should not be expected to be a major source of medium- or long-term loans for SMEs. They traditionally provide short-term working capital for large well-established businesses, and efforts to get them into development lending programs have never been very successful. The institutions with the most potential for development lending appear to be private development banks and rural banks. However, they currently have weak management and need training in how to assess creditworthiness and properly evaluate loan applications.

A second more important reason for avoiding subsidies is that the Government does not appear to have come to grips with the problem of designing a workable and effective subsidy program. Not enough thought has been given to the need to provide for the phase out of subsidies before initiating them. If a large subsidized credit program for rural SMEs were to be started now, it is almost certain that many loans would be for financially non-viable undertakings that stand no chance of surviving without continued subsidies. There is also a history of political interference in these programs, so that funds are often diverted to priviledged individuals for activities that are not necessarily consistent with the objectives of the program.

There is also a lack of differentation between the development role of subsidies and the need for financial instititutions to remain solvent. Government credit programs should not force banks to make bad loans or to subsidize borrowers. For example, if the Government wants to promote rural development by making credit available to SMEs at 15 percent when the market rate is 25 percent, the program should be designed so that the bank lends only for activities that it considers economically viable (i.e., not for activities mandated by Government) and receives the full 25 percent rate of interest. The borrower would pay 15 percent and the Government would pay the 10 percent.

Policy Recommendations

1. The Government should not become involved in direct lending programs for rural SMEs at subsidized interest rates.

2. The Government must accept that the micro-business sector should not expect to obtain credit from formal financial institutions, either government or private, with no collateral and no credit rating, and at highly subsidized rates of interest. The Government should not try to fill this gap with programs to provide very small loans to very small firms.

3. The main vehicle for providing credit to the rural SME sector should be the private banking system. USAID and the GOP should give priority attention to strengthening the capacity of private financial institutions to lend to small businesses in rural areas. Specific steps that could be taken include:

   a. Continue support of IGLF by assuring that enough total funds are available.

   b. Support studies and pilot projects to make SSE lending more profitable to private sector banks. The effort should include:

      (1) Allow banks to charge higher interest rates for SSE loans to reflect risk, or compensate banks for successful SSE loans while keeping nominal rates to SSE's the same as prime industrial customers. The latter is essentially subsidized SSE loans because interest rates would not reflect risk.

      (2) Development of reliable and efficient loan evaluation and supervision procedures for SSE's which both the DBP and private banks can employ.

      3) Investigate and implement innovative financing mechanisms such as loan "subcontracting" proposed by the Bureau of Small and Medium Industries (Louis Berger International, 1984). In this approach a small firm which is a subcontractor to a large more creditworthy firm reaches an agreement whereby the large firm guarantees the smaller firms' loans.

      (4) Find ways of strengthening the analytical capabilities of private development banks so that they are better able to assess risk and economic viability of investments in non-traditional areas, especially the production and processing of non-traditional agriculturl products.

   c. Support studies and pilot projects to tailor SSE loans more closely to borrower needs, including:

      (1) Provide working capital loans--a critical missing ingredient in the SSE portfolio.

      (2) Reduce collateral requirements.

      (3) Emphasize lending to SSE's outside of Metro Manila.

Studies could be carried out by Philippine institutions such as SGV consulting, the University of the Philippines' Small Enterprises Research and Development Foundation, or others. Pilot projects should be undertaken by participating financial institutions in rural areas with good RNA potential. Financial risks incurred in the pilot projects could be initially shared by the IGLF or government-sponsored program.

LOCAL GOVERNMENT INSTITUTIONS

The two key issues that relate to local government institutions are: 1) the need increase their budgetary revenues, and 2) the need to reorganize their regulatory functions.

Budgetary Resources

The sub-national government structure in the Philippines is organized on three levels:

- The Barangay is the basic unit of local government at the community level.
- The Municipality consists of a group of barangays in non-urban areas.
- The City is a group of barangays in more densely populated areas.
- The Province is composed of a group of municipalities.

Each level has its own responsibilities, authorities and designated sources of revenues. They are not, however, fully autonomous in that they function under the overall authority of the Ministry of Local Government.

Local governments have a key role to play in supporting the development of the rural non-agricultural sector. In addition to providing basic social and economic services and maintaining infrastructure, they are supposed to participate fully in the preparation of regional development plans and strategies. They are constrained in the carrying out of their responsibilities by weak staff and administrative capabilities, but from a policy standpoint their most serious problem is the lack of financial resources. Their revenues are barely adequate to cover their recurrent expenditures and they have no sources of funds to finance development projects.

Further, most of their revenues come from the national government, mainly through PD 144 which provides for 20 percent of national internal revenue taxes to be allocated to local government units. Other less important sources of funds from the national government include: 1) a share of taxes on various petroleum products, 2) a Local Government Fund of 5 percent of internal revenue collections released at the option of the President, and 3) the Highway Special Fund for road maintenance financed from a portion of fuel taxes and funds collected under the Motor Vehicle Law.

The major local sources of revenue are property taxes, licensing fees, rents for the use of public properties, service charges, and a Special Education Fund financed by a 1 percent property tax which is exclusively for elementary and secondary schools. These revenues are minor and some are related to the provision of services that frequently cost more than the fees being charged to recipients.

It was not possible during this consultancy to determine the amounts available to each level of local government from the various sources. This will need to be done before specific changes can be recommended. However, two important points can be made at this time. First, local governments do not have sufficient revenues to take meaningful initiatives in promoting regional development. They do not even have sufficient funds to maintain local infrastructure and provide basic services.

Second, they are too dependent of the national government for revenues. The national government should collect taxes to meet government responsibilities at the national level. Services provided at the local level should be financed from local taxes. This has two advantages: 1) Taxpayers are able to make a connection between the taxes they are paying and the services they are receiving, and 2) local governments are more motiviated and better able to respond to the felt needs of the population. The result is a system of local government that responds to local needs instead of looking to the national government for funding and instructions. Aside from political will, the main obstacle to the decentralization of fiscal authority is the lack of capacity at the local level for effective fiscal administration. Even if the decision to decentralize were to be made immediately, it would take some time before the local governments could increase their revenue collecting capabilities to equal those of the national government.

Local Government Regulatory Functions

A common complaint of small businesses in the regions is that there is too much paperwork. This especially noticeable as a business expands from cottage industry to small business, but even cottage industries are faced with documentation requirements that are confusing and often unnecessary. A typical list of approvals for a small producer would include: a municipal license, registration for sales tax, zoning approval, building code approval, a sanitary permit, pollution clearance, and machinery inspection. None of these approval requirements are unreasonable, but because of the way that they are administered, they are a considerable burden on small businesses. Some of these approvals, such as the sanitary permit and environmental clearance or the zoning and building code approvals, could be combined. A more important problem is that obtaining signatures can be extremely time consuming requiring long waits and numerous return visits.

Recommendations

1. The Government should take concrete steps to revenue generation authority and responsibility to the local levels. The decentralization of fiscal powers should be an integral part of AID-financed efforts to improve local resource management and develop rural infrastructure. In the short run the focus of the policy dialogue should be on improving the capacity of local govenrments to collect property taxes and reducing the strings attached to the return of tax revenues collected by the national government. In the long run, the objective should be to reduce the proportion of budgeting revenues and expenditures controlled by the national government.

2. The Ministry of Local Government should adopt a policy of minimizing the documentation requirements of small businesses in the rural areas. To implement this policy the ministry should issue guidance to provincial, municipal, city, and barangay governments and ways of simplifying and expediting regulatory procedures for small businesses.

IV

ASSESSMENT OF POSSIBILITIES FOR EFFECTIVE POLICY DIALOGUE IN THE RNA SECTOR

This report contains 15 recommendations relating to policy issues that directly affect the RNA sector. These recommendations can be summarized into five policy objectives:

1. Increase the share of infrastructure investments going to the regions at least enough to remove the pro-Manila bias.

2. Rationalize utility rates throughout the country.

3. Increase the effectiveness of incentives for industrial dispersal.

4. Increase the availability of credit to the RNA sector from private banks.

5. Increase the fiscal autonomy of local governments.

A brief discussion of each of these objectives will provide some indication of what is achievable and what AID's priorities should be.

With respect to infrastructure, this report recommends that the Government allocate a larger share of infrastructure investments to the regions, and place more emphasis on economic factors in deciding between projects. Political tampering will inevitably be part of the process, but AID's objective would be to reduce it substantially. This change implies a major shift in priorities at the highest levels in favor of decentralization and regional development. Realistically, AID can expect to have very little effective influence in this policy area, at least not in the context of an RNA policy dialogue. However, when negotiating large infrastructure projects such as the Local Government and Infrastructure Development project, it should be possible to have a temporary impact on the allocation process. Also, since there is a steady stream of infrastructure projects being financed by different donors, a concerted multi-donor effort in this area would seem to be called for.

The second objective is a largely political issue over which AID cannot hope to have any leverage. At best, AID could contribute to a study of the utility rate structure if asked to do so by the Government.

The third objective, an improved incentive system for industrial dispersal, should be achievable. The Government has a stated policy favoring industrial dispersal. The problem is that the incentives currently available to businesses for investing in the regions are almost totally ineffectual. The system can easily be improved at little or no political cost. All that is needed to start the process is a decision by the Minister of Trade and Industry to improve the incentives. Once that decision is made, two actions are required. The first is to revise the incentive system for firms that are registered with the BOI. This requires a study of the regions to identify needs and potentials followed by a tailoring of incentives to maximize industrial dispersal. The actual impact of these incentives on the number of jobs created outside of Manila will be quite small. Most BOI Firms would locate in the Manila area regardless of incentives, and if they did locate outside of Manila, it would most likely be in Regions III and IV.

The second required action is to establish an investment incentive system for SMEs in rural areas that do not have access to BOI incentives. This system could have a much larger impact on RNA employment because the incentives will be available to large numbers of small firms that are already inclined to invest in rural areas. The objective of these incentives would be to facilitate the transition from cottage industry to small business and to encourage small businesses to expand.

Responsibility for this policy area falls entirely within MTI, so this is where the policy dialogue should be focused. Our impression is that AID projects in the rural SME sector are not large enough to provide much leverage. The dialogue might therefore more effectively be conducted in conjunction with the World Bank which is financing the Third Small and Medium Enterprise Development Fund.

The fourth policy area covers two issues: 1) providing credit to SMEs through government loan programs instead of entirely through private financial institutions, and 2) the pros and cons of subsidized interest rates. The position taken in this report is that government loan programs and subsidized interest rates will not solve the credit problems of rural SMEs. The problem that remains, however, is that rural SMEs have almost no access to credit from financial institutions in the formal sector. For most firms that only source of credit is the informal sector at rates of interest of over 100 percent. This is clearly a constraint to growth in the non-agricultural sector. The action proposed in this report is for AID and the Government to explore ways of making loans to SMEs profitable for private sector financial institutions. Any program to address the credit problem of rural SMEs must be based on a system that allows private banks to make a profit.

This position, however, does not preclude any possibility of subsidies. Two of the most widespread uses of interest subsidies throughout the world are to help small businesses and to promote the development of rural areas, so it does not make much sense for donors to insist that the Philippines not have interest subsidies for the RNA sector. The key requirement is that the subsidies be properly administered. For a subsidy program to work, provision for the phase out of subsidies should be made at the outset. Banks must always operate on the basis of creditworthiness and must never be put in the positon of having to subsidize the borrower.

The policy dialogue on credit issues is an ongoing one since there are always credit programs being financed by one donor or another. There should therefore be considerable scope of exercising leverage. The focus of the policy dialogue as it relates to the RNA sector is to find ways of increasing the access of rural SMEs to credit without resorting to government direct loan programs. This will require special efforts to strengthen private financial institutions in rural areas which AID should encourage and stand ready to support.

The final objective, increased fiscal autonomy for local governments, does not directly impact on incomes and employment in the RNA sector. However, it is a key element in the effort to reduce and decentralize government controls over economic activity. There is no doubt that government services to rural areas would be more satisfactory if the financing and provision of those services were in the hands of local governments. The issue is highly political but AID has two projects, Local Resources Management and Local Government and Infrastructure Development, that provide opportuniites for dialogue and possibly some movement in the right direction.

If all of these policy objectives were to be achieved, the impact on the RNA sector would be significant. Businesses would be more efficient, more competetive with Manila, and better able to respond to export opportunities. The links with the agriculture sector would also be strengthened. Light consumer products and some agricultural inputs could be produced locally, although consumer durables and other products requiring economies of scale would continue to be produced in Manila. More important but less quantifiable benefits include: a more diversified rural economy, a general increase in productivity in the RNA sector, and a more broad-based and sustainable develompent process for the country as a whole. However, the combined impact of these policy changes on RNA employment and incomes would still be less than the impact of improved policies at the macro level and in agriculture.

On the other hand, it is useful to ask how harmful it would be to the overall development of the country or even to development in the regions if these policy objectives were not achieved. We know that increased agricultural growth will do more for RNA employment and incomes than all of these policy changes put together. We also know that if macro-economic policies are changed as planned, rural-urban imbalances will gradually diminish, and many of the constraints identified in this report will be eliminated or significantly reduced. It must be recognized, however, that this will be a very slow process. In the meantime, growth and development will continue to be concentrated in the Manila area, and large rural-urban gaps will remain. The policy changes recommended in this report would facilitate and speed up the process of redressing the imbalances.

If AID decides that these policy objectives are worth pursuing, there are two possible approaches. One is for AID to address these policy issues individually as opportunities arise. The second is to define the RNA sector as a separate area of high priority dialogue. This approach raises two problems. First, policy dialogue cannot be truly effective unless both sides want to talk. Although this appears to be the case for macro-economic and agriucltural policies, there is no evidence that the Government is prepared to give enough priority to RNA sector policy issues to provide the basis for a dialogue. Second, designating the RNA sector as a separate policy dialogue area implies a major analytical and negotiating effort. More information needs to be obtained on the existing situation in each of the policy areas, progress indicators need to be identified and monitored, and arrangements need to be made for periodic reviews and exercise of leverage.

What AID needs to decide is 1) whether the importance of the RNA policy issues justifies this level of effort, and 2) whether, given the already heavy involvement of the Mission in the macro-economic and agriculture policy dialogues, it is realistic to expect a third major policy dialogue thrust to be very effective.

NEXT STEPS

Baseline Data

If AID wants to initiate a policy dialogue relating to the RNA sector, the first requirement is for a data base pertaining to the overall objectives of the dialogue. These objectives can be stated as:

- Increased employment in the RNA sector;
- Increased per capita incomes in the RNA sector;
- Increased share of manufacturing value added outside Manila;
- Shift out of cottage industries into SMEs in rural areas; and

- More non-agriculture-based production for urban and export markets.

Although there is little likelihood that the policy changes recommended in this report will have any measurable impact on these objectives in the short or medium term, in the long run it is changes in these indicators that will measure the success or failure of the Government's regional development policies. For the time being. AID should assemble available baseline data on each of these indicators and try to fill gaps whereever possible.

Another set of data requirements relates to the RNA sector itself. Information is needed, by region, on the potential for and constraints to RNA growth. This requires a knowledge of the characteristics of the existing RNA sector (size and types of businesses, links to agriculture, extent of production for urban or export markets, current growth trends, apparent infrastructure and institutional constraints). This information is needed as a basis for formulating policies and setting policy dialogue objectives especially in the areas of incentives and infrastructure allocations. (See Annex II for the scope of work for this study.)

Actions Relating to Each Policy Area

All of the policy areas identifed in this report have implications that extend beyond the rural non-agricultural sector. Policy changes favoring the RNA sector, if effective, will necessarily have a negative impact on urban areas and the impact on overall economic performance is not always clear. It is important that donors not urge policy changes until they have carried out the necessary data gathering and policy analysis. For some of the policy areas relating to the RNA sector the issues are well understood and an effective and responsible policy dialogue can be initiated. For others, AID needs to have a better grasp of the issues before taking a policy stance or defining policy dialogue objectives.

The Allocation of Infrastructure Investments

This is one area where further study is not needed. The issue is straightforward and progress is easy to monitor. The policy dialogue is in fact ongoing in the context of infrastructure projects being financed by AID and other donors.

Electricity Rates

This issue is both highly political and complicated. Before AID can initiate a policy dialogue in this area, it must become better informed on the following points:

- How to lower the cost of producing electricity in the Philippines to bring it more in line with that of other countries;
- How to improve the performance of electricity cooperatives in the regions; and
- How to rationalize the rate structure, including the removel of subsidies for Manila, and looking for ways of reducing the large differences in rates between regions.

This is not an area where AID is in a position to exercise much leverage, so this study should not be conducted without some expression of interest by the Government or other donors. (See Annex II for scope of work.)

BOI Incentives

The first step is to find out if investment incentives can have s significant impact on industrial dispersal. Can firms actually be induced through investment incentives to locate in the regions instead of in Manila? If not, can incentives significantly reduce the disadvantages to firms that would like to locate outside Manila but cannot afford to because of higher operating costs? A study of this issue should focus on the Tier II and III regions as defined in the report. (See Annex II for scope of work). If a set of effective incentives can be identified this would provide the basis for a policy dialogue with MTI. If incentives are found to be of minor importance in bringing about the regional dispersal of industry, the findings of the analysis should be conveyed to MTI, and the issue should be dropped from the policy dialogue agenda.

Incentives for Rural SMEs

This policy area requires further study. The two issues are: 1) should SMIs be given the same incentives as cottage industries and if so under what circumstances and for how long, and 2) are there ways of giving BOI-type incentives to rural SMEs for investing in "preferred areas". If the incentives prove to be of little or no significance to rural SMEs are there other incentives that would be cost-effective from an overall development standpoint? (See Annex II for scope of work.)

Credit

The policy issues related to credit do not need further study. AID favors the provision of credit to rural SMEs by private financial institutions at market rates of interest. If subsidies turn out to be part of the Government program to promote RNA development, which appears to be the case with with World Bank-financed loans at 15 percent, AID's objective will be to push for sound design and implementation of the subsidy program. The main unknown with respect to credit is how to increase the capacity of private financial institutions to meet the credit needs of rural SMEs. This is an implementation rather than a policy issue which should be addressed in the context of a specific SME development project. The study recommended in this report and described in Annex II could be funded by SMEs and be incorporated into the design of the PEP project.

Fiscal Autonomy for Local Governments

AID has already begun a policy dialogue in this area. A considerable amount of data has been collected and analyzed under the Local Resources Management project and several key issues have been clearly defined. AID's primary objectives at this time are to increase the fiscal management capabilities of local governments and to expedite the return of revenues from the national to the local governments. Appropriate policies have already been adopted by the Government and the main concern now is with the implementation of those policies.

Two important unresolved policy issues are: 1) continued excessive control by the national government over the budgetary revenues and expenditures of local governments, and 2) the net outflow of tax revenues from the regions to Metro Manila. These issues do not yet appear to be well defined. Policy changes in this area will require tax legislation and an increased commitment to decentralization. AID should be fully informed on all of the technical and political factors involved before initiating a policy dialogue. This will require a policy-oriented study by a public finance economist with expertise local revenue generation. The study could be funded under the Local Resource Management or the Local Government and Infrastructure Development projects. Since the latter project is much larger and still in the design stage the study might have more impact in that context.

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LIST OF FILIPINO BUSINESSMEN AND GOVERNMENT OFFICIALS CONTACTED

This is a partial list. In several instances we met with large groups of businessmen in meetings organized by AMCHAM, the Philippine Chamber of Commerce and Industry (PCCI) and the Kakati Business Club. We were unable to obtain the names of all of the individuals who participated in these meetings.

Eugenio Ladrido, Principal
SGV & Co.
Manila

Emeline Relubit Navera, Ph.D.
Regional Manager
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Rosanio Franco
Chief, Planning Service
Ministry of Trade & Industry

Magdalena Villaruz
Chairman & President
SV AGro-Industries Enterprises, Inc.

Jose Nelson Dolorias
President
Sorsogon Crop Diversification Program, Inc.

Jose Divinagracia
Manager
Small Business Advisory Center
Iloilo City

Milagros Dignadice, Dean of Business School
of Central Philippines Central University
Director of Small Business Institute
Sorsogon

Josefina Ramos, Director
NEDA Regional Development
Manila

Dr. Rodolfo Ante
Governor, Region V
Philippine Chamber of Commerce & Industry

Leopoldo Andal
Deputy Governor - Bicol Region
Philippine Chamber of Commerce Industry

Antonio Yap
Executive Director
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Alejandro Tinio
PCCI Regional Governor - Central Luzon

Estrellita Juliano Llane
Regional Governor PCCI Region 12

Jose Luis Yulo, Jr.
Chairman, Regional Division
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Felix Maramba, Jr.
President, PCCI
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Rolando Dy
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Alberto Olagner
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Dr. Wilfredo Nuqui
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Rojelio Florete
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Queen City Develompent Bank
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Dr. Dante Canlas
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Deputy Minister "Tony" Carag
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Jose Romero, Jr.
President
Research & Management Associates
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Dr. Joseph Lim, Professor
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Dr. Bernardo Villegas
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ANNEX I

SUMMARY OF THE NEW BOI FISCAL INCENTIVES

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SUMMARY OF THE NEW BOI FISCAL INCENTIVES

Incentive	Rate and eligibility: Domestic producer: Pioneer	Domestic producer: Non-pioneer	Export producer /a: Pioneer	Export producer /a: Non-pioneer	Conditions
1. Tax credit on net value earned./b	10%	5%	10%	5%	Available only for new or expanded capacity. Tax credit earned for the first five years of commercial production.
2. Tax credit on net local content of export production./c	10%	10%	10%	10%	Tax credit earned during 10 years of operation, for last five years on increment of local content. Incentive also available to indirect exporters. For existing export producers /d tax credit payable on increment of local content only.
3. Tax credit for taxes and duties paid on raw materials, supplies used in export production.	Yes	Yes	Yes	Yes	Available for an indefinite period to all export producers.
4. Exemption from export taxes and fees.	Yes	Yes	Yes	Yes	As for incentive (3).
5. Exemption from taxes and duties on imported capital equipment.	100% (deferred payment)	50% (deferred payment)	100%	100%	
6. Tax credit for locally purchased capital equipment (equal to value of taxes and duties which would be waived for imported equipment).	100% (deferred payment)	50% (deferred payment)	100%	100%	
7. Net operating loss carry-over.	Yes	Yes	Yes	Yes	Losses incurred in any of the first 10 years of operations may be carried over as a deduction from taxable income for a maximum period of 6 years following the period in which the loss was incurred.
8. Tax credit for withholding tax on interest on foreign loans.	Yes	No	Yes	No	Available for loans taken during the first five years of registration or operation.

/a Producers exporting at least 50% of output from new or expanded capacity.

/b Net value earned is calculated as value of sales minus purchases of raw materials, supplies, utilities and some specifically excluded commodities.

/c Net local content of export production is calculated as value of export sales minus imported raw materials and supplies, depreciation of capital equipment, and some specifically excluded commodities.

/d Registered enterprises already engaged at the time of registration in the production, manufacture or processing of export products.

Source: World Bank, The Philippines: An Agenda for Adjustment and Growth. 1984

ANNEX II

SCOPES OF WORK FOR FOLLOW-ON STUDIES

ANNEX II

SCOPES OF WORK FOR FOLLOW-ON STUDIES

REGIONAL ASSESSMENT OF RURAL NON-AGRICULTURAL SECTOR ECONOMIC GROWTH POTENTIAL, GROWTH CONSTRAINTS, AND INVESTMENT INCENTIVES*

The Issues

Regional economic growth of the rural non-agricultural (RNA) sector outside the National Capital Region is driven primarily by agricultural income. The portion of RNA which is not agriculture-dependent is small and stagnant. Diversification and growth of the RNA sector is desirable to provide rural employment, mitigate the growth of Metro Manila, and make better use of the rural resource base.

The 12 regions of the Philippines are distinctly different in their resource bases, infrastructure, and potential for economic growth. Since national financial resources for development of infrastructure are limited, regional priorities should be established which will maximize the long-term benefits to the country.

In addition to the prioritized provision of infrastructure there should be an incentive program to attract new enterprises to regions where they can be expected to prosper. The incentive program should recognize the needs of each particilar industry and the development trends already underway; unrealistic expectations of locating in remote or unfavorable regions should be avoided.

Constraints on the growth of existing RNA enterprises should also be examined on a regional basis when formulating the investment and incentive plans. Excessive regulations, controls, or other obstacles to enterprise health should be dealt with.

Objectives

1. Gather baseline data on the following policy dialogue impact indicators: employment in the RNA sector; per capita income in the RNA sector; share of manufacturing value added outside Manila; relative shares of cottage industries and SMEs in the RNA sector; and non-agriculture-based production outside of Manila for urban and export markets.

2. Gather data on characteristics of the RNA sector in each region, including size and types of businesses, links to agriculture, extent of production for urban and export markets, current growth trends, and apparent infrastructure and institutional constraints.

3. Identify constraints on attracting new firms and constraints on the growth of existing firms.

4. Set priorities for relieving the constraints in regions determined to be most conducive to RNA growth.

5. Design incentive systems to achieve industrial dispersal commensurate with regional characteristics and the nature of the industries likely to locate or grow there. Two separate systems are needed, one for larger firms registered with the BOI and another for small and medium enterprises already located in rural areas.

Personnel and Duration

The basic data gathering can be carried out by junior researchers over a period of 4 to 6 weeks. The analysis will require an economist and a SME development specialist for 5 or 6 weeks. The design of the incentive systems could require follow-on work with MTI.

* Note: This scope of work covers four of the needs identified in Chapter IV of the report: 1) baseline data on policy dialogue objectives; 2) data on RNA characteristics in each region; 3) the design of an incentive system for BOI firms; and 4) the design of an incentive system for rural SMEs.

ASSESSMENT OF POSSIBILITIES FOR LOWERING ELECTRICITY RATES OUTSIDE MANILA

The Issue

A major complaint of industries located outside Manila is that they have to pay much higher utility rates, especially electricity. One reason is that Manila businesses are probably receiving subsidized rates. Even if these subsidies were removed, however, there would still be substantial rate differentials because the level of demand is lower and the cost of delivering electricity is higher in the rural areas. The issue is whether to subsidize businesses in rural areas by having uniform rates throughout the country or at least reducing the differences.

Aside from the market-distoring effects of these subsidies, there is the problem of the impact on the competitiveness of the country's Manila-based manfacturing sector. Electricity rates in the Philippines are among the highest in the world because the electrical industry is extremely inefficient. Before taking actions to reduce the differences in electricity rates between Manila and the rest of the country it will be necessary to reduce the overall costs of producing and delivering electricity. This includes improving the performance of electrical cooperatives in the regions.

Objectives

1. Identify the steps to be taken to bring the cost of producing electricity down to the level of other countries. Much of the information needed to carry out this analysis is available in studies on the infrastructure sector prepared recently for AID and other donors.

2. Identify steps to be taken to improve the performance of electricity cooperatives in the regions.

3. Recommend ways of rationalizing the electrical rate structure, both with and without improvements in the performance of the National Power Corporation and the rural cooperatives. This should include an assessment of subsidies in Manila and an analysis of the pro and cons of reducing the large differences in rates between regions.

Personnel and Duration

Needs to be determined by someone with expertise in this area, but would probably need an electrical engineer and someone with expertise in the public policy aspects of setting utility rates.

DESIGN AND IMPLEMENTATION OF CREDIT DELIVERY SYSTEMS FOR RURAL SMALL AND MEDIUM ENTERPRISES

The Issues

The basic framework is in place for institutional lending to rural SMEs, but credit is not reaching those who need it. As a consequence their growth is constrained by lack of funds -- particularly long-term loans and working capital -- or high-cost loans form informal lenders. To reach these potential borrowers the commercial banks must participate, but so far they have been reluctant. The principal reason is that lending to rural SMEs is unprofitable given the high rate of borrowers in arrears and the high costs of small loan administration. Furthermore, banks typically do not have the expertise to appraise such loans.

From the potential borrowers' point of view the financial institutions impose difficult terms and conditions on loans, hence they often choose not to apply for institutional credit. Potential borrowers themselves are frequently at fault for not providing proper financial records or a business plan.

Better credit delivery systems are needed to help SMEs avail themselves of institutional credit via the commercial banking system. Experimentation with innovative systems and procedures should be conducted by means of a few pilot projects with commercial or development banks in selected areas. Once improved systems and procedures have succeeded they can be extended to other areas.

Objectives

1. Describe existing credit delivery systems for rural SMEs.
2. Determine the constraints, problems, and successes associated with existing credit delivery systems.
3. Design new systems or revise existing ones for trial in selected areas.
4. Assist cooperation commercial banks implement the revised systems in the pilot project areas.

Personnel and Time

At least two professionals six weeks for initial design and coordination; four weeks follow up.