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MINISTRY OF TRADE AND INDUSTRY
Republic of the Philippines

THE SMALL BUSINESS POLICY DIRECTION STUDY

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with assistance from

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EXECUTIVE SUMMARY

The Philippine economy is in a crisis precipitated by a combination of lagging economic growth and deeply-rooted inequities in the distribution of income and wealth. The last three years of decline have wiped out many of the welfare gains made in the past. The urgent task facing the nation's leaders at this juncture is to get growth moving, but to do it in a way that spreads its benefits more equitably than has historically been evident. Lifting the barriers that constrain participation and expansion of progressive small and medium manufacturing enterprises represents a strategy that can help achieve higher growth together with a more equitable distribution of income.

For the past three months, a team from the Harvard Institute for International Development, with assistance from the Center for Research and Communication, has been engaged in an in-depth analysis of the role of small and medium enterprises in Philippine manufacturing, and of what policy and programmatic measures might further the participation of these firms in dynamically efficient industrial expansion. In the face of the urgent need to promote equitable growth, the focus of the Harvard team - in a major departure from much of the previous work on small and medium enterprises in the Philippines - has been on progressive enterprises. Our team conducted interviews with government officials, with the heads of industry associations, and with firms in five industries -- clothing, furniture, electronics, metalworking and jewelry. This report presents the findings of the team.

A troubling feature of industrial structure in the Philippines is the degree to which progressive small and medium enterprises are missing. The size structure of business firms shows a sizable group of mostly "traditional," cottage and very small firms at the bottom end, a relatively small segment of "modern," progressive, small and medium enterprises in the middle, and a dominant group of large firms in the upper tail of the distribution. Chapter 1 of the report sets the Philippine industrial structure in international perspective and analyzes the determinants of Philippine industrial structure.

A dynamic middle of progressive small and medium firms offers important benefits to a developing country like the Philippines. The presence of these firms not only spreads the benefits of economic expansion relatively evenly, it also facilitates competitiveness, and the capacity of an economy to adjust to changes in policy or to fluctuations in capricious international markets. In addition, the presence of progressive small firms limits the degree of concentration of economic power, thereby reducing the likelihood of the emergence of "crony capitalism." Progressive small and medium firms are different from their less progressive and livelihood cousins. They have the objective of expansion over the long haul, and a more or less coherent strategy for achieving this objective. They are firms that endeavor to internalize a proactive, adaptive relationship to their environment, anticipating and planning for change, rather than reacting defensively and being left behind by the ongoing

swirl of economic events.

Policy and the Participation of Progressive, Small Firms

The primary explanation for the relative paucity of progressive small and medium enterprises in the Philippine economy is to be found in the realm of policy. This report highlights four policy areas that have been especially crucial in shaping the pattern of participation of small and medium enterprises in the Philippine economy: trade policy, financial policy, investment incentives policy, and regional policy.

Trade policy influences the opportunities for small and medium enterprises in a number of different ways. First, protectionist policies make access to imported intermediate inputs difficult for small and medium export producers; this issue is explored in detail in chapter 2.1.3. More fundamentally, trade policy is the single most important determinant of the degree to which firms -- both small and large -- evolve in a dynamically efficient direction. The relation between trade policy and dynamic efficiency is explored in detail in chapter 2.1; here only a few illustrative points will be highlighted.

The impact of trade policy on dynamic efficiency emerges vividly through comparison of the findings of the studies of, on the one hand, the garments and rattan furniture industries, and, on the other, the electronics and metalworking industries. (The industry studies are presented in chapter 4.)

Extensive exposure to international competition forced garments and rattan furniture producers to engage in an ongoing

search for ways to reduce unit costs of production, upgrade product quality, and penetrate new foreign markets. In both industries, this intense competitive pressure had desirable consequences for small and medium firms: the search for productive efficiency led exporting firms to extend their networks of subcontracting, thereby extending the opportunities for small subcontracting producers. And along with the general dynamism of these exporters, there were enhanced opportunities for entry and expansion by progressive small and medium direct exporters.

In sharp contrast, the impetus for expansion in the electronics and metalworking industries came not from the lure of export markets, but from local content policies designed to shelter infant local producers from import competition, and to promote the development of subcontracting networks by product assemblers. As the industry studies reveal, local content policies in the electronics and automotive industries did, to be sure, create opportunities for participation by small and medium producers. But the manner of participation was fatally flawed. For one thing, in the absence of incentives to be efficient, assemblers were reluctant to employ local subcontractors for components production, and -- where they did turn to local sourcing of components -- devoted few resources to upgrading their productive capacities. More fundamentally, the local content programs lured firms down what turned out to be a dead end road; their continued survival dependent upon a fragile combination of buoyant domestic demand and continuing protection,

when domestic demand and import protection declined in the early 1980s, large numbers of the firms established in the 1970s were forced to close down.

The comparison of dynamic and dead-end sectors is not intended merely to make the argument for liberalization (although to promote participation in industry of progressive small firms, further import liberalization is desirable in the Philippines). The key point rather is that, given the consequences for dynamic efficiency of outward-oriented policies, protection should be imposed highly selectively and, where imposed, should function in a way that spurs firms to become efficient. Import protection should be structured in such a way as to provide both the opportunity for learning , and the incentive to be competitive; longer production runs can ensure the former, while the linking of protection to export performance (or other performance measures) can ensure the latter. Specific recommendations for the implementation of effective selective protection are presented at the conclusion of chapter 2.1.

To summarize briefly the analysis in other policy areas: chapter 2.2 explores the relationship between financial policies, financial deepening, and the participation of progressive small and medium enterprises in financial markets, and also the impact of selective credit controls on access of small and medium firms to finance. Chapter 2.3 analyzes the impact of BOI incentives; highlighted here are the absence of incentives for the promotion of dynamic industrial efficiency, the lack of concern with the

impact of incentives on industrial structure, the ways in which BOI incentives create barriers to participation for progressive small firms, and the underrepresentation of progressive small firms among BOI registrants. The subject of chapter 2.4 is regional policy; analyzed here are the determinants of the regional distribution of manufacturing activity, the relationship between regional development and the Philippine policy regime, and the opportunities for efficient participation by progressive small regional firms in industrial growth. Specific policy recommendations can be found at the end of the relevant subsections.

Program Support for Small Progressive Firms

As has already been noted, it is the policy environment that is overwhelmingly the most important determinant for efficient participation and expansion of progressive small and medium firms. Do these firms, then, need the assistance of government programs? Our study suggests that they do. Bearing in mind that program interventions will not be effective in the face of adverse policies.

Chapter 3 lays out ways in which the provision of program support for progressive small firms might be upgraded. Section 3.1 lays out the circumstances that call for program interventions, and highlights some general characteristics of programs that effectively serve progressive small firms. Section 3.2 critically examines the rationale for, and effectiveness of, programs for technology acquisition, financial programs,

marketing programs, and programs for the promotion of subcontracting; the section includes recommendations on how, where appropriate, these programs might be upgraded. Section 3.3 presents a series of proposals for enhancing the promotional capacity of the Ministry of Trade and Industry.

As is explained in section 3.2, the programs that can effectively serve progressive firms are different in kind from those that provide useful support for less progressive and livelihood enterprises. If programs are to provide effective support for progressive small and medium firms, they should:

* focus on the interface between the enterprise and its external environment, and not so much on questions of internal firm management;

* be staffed by specialized industry professionals, with the business training necessary to diagnose what specialized support is -- and is not -- relevant to client firms;

* be incorporated in program packages, which offer firms one-stop access to the whole range of support services;

* have well-defined objectives, and be evaluated in relation to these objectives, and not in terms of the number of small firms with which they had contact over a period of time;

* be client-centered, offering services for which users are willing and required -- in proportion to their size and profitability -- to pay.

This is not the place to repeat all the specific recommendations with respect to existing programs that are laid out in section 3.2. Three examples must serve to illustrate the findings of that section.

First, there is a need to upgrade and redirect the market intelligence and information dissemination capabilities that are

crucial to effective export marketing support programs. In the course of interviews with firms, it became apparent that export marketing programs would be most effective if they were targeted towards firms endeavouring to begin exporting in sectors where the Philippines, thus far, has little or no foreign presence. Presently, the focus of marketing programs is on precisely the sectors where the private marketing network is most developed. The firm interviews uncovered an especially egregious example of the kind of problem that an effective export marketing program could help overcome: a Philippine mufflers producer, seeking to sell his product on the USA auto components aftermarket, has no option other than to begin his marketing efforts by flying to the USA and using the Yellow Pages of the telephone directory to make contacts.

Second, for reasons that are explored in detail in section 3.2.1, the Harvard team is doubtful of the capacity of any government program to provide usable technical assistance to progressive small and medium firms. The focus of the program support should rather be on the provision of financial support to enable firms to hire skilled technical consultants.

Third, for all of the appeal of the promotion of subcontracting as a way of fostering entry by small firms, the evidence is that the crucial determinant of the extent and efficiency of subcontracting is the policy environment, rather that specific programs. The resources that are presently engaged in programs for subcontracting promotion could more fruitfully be

used in other activities.

At present, there are two fundamental differences between the present character of the Ministry of Trade and Industry (MTI) and the character of a ministry that would have the capacity to make policies and devise programs that could effectively promote dynamic small firms. First, at present the agencies that are charged with the promotion of small firms operate in relative autonomy from the rest of the Ministry. In a ministry that had the capability to promote dynamic modern firms, there would be no dichotomy between the formulation of policy and the promotion of small firms; those agencies responsible for small firm promotion would have direct influence in the policymaking process. Second, at present, MTI is staffed largely by generalists. An effective ministry would have an in-house reservoir (more substantial than BOI's present capacity) of sector specialists capable of devising policy, monitoring performance, delivering effective program support along sectoral lines, and negotiating on equal footing with firms operating in the relevant sector.

Moving MTI from where it is at present to where, in the view of the Harvard team, it ought to be, cannot be achieved at the stroke of a pen. Industry specialists cannot be created overnight; nor can the Ministry personnel responsible for small and medium enterprises, to this point engaged almost exclusively in the design and implementation of specific programs, be expected to immediately become effective contributors to the policymaking process.

Section 3.3 of the report presents four recommendations, all

of which can be implemented immediately, which together can provide the impetus for moving the Ministry in the desired direction. Of these, this executive summary will highlight the recommendation that, in the view of the Harvard team, has the greatest likelihood of in the long run transforming MTI into a ministry capable of providing effective promotional support for progressive Philippine industry:

> The Small Business Development Group should collaborate with BOI and other relevant ministry units in the formation of specialized cells of industry experts. These cells should be under the direct authority of the Minister or relevant Deputy Minister of Trade and Industry.

The precise details of how to organize and make these cells effective must necessarily unfold in the course of implementation. We hope that a second phase of this project will provide the opportunity to operationalize the concept of the industrial cell. Even so, it may be useful to make some preliminary suggestions. The program should begin modestly, with the selection of no more than two or three narrowly-defined sectors, and the establishment of cells for these sectors. Each cell should contain no fewer than five personnel, at least two of whom should have had advanced business training. Only after sufficient time has elapsed to evaluate the success (or failure) of the initial experiments, should consideration be given to the creation of cells for a wider group of sectors.

The long-run objective is that each cell be responsible, in its specific sector of expertise, for policy and program design,

the monitoring of performance of programs and policies, and adaptation of policies and programs as results come in. The development of such cells would not only break down the formal barriers that presently serve to marginalize issues relevant to small and medium enterprises, they would also enable MTI to accumulate the specialized capacity that -- as is noted time and again in the report -- is the prerequisite for effective policy and program design for dynamic small firms.

Chapter 1 : Philippine Industrial Structure and the "Missing Middle"

A troubling feature of industrial structure in the Philippines is the degree to which progessive small and medium enterprises are missing. Large manufacturing firms (>200 employees) have, for the last two decades, dominated industry. They have produced the bulk of manufacturing value-added and have absorbed a large share of those employed in manufacturing. A look at Figures 1 and 1a illustrates this fact. The size structure of business firms, according to the number of employees per establishment, shows that the bulk of manufacturing labor force is employed in cottage and very small firms at the bottom end, and large public, private and multinational enterprises in the upper tail of the distribution. Progressive small and medium enterprises that would be located in the middle of the size distribution of firms employ an unusually small share of manufacturing workers. In terms of value added, the dominance of large enterprise is even more striking. As figure 1a indicates, approximately 2 percent of firms produce more than 85 percent of industrial value added. Put simply, for its level of per capita GNP, the Philippines has one of the most concentrated industrial sectors in the world.[1]

This chapter has four objectives. First, it will set the Philippine industrial structure in its international context. Second, it will lay out the reasons that increased participation by progressive small and medium firms in Philippine industry might be desirable. Third, it will examine in broad terms the reasons for the high levels of industrial concentration in the

Philippines. Finally, it will lay out the various ways in which progressive small and medium firms can participate in a dynamic efficient industry, and the obstacles to this participation.

1.1. Philippine Industrial Structure in International Perspective

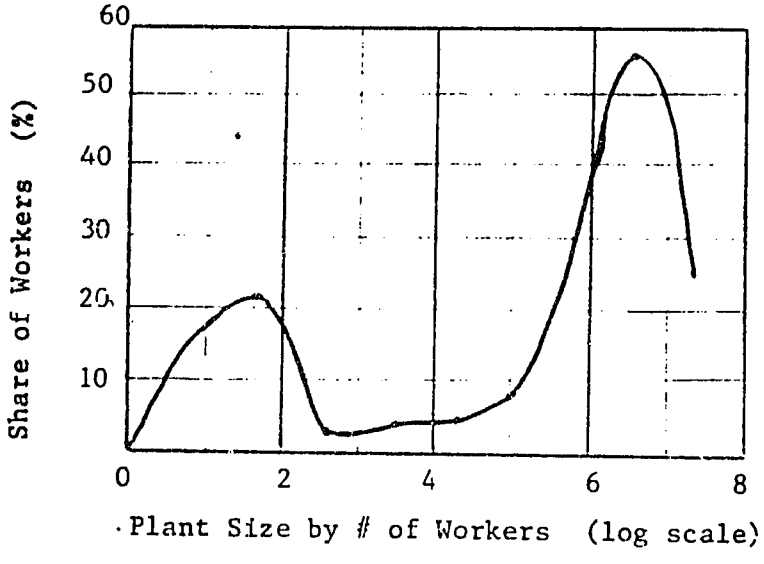
If we compare Philippine industrial structure with that of other countries, we see that it is decidedly skewed towards large enterprises, much like the manufacturing sectors of advanced industrial countries (USA, UK, GERMANY) - see Figure 2. The difference is that in the advanced industrial countries, cottage and small firms have, over time, been incorporated into the modern manufacturing sector. In the Philippines, manufacturing still remains highly dualistic, with a pronounced distinction between large, capital-intensive, continuous - process manufacturing establishments on the one hand and small scale, job-shop establishments (using "traditional" technology in many cases) on the other. Changes in industrial structure are occurring in the Philippines (figures 3, 3a, 4 and 4a depict the changes from 1972 to 1983), but the size of the household and cottage sector still remains large. Cottage and very small firms have declined since 1972 and the large firm share has increased. The disturbing fact is that after 40 years of industrialization, the low productivity subsector has not been more fully incorporated into higher productivity, modern manufacturing activity.

In passing, it is interesting to note that planned economies, like Czechoslovakia (Figure 2), have only a few small and medium firms in organized manufacturing. In highly

FIGURE 1

Distribution of Employment by Plant Size:
The Philippines

Total Manufacturing: 1983



Manufacturing, 1983

Plant Size	Interval	Midpt.	ln (midpt.)	% - share
			0.0	0
10	1-10	5.5	1.7	21.01
10-19	10-19	14.5	2.7	3.37
20-49	20-49	34.5	3.5	5.92
50-99	50-99	74.5	4.3	5.56
100-199	100-199	149.5	5.0	7.98
7200	200-1000	600.0	6.4	56.66
			8.0	0

SOurce: Philippine Industrial Census 1983, NCSO

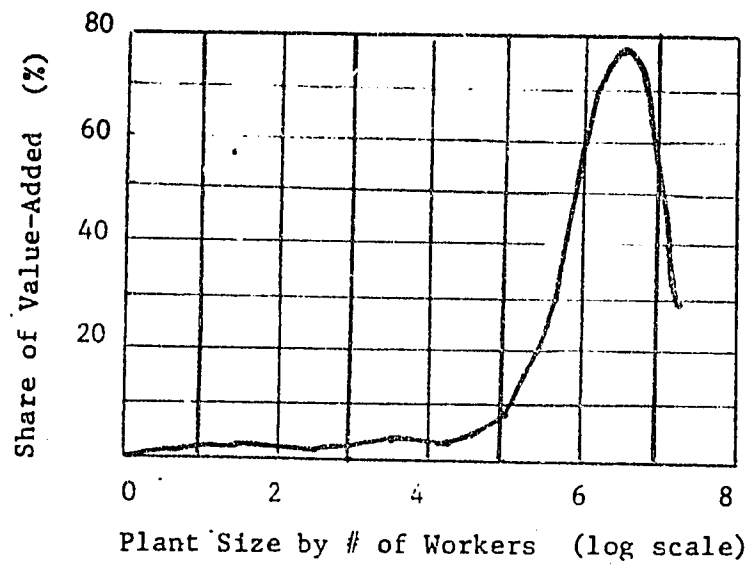
*It should be noted that, in these plots of size structure data, no correction for the changing width of intervals of plant size classes has been made. However, when this is done, the shape of the frequency distribution does not change significantly. The missing middle continues to be quite evident.

a

FIGURE 1a

DISTRIBUTION OF VALUE-ADDED BY PLANT SIZE:
THE PHILIPPINES

(Total Manufacturing 1983)



Source: Industrial Census 1983, NCSO

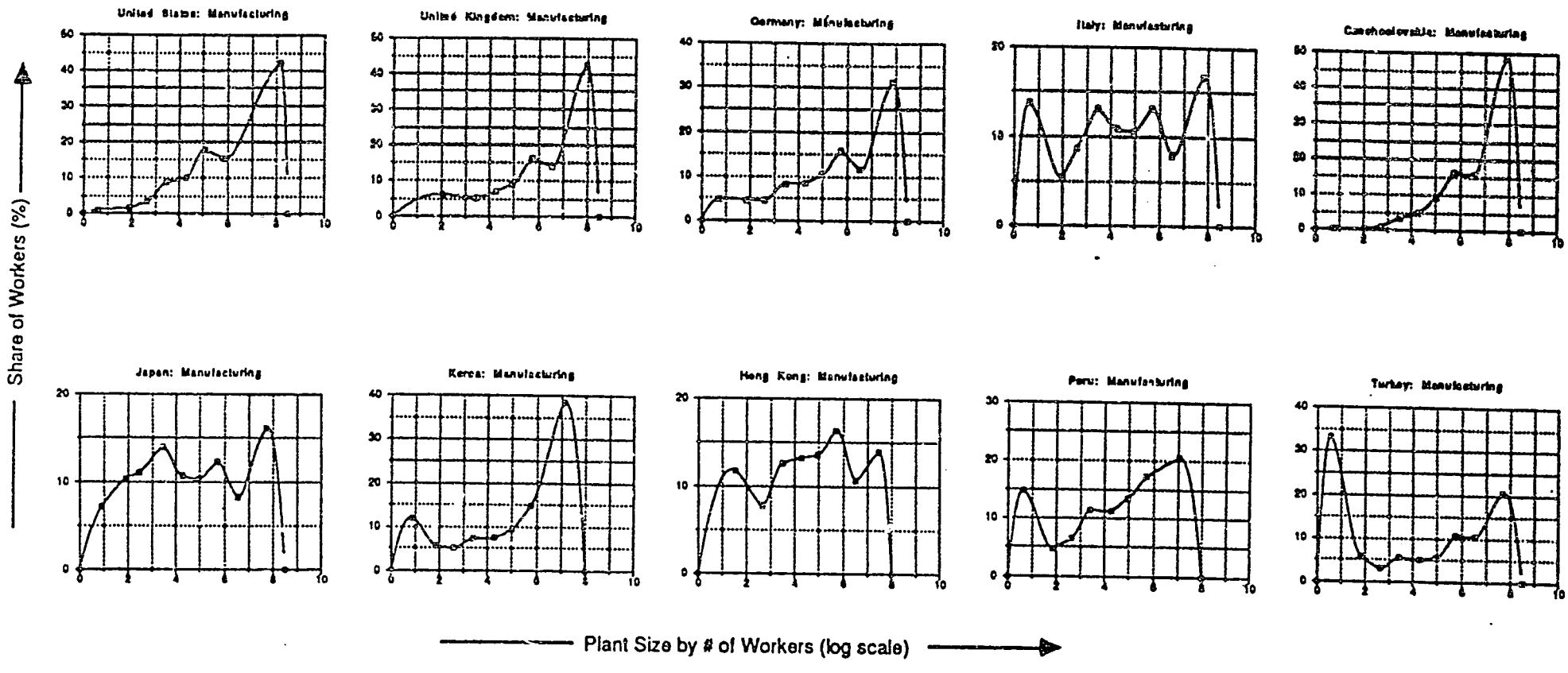


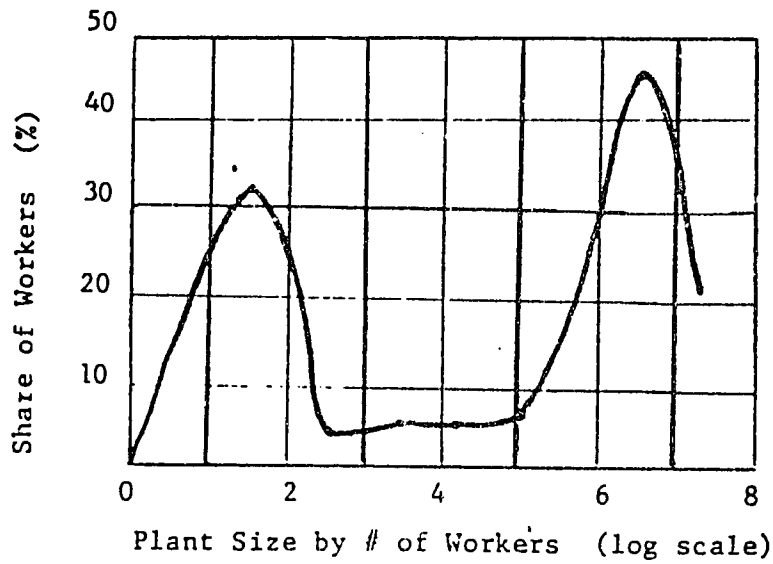
Figure 2

Distribution of Employment by Plant Size:

10 Countries, Manufacturing

FIGURE 3

DISTRIBUTION OF EMPLOYMENT BY PLANT SIZE:
THE PHILIPPINES
(Total Manufacturing 1972)



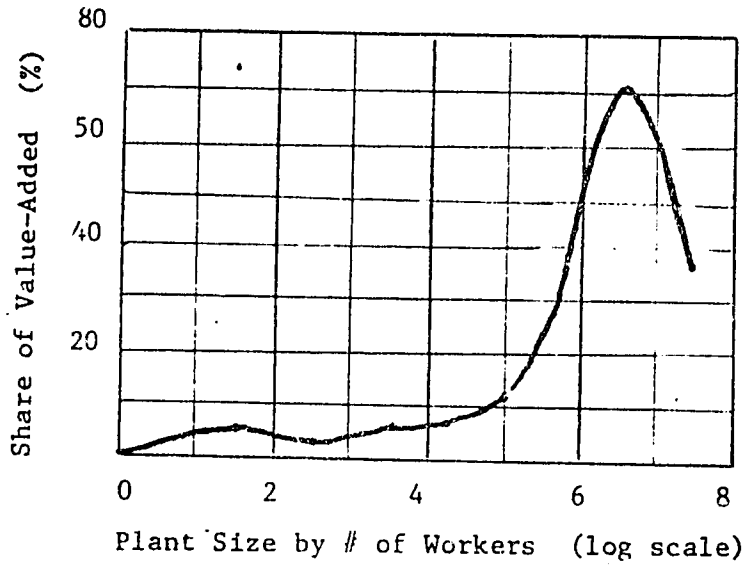
Manufacturing 1972

Source: Philippine Industrial Census 1972, NCSO

FIGURE 3a

DISTRIBUTION OF VALUE-ADDED BY PLANT SIZE:
THE PHILIPPINES

(Total Manufacturing 1972)

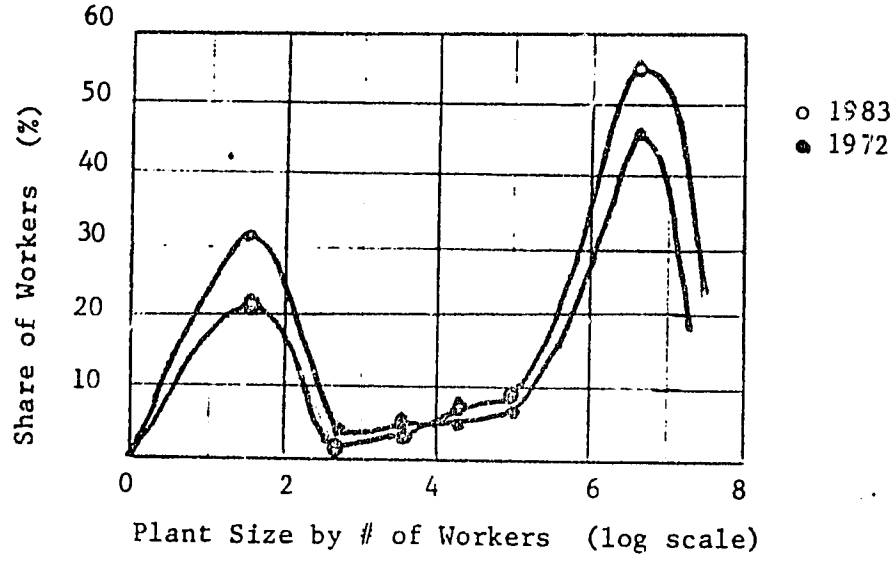


Source: Industrial Census 1972, NCSO

FIGURE 4

DISTRIBUTION OF EMPLOYMENT BY PLANT SIZE:
THE PHILIPPINES

(Total Manufacturing 1972 and 1983)

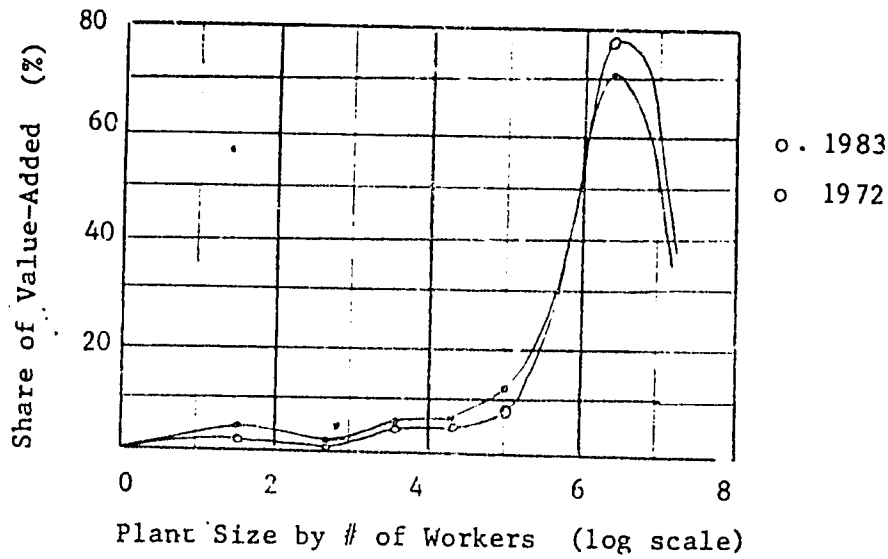


Source: Philippine Industrial Census 1972 and 1983, NCSO

FIGURE 4a

DISTRIBUTION OF VALUE-ADDED BY PLANT SIZE:
THE PHILIPPINES

(Total Manufacturing 1972 and 1983)



Source: Industrial Census 1972 and 1983, NCSO

centralized economies, planners seem to prefer large (publicly-owned) enterprises in all sectors. The most likely reason is the reduced problems of planning and control. More interesting is the fact that all of the fast growing, outward-oriented Asian countries, with the exception of Korea, have very sizeable groups of small and medium firms in manufacturing (Singapore and Malaysia are not shown in Figure 2 but have similar firm size structures). In all these countries, progressive small and medium firms have contributed to manufacturing growth. Of the fast-growing countries, only Korea neglected small and medium enterprises, as its industrial size structure indicates (figure 2).

What are the determinants of firm size structure over time in developing countries? And, in particular, what part does government policy play in the organization of manufacturing activity? To answer these questions we need some notion of the "normal" patterns of firm size structure as economic development proceeds. What follows is a brief discussion of the forces that drive the size structure of industry as development proceeds.

Empirical evidence indicates that, in the process of economic development, aggregate industrial structure appears to pass through three stages:

- A phase in which household and cottage-shop manufacturing is predominant (50 to 75 percent of the total manufacturing employment);
- A phase in which small and medium workshops and factories

emerge at a comparatively rapid rate and act to displace cottage-shop manufacturing in many sectors;

- A phase in which large-scale production becomes predominant, displacing the remaining cottage-shop activities and a large share - though not the whole - of workshop and small production.

None of these phases, however, are distinct. In fact, there is considerable overlap between the three, and the rate of change of the phases can be different between industrial sectors and among different regions of a country.

The forces that drive the organization of manufacturing activity through these phases and thus ultimately determine, in large part, the firm size structure at any point in time are extremely complex. But the main outlines of the story can be told in terms of changes in per capita income and patterns of domestic demand, changes in productive resources and technologies, and the interaction of these variables with government policy.

On the demand side, increases in per capita income result in a shift in the mix of products produced in the manufacturing sector. If demand shifts towards those products which are most efficiently produced by larger firms (i.e. those products where significant economies of scale exist in their production), then this will be reflected in a change in the aggregate size structure of manufacturing activity. On the supply side, changes in both the pattern of demand, which motivates a reallocation of productive resources, and changes in technology cause

production changes within industries to increase the share of large firm production in manufacturing.

The third main influence on the aggregate size distribution of firms is policy. Government policy can have profound implications for the mix of products that are produced and the technical aspects of production within industries. For example, policies which distort trade patterns may result in a "premature" shift of resources into industries which require more complex capital-intensive production arrangements. The size structure of industry in this case becomes more skewed towards large firms as production shifts into products that require capital-intensive techniques and longer production runs. Financial policies can have a similar impact. In the case of controlled interest rates and credit rationing, which generally discriminate against small firms, financial policy will work to promote larger firm size in every industry.

As this report will show, the prevailing policy regime also affects small enterprises by the way it influences the organization of production. Trade policy, investment incentives and the way labor markets operate may create incentives for existing large firms to vertically integrate. Similarly, high levels of effective protection and measured capacity rules may reduce competitiveness and the effort firm managers put into cost cutting measures. In either case, the opportunities for small and medium firms to participate in economic growth are reduced. Vertical integration and reduced pressure to minimize costs will severely reduce subcontracting activities of larger enterprises,

a primary avenue for small firm participation in the economy. Moreover, there will be a tendency for firms not to specialize as much as would be optimal under competitive conditions. This can constrain small firm participation in direct production if larger enterprises are able to erect barriers to entry and mobility - a distinct possibility given existing subsidies which allow predatory pricing.

The influence of government economic policy on the size structure of firms means that the developing countries have some discretion in the matter of the average size of industrial enterprise. Unfortunately, industrial development in most countries in the mid-20th century typically took the form of growth in the size rather than in the number of industrial enterprises, owing partly to actual and perceived economies of scale and partly to its being so much harder for governments to facilitate the establishment of new modern firms than the growth of already established ones. There have been exceptions to this general rule, mainly in Asia. Taiwan is a prime example.

Taiwan managed to take a different route to industrial development. Between 1966 and 1976, the number of manufacturing firms in Taiwan increased by 150 percent while average size of individual enterprise increased by only 29 percent. By comparison, in Korea, where industrial development took the more common route , the number of manufacturing firms increased by a mere 10 percent, while the number of employees per enterprise increased by 176 percent. The result of Taiwan's route was much smaller average size of private manufacturing enterprises and

the more competitive spirit that goes with it. The average firm size in Korea by the late 1970s was almost three times that in Taiwan.

What explains the smaller average firm size structure in Taiwan? To some degree, culture and circumstances played a part, but two other factors stand out as paramount. First is Taiwan's policy of helping people with entrepreneurial inclinations and know-how to establish themselves in independent business. Financial and other supportive economic policies were influential in this respect, coupled with investments in infrastructure and innovative institutional arrangements. Second, and probably more powerful, was the absence of policies encouraging the growth of firm size. Taiwan, for example, did not selectively allocate credit to large enterprises as Korea did. It kept interest rates relatively high at market-clearing levels to encourage savings and, when it did subsidize interest rates, it did so in a roughly enterprise - neutral way to all exporters.

1.2 The Economic Advantages of a Dynamic Middle

It is imperative to understand, on the one hand, that size structure of industry is shaped by factors such as the level of per capita income and government economic policy, and, on the other hand, that the size structure itself may also be an influential force conditioning economic events. This report contends that there are important economic advantages for a developing country like the Philippines in having an industrial structure that contains a sizable group of progressive small and medium enterprises. The case may be even stronger in developing

countries where trade of labor intensive goods is an important engine of growth.

This does not mean that indiscriminate promotion of small and medium firms should be a policy goal. Rather, we argue that by formulating a policy regime that provides a supportive environment which encourages progressive small and medium enterprises to participate in efficient industrial growth, a country creates not only a setting conducive to growth and development, it also creates positive externalities that make the economy more resilient, vital, and more equitable. It is our position that attention should not be addressed simply to establishing more small and medium firms. Instead, attention should be focused on building up a sizable group of progressive small and medium enterprises ("firms with a strategy") that are competitive and innovative at home and abroad. Such firms, we believe, can help to spark higher rates of economic growth and foster a more equitable income distribution in the Philippines. In the discussion that follows, we elaborate more specifically on potential benefits of building up the "middle" of industrial structure in the Philippines.

Competitiveness

For a market economy to function properly, it must be competitive. Competition depends on the presence of many small firms and the absence of overwhelmingly large ones. These conditions are generally met in international markets because most countries do not export or import enough to influence market price. In domestic markets, however, a combination of various

forms of trade protection and policies which limit entry or promote excessive size and industrial concentration can severely reduce competition. The Philippines is an extreme example of what can happen to industry when it is heavily protected from international competition and when government policies promote only limited competition in domestic markets. For more than 30 years, industrial productivity has been declining in the Philippines, first slowly in the late 1950s and 1960s (-.7 percent per year) then much more rapidly in the 1970s and 1980s (- 2.5 percent per year). The presence of a significant group of progressive, competitive small and medium enterprises would allay some of these problems of domestic competitiveness and would thus help to raise productivity in many sectors.

It is interesting in this respect to compare Taiwan and Korea with the Philippine situation. In Taiwan, the conditions of competition and proper functioning of markets are better fulfilled than in most other private enterprise economies. Many small and medium firms at home and only limited protection from international markets fosters innovativeness and rapidly rising productivity. Firms that do not reduce costs to optimal levels will not survive. New technologies and innovations in one industry or sector are quickly spread to others. Korea, on the other hand, because of the dominance of large firms and state interventions, has much less domestic competition than Taiwan. On its own, this could be a problem. But Korea fosters competition in its industrial sector by exposing its firms to international competition and by state policies that reward only

those firms that perform. In this fashion, it has made its industrial sector one of the fastest growing in the world. The interesting point raised by Taiwan and Korea is that the firm size structure by itself does not signal that industry is uncompetitive and less productive than it might be. Korea and the Philippines have very similar industry structures. But international competition in Korea made industry highly productive. The lesson for the Philippines is that it must subject its industrial sector to more competition from abroad. But , if it chooses to maintain trade protection, it should try to foster competition at home by promoting a more competitive size structure - eg. more progressive small and medium firms. In essence, getting the policy environment right so that it promotes competition is the key to dynamically efficient industrialization, not indiscriminate promotion of a particular industrial structure. However, because the policy environment is never perfect and because a certain level of protection is necessary to help infant industry, industrial structure may be an important intervening variable to foster greater competition.

Adjusting to Economic Shocks

When industrial firms grow to excessive size, there is diminished resilience of the economy. Small and medium firms render the always painful adaption of the economy to changing circumstances a little more bearable. Large firms can usually successfully resist cutting down their operations, thereby prolonging the agony but not obviating the necessity of change.

When domestic and international economic shocks hit, painful changes in the pattern and scale of manufacturing production are called for and small average firm size facilitates the process of adjustment.

Flexibility to Adapt to Capricious International Markets

Future Philippine industrial growth and participation on international markets will require progressive small and medium firms flexible enough to respond to changes in prices and tastes, as well as changes in technology, that occur so frequently. In fact, the more open the economy, the more industrial flexibility is needed to respond to changing world markets. Even in the developed countries that have had success in export markets in recent years, medium and smaller progressive firms have played an important role, along with larger enterprises. For example, one key to German wealth is the medium-size specialist manufacturing firm. Companies of this sort - with a small to medium turnover and work force - account for roughly half of Germany's exports of capital equipment. One of the surprises of the 1970s was the way they mastered the challenge posed by the high Deutschmark, after the breakdown of the fixed exchange rate order. It became clear that dedication to a particular product, continuous technical development, reliable delivery times, after - sales service and, above all, exact fulfillment of orders could outweigh quite a handicap on price. In addition, a study found that smaller German companies were more likely to make use of new inventions than big ones: 70% of new ideas were incorporated into the products of small companies within two years; within large firms,

only about one third of the new ideas was used.

Employment and Income Distribution

It is often conjectured that, for any given level of investment, small enterprises offer much more employment than large enterprises. For this to be true and of interest to policymakers, two conditions must hold. First, small enterprise in most important industries must be significantly more intensive in its use of labor than large enterprise. Second, small firms must use resources more efficiently (or as efficiently) than large firms. If the first condition holds and the second does not, special encouragement of small enterprises entails an undesirable trade-off between expansion of output and additional jobs. If, on the other hand, small and medium firms do not turn out to be clearly more labor-intensive in every case, then the employment argument for promoting small enterprises is weakened.

What does current evidence suggest in respect to these matters? As to the question of resource use efficiency, the results of industry studies do not generally support the case for special encouragement of all small enterprise. In surveys of narrowly defined industries in India, Colombia, the Philippines and elsewhere, the notion that small, especially very small, manufacturing enterprises are relatively more efficient users of resources was found to have no general validity (either from a technical or social point of view).[2] On the other hand, these studies did find that medium-size enterprises are generally efficient. In many industries, medium-size enterprises come out best in examinations of relative efficiency of different scales

of production. This evidence lends support to the contention that a "missing middle" in the enterprise size structure, holding other things constant, may imply reduced industrial efficiency.

On the subject of relative factor-intensity, the studies cited above arrive at a somewhat surprising conclusion. First, in some industries, the differences in labor-intensity between large and small enterprises is not that great. Very small modern factories or workshops may be very capital-intensive. Moreover, the differences in labor-intensity between firm size classes within industries that do exist are dwarfed by differences between industries. This implies that, for manufacturing as a whole, small and very small firms are labor-intensive because labor-intensive industries have a relatively high proportion of small enterprises. That is, small enterprises are labor-intensive because they are usually found in labor-intensive industries, not because they are always and everywhere labor-intensive. This conclusion points to the importance of a country's pattern of industrial output for both the existence and factor-intensity of small enterprises.

What does all this ultimately say about small and medium enterprises and employment? In essence, these findings underscore the fact that <u>indiscriminate</u> promotion of small enterprise is not the answer to the employment problem[3] in developing countries. This is true for at least two reasons. First, programs and policies that target small-scale enterprise indiscriminately may achieve short-run employment gains at the expense of longer-run efficiency and even greater potential

employment benefits. Second, expanding employment is not the only relevant policy goal. The conditions of employment are equally important. In the Philippines, real wages have been declining for almost 20 years. In these circumstances, finding jobs has not been the most pressing problem. The toughest proposition has been that these jobs are being found in low productivity economic activities and enterprises. One example of low productivity job creation is the rise of "informal" (sometimes illegal) enterprises, many of which enter into business solely as a result of restrictive government policy. Another is the rise of the low productivity service sector as opportunities for other employment dry up.

Policy and programs aimed at promoting efficient industrial growth and an industrial structure with a progressive "middle" of small and medium firms would, in the opinion of the Harvard team, address both these matters in the Philippines.

To begin, progressive small and medium firms generally fall into the efficient, medium-size category of industrial size structure. Hence, the potential for promotional efforts to induce an undesirable trade-off between employment and growth is, for the most part, allayed. In addition, policy and programs that foster the participation of progressive small and medium firms also foster the building blocks of more labor-demanding manufacturing growth. Trade liberalization, investment incentives and regional policies that encourage the participation of progressive small firms twist the pattern of industrial output towards products where the Philippines has a relatively greater

comparative advantage, induce exante and expost technical production choice more in line with local resource endowments, and stimulate greater industrial competition, which creates pressures for industrial organization changes and cost cutting that increases the productivity of enterprises and spurs growth.

An environment that supports entry and expansion of progressive smaller firms would similarly work to enhance the conditions of employment in several important ways.

First, the locomotive driving manufacturing growth and structural transformation in developing countries is the process of technological "learning." Unlike most of the advanced industrial countries of the 19th century that sparked industrialization by invention, 20th century industrializers acquire technological competence by importing foreign technologies, adapting them to local conditions, and learning-by-doing as production proceeds along the international product cycle. Within "learning" countries, industries, firms and entrepreneurs differ greatly in their ability to acquire necessary technological capability and new technologies. Thus, at any point in time, one would expect to find considerable variation among firms with respect to vintage of their technology between and within industries. This ability to acquire technological capability is not just a function of the level of human resources (education and experience), it is also influenced by the investment climate and by the ruling policy regime. Further, imperfections in domestic factor markets either policy-induced or otherwise tend to slow down the acquisition of

technological capability by raising the cost of expanding firms.

In the end, a lagging process of technological acquisition and diffusion means slower industrial growth and declining (or stagnating) conditions of employment (falling value added per worker), depending upon the rate of labor force growth. It also means that there is less survival pressure on inefficient producers to modernize. As a consequence, the shift in the composition of the work force toward higher productivity activities and enterprises (away from household and cottage production), an important element of structural transformation of the economy, will be retarded. As this report argues in subsequent sections, policy and programs to encourage a dynamic middle of progressive small and medium firms would help to stimulate the pace of technology acquisition and foster the shift to higher labor productivity. Progressive small and medium enterprises would increase competition and put greater pressure on low productivity producers to become more efficient or go out of business. In addition, a dynamic middle would offer directly higher productivity job opportunities.

Second, medium-size and larger progressive firms (and smaller ones in some industries) have the necessary economies of scale in export marketing and production techniques to develop a competitive advantage in various products in world markets. In countries like Taiwan and Korea, the rapid growth of relatively labor-intensive exports emanating from these firms pulled labor from lower productivity activities and enterprises into higher productivity jobs. The decline in lower productivity small-scale

producers this shift engendered was compatible with a pattern of highly labor-demanding development with rising conditions of employment.

Finally, All these factors should have beneficial implications for the distribution of income. It can be argued that a strategy to remove the barriers to participation of progressive small and medium firms can result in growth with equity.

Entrepreneurship, Learning - by - Doing and Demonstration Effects

Increased participation of small and medium firms will mean that more individuals can develop and utilize their entrepreneurial talents. In the Philippines, potentially valuable human skills have been allowed to remain underutilized. Right now, underemployment of trained technicians is so widespread that thousands emigrate to other countries in search of useful employment. The Philippines has the largest number of trained scientists per capita in all Southeast Asia. Such human capital could be the foundation for a thriving, progressive group of small and medium firms in industry, if barriers to their participation were removed.

The existence of a large group of progressive small and medium firms also will have a powerful demonstration effect for the rest of the economy. Innovations should spread from small progressive firms to others and to less progressive enterprises. In addition, entrepreneurs will learn from the success of others. The participation of progressive small and medium firms in economic growth should in this way produce more widespread

benefits than the mere results of their direct contribution to industrial production.

Political Economy

A potential danger of excessive business concentration is that it may wield influence over government policy, encouraging the enactment of measures that, while privately profitable, are socially unproductive. Philippine "wrong capitalism" of the 1970s and early 1980s offers an extreme example of how collusion between business and government in pursuit of profits can wreak havoc on a nation's economic development. A lowering of the barriers to participation of progressive small and medium enterprises can help to reduce the concentration of economic power. In turn, reducing economic concentration may improve the conditions for the formulation of more productive and equitable industrial policies.

1.3 Determinants of Philippine Industrial Structure

This part of Chapter 1 presents a general model of the relationship between policy and industrial structure in the Philippines. The final part of the chapter will link this macro-story to more micro-analytic explanations of the barriers to small and medium progressive firm participation. The macro-story, which shows how the overall policy environment has created a highly dualistic industrial structure, is developed in two sections. Section 1 looks at the way in which policy - particularly trade policy - has combined with the operations of capital markets to "crowd out" small and medium progressive

firms. Section 2 looks at the other end of its size distribution to examine why there is such an accumulation of a small less progressive, livelihood firms. In particular, it asks whether government "livelihood" programs - targeted at the cottage industries - may have contributed to a "small firm growth trap." That is, the effect of selective interventions to improve the welfare of small entrepreneurs may have imposed very high marginal rates of tax on small firm growth. The joint effort of disincentives to growth at the bottom end of the size distribution, together with crowding out at the top, has created a series of barriers to the entry and expansion of small modern firms.

1.3.1 Crowding out at the top

The predominant thrust of industrial policy in the Philippines has, since the time of independence, been the promotion of import - substituting activities. Simple theory, of course, suggests that in a labor - abundant country, such as the Philippines, import - substitution is more capital-intensive than production of exports. The theory is borne out by the actual numbers. Table 1, which compares the (5) main industries whose production is directed toward domestic markets with those which produce primarily for exports, shows clearly that the former group are much more capital-intensive.

Unsurprisingly, the Table also shows how the contribution of small and medium firms shrinks in the capital - intensive manufacturing sectors.

Table 1

"Export" Industries	K/L (1983)[1]	% Employment in Large Firms
Garments	6.64	47%
Furniture	9.44	30%
Footwear, except rubber and plastics	9.87	31%
Leather products, except footwear 2	15.34	40%
Electrical Machinery	34.45	88%
"Domestically-Oriented" Industries		
Industrial Chemicals	237.78	50%
Textiles	70.30	78%
Glass Products	125.42	87%
Transport Equipment	112.57	66%
Iron and Steel	214.78	67%

Source: NCSO

1. Large Firms are those with more than 200 employees.
2. Exporters in this industry are mainly large labor-intensive assemblers and EPZA firms.

In fact, the evidence on trade policy (for more detail see, Chapter 2.1) goes somewhat further. If, instead of nominal tariffs, the data on effective rates of protection are presented (see Table 2), then a strong relationship emerges between the capital - intensity and the ERP of an activity. Again, the contribution of small and medium progressive or the "middle" firms declines as capital - intensity rises.

Table 2

Industries	ERP (1985)	K/L (1983)[1]	Share of Large Firms
Garments	0	6.64	47%
Leather products excluding footwear	0	15.34	43%
Footwear excluding rubber and plastics	0	9.87	31%
Paper Products	101	199.00	65%
Tobacco	110	77.00	95%
Transport Equipment	56	112.00	66%

Source: NCSO

1. Larger firms are those with more than 200 employees.

Trade policy, although perhaps the worst offender, is not the only reason that manufacturing in the Philippines has become prematurely capital - intensive. Three other sets of policies are also accessories to the fact:

(1) Until recent modifications, BOI incentives (for a more extensive discussion, see Chapter 2.2) had a significant bias towards capital-intensive techniques of production. The most important fiscal incentives in the Investments Incentives Act (RA 5186) contained capital - cheapening provisions: accelerated depreciations, tax exemption on imported capital equipment, tax credit on domestic capital equipment, expansion reinvestment allowance and tax credit for

withholding tax on interest.

(2) Minimum wage laws, fixed above the market rate, together with government regulations which have raised the overhead costs of labor, encourage firms to substitute towards the use of more capital.

(3) An over - valued exchanged rate reduced the private cost of capital below its social cost for firms able to borrow on the international capital markets.

One of the ways that this macro - bias towards the use of capital shows up is in the incremental-capital-output-rates (ICOR). Policies which have raised the private return of capital-intensive activities and which have lowered the private cost of capital, have resulted in an extremely inefficient use of scarce capital resources. Table 3 compares the ICOR for the Philippines with that of Korea and Taiwan over the last decade. Although ICORs are, in theory, supposed to rise with per capita income, the Philippines has performed consistently worse than its more affluent South East Asian neighbors.

This bias toward capital-intensive activities would, of course, have few implications for industrial structure if all firms had equal access to capital markets. However, the truth is that some businesses are more equal than others. "Primus inter pares" is the government and state-owned enterprises. (For more details, see Chapter 2.3.)

Table 3

Incremental Capital Output Ratios (ICORs)
for Selected Asian Countries

Country	1971	1976	1979	1981
Philippines	3.48	3.54	4.02	6.71
South Korea	2.72	2.11	5.74	4.56
Taiwan	2.13	2.32	3.86	5.64
Singapore*	3.01	4.43	1.83	3.92

Source of Basic Data: Key Indicators of ADB DMB's

* ICORs can be extremely variable in the short-run, due to cyclical factors.

The government has affected the supply of credit to small and medium modern enterprises in four main ways:

(1) Financial macro policy has reduced the overall supply of loanable funds, which are mediated through the commercial banks. Interest rates fixed by the government (to reduce its domestic debt-servicing costs) have reduced the ability of the commercial banks to mobilize domestic savings. In addition, the general set of regulations on commercial banks - the high (low-interest earning) reserve requirements, the agri/agro loan rules, the gross receipts tax - have all conspired to increase the costs of financial intermediation and to slow down the process of financial deepening. Although, at present, the commercial banks are extremely liquid, this is merely

a symptom of the depressed state of the economy. As soon as the economy begins to pick up, the low level of financial intermediation may well bring any recovery to a premature halt. To the extent that the commercial banks have only restricted funds to on-lend, credit rationing rules automatically discriminate against smaller firms, who are perceived as higher risks.

(2) Financial micro - policy has reduced small firm access even to that pool of financial resources which the commercial banks are able to mobilize. First, the commercial banks have been forced to hold too high a percentage of their assets in the form of government securities. Table 4 shows the proportion of the "national debt" held by the commercial banking sector. Since the government, in the past, also fixed interest rates, the net effect may have been to substitute public for private borrowing on a one-to-one basis. This crowding out has particularly undesirable implications for small modern firms, for whom commercial banks may represent the only source of external financing.

Rules regarding the selective allocation of credit may also have discriminated against small, progressive firms. Credit has been channelled to the state-owned enterprise sector, the financial assets of which have increased from 13.5% (1965) to 33.4% (1982) of total non-financial corporate assets. Moreover, excessive

quantities of credit have been diverted at the 11 basic industries, where significant economies of scale inevitably result in a large average firm size.

Table 4

Year	Commercial banks	Central Bank	Private Sector	Others
1965	19%	43%	2%	36%
1970	25%	46%	10%	19%
1975	31%	23%	12%	34%
1980	38%	18%	11%	33%
1985	36%	15%	9%	40%

Source: Central Bank

There is an important theme which recurs time and again in this report: that the overall policy environment is inconsistent with the programmatic objectives of the government. Macro - policy combines a systematic bias towards relatively capital - intensive activities (through import - substitution tariff incentives) with a highly selective allocation of credit, biased against small and medium enterprises. Government programs then attempt to work at cross purposes with the overall policy environment by channeling very limited financial resources, through discount windows, to a restricted group of small progressive firms. In other words, policies and programs are in direct competition with each other.

The group which really gets hurt by these contradictions are the firms in the middle. Very large firms are, in most

circumstances, able to get access to capital from either "captive" commercial banks or international capital markets. The micro and cottage firms, which, in any event, have limited capital requirements, have access to soft loans (channeled through Rural Banks, NACIDA, ALF), informal funding from relatives and short - term loans in the curb market. The firms which really appear to suffer from a lack of access to external financial resources are those who:

(1) need to borrow for the first time on a scale available only through formal channels,

(2) who have growing working capital requirements and therefore need permanent financial relationships,

(3) who need a guarantee of medium - term financing (even if this comes in the form of roll - over agreements) and,

(4) who lack collateral and contacts.

1.3.2 Structural Transformation and the Small Firm Growth Trap

The problem in the Philippines is not only the tendency toward excessive bigness in firm size and business concentration. At the other end of the size distribution, the economic environment continues to support the survival of an extremely large number of small and cottage producers. Despite low levels of productivity in this group, there appears to be a relatively low rate of firm mortality. In other economies at a similar stage of development, what we see is a much more rapid

transformation of the industrial structure. The more efficient small firms expand and drive out the less competitive small producers. Cottage producers are forced to adapt or die. In the Philippines, however, this process is taking shape at a relatively slow pace. The small-scale sector, despite low levels of productivity, continues to be a major source of manufacturing employment.

Table 5

1960	100
1965	90
1970	89
1975	64
1980	63
1985	62

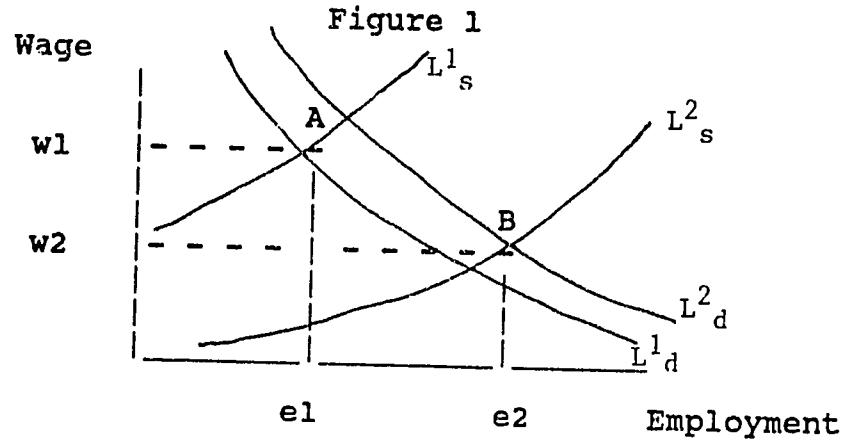
[Source : BAECON wage surveys, NEDA]

One of the reasons for the suspended transformation of the industrial structure may be the sustained decline in real wages, which has characterized the Philippine economy since 1960. Table 5 presents the data for wage earners in Manila between 1960 and 1985.

Trade and exchange rate policies, which encouraged the growth of relatively capital-intensive sectors, in combination with a rapid increase in the supply of labor have reduced real wages over time. Figure 1 shows the basic story. Not only has labor supply increased over time (a shifting out in the Ls curve), but the demand for labor has failed to increase

proportionately. The net effect of these changes is that the real wage rate has fallen from A to B.

Figure 1



One consequence of this fall in the real wage is that small inefficient producers have been able to survive. In an economy where real wages are rising, only those producers which increase their labor productivity over time can survive. Small firms are forced to modernize if they are to meet increased labor costs and still remain profitable. The effect of falling real wages is that low productivity firms can continue to survive. Falling real wages may contribute to labor absorption, but at the expense of investment in more productive employment opportunities.

Very small firms, of course, pay much lower wages than larger firms. Not only are the minimum wage regulations graduated, but in practice, the smaller firms easily avoid compliance. Table 6 contains the aggregate data for average wages, broken down by the size distribution of firms.

Table 6

Firm Size	Compensation (P'1000) per worker 1972	1983
less than 20	.91	2.88
20-99	3.48	11.42
greater than 100	4.81	16.95

Source of basic data: NCSO

Table 6 shows not only the wage differential across the size distribution, but also how that differential has increased over the last 10 years. Average wages in the larger firms are now almost six times those in the small category of enterprises. The ability of small firms to pay progressively lower real wages over time has assisted their survival and slowed down the whole process of structural transformation.

Declining real wages are not the only explanation for "suspended" structural transformation in the manufacturing sector. Somewhat paradoxically, government programs designed to help small businesses may have created certain barriers to small firm growth. There are two dimensions to the problem: first, the overall set of government objectives and second, the implementation of policies.

The Set of Government Objectives [Detailed Discussion in Chapter 3]

The government can approach the issue of small and medium

enterprise development from two different directions. The first route is to promote small and medium firms as a goal for its own sake. The underlying argument straddles an uneasy set of claims which mix labor absorption and income distribution with regional dispersal. Irrespective of sector, assistance to small and medium enterprises is looked on as a way to accomplish three objectives with one policy instrument. From a programmatic perspective, such an outlook implies that government assistance should be organized according to firm size criteria. Considerations of industrial efficiency, of potential firm entry and expansion , or of the medium-term comparative advantage of an industry necessarily take a backseat to the more pressing program objective: assisting firms of a particular size. Evaluation of program success becomes a question of counting the number of firms that have actually received assistance.

The obvious alternative is to focus on generating greater efficiency and on creating an environment in which resources are allocated on a more rational basis. Program design would emphasize:

1) the reduction or elimination of structural barriers to entry or expansion, which limit the participation of <u>efficient</u> small firms. Programs should not simply channel support to firms of a particular size. Rather, they should be thought of as selective interventions, addressing specific market imperfections that create barriers to small and medium progressive firms.

2) the avoidance of small firm dependency on government support. Programs which implicitly encourage firms to remain in a particular size class, so that they can continue to receive government assistance, are completely self-defeating. Only programs which are targeted at dynamically efficient small producers can avoid the problem of perpetual firm infancy.

3) the possibility of firm death. At least in the short run, the provision of support for small efficient producers may be at the expense of their small inefficient colleagues. Programs that support entry only into "uncrowded markets" do not provide incentives for existing producers to improve their production techniques. Programs whose principal objective is to increase short-term employment opportunities, neither promote greater small firm efficiency nor address the problem of high structural barriers to small firm growth. The central issue should be total factor productivity, not the labor/output ratio. There is nothing wrong with small, efficient, capital-intensive firms. Designing programs on the basis of asset size could eliminate this group of firms.

BSMI today appears to place a higher priority on small and medium enterprise promotion than on the overall goal of

industrial efficiency. Client groups are defined purely in terms of asset size. Small and medium enterprises are thought of as living in an entirely different world from the overall strategies for industrial development. As a consequence, BSMI is all but marginalized in the general policy debate. Since program design rarely addresses the issues of entry, expansion, and efficiency, government assistance gets subsumed in a set of livelihood objectives and hand-holding exercises. The minimization of small firm mortality rates becomes a substitute objective for the promotion of efficient industrial growth.

While the Harvard team appreciates the political expediency of livelihood-oriented, employment - generating small business programs, short-term considerations cannot prevail forever. The transformation of the industrial structure - as the manufacturing sector moves to a more efficient set of production relations - inevitably means that small inefficient producers get phased out. Government programs which sustain relatively inefficient small producers merely slow down this process of transformation and may make the necessary longer-term adjustments more painful. If small businesses are to thrive and to generate <u>productive</u> employment opportunities, then program design has to make explicit <u>efficiency</u> and <u>profitability</u> criteria. Small firms are in the business of profit, not employment maximization. The ability to increase revenues and net income is logically prior to the generation of additional employment. Program design has to recognize this fact.

The Implementation of Policies

As firms grow, two things happen. First, firms no longer receive the benefit of the government programs which are targeted at the bottom end of the size distribution of firms. Second - and equally important - is the fact that firms find themselves subject to a much more comprehensive set of regulations and tax rules. The withdrawal of subsidies, implicit in government programs, interacts with the more consistent application of administrative and tax requirements. The net effect of this interaction may be to impose a very high marginal rate of tax on small firm growth. This is the "small firm growth trap."

There are two main aspects to the trap. First, firms' growth leads to a graduation through the tax and labor law brackets. Second, growth results in entry into a more formal business world. Rules and tax obligations which can be safely ignored (or "negotiated") when small become more legally binding. In other words, the effective tax burden of an enterprise is likely to increase sharply at certain points in its life cycle.

In the past, the existence of NACIDA incentives and a graduated system of minimum wage regulations created a very extreme version of this growth trap. Firms which left the league of cottage producers faced, all of a sudden, sales taxes, import duties and higher minimum wages. Recent reforms in the system - the abolition of NACIDA incentives and the unification of the wage legislation - have, in principle, made the world of cottage and livelihood producers much less favored.

What really counts, of course, is the way that the system works in practice. Evidence from interviews with a stratified sample of firms in a number of industries suggests that:

1) Most cottage firms, irrespective of the change in NACIDA rules, pay at most a small proportion of their sales taxes;

2) Labor code regulations are systematically enforced only after firms grow beyond the 20 employees size. Below that scale of production, firms pay the going market wage which in low-skill activities is significantly below the legal minimum wage;

3) Firms, as they grow out of the cottage/small categories, do <u>not</u> instantly take advantage of BOI incentives. The BOI is widely perceived as an exclusive preserve of larger firms. Despite the elimination of some red tape, small firms are extremely uncertain about the benefits of registration and find the initial and ongoing costs of compliance too high.

Table 8 compares the cost structure for a typical small firm before and after its entry into the formal sector of the economy. The firm is assumed to pay no sales tax and wages at 20% less than the legal minimum, prior to entering into the economy. Even on the presumption that the firm continues to pay the same rate of corporate income tax on its net income, its post-tax profits rise only if entry into the formal sector is

of production. The most important fiscal incentives in the Investments Incentives Act (RA 5186) contained capital - cheapening provisions: accelerated depreciations, tax exemption on imported capital equipment, tax credit on domestic capital equipment, expansion reinvestment allowance and tax credit for

accompanied by an 85% expansion in output! If firm expansion is

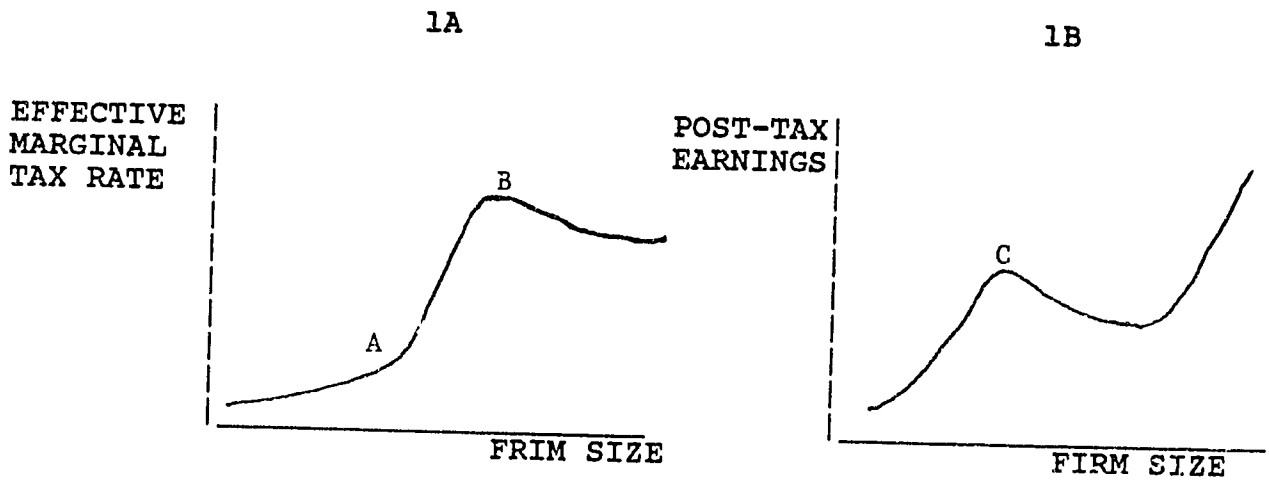
Table 8

	Before	After
Materials	35%	35%
Labor	20%	25%
Overheads	12%	12%
Taxes (sales)	—	10%
Profits	35%	18%
TOTAL	100%	100%

less than 85%, then the marginal tax rate on entry into the formal sector is more than 100%. Figure 2 makes the same point in a slightly more graphic fashion. Figure (2a) illustrates the effective marginal tax rate on firm growth. The rate rises sharply at point A, where firms enter into the formal sector and then begins to decline at point B, where BOI incentives become more accessible. Figure (2b) shows the evolution of post-tax earnings which are likely to accompany firm growth. Earnings fall when the firms (at point C) enter the formal sector and then begin to rise again as firm expansion continues.

The basic issues are extremely simple. First, the tax rates must be set at a level which encourages firms to operate, from the start, in the formal sector of the economy. Excessive taxation encourages firms to operate "underground", implicitly creating a high barrier to entering the "legitimate" business

world. Second, tax policy must pay explicit attention to the relationship between high marginal tax rates and disincentives to



firm expansion. Third, minimum wage laws are highly distortionary. Not only do they encourage firms to cut down on labor use, but, in addition, they discourage firm growth.

This part of the report has argued that there are systematic biases against the efficient participation of small and medium enterprises in the Philippine industry. One consequence of the overall policy environment is to raise the return to capital-intensive activities in which large, established BOI registered firms are dominant. Chapter 2 provides a much more detailed discussion on the relationship between policies and the barriers to small progressive firm expansion. While policies conspired to crowd out this group of firms, the effect of programs may be to slow down the whole process of structural transformation in the manufacturing sector. Small, inefficient producers continue to survive and absorb labor in low productivity jobs. Programs

based on employment rather than efficiency criteria reinforce the existing industrial structure and do little to support the growth of dynamic small firms. The next section presents a classification of the way in which small modern enterprises participate in a more progressive industrial structure.

1.4 The Forms of Participation by Small and Medium Enterprises and their Associated Obstacles.

The first section of this chapter made the case for enhanced participation of progressive small and medium firms in Philippine industry. This last section will lay out different ways in which progressive small and medium firms participate in industry, and the obstacles associated with each form of participation. As a prelude, it is necessary to delineate more precisely the character of the progressive firm.

Progressive firms are not established simply to provide their owners with a livelihood equivalent to what might be earned in wage employment. Rather, the owner/entrepreneur of the progressive firm typically has the objective of expansion over the long haul, and a more or less coherent strategy for achieving this objective.

The progressive entrepreneur places a high priority on technically efficient production, and is engaged in an ongoing search for ways to reduce unit costs and improve product quality. Most fundamentally, the progressive firm aims to internalize a proactive adaptive-relationship to its environment, anticipating and planning for change, rather than reacting defensively and being left by the ongoing renewal of economic

events. Progressive small and medium firms are not as likely to benefit from government assistance that aims at upgrading internal management process. What will prove most useful are policy and program interventions that enable firms to overcome obstacles and the external environment.

We have identified four distinct classes of participation:

(i) SMEs that produce as subcontractors for the local market;

(ii) SMEs that produce and sell directly to the local market;

(iii) SMEs that produce as subcontractors for direct exporters who sell to foreign buyers;

(iv) SMEs that produce and sell directly to foreign buyers.

The studies of the automobile and electronics components industries will provide the most useful insights with respect to the first class; the wood furniture, radio and jewelry industry studies will be most relevant for the second class; insights of the third and fourth classes will emerge through analysis of the garments and rattan furniture industries.

As will be laid out below, each of the four classes of participation is associated with a specific set of obstacles to entry and expansion. One major goal of this report is to explore the extent to which existing policies and programs help offset -- or, alternatively, exacerbate -- these obstacles. But before we

turn to the task of delineating the character of these obstacles, a few more general observations on the relationship between dynamic efficiency and the various classes of participation are in order.

First, although, in principle, all four forms of participation could be associated with dynamically efficient industrial expansion, in the context of the Philippines, the implications for efficiency vary from one class to another: given the prevailing policy environment potential for firms to be dynamically efficient is overwhelmingly greater in sectors geared at least partly for export than in sectors where production is overwhelmingly for the local market. Second, to the degree that industrial expansion involves the proliferation of subcontractors under the sway of a relatively small number of principals, economic power will be relatively highly concentrated. As has already been noted, in the Philippines, the concentration of economic power has been associated with a rise over time of profit seeking alliances between government and large firms, and the consequent promulgation of socially inefficient economic policies. Insofar as this pattern of business-government relationship can be expected to persist, direct participation by small and medium enterprises is more likely than partnerships between subcontractors and large firms to lead the economy in a dynamically efficient direction. Third, considerations of political economy aside, for all that (as the case studies of the garments and rattan furniture industries highlight) the proliferation of subcontracting networks can be a key element in

dynamically efficient industrial expansion, and for all of the apparent ease of entry for small firms as subcontractors (on which more momentarily), subcontracting is no panacea for small and medium enterprises: as our case studies make clear, there is no guarantee that a subcontracting relationship will induce a transfer of technical and other business skills from principal to subcontractor. Even where this transfer does occur, the difficulties faced by subcontractors endeavoring to become direct producers remain formidable; indeed, in our industry studies, we were able to identify very few instances of 'graduation' of this kind.

To return to the issue of the obstacles to entry and expansion of firms within each of the four forms of participation, Table 9 lays out the characteristic obstacles to entry and expansion for each class of participation. The simplest point of entry for SMEs is as subcontractors for producers or assemblers that sell on the local market. As Table 9 summarizes, entry here involves the ability to negotiate a tie-up with a principal who purchases the goods, to manufacture a product of a quality that is acceptable locally, and to finance the investment in the necessary capital equipment (according to interviewees, in the clothing industry this finance sometimes is provided by the purchasing principal). Insofar as the principal provides raw materials on consignment and pays promptly for completed production (both standard practice in the clothing, furniture and handicraft - but not electronics and metalworking - industries) the need for working capital is circumvented.

Table 9

Obstacles to Entry or Expansion for Different Classes of SMEs

	MARKET	
CONTRACTUAL RELATIONSHIP	LOCAL	EXPORT
SUBCONTRACTING	1. Tie-up with purchasing principal 2. Finance; Investment capital	1. Tie with purchasing 2. Finance; Investment capital
DIRECT SALE	1. Local Marketing 2. Finance: Investment and Working Capital 3. Competitive position relative to large firms 4. Access to raw materials	1. Export Marketing 2. Finance: Investment and Working Capital (L/Cs) 3. Ability to compete with large firms 4. Access to raw materials

In principle, subcontractors to the local market could expand their operations (if they choose to expand according to some interviewees, 90 percent of subcontractors are content to maintain a steady level of operation) by seeking out more local orders; but in sectors where export growth has been rapid, many subcontractors have shifted to producing for exporting principals. As Table 9 illustrates, as with subcontracting for

the local market, export subcontracting greatly simplifies both finance and marketing problems. But it places substantially larger demands for efficient production on subcontractors: tight delivery schedules, low margins, and stringent quality control together imply that the productivity levels and cost consciousness of exporting subcontractors must be substantially greater than that of subcontractors for the local market.

Rather than shift to subcontracting for exporters, a domestic subcontractor seeking to expand might try to move from subcontracting to direct sale on local markets (or a new firm might enter directly as a final producer for the domestic market). Such a shift is not likely to place substantially new demands on the firm's technical capabilities insofar as it has already built a track record of production at a cost and quality adequate to supply the local market. Rather, the added difficulties lie in the domains of finance, of raw material and intermediate inputs procurement, and of marketing. The firm now has to find its own source of working capital; it has to uncover its own sources of raw materials and intermediate inputs and -- for those requirements that are imported -- navigate the requisite importation procedures; and it must develop its own outlets for its products, no longer as a complementary supplier of large firms, but as a direct competitor.

Of all the routes of entry or expansion, direct exporting involves the most substantial obstacles. To survive, the direct exporting firm must not only -- as with the domestic subcontractor -- produce at a high level of efficiency, it must

also -- as with the direct producer for local markets -- find sources of working capital, raw materials and intermediate inputs, and win a market for its products, now as an actor in a global market. The ability to make contact and negotiate effectively with foreign buyers, offering a price that is competitive while at the same time protecting a margin for profit (with the associated demands of sourcing quality raw materials from the lowest cost sources, abroad if necessary, and taking advantage of every conceivable cost saving in the production process) is likely to be the province of only a selected few firms.

To summarize, the delineation of the classes of participation has helped us to identify five characteristic obstacles to entry and expansion by small and medium enterprises. Not all of the obstacles are faced equally by all classes of small and medium enterprises: finance is the most general obstacle, although subcontractors (generally in the garments industry) usually need be concerned only with investment capital, while direct producers must raise both investment and working capital; the demands of high technical efficiency are largest for exporters, both direct and subcontracting; and questions of access to raw materials and intermediate inputs, of competition with large firms, and of marketing are relevant only to direct producers.

Chapters 2 and 3 will examine a series of policy and programmatic questions relevant to the obstacles associated with finance, technical efficiency and access to inputs; the impact of

public programs on subcontracting and marketing will be examined in chapter 3; chapters 2 and 4 will offer some further comments on the relationship between small and large firms.

NOTES

1. C. W. Lindsey, in his study of industrial concentration in the Philippines, found that 60 of the largest manufacturing firms accounted for more than 57 percent of total industrial assets in 1970. He also found, as might be expected, that these firms had substantial monopoly power in many Philippine industries. All evidence points to the fact that this situation worsened in the 1970s. See "Size Structure, Turnover, and Mobility of the Largest Manufacturing Firms in a Developing Country: The Case of the Philippines," Journal of Industrial Economics, Dec. 1979.

2. I. M. D. Little, D. Masumdar, J. M. Page, Small Manufacturing Enterprises: A Comparative Study of India and Other Countries, (World Bank: Forthcoming 1987) and Cortes, Berry, and Ishaq (World Bank: Forthcoming 1987).

3. The employment problem is defined as the effort to establish a pattern of development that is more demanding of unskilled (or initially unskilled) workers.

Chapter 2: Policy and the Participation of Small Progressive Firms

The policy environment is the single most important determinant of the efficient participation of small modern firms. Three types of policy define the main contours of this environment: trade policy, financial market policy and the system of fiscal incentives. The way that these policies work is through their influence on the relative profitability of different economic activities. Policies are market - based instruments. The effect of a policy is to change the set of prices which firms face when they make their investment and production decisions. Policies also create the overarching structure within which government programs have to operate. Programs work within this structure to help firms overcome specific "market failures" and to take advantage of profitable opportunities. Policies define the overall opportunity set open to firms. Programs, on the other hand, assist firms to make the most of the pre-existing set of opportunities, as defined by the policy environment. The effectiveness of programmatic interventions is fundamentally constrained by the nature of the policy environment.

This chapter is concerned with the policy environment. In the view of the Harvard team, this environment severely inhibits the efficient participation of small progressive firms. Policies conspire (often unintentionally) to create high barriers which limit the entry and expansion of small progressive firms. Moreover, the present set of policies makes it very difficult to implement meaningful programs, whose objective is to assist small

progressive firms. This chapter is organized in four sections. Section 1 looks at trade policy, section 2 at BOI incentives, section 3 at financial market policy and section 4 at the issue of regional policy and its effect on the participation of small and medium progressive firms.

2.1 Trade Policy

Since 1981, the Philippines has undergone an ambitious and comprehensive program of trade liberalization. As Table 1 shows, considerable progress had been achieved by 1984. Some quantitative restrictions had been eliminated and a rationalization of the tariff structure was slowly taking place.

Table 1
Comparison of Effective Protection Rate
Before and After the Tariff Reform Program (1984)

Industry Sectors	Pre-TRP	Post-TRP
Agrie. and Primary	5	3
Manufacturing	66	36
Non-Exportables	89	45
Import-Competing	49	35
Import Non-competing	185	67
Exportables	17	12
Overall Average	52	28

Source: Tariff Commission (1984)

Unfortunately, a series of foreign exchange crises since the assassination of Senator Aquino has thrown certain provisions of the Tariff Reform Program (TRP) into reverse. The principal beneficiaries of protection have been granted a breathing space in which to regroup their forces.

In the view of the Harvard team, restrictive trade practices damage the prospects of small and medium efficient producers in a number of ways. First, trade policies which encourage import substitution tend to result in a "prematurely" capital-intensive sectoral mix of output, discriminating in practice against those firms with limited access to capital. Second, policies which provide protection against international competition water down the incentives for firms, irrespective of size, to produce in the most efficient manner. A related cost of restrictive trade policy, for small firms, is that insufficiently specialized division of labor - which occurs when firms are not forced to cost minimize - reduces the opportunity for small and medium firm entry and mobility in a number of industries. Third, policies which in effect discriminate against domestic suppliers of intermediate inputs - the cascading tariff problem - can cause disproportionate difficulties for small and medium firms trying to enter export markets. Quantitative restrictions on intermediate inputs and capital equipment imports only serve to exacerbate this problem. Smaller firms are rarely among the favored few who receive the quota allocations.

This review of the troubling relationship between restrictive trade policy and small and medium progressive firm participation falls into 4 main sections. Section 1 looks at the way in which trade policy affects the sectoral mix of output. Section 2 discusses the linkage between the trade policy, the uncompetitive practices of the manufacturing sector and the opportunities for efficient small firms' entry and expansion.

Section 3 examines how restrictive trade policy has reduced small and medium firm access (especially that of exporters) to competitively priced intermediate inputs. Section 4 presents the main set of recommendations.

2.1.1. Trade Policy and the Sectoral Mix of Output

In the Philippines, as elsewhere in the developing world, restrictive trade policy has resulted in an allocation of resources which is out of line with even the most generous definition of dynamic comparative advantage. An accumulation of tariffs and quotas - often the first response of the government to periodic balance of payments crises - has a resulted in a composition of output which bears little relation to domestic resource cost. Small and medium progressive firms have fared particularly badly in this process, since policies which encourage import substitution inevitably result in a premature allocation of resources to relatively capital-intensive industries where large firms predominate. As Table 2 shows, there is a one to one relationship between the degree of tariff protection, the capital intensity of output and the market share of larger firms.

Table 2

Industry	K/L (1983)	ERP (1985)	Share of Larger Firms
Garments	6.64	0	47%
Footwear	9.87	0	31%
Rubber	23.94	65	66%
Plastics	39.47	65	56%
Textiles	70.01	42	78%
Tobacco	77.08	110	95%
Paper	198.75	101	65%

Source: NCSO, Tariff Commission

The theory which lies behind the sectoral mix effect of trade policy is quite straightforward. The comparative advantage of a labor abundant country, such as the Philippines, lies in the production of relatively labor-intensive products. In the absence of tariffs and quotas, firms would receive the highest rate of return by investing in the production of goods, whose wage component of value added is relatively large. The effect of tariff and quotas is to raise the rate of return in those sectors which makes relatively intensive use of the Philippines' scarce resource - capital. Firms are able to make a profit in sectors where, in a more liberal trade environment, they would make a loss. In other words, tariffs and quotas offer an incentive for firms, with access to capital, to produce capital - intensive goods. Longer term "industrial learning" is held to be worth the sacrifice of the short term gains from trade.

The Harvard team is not committed to a naive free trade view of the world. Trade policy is one of a variety of instruments which, if used selectively, can assist the evolution of comparative advantage away from a dependency on labor - intensive output. Nevertheless, the fact that trade policy has provided blanket support for the more capital - intensive sectors may have damaged the growth prospects of small and medium progressive firms in a number of ways.

First, small and medium firms are in practice excluded from many of the capital - intensive sectors which receive the greatest benefits from tariff protection. It is not simply because the minimum efficient scale of production tends to be

higher in the relative capital - intensive industries. The reality of the Philippines is that small progressive firms continue to find it hard to raise capital in sufficiently large amounts to enter into capital - intensive industries. Only the larger firms, especially those with 'captive banks', can really play that game. Any policy which favors lumpy investments in capital-intensive sectors automatically discriminates (in a static sense) against small and medium progressive firms, who lack easy access to external finance.

Second, the premature development of capital - intensive manufacturing activities may have tied up the available investible funds in socially inefficient production. In other words, there is a spill - over effect from trade policy into the financial markets. The problem is not merely that small firms are excluded from capital - intensive manufacturing. A deeper concern is that, in an economy characterized by extremely limited financial deepening, the misallocation of scarce capital resources can damage the growth prospects of those sectors, whose output is more in line with the Philippines comparative advantage. Even the relatively labor-intensive sectors - the nontraditional exports - use capital. Indeed labor-intensive sectors may also be relatively "working capital-intensive". To summarize, the effect of restrictive trade policy on the allocation of financial resources may be to decelerate the growth of precisely those sectors where small progressive firms can be effective participants. Small and medium nontraditional exporters still find it hard to acquire automatic LC - backed

working capital!

Third, once the period of easy import substitution is over, a lack of export competitiveness continuous with slow growth in the domestic market makes new entry extremely difficult. Initially, policies which encourage import substitution often result in a rapid growth of the manufacturing sector, largely based on the assembly of relatively simple final consumer goods. A cascading tariff structure - which makes the import of intermediate inputs cheap - discourages the development of backward linkages. When the domestic capacity of final goods is in line with domestic demand, there is no further source of growth for the manufacturing sector unless it can begin exporting. Unfortunately, one of the effects of tariff protection is to reduce the competitiveness of the domestic industry so that exporting is very hard.

This set of circumstances can create enormous barriers for small and medium firm entry and expansion. On the one hand, exporting has extremely high fixed costs of entry. On the other, a satiated, slow growing domestic market means that entry is always at the expense of an established firm's market share. As a rule of thumb, entry into rapidly growing markets is always easier. Especially in light of the high fixed costs of entering the export markets, restrictive trade policies that increase the return on investment in the low growth domestically - oriented sectors fail to create a supportive environment for small and medium firms.

Fourth, it is not just tariffs and quotas which discriminate

against the nontraditional export industries where small and medium firms are able to enter and expand. The management of the exchange rate can have very similar effects. An over - valued exchange rate makes imports cheaper and exports less competitive. In other words, it turns the terms of trade in favor of importables and against exportables. There is a significant body of literature which provides compelling evidence on the over - valuation of the exchange rate, despite the frequent nominal devaluations which have occurred during the 1970s and 1980s. Table 3 contains a summary of evidence.

Table 3
(Based on 1972 Rates)

Year	General Real Effective Exchange Rate
1972	100
1974	117
1976	109
1978	109
1980	117
1982	121

Source: Central Bank, World Bank, ADB

Now that the "easy phase" of import substitution is over, any policy - be it exchange rate or tariff - which discriminates against the leading export sectors is bound to harm the prospects of small and medium firms.

To summarize, the sectoral mix effect of restrictive trade policy has worked against small progressive firms' participation in a number of ways. First, it has provided incentives for the growth of relatively capital - intensive sectors where small and

medium firms are at an obvious disadvantage. Second, the consequent misallocation of limited financial resources has retarded the growth of those sectors where there are lower barriers to small and medium firm entry. Third, restrictive trade policy has discriminated against the fast growing nontraditional export sectors where small and medium firms have the space to enter the market. Exchange rate policy has added to the difficulties of potential exporters. Finally, restrictive trade policy has favored the mix of output produced in Manila and has discriminated against small scale producers in the provinces. The relationship between trade policy and regional development is discussed more fully elsewhere in the report.

2.1.2 Trade Policy and the Opportunity for Small Firm Entry

Restrictive trade policy has not only resulted in a severe inter-sectoral misallocation of resources. It has also permitted two major sources of inefficiency to arise in the operation of the protected manufacturing industries. First, protected firms have been able to get away with certain forms of "technical" inefficiency. Capital equipment of an obsolete vintage in combination with sub-optimal production runs cause levels of productivity which are well below international standards. Second, protection of the domestic industry has resulted in a whole series of "organizational" inefficiencies. In a number of industries, excessive vertical integration within the firm has crowded out a more specialized division of labor across firms. This section, drawing on evidence from firm interviews and secondary literature, investigates the

implications of technical and organizational inefficiency for the participation of small and medium progressive firms.

Technical Inefficiency and Small Firm Participation

The technical inefficiencies which characterize a number of protected industries impose a series of costs on small modern firms and limit their efficient participation. The most general statement of the problem is that protection allows technically inefficient firms of all sizes to survive. Policies which spawn a proliferation of small inefficient producers are no better than those which concentrate inefficiencies in a narrow group of larger firms. There is no particular merit in the survival of low productivity labor - absorbing small firms, unless their existence is seen as part of a transition to a more efficient set of production relations. Restrictive trade policy, which protects inefficient small firms, is at best a short term measure to generate low wage jobs. The longer run objectives must lie in the development of productive employment opportunities.

A good example of this problem can be found in the wood furniture industry (discussed more extensively in chapter 4). Although a few progressive firms are tentatively entering the export markets, small, domestically - oriented, craft workshops continue to account for the levels of unemployment in this industry. Production is geared to a highly fragmented made - to - order market. Almost no specialization takes place, and each workshop insists on supplying complete items. One of the main reasons that this low productivity style of production can continue to survive is, of course, the high level of protection

which the furniture industry receives. A nominal tariff of 45% ensures that, despite the Philippines' proximity to Taiwan - the world's low cost supplier of straight-line furniture, there are almost no imports in this category of product. The only way that a major restructuring of this industry will take place is in the context of a significant tariff reduction.

A related example is the production of garments for the domestic market. In our interviews with garments exporters, it was repeatedly argued that production for the domestic market provided almost no learning for firms that wanted to export. Production runs are too short and quality control does not enforce export standards. Production for the protected domestic market - much of which takes place in small tailoring shops - was, according to our sample, extremely poor preparation for reaching the standards necessary to compete efficiently in the export trade. All that protection does is to penalize domestic consumers and to reward inefficient producers.

A second aspect of technical inefficiency is the short production runs that occur in many industries. Short production runs have two obvious costs. First, they reduce the possible productivity gains that can be achieved from the repetition of simple tasks. Second, they result in a proliferation of models and a lack of standardization in the use of component parts. One feature of the Japanese economy is that relatively small producers are able to enter as specialized suppliers of a restricted range of component parts to a few final goods manufacturers. Long production runs on models, which require a

narrow range of standard inputs, lie at the heart of a complementary relationship between the final producers and small intermediate suppliers. Restrictive trade policy which keeps out cheap imports and thereby allows the domestic final goods manufacturers to segment the local market with an extraordinary profusion of models, is a major barrier to the evolution of complementary manufacturing relationship.

A good example of this problem can be found in the local electronics and automobile components industries. Local content programs involved a large number of small and medium enterprises to begin producing automobile and electronic components for local assemblers. However, for reasons that are laid out in more detail in chapter 4, in neither sector were components suppliers afforded the opportunity of long production runs; instead, suppliers geared their operations to the manufacture in short-runs of a highly diverse set of products. These suppliers were unable to adopt when, in the early 1980s, local content programs were no longer capable of offering assured demand. The local content programs, instead of encouraging infant firms to move to become dynamically efficient, had led them down a path that proved to be a dead end.

Three depressingly familiar conclusions emerge from this analysis of effects of restrictive trade practices on industrial performance. First, protection must be on a highly selective basis, and should be linked to realistic infant industry arguments. The goal must be to provide some <u>initial</u> (tariff - based) assistance to sectors where the Philippines has a genuine

long term comparative advantage. Second, protection cannot be allowed to last forever. There are too many geriatric industries which receive protection and remain wedded to inefficient techniques of production. Firms will restructure their operations only when competition forces them to do so. Protection has to be viewed as a short-term measure, linked to the objective of achieving international competitiveness in the medium term. There is a strong case for making continued protection tied to certain export performance criteria. Third, industries which receive the benefits of protection should be subject to certain restrictions on their production decisions. In particular, firms should not be allowed to indulge in an endless proliferation of models which inhibits the independent efficient supply of standardized component parts. Specific recommendations which emerge from these conclusions are contained in section 4.

Organizational Inefficiency and Small Firm Participation

Restrictive trade policy means that the protected firms do not have to produce "on the efficiency frontier". The problem is not simply that firms can use out -of - date production techniques. Protected firms are also spared the need to organize their production in the most efficient way. What this means in practice is that firms can internalize much of their production and do not need to develop long-term relationships with specialized suppliers and subcontractors. The problem is one of excessive vertical integration. Protected firms are not forced to find the most efficient balance between in-house production

and the use of subcontractors and other specialized suppliers.

From the perspective of small firms, the principal cost of this "organizational inefficiency" is that it restricts the ways in which they can participate efficiently in the manufacturing sector. One of the easiest ways for small firms to enter is as subcontractors and specialized suppliers. The indirect effect of restrictive trade policy - which reduces the incentive for organizational efficiency - is to lower the demand for these types of services. There are two analytically distinct aspects to this problem. First, vertically integrated firms have no need for independent specialized suppliers. Second, protected firms are not pressured to minimize costs - particularly overheads - by sub- contracting part of their production to smaller firms, with a lower wage structure.

The protected textile industry is the classic example of excessive vertical integration. The industry is organized mainly on a vertical pattern, with little specialization on the major subprocesses of yarn manufacturers, cloth production and finishing. On the scale of operations which exists in the Philippines, this form of organization is generally uneconomic and can thrive only in a protected home market. The effective rate of protection on textile production remains high - on average 40% - which means that the few efficient firms make high profits and inefficient overly integrated producers are able to survive. Aside from the obvious costs which uncompetitive domestic textile production imposes on garments producers (see section 2.1.3 and the study in Chapter 4), the consequence of

excessive vertical integration is that there is no room in the market for smaller specialized suppliers. Firms who want to "supply" only one part of the process are locked out, given the current structure of the textile industry. In other words, the organizational inefficiencies generated by high levels of protection have blocked the opportunities for small specialized suppliers to enter the textile industry.

Subcontracting is dealt with extensively in another part of the report (see chapter 3). However, the main issue can be stated succinctly at this point. The nontraditional export industries are the place where subcontracting has really taken off. Subcontractual relationships are important in both garment and rattan furniture, and are the dominant form of production in the handicrafts sector. The explanation is extremely straightforward. Firms which compete on the international markets have to minimize their costs. One of the easiest ways to reduce the wage bill and overhead costs is to subcontract out part of the production to firms with a lower wage structure. This practice not only cuts down on labor costs. It also reduces the overheads associated with a larger plant and labor force. Subcontracting becomes an economically rational procedure in a highly competitive environment, where margins are low and every peso counts. Subcontracting arises naturally in this context without the need for any government assistance. The contrast with the protected domestically - oriented industries could not be more striking. Firms in the wood furniture industry rarely enter into subcontracting relationships. The same is true in the

domestic garments, footwear and food-processing industries. Protected firms, who do not need to minimize costs, simply will not pay the search costs associated with development of a reliable network of subcontractors. Once again, the policy environment is a critical determinant of firms' production decisions.

The costs of restrictive trade policy, from the view point of small and medium progressive firms, are not restricted to its implications for the sectoral mix of output. At least as important is the relationship between trade policy and various forms of inefficiency in firms' production decisions. In its most general form, the problem is that high levels of protection reduce the incentive for all firms irrespective of size, to be efficient. However, the malaise runs deeper. Restrictive trade policy, through its effect on the demand for services of subcontractors and specialized suppliers, reduces the number of opportunities for efficient small firm participation. In the view of the Harvard team, small progressive firms are likely to thrive in a less restrictive trade policy environment. Every effort should be made to accelerate the tariff reform program.

2.1.3 Restrictive Trade Policy and Intermediate Inputs for Small Firms

The restrictive trade policies in place in the Philippines are the source of a host of problems for both the users and the suppliers of intermediate inputs. Present trade policies have created a double difficulty with respect to the procurement of

intermediate inputs: on the one hand, as a result of cascading tariffs and discrimination against indirect exporters, they have contributed to the underdevelopment of local supply of intermediate inputs, and a heavy dependence on imports (especially for re-export); on the other hand, where intermediate inputs are supplied locally, they tend to be high in cost and low in quality. The result of the present pattern of access to intermediate inputs for small and medium producers of final goods is to place them at a disadvantage relative to large firms.

The first task of this section will be to lay out the reasons that dependence on imported inputs discriminate disproportionately against small and medium enterprises. The second task will be to explore the relationship between restrictive trade policies and the underdevelopment of intermediate input production.

Dependence on imported intermediate inputs discriminates against both small and medium enterprises producing for sale in the domestic market, and small and medium enterprises producing for re-export. Discrimination against small firms producing for the local market occurs where access to imported intermediate inputs is rationed by quotas: larger firms tend to have relatively more influence with the government agencies that allocate quotas; and the transactions costs of allocating quotas to a small number of large firms are lower than the costs of quota allocation to a large number of small firms. As a result, large firms tend to be allocated disproportionate shares of available quotas.

In principle, producers for re-export are afforded tariff-free access to their requirements of imported intermediate inputs. In practice, such tariff-free access is more readily available for large firms. Before exploring the reasons for this difference in access, it should be noted that insofar as the origin of this discrimination is to be found in the presence of tariffs, the most effective and direct way of ending discrimination against small and medium enterprises is to limit the incidence of tariffs.

The Philippine government offers two alternative schemes to alleviate tariff requirements for exporting firms -- bonded warehouses and duty drawbacks.

Small and medium firms find it difficult to gain access to bonded warehouses. Only large firms have the incentive to lay out the fixed costs necessary to operate their own bonded warehouses. (Indeed, prior to 1980, only firms with export sales in excess of P1 million were permitted to open bonded warehouses). Small and medium clothing exporters have access to the co-operative bonded warehouse operated by Philippine Integrated Exporters (PIE); and NACIDA-registered firms can procure tariff-free inputs from the NNRMC; but other firms have no ready avenue of access.

In principle, lack of access to bonded warehouses should not affect the competitive position of small and medium enterprises insofar as their tariff payments are rebated. In practice, however, few small and medium firms avail themselves of tariff drawbacks: application for drawbacks is administratively complex and time consuming, drawback approval can take months to receive,

and even then is only a credit on future taxes. Not only do the delays imply that firms must meet the costs of working capital tied up in import taxes, the lump-sum administrative costs associated with the applications are sufficiently high that it is worth applying only if expected rebates exceed a minimum amount.

It is not simply the need for bonded warehouses or drawbacks that create problems in procuring intermediate inputs. As was made most vividly apparent in interviews conducting with firms in the clothing industry - and as is laid out in detail in Chapter 4 - even for firms with access to tariff-free inputs, the time delay associated with navigating the administrative maze surrounding import procurement represents a substantial additional cost. Again, as will be explained in Chapter 4, these time delays are disproportionately burdensome for small and medium firms. It is a paradox that for all that problems of access to intermediate inputs are a result of import restrictions, restrictive trade policies discriminate in two important ways against local producers of intermediate inputs. First, as Table 4 illustrates, effective rates of protection in the Philippines exhibit the familiar cascading structure: protection tends on average to be higher for producers of final products than for producers of intermediate inputs, with the result that local production is concentrated disproportionately in the former category.

Indeed, it appears that the Tariff Reform Program has magnified the problem, with intermediate and capital goods being disproportionate losers in the liberalization process. Second,

the provision of tariff-free access to inputs for direct -- but not indirect -- exporters implies that local suppliers of intermediate inputs to exporters are unable to compete on equal terms with foreign suppliers. Given tariff-free access, if local input suppliers are to win orders, they must offer inputs equivalent in quality at prices that are not much different from those of (tariff-free) imports. However, insofar as the suppliers of intermediate inputs are themselves subject to tariffs on their raw materials, they will be burdened with negative effective protection, and thus be at a competitive disadvantage relative to foreign suppliers.

Table 4

Effective Rates of Protection by Category of Product*

	1979	1985
Consumption Good	65.5%	62.7%
Intermediate Good	24.9%	7.6%
Capital Good	37.6%	22%

*weighted means

Source: Tariff Commission
Bautista, R.M., Journal of Philippine Development

Section 4 will lay out some specific recommendations for redressing the discrimination against small and medium firms in access to imported intermediate inputs and for offsetting the difficulties faced by local producers of intermediate inputs. The measures laid out in those recommendations are, however,

necessary only given the persistence of restrictive trade policies. In a liberalized trade regime, none of the problems analyzed in this section would be apparent.

Conclusion and Recommendations

This section of the policy chapter has argued that restrictive trade policy damages the prospects for efficient participation by small progressive enterprises in 3 main ways. First, the resulting sectoral mix of output practice discriminates against small and medium progressive firms. Second, protection has a generalized undesirable influence over productive efficiency in the manufacturing sector. Firms, irrespective of size are released from the competitive pressure to use the best techniques and to organize their production in the most efficient manner. As a consequence, small firms in many sectors lack the incentive and are deprived of the opportunity to participate in an efficient manner. Third, restrictive trade policy creates extraordinary problems for small exporting firms, which require imported inputs if they are to become competitive on world markets. The recommendations of the Harvard Team fall into two main groups. The first pertains to the way in which trade policy can be used to foster dynamic comparative advantage rather than to generate excess profits for inefficient domestically - oriented producers. The second set suggests ways to improve access of small exporting firms to intermediate inputs.

A. Policies to Promote Dynamically Efficient - Infant Industries

1. Any extension of protection against import competition

should be on a highly selective basis, targeted to a small number of products. As far as possible, the use of protective tariffs should be restricted to those sectors where the Philippines has a distinct comparative advantage in the medium term. If any product is to receive protection, (a) the technology should be sufficiently stable to permit new entrants to, in time, reach the global frontier; and (b) it should be technically feasible to impose standardization on local users of the product, so that new entrants can achieve the scale economies associated with dynamic efficiency. Protection should take the form of tariffs. There is no good reason why, in any industry, the effective rate of protection should be over 100%, and for no product should protection exceed 7 - 10 years.

2. The provision of tariff protection on selected products should be contingent on protected firms meeting performance criteria, such as pre-specified export targets in these products. Indirect exports should be admissable as evidence of performance. The selected performance criteria, for example, export targets, should progressively increase each year from, say, 10% of total sales in year 1, to 15% in year 2, and so on. To allow for cyclical fluctuation in the domestic and export markets, it might be advisable to set performance targets on a biannual basis. A failure by any firm to meet these targets should result in a penalty, which might take the

form of a higher rate of corporate income tax.

3. The determination of both tariff levels and export targets, and the annual revision of each, should be based as far as possible on automatic criteria, specified at the outset of any infant program, with only very limited opportunity for case-to-case discretion. Tariffs should be progressively reduced over the 7 - 8 year period of infancy.

4. The Ministry of Trade and Industry should take steps to build upon the resources available at BOI to establish an in-house cadre of technical personnel with the specialized industry specific skills necessary to design and implement an effective policy of selective industrial promotion. [Recommendation 3 at the conclusion of Chapter 3 offers more detailed guidelines for how this can be achieved.]

B. Policies to Improve Intermediate Input Access

1. Steps should be taken to extend access to bonded warehouses to re-exporting small and medium enterprises and to traders selling to such re-exporters. Such a bonded warehouse(s) should operate on the lines of the facility presently run by PIE.

2. The drawback system should be streamlined to ensure prompt, preferably cash, refund of tariff duties paid by re-exporters. If refunds take the form of tax credits, these credits should be tradeable. As an incentive to

improve the efficiency of the system, refunds should be inclusive of the working capital costs tied-up in the initial duties.

3. Indirect exporters should have the same access to the drawback system as that enjoyed by direct exporters. For a detailed discussion of Local Content Programs, and possible improvements, see Chapter 4 report on the metalworking industry.

C. The Administration of Customs

The administration of customs clearly provides excessive discretion to low-level officials. Abuse of this discretion results in expensive time-delays and actual payments for "expediting the process" (the sector review on garments (4.1.2) contains a more detailed discussion on these costs). The burdens of this system fall disprortionately on the smaller less well-connected firms and firms that cannot afford a staff to deal exclusively with these problems. We therefore recommend

1. a review of customs and its procedures be undertaken as soon as possible.

2. an impartial council be established at a high level to hear and respond to the complaints of firms that deal with customs.

2.2 BOI Incentives and Industrial Structure

BOI, the institution mainly responsible for industrial promotion, has been conspicuously unsuccessful in its interventions to encourage efficient industrial growth. Over the

last twenty years, the growth of the manufacturing sectors has been (un)distinguished by inefficient capital investment, often out of line with the Philippines' comparative advantage, and painfully slow labor absorption. As Table 1 shows, the proportion of the labor force employed in the manufacturing sector may have actually fallen since 1965.

Table 1

Year	% Employed in Manufacturing Sector
1965	10.9%
1970	11.9%
1975	11.4%
1980	11.0%
1984	9.8%

One important theme of this report is the relationship between industrial structure and performance. Especially in those activities where domestic producers are protected from international competition, structure can be an extremely important mechanism which forces firms to be dynamically efficient. Small and medium progressive firms play a critical role in creating a competitive manufacturing environment.

Interviews with a number of senior BOI staff suggested that, in terms of industrial structure, the present system of incentives has serious shortcomings. Indeed, BOI displays an apparent lack of concern with the relationship between the participation of small progressive firms and overall industrial

efficiency. It seems probable that, far from facilitating the entry and expansion of these firms, BOI incentives may have created an additional series of barriers. This undesirable side-effect of incentive policy is the culmination of numbers of steps:

(i) the weak link, especially prior to RA391, between incentives and efficient performance,

(ii) the lack of structural criteria in the determination of incentives,

(iii) the barriers, created by the effective operation of BOI incentives, which have hindered the entry and expansion of small and medium firms, and

(iv) the implementation of the incentive system, which has deterred small progressive firms from registration.

To answer the question whether BOI incentives discriminate against small progressive firms it is not enough to look at the size distribution of registered firms (although such an exercise would hardly produce favorable conclusions). The fundamental point is that incentive packages which permit inefficient industrialization, limit competition and impose high compliance costs are geared to excluding small modern firms from a whole range of manufacturing activities. The objective of this section is to examine these more pervasive ways in which BOI incentives have undermined the participation of small progressive firms.

(1) <u>The Lack of Incentives for Industrial Efficiency</u>

Industrial incentive packages have two main justifications.

First, they correct policy-induced distortions which operate elsewhere in the system. Second, they address the divergence between private and social returns. To take an obvious example, BOI incentives can be a useful instrument to offset the preponderant biases, which restrictive trade policy sets in motion. If trade policy allows firms to realize greater profits by producing for the domestic market, then BOI incentives can be a useful way to raise the rate of return on export activities. Similarly, an incentive which is targeted towards reducing the cost of worker training is a classic example of subsidizing an activity whose return cannot be fully appropriated by a single firm. A different type of example is one where distributional objectives enter into the social return of an activity. A necessary (if not sufficient) condition for an improvement in the regional distribution of income may be the provision of fiscal incentives for investment in agriculture and agro-based industries. This is especially the case in areas where poor infrastructure increases the riskiness of an investment. BOI incentives are not, however, sufficiently diverted toward helping firms overcome either market failures or policy distortions. The truth is that BOI remains wedded to a philosophy which places a high priority on national self-sufficiency. The intention remains to provide incentives both to exporters and to those industries in which domestic capacity is estimated to fall short of domestic demand.

As Table 2 shows, 20% of BOI registered firms still produce exclusively for the already protected domestic market. While

this figure constitutes an improvement over former years, it remains unclear why firms should receive the double benefit of tariff protection and fiscal incentives. In such cases, fiscal incentives serve only to magnify the existing distortions in the policy environment.

Table 2

Type of registered firms	Number of firms
Export producer	1379
Domestic producer	408
Agricultural producer	106
Export trader	163
Service exporter	52

Source: BOI, 1986 (November)

It is not enough to argue, as the BOI staff does, that performance-based incentives force registered firms to be efficient. Where that argument falls down is in its failure to distinguish between local and global efficency. Even if incentives are attached to net income, this does not imply that firms are encouraged to allocate resources in line with the country's comparative advantage. Firms are encouraged to be locally efficient to profit minimize in an environment which is globally inefficient because of tariff and tax-induced price distortions.

One recurrent theme of this report is that small and

medium progressive enterprises participate most successfully in a globally efficient environment. It is in the growing non-traditional export industries where small progressive firms are able to enter and expand in the context of a dynamically efficient industrial structure. It is true that BOI provides fiscal incentives for these industries. However, from the perspective of national resource allocation, some of this support is neutralized by the continued provision of incentives to activities which already receive the substantial benefits of tariff protection. Indeed, pioneer firms which produce for the domestic market can even apply for post-operative tariff protection. In the view of the Harvard team, a policy environment which forces firms of all sizes to be dynamically efficient, is best to facilitate the emergence of small modern firms. BOI incentives, when at times they reinforce existing distortions, do so at the expense of efficient participation by small and medium progressive enterprises.

(2) The Lack of Structural Criteria

Particularly in protected industries, a competitive domestic market structure can at times substitute for the role of imports in maintaining the pressure on firms to adopt efficient production techniques. Not only does BOI offer additional "redundant" protection to producers for the domestic market, but it also displays an apparent disregard for the importance of industrial structure. Indeed, interviews with senior staff suggest that the recent reforms in the incentive system have

neither eliminated the concern with "measured capacity", nor led to a revision of attitudes toward "sunk costs". There appears to be a view that BOI firms should not be allowed to fail. Their failure might reflect not just "wasteful investment" and the need to write off "sunk costs", but also certain deficiencies in the BOI screening system.

An alternative approach - one supported by the Harvard team - is that firm failure is an essential component of a healthy efficient structure. Firm death and firm birth /expansion are two sides of a single coin. Policies and incentives which preserve geriatric firms and fossilize the industrial structure also slow down the growth of more efficient producers.

One problem with BOI incentives is that they can contribute to this structural fossilization of industry. The incentives do nothing to offset the barriers which limit the entry and expansion of small, modern enterprises. Rather they reinforce existing distortions by raising the post-tax rate of return on investment for BOI registered firms, which do not suffer from collateral deficiencies. BOI incentives reduce the risk of bank lending to the larger firms which already have access to capital and therefore have the opportunity to take advantage of the packages. BOI registered firms, which benefit from both protection and incentives, are safe bets for the banks. There is an implicit guarantee that BOI firms are rarely allowed to fail.

BOI's lack of concern either with structure or with the size distribution of registered firms ultimately translates into

further disadvantages for small and medium progressive enterprises. First, there is the opportunity cost implicit in the failure to use BOI to correct existing distortions which inhibit the evolution of dynamically efficient industrial structure. Small and medium, modern firms get shunted off into BSMI, and their importance gets marginalized in a welter of cottage and livelihood programs. Second, the lack of explicit attention to the problematic relationship between structure and performance means that, in practice, entrenched larger firms capture most of the benefits of the incentives. Third, to the extent that collateralized BOI registered firms are safe bets, banks neither have the available funds nor the motivation to assess potentially profitable projects by smaller less established enterprises.

(3) BOI Induced Barriers to Small Modern Firms

BOI does more than just neglect the importance of industrial structure and the important role that small modern firms can play in a dynamically efficient sector. The consequence of BOI incentives may be a relative deterioration in the competitive basis for small modern firm participation. In other words, BOI incentives can assist larger firms to build structural barriers that limit competition and protect their market share. There are two principal ways in which this undesirable process occurs.

First, interviews with a representative sample of registered firms suggest quite strongly that BOI incentives are marginal in

most investment decisions. Despite the fact that BOI incentives can be worth up to 20%, no firm in the sample claimed that incentives were a critical determinant of new investments. If BOI incentives are marginal to ex ante investment decisions, then it is possible that their more significant effect is in ex post pricing behavior. Firms that receive incentives have an additional degree of freedom when it comes to setting prices. If new entrants try to "steal" the market share of registered firms, the latter group are able to reduce prices (by virtue of the cash subsidy implicit in the incentives) without suffering operating losses. BOI incentives do not merely reward registered firms for making risky investments. They allow those firms to defend their investments against even domestic competition by price strategies designed to protect market share. The adverse consequences of such behavior for unregistered entrants does not need to be elaborated.

Second, BOI incentives continue to operate in a way that discourages domestic competition and encourages excessively large investments by registered firms. Although "measured capacity" is no longer on the statute books, BOI has a number of additional instruments with which to limit entry and reduce domestic competition. BOI has been given the authority to regulate entry into non-preferred areas of investment through the administration of licenses for the importation of industrial machinery and equipment. Despite claims by certain staff members at the Central Bank, it does not appear that the private sector has unrestricted access to foreign exchange. While there are no

explicit quantitative restrictions on the importation of capital equipment, the selective allocation of foreign exchange continues to give the BOI wide discretionary powers over entry and expansion investment decisions. In light of BOI's attitude towards "sunk capital" and the need to protect the profitability of pre-existing fixed investments, it is hard to believe that the importation of equipment, which results in "over-capacity", receives much support.

Moreover, the procedures for registration of investment projects and availment of individual incentives has provided BOI with a high degree of discretion in granting industrial incentives. Firms can petition to be granted pioneer status and are implicitly encouraged to install a manufacturing capacity sufficient to meet domestic requirements for the forseeable future. The designation of activities as pioneer and non-pioneer is subject to non-reviewable adjustment as soon as the industry is "filled up". Early entrants not only receive the normal market - determined rewards for risk-taking innovative behavior. In addition, BOI gives them a five year license to make money, protected from both international and domestic competition. Small and medium progressive firms, who neither have the contacts or the resources to acquire registered status, are de facto excluded from a whole series of activities. BOI registered firms are handed the opportunity to monopolize the spoils which always accompany the introduction of new products. Small unregistered firms - even those with a "strategy" - get only the crumbs and

find it difficult to generate the retained earnings necessary to finance new investment.

(4) Small Firm Registration

Perhaps the least important dimension of the relationship between the BOI and small and medium firms is the size distribution of registered firms. The fact that the preponderance of registered firms is in the "large category" tells little about the undesirable consequences of the present industrial incentive system for small progressive firms. Nevertheless, it remains the case that smaller firms find the compliance costs of BOI registration too high. The problem is not simply that the initial documentary requirements make it difficult for small and medium firms to register without substantial external advice. There are also high ongoing costs of compliance in that firms are required to submit quarterly statements and annual reports in order to avail of BOI incentives.

The difficulty faced by smaller firms is further compounded by the large number of incentives available under the existing (albeit reformed) system. The administrative complexity of the incentives system and the fact that BOI maintains its only office in Manila has effectively made incentives available only to those firms which are located in the NCR or can afford to send representatives there on a regular basis. This has discriminated against regional, especially small and medium firms, and has reinforced the over-concentration of industrial investment in the

Metro Manila area.

Table 3

Size Distribution of Registered Firms (1984)

Less than P500,000	34
P500,000 - 5M	191
P5M - 20M	203
Greater than P20M	302

The real issue, however, is not whether high administrative requirements discriminate against small modern firms. What has to be questioned is the whole rationale which lies behind the registration requirements. All firms irrespective of registration status, should be able to benefit from incentives if they perform in line with national economic objectives. All firms which export should receive automatic performance - based incentives. Proof of the net local content of exports, submitted on an annual basis, is all that should be needed to benefit from tax credits. Registration has no real economic function and merely enables the BOI to exercise a supervisory role, whose purpose is curiously ill-defined. Incentives should be performance - based. However, they should be automatic, not contingent upon registration.

Conclusions and Recommendations

In the view of the Harvard team, the present operations of the BOI may be extremely damaging for the growth prospects of small, modern, unregistered firms. The structure of the present

incentive system does not do enough either to improve the global efficiency of resource allocation or to correct existing policy - induced distortions. The allocation of incentives is determined in a way that neglects the importance of industrial structure. A stronger claim is that BOI incentives actually give registered firms the freedom to establish market barriers that limit the entry and expansion of small modern firms. Registration is an important source of "rents" for the established firms and does not appear to possess any function which automatic performance criteria could not satisfy. Finally, the BOI "strategy" for industrial development marginalizes the small and medium progressive firms and underestimates their potential contribution to dynamically efficient growth. BOI helps to perpetuate the myth that all small firms are inefficient livelihood operations.

(1) The BOI should rapidly eliminate incentives, given to manufacturers, producing for the domestic market.

(2) BOI registration requirements should end as quickly as possible. The incentive system should be placed on an automatic performance basis.

(3) The BOI should establish regional offices, certainly in Cebu and also possibly in Iloilo and Davao.

2.3 The Financial Sector and the Participation of Small and Medium Firms

The way the financial sector functions has important implications for the ability of small and medium enterprises to participate in economic growth. At the macroeconomic level,

financial policies influence the development of the capital market, the resulting mobilization of domestic savings and the efficiency with which these resources are intermediated. The influence of financial macro-policy over the availability of loanable funds and, ultimately, the rate of economic growth is a critical determinant of small progressive firm development. At the microeconomic level, financial policies influence the allocation and the cost of loanable funds that flow through intermediaries to particular sectors and to various economic agents. Financial policies, through their influence over the structure and composition of industrial output, have serious implications for the efficient participation of small modern firms in economic activity.

This section of the report will discuss Philippine financial policies at both the macroeconomic and microeconomic levels to examine how they affect the participation of small modern enterprises. Section 1 explores the relationship between financial policies, deepening in the capital markets, overall economic development and the participation of small modern enterprises. In section 2, we discuss the microeconomic implications of financial policies, in particular as they affect small and medium firms.

2.3.1 Financial Policies, Financial Deepening and Overall Economic Growth

A lesson learned from the rapidly growing developing countries over the past two decades is that economies which have

rates of real financial growth (financial deepening) and, in turn, higher real economic growth. Data on private holdings of "broad" money illustrates these issues.

Table 1 presents ratios of the broad money supply (M2) to gross national product (GNP). These figures show that substantial financial deepening has occurred in the rapidly growing Asian economies. A high M2/GNP ratio and its rapid increase both indicate a large real flow of savings and loanable funds through the organized financial sector. (By and large the capital market in most of these economies was dominated by the banking system, hence the ratios of M2 to GNP encompass the main domestic flow of loanable funds in the system.) By 1980, all the

Table 1

Bank Loanable Funds Several Asian Countries
(ratio of M2 to GNP)

	1955	1960	1965	1970	1975	1980
Philippines		.186	.214	.235	.186	.219
Indonesia	.105	-	.113	.100	.169	.186
Sri Lanka	-	.284	.330	.275	.255	.317
Thailand	.232	.268	.263	.339	.346	.374
India	-	.283	.262	.264	.295	.382
Malaysia	.427	.365	.280	.359	.463	.532
Japan	.254	.737	.701	.863	1.026	1.390
South Korea	.069	.114	.102	.325	.323	.387
Taiwan	.115	.116	.331	.462	.588	.750
Singapore			.542	.701	.668	.826

Source: IMF Statistics (Various issues)

fast growing economies of Asia - Japan, Taiwan, Singapore - had ratios of .75 or more.[1] Only South Korea had a much lower ratio (.34) and had to make up for this shortage of domestic loanable funds (low domestic savings rate) by borrowing heavily abroad.[2] In contrast to the fast growing countries, the slow growing Asian countries all had low ratios, particularly the Philippines where financial intermediation actually declined from its 1970 level.

The interesting point from the policymakers perspective is that financial deepening and its proximate impact on economic growth, holding other things constant, can be stimulated through higher levels of real interest rates. The most apparent reason for this is, of course, that high real rates of interest attract more domestic savings deposits to banks, which, in turn, intermediate these financial assets into productive investment.

Small progressive firms can benefit from growing financial intermediation in at least three ways. First, small enterprises grow with the rest of the economy due to rising aggregate consumption and investment. Second, small firms potentially have greater access to commercial credit as a result of the increasing availability of loanable funds. However, the increased amount of loanable funds actually allocated to small firms in more highly developed financial markets is largely determined by financial policies other than the <u>level</u> of real interest rates. We turn to this question in the next section. Third, high real

interest rates induce more labor-intensive modes of production which will enhance the competitive bases for small and medium sized firms.

In the Philippines, financial deepening has generally been repressed and capital markets have failed to mobilize sizable increases in loanable funds, as the ratios above indicate. Government policy in the 1960s and 1970s, for the most part, retarded rather than supported capital market development. Until 1981, the monetary authority controlled interest rates at less than market clearing levels in order to stimulate priority investments, relegating savings mobilization to the background. In addition, reserve requirements on savings and time deposits of commercial banks were gradually raised from 5 percent in 1959 to 20 percent in the 1970's and early 1980s, exacting an increasing tax on financial intermediation. Coupled with this, government regulations which allowed banks to hold a large proportion of their reserve requirements in the form of government securities, systematically transformed the banking sector into a captive market for government borrowing.[3] Larger and larger portions of available loanable funds went to the government, increasingly crowding out private sector borrowers.

Government interest rate policy has created a further set of problems for financial sector development. Controlled low interest rates and the rediscount policies of the Central Bank have made commercial banks excessively reliant on rediscount windows for their loanable funds. Commercial banks, as a result, have become more active conduits of Central Bank funds and less

active intermediaries between domestic savers and borrowers. Low interest rate policy also contributed to the underdeveloped nature of the market for equities. Those firms - often the larger well-established ones - which had access to cheap capital, found it more profitable to borrow from banks than to raise equity capital by selling stocks. To the extent that larger firms choose loan over equity sources for external financing, the pool of commercial bank funds for smaller enterprises became more restricted.

One consequence of the thinness of the capital market is that the whole financial system remains notoriously unstable. Although the institutional structures are fairly well-developed, the financial system has evolved in a very uneven way. As a consequence, the commercial banking sector has been exceedingly vulnerable, with several bank runs and failures. The Philippines has probably seen more financial scandals and financial institutions in distress than any other South East Asian country. Problems were particularly severe in the 1960's and early 1970's and again in 1981. Not surprisingly, the perceived instability of the commercial banks makes it extraordinarily hard for them to function as effective intermediaries.

Recognizing the need for financial liberalization to mobilize investible resources, the government instituted a major financial reform in 1981 and 1983. Interest rate ceilings on all types of deposits and loans were lifted, reserve requirements on all deposit liabilities of commercial banks were to be gradually reduced to 16 percent, and the financial system was to be

restructured to increase competitiveness and efficiency and to increase medium and long-term lending.

To date, the impact of the liberalization program has been modest. But the economic and political crisis of the 1980s may largely be responsible for this outcome. Since the program's inception, only a slight increase in financial intermediation has occurred, as indicated by the M2/GNP ratio. Insofar as real interest rates in the 1981-1985 period were negative, due to rapid price inflation, the limited increase in savings mobilization is not surprising. It should alert policymakers that government fiscal imprudence must be controlled in future for financial liberalization to have a chance for success. Another potential malfeasor that policymakers should watch is the Central Bank's propensity for rediscounting. During the period after liberalization, the Central Bank opened many new rediscounting windows. In doing so, it created additional incentives for disintermediation. Both private and government banks took the opportunity to increase their borrowing from the Central Bank which, as stated earlier, reduced their incentives to function as intermediaries. Finally, capital flight also added to the forces retarding the potential impact of liberalization. Negative real interest rates, political uncertainty, bank failures, and expectations of further devaluations have all encouraged the outflow of capital.

Although many of the factors sighted above are transitory, several problems remain that will have lasting effects on the process of liberalization and financial deepening in the

Philippines. First, while freely floating interest rates may produce profitable spreads between short- and longer-term lending, (see current spreads in table 2) bankers will continue to resist longer-term lending if their expectations about the future are uncertain. Current political and economic uncertainty, coupled with the experience of large swings in interest rates that occurred in the last several years, cause bankers to be wary about getting locked into medium and long maturity loans. It is

Table 2

	Dec. 1986
Short term prime	10%
Long term prime	16%
Ordinary rate	17% - 24%

important, therefore, for efficient operation of the financial system that government recognizes the need to make monetary and fiscal stability a priority over the next several years.

Second, the existing tax code acts as a significant disincentive to savings mobilization and intermediation. The current 20 percent withholding tax on savings deposits reduces the existing effective return to savers to about 5.6 percent. In the current economic climate, this is too low a return to stimulate the needed increase in domestic savings.

Third, although the liberalization program called for a gradual reduction in reserve requirements, the current reserve requirement at 21 percent is higher than it was at the time liberalization began. On top of this, a recent change in the

rules announced by the monetary authority makes the reserve requirement on government deposits in banks 75 percent. Such high reserve requirements put an unduly high tax on intermediation. Given the present liquid state of commercial banks, resulting from the depressed demand for loanable funds, such high reserve requirements are not constraining. But in the future, as economic activity picks up, this tax on intermediation should be lowered.

Fourth, it is clear that reserve requirements, and the prescribed forms in which reserves can be held, are currently connected to the ability of government to sell its securities in a ready market. These and other factors have encouraged an already conservative banking system to be more conservative: investing excessively in government securities. Some way should be found to reduce this and the "crowding out" effect on the private sector that can result.

Fifth, while the Philippines has not had much of an active equity financing market in the past, this could be an important source of investment funds in the future. Efforts should be made to find ways to stimulate equity financing along with other segments of the financial market such as bankers' acceptances.

In this respect, one innovation that might be considered is the creation of independent, private, closed-end investment funds run by professional managers. At its current stage of evolution, the financial market needs securities that can combine the advantages of risk diversification (for the investor) and relatively undemanding corporate accounting information (from the

borrower). Closed-end funds could potentially serve such a function.

Closed-end funds come in two forms - bond & equity. The bond fund would sell a fixed number of units or shares at its inception and would thereafter be in position to invest in the intermediate or long-term debt securities of operating companies. The yield that the fund could offer to the investor would be the anticipated weighted-average yield on its portfolio holdings, minus a small amount of operating expenses, plus whatever capital gains are realized on securities sold to prior maturity. Equity funds would operate in an almost identical fashion except that, in the case of riskier ventures, the fund's managers would need to provide the kinds of expert assistance and monitoring that have been successful in the "venture capital" companies in the US.

Such funds appear to have a number of practical advantages in countries where the equity markets are still thin. First, individual investors receive some assurances on the expert management of fund assets. Second, the fund would not be dependent on price signals from a still-thin securities market for valuation and on large-scale purchases or sales to increase or shrink its base with shifts in investor sentiment. By utilizing the closed-end fund appraisals, it might be possible to achieve a larger flow of activity in the capital market more quickly. Professional managers would not only serve as watchdogs for investors' interests, but would bring external equity financing to companies that today could not qualify for stock

market listing or long-term debt issue.

Such a fund could work only if the nature of its organization provides certain guarantees for the investors. In particular, the fund should:

(1) establish a board of trustees of high visibility, whose names would assure the investor of the integrity of the fund's management,

(2) employ professional portfolio managers, who should be paid on a salary plus incentive basis,

(3) employ an independent accounting firm, which could certify the books of account for each fiscal period.

Provided that sufficient safeguards can be established, regarding the proper management of these closed-end funds, individual investors - together with institutional investors - may find such arrangements the most convenient conduits for their equity funds. Professional managers, together with the board of trustees, in effect replace the more extensive disclosure requirements of the SEC and can act as intermediaries in capital markets where information is thin. To date, however, the Philippine Investment Banking houses have preferred to rely on money market operations instead of more active equity portfolio management.

Summing up, financial macro-policy in the Philippines appears to have had a number of undesirable consequences for the development of financial markets. The level of domestic savings and thus loanable funds in the financial system has been repressed by controlled low real interest rates. And the

government has appropriated too large a chunk of the limited supply of domestic savings that were mobilized by the commercial banking system. In addition, Central Bank regulations and rediscount windows have acted in a way that tends to discourage financial intermediation. Interest rates, fixed below market clearing levels, mean that the funds available through the discount windows have, in practice, substituted for the mobilization of a greater pool of savings by the commercial banks. Insofar as small progressive firms may depend on commercial banks for their fixed-and-working-capital external financing, policies which conspire to reduce the steady state liquidity of the banking sector can have extremely adverse effects on small firms. The next section will examine more closely the question of small firm access to the loanable funds of the banking sector.

2.3.2 Financial Policies, The Competitive Bases For Small and Medium Firms, and the Size Structure of Industry

Financial policies which control interest rates and direct selective credit controls can have a pervasive influence on the ability of small firms to participate in industrial activity. Consider first the problem that arises when the government fixes interest rates below their market clearing levels. Such policies inevitably result in a form of credit rationing which generally leads to a large-firm bias in financial markets. With excess demand for credit, banks tend to lend to low risk, low cost borrowers who have been their established customers. Small firms are usually viewed as having relatively uncertain earnings

trajectories and high default rates, and thus are to be avoided if possible. Accordingly, credit rationing can act to promote excessive firm size. This occurs in two ways. First, access to cheap credit allows larger enterprises to accumulate higher profits and to reinvest them in expansion. Second, when access to credit is linked to size, larger firms are in a position to make more profitable use of productive assets than small firms. This exposes smaller firms to takeovers or to barriers to entry (unfair price competition, etc.) and growth which, in turn, exacerbates the advantages of larger firms. Thus, interest controls and ensuing credit rationing encourage concentration of economic power.

Next, consider the problems caused by selective credit controls. As they are practiced in many developing countries, credit controls influence industrial size structure to the degree that they channel financial resources to (a) preferred industrial sectors that require relatively large-sized firms for efficient production, and (b) to favored economic agents. When the economic activities chosen for preferential allocations of credit are ones that require large-scale production units because of significant economies-of-scale (such as chemicals, steel, ship building, and auto assembly), the pattern of industrial output tends to provide a relatively uncompetitive bases for smaller firms, that generally thrive in economic activities with lower returns to scale. The ability of small and medium enterprises to participate in economic growth is limited in this case. The result is that the size structure of industry becomes more

concentrated at the upper end.

Government - directed selective credit controls may also "squeeze out" small and medium enterprises by allocating scarce financial resources to other, more favored economic entities. The most common example of this is the allocation of credit to public enterprises or to particular large companies, as in Korea and Japan. The Philippines provides its own home-grown example with the preferred treatment that was given to Marcos' cronies.

In the Philippines, allocation of credit to priority industrial areas as well as preferential treatment of public enterprises and the politically well-connected have been practiced over the years. For the most part, the allocation of credit to priority investment areas was advanced indirectly through rediscounting facilities at the Central Bank. But at times, government and private financial institutions played a direct role. The impact of such practices on the prevailing structure of industry has been significant.

First, the allocation of credit to many of the preferred industries has helped to promote a high cost, capital-intensive pattern of industrial investment. Total factor productivity data on the individual industries that were targeted for financial support indicates that the productivity performance of this group has consistently been much lower than others (see, for example, R. Hooley "Total Factor Productivity in Philippine Industry" PIDS 1983). For the 1970s as a whole, the incremental capital/output ratio for the Philippines was 35 percent higher than for comparable Asian countries, indicating an exceedingly

inefficient allocation of investible resources. Second, excess size was promoted in industrial establishments rather than stimulating entry and development of smaller firms which would have created a more competitive and flexible industrial sector. Third, manufacturing firms have excessively high debt equity ratios, averaging about 3 to 1 (although many of the largest firms have ratios that are much higher). Such high debt equity ratios say much about the Philippine style of growth. Financial policies have made it comparatively easy for established larger firms to grow without generating their own savings (retained earnings). By way of contrast, in Taiwan, where businesses are relatively small, debt/equity ratios are less than 2. There, the style of growth encourages personal savings by newly entering or about-to-enter small businessmen.

A comparison of development policies in Korea and Taiwan sheds further light on how financial policies can promote excessive firm size. Although these two fast growing countries began the development process with similar industrial structures in approximately the same period, the early 1960s, they now have considerably different firm size distributions. Average firm size in Korea is about three times larger than it is in Taiwan. Also, between 1966 and 1976, the number of manufacturing firms in Taiwan increased by 150 percent while the average size of individual enterprise (as measured by the number of employees) increased by only 29 percent. In Korea, on the other hand, the number of manufacturing firms, in the same period, increased by a mere 10 percent, while the number of employees per enterprise

increased by 176 percent.

The crucial difference between Korea and Taiwan lay in their very different monetary policies. In Taiwan, interest rates were controlled but at relatively high market clearing levels. This encouraged savings and reduced the need for credit rationing by means other than interest rates (by bank or government officials). This ultimately rendered investment a more efficient engine of growth and eliminated the rationing bias that develops against small enterprises. Korea took the opposite route. It controlled interest rates at below market clearing levels and rationed credit to large firms. In fact, the government had an active policy early on to promote particular economic activities and particular large enterprises by allocating cheap credit to them. Fortunately, Korea circumvented much of the inefficiency side effects of credit controls by concerted attention to project evaluation and performance-based allocation (ie. if you don't perform, you get cut off). But the Korean policies, by promoting large-firm activities and large firms discouraged newcomers, especially due to the practice of granting loans on concessionary terms to already established firms, a practice which discriminated in favor of growth through increases in size of firms. In contrast, in Taiwan the small size of the average firm made it easier for newcomers to establish themselves on a modest scale with small initial investments.

Since the Revolution, the Government of the Philippines has begun seriously addressing the problems of bias in financial

resource allocation, and the excesses of the past are not likely to occur again. Today, in fact, there seems to be some interest in redirecting things in the opposite direction. That is, in directing more financial resources to the rural areas and to small and medium firms in industry. Considering this interest, a few words about selective credit controls in favor of small and medium firms and other such groups are in order.

Preferential allocation of credit to small and medium enterprises has been tried in several countries, generally with limited results. The weight of the evidence that emerges from such efforts looks like this. First, most small firms start out with very small amounts of finance, either from personal savings or borrowed from family or friends. In the initial stages, small firms do not generally have significant demands for institutional finance. Investments at this stage, and even in later stages, are most likely to be a function of earnings records. For this reason, an important factor determining small firm investment and access to working capital appears to be more than anything a favorable policy environment and higher rates of overall economic growth. (In a low growth economy, such as the Philippines today, the requirement for formal sources of credit is more compelling.) In later stages, when small firms are somewhat larger and more advanced (though this may still be in the small-scale range), their demands for institutional finance rise. Hence, access to finance for fixed or working capital seems not to be a barrier to entry, though it may well place more of a restriction on expansion or the maintenance of output. These factors tend to

limit the impact of small firm selective credit allocation policies. Even in cases like Korea, where National Banks were forced through selective credit controls to lend 35 percent of their portfolios, bank financing had only a small impact on small firm investment. The key to investment in Korean small enterprises remained generation of internal resources.

Second, selective credit controls can usually be circumvented in many ways and thus are difficult to police. In the Philippines, for example, this has been done to some degree with government acquiescence. The agri/agra regulations, for example, have been systematically circumvented by financial institutions through purchase of government securities and by investing in large agribusiness firms. On the other hand, in cases where selective credit controls have been enforced, evidence shows that some extremely poor projects can receive finance. This is particularly true where specific groups, such as small firms in region X, are singled out for special treatment. First, it is often difficult to obtain full information on the marginal social value of investments. And second, the social opportunity cost of investments to this group may be high. The result is a low social return on investable funds.

On the beneficial side, evidence indicates that larger firms are not usually burdened much by forced allocation of bank credit to smaller enterprises. Larger firms can often substitute foreign borrowing, or bond and equity funding for bank financing, and, for working capital, they can get more trade credit. In

fact, rationing bank credit to large enterprises may have the effect of providing an added incentive for them to borrow from bond or equity markets or to enter into joint ventures with foreign investors to finance a given level of investments. This could conceivably result in higher overall availability of investment finance for the country as a whole.

Does preferential allocation of credit to small firms directly benefit them? Evidence seems to indicate that the level of interest rates does not affect small firm investment substantially. The main problem of credit for small enterprises appears to be more one of limited access. Insofar as selective credit controls can give small firms greater access they do seem to affect directly the levels of investment, inventories and working capital. But, in the end, the lack of selective credit controls does not appear to be crucial to fixed investment in small enterprises. At least in beginning stages of growth, internal financial resources usually substitute for bank credit. In later stages of growth, small firm access to credit does become important and perhaps then selective credit controls could provide a needed stimulus.

2.4 Regional Dispersal of Industry

Manufacturing activity is excessively concentrated in the National Capital Region. In 1983, NCR accounted for over 50 % of value added in the manufacturing sector, a share almost unchanged over the past decade.

Moreover, the main source of growth in manufacturing

activity outside NCR has been in its satellite regions (Region III & IV). Together, its Central Industrial Regions amount for over 75% of manufacturing output. Outside the CIR, agricultural and some mining activities are dominant sectors and provide employment to the bulk of the regionally based population.

Table 1

Regional Distribution of Gross Value Added in Manufacturing

Year	Percentage of GVA in		
	1 NCR	2 CIR	3 ROR
1972	52.9	79.1	20.9
1977	54.7	78.1	21.9
1985	52.9	76.9	23.9

1. NCR - National Capital Region
2. CIR - Central Industrial Region: NCR, Central Luzon (Region III), Southern Tagalog (Region IV)
3. ROR - Rest of the Region: Ilocos (Region I), Cagayan Valley (Region II), Western Visayas (Region VI), Central Visayas (Region VII), Eastern Visayas (Region VIII) Western Mindanao (Region IX), Northern Mindanao (Region X), Southern Mindanao (Region XI), Central Mindanao (Region XII)

Source: NEDA

Today, there is widespread concern about the problem of regional equity. Per capita income in Manila is more than twice the national average and almost 4 times the level in the poorest region. In part, these differences may be a reflection of differences in the efficiency of resource utilization.

Table 2

Regional Distribution of Gross Value Added, 1983

	Percentage in		
	NCR	CIR	ROR
Agriculture, Fishery and Forestry	0	25.3	74.7
Mining and Quarrying	0	27.2	72.8
Industry	46.3	71.0	29.0
Construction	35.0	62.9	37.1
Electricity, Gas & Water	56.5	70.9	29.1
Service	40.0	59.0	41.0
Transport, Communication & Storage	43.4	66.8	33.2
Commerce	51.0	63.6	36.4

Source: NEDA

Table 3

Regional Per Capita Income (in Pesos at 1972 Prices)

Year	Regions			
	Phils.	NCR	CIR	ROR
1972	1450	3816	2244	1053
1977	1760	4556	2728	1249
1983	1922	4948	2980	1342

Source: NEDA, NCSO

However, the predominant explanation lies in a series of historical biases which have encouraged the convergence of resources necessary for modern sector manufacturing development in the NCR.

The section addresses three principal issues. First, what is the general set of problems which limit the effectiveness of regional policies and programs. In other words, what would a regional "package " have to do to alter the spatial distribution of incentives? Second, what are the constraints placed by the present economic and policy environment on the successful pursuit of regional objectives? Third, when is there a meaningful intersection between the goal of greater regional equity and the efficient participation of small and medium enterprise?

2.4.1 What determines the regional distribution of manufacturing activity?

Four factors fundamentally determine the distribution of manufacturing activity between different regions in a country:

(i) The comparative advantage of each location in producing certain commodities. Comparative advantage includes not only the initial endowment of a given region, but also the location-specific accumulation of

- (a) infrastructure
- (b) agglomeration economies i.e. availability of supplies and services
- (c) industrial know-how and experience, i.e. human capital

The evolution of regional comparative advantage turns

on the development of various forms of immobile capital (both physical and human).

(ii) The policy environment - especially the trade regime - which differentially affects the profitability of the manufacturing activities in which each region has a distinctive comparative advantage. Import substitution policies inevitably favor the region which has a comparative advantage in the production of capital-intensive goods.

(iii) The availability of information about the opportunities open in each region. To the extent that information is imperfectly distributed across the different regions, firms will be less willing to invest in the higher risk, more backward regions unless the returns are very good.

(iv) Access to the final market. Especially if transport costs are high and inputs are not regionally sourced, then firms will have a strong incentive to produce near the end-user market. High transport cost generally hamper commodity flows and limit the possibility of inter-regional gains from trade. At the same time, these costs offer "natural" protection to producers based in the technologically more backward regions.

These four factors - comparative advantage, policy, information and proximity to final markets - constrain the general environment within which regional policy attempts to generate a new set of spatial outcomes. Regional "packages" if they are to be successful, have to hit a whole set of targets at one time. They are extremely difficult to get right and often

involve throwing subsidies at inefficient operations.

The only honest way to address the regional issue is to work on easing the "environmental constraints." The overall set of policies has to be reconciled with a fairer inter-regional distribution of income. The government should spend money on infrastructure with the highest social returns (explicit weighing being placed on distributional arguments). There may also be a role for the government - especially in the short run - in improving the quality of information about investment prospects in the more backward regions.

Table 4

Size Distribution of Firms by Number of Employees, 1983

No. of Employees	Percentage of Firms in		
	NCR	CIR	ROR
Less than 10	35.4	59.9	40.1
10 - 99	54.3	71.5	28.5
100 - 199	63.6	76.9	23.1
200 and over	54.6	74.2	25.8
TOTAL	55.5	74.0	26.1

Source: NCSO

In the absence of a facilitative overall environment, policies and programs which channel efforts to small regionally-based enterprises are doomed to almost certain failure. Sustainable growth in regional income depends upon the development of dynamic regional comparative advantage. Welfare-oriented livelihood programs do little to promote either

industrial efficiency or a more equitable inter-regional distribution of income, which is sustainable in the medium term. They are marginal in their effect. While average firm size is larger in Manila than elsewhere in the Philippines, this does not automatically imply that the promotion of small firms is an optional strategy for the evolution of regional manufacturing capacity. A proliferation of tiny backward firms does not create productive employment opportunities.

2.4.2 Limits to Regional Policy in the Philippines

There are five aspects of the current system which are highly prejudicial in terms of an improvement in inter-regional equity: the relative neglect of agriculture; inadequacies in regional infrastructure; the current concentration of manufacturing assets in Metro Manila; the excessive centralization of administration in Manila; and the current structure of tariff protection. These five factors, in combination, place severe constraints on the effective implementation of realistic regional programs, which seek to support manufacturing activities outside the NCR. The development of regional manufacturing - and the regional growth of poles - has taken place largely in spite of the overall economic environment and is certainly not the consequence of any systematic approach to spatial planning. This section looks briefly at each of the constraints and considers their effect on the potential for regionally dispersed industrialization.

(1) The Relative Neglect of Agriculture

The relative neglect of agriculture has come about in two main ways:

(a) through an over-valued real exchange rate which has reduced the return to agricultural exports and has

Table 5

Nominal and Real Exchange Rates, Exports and Imports in Agriculture

Year	Foreign Exchange (P/$)		Agriculture (FOB Value in U.S. $ M)	
	Nominal	Real (in Mfg.)	Exports	Imports
1972	6.7	100.00	422	1114
1977	7.4	92.00	1302	3492
1983	11.1	114.9	3155	6789

encouraged greater imports (i.e. a cheap food policy for the cities)

(b) through tariff protection on agricultural inputs, resulting in a negative rates of effective protection for agricultural producers.

The consequence of turning the terms of trade against agriculture is to depress severely the incomes of a majority of the population, which lives in the countryside.

Low agricultural incomes narrow the regional markets for consumer products and provide insufficient incentives for locally-based producers to upgrade their manufacturing facilities. Technology programs for rural manufacturers miss the fundamental point. Low-income and fragmented rural markets

in regions where manufacturers benefit from some "natural

Table 6

Regional Distribution of GRDP

Year	Percentage in		
	NCR	CIR	ROR
1972	29.6	51.7	48.3
1977	31.1	53.6	46.4
1983	32.4	55.0	45.0

Source: NEDA

protection" simply do not create an environment conducive to further investment along efficiency criteria. Rural producers of the basic consumer products - processed food, garments, footwear are "inefficient" not because they are necessarily ignorant of ways to improve their manufacturing process. Rather, they make a rational appraisal of the potential returns to their investment. An improvement in the agricultural terms of trade would be the best - and perhaps the only way to deepen regional manufacturing capability.

(2) Inadequacies in Regional Infrastructure

Modern business needs a "package" of infrastructural services to operate efficiently. Roads, power, telephones and reliable water supplies need to be provided on a coordinated, and not a piecemeal basis. A summary of basic infrastructural data is contained in Table 7. A cursory review of the information shows the concentration of roads in NCR and the high proportion of telecommunication stations in CIR (given its size) relative to

the rest of the regions. One can also see the high correlation between regional per capita income and road density.

Table 7

Per Capita Income and Road Density, 1983

	NCR	CIR	ROR
Per Capita Income (P at 1972 prices)	4948	2980	1342
Road Density (km/sq.km.)	4.16	0.52	0.51
Number of telecommunication stations	46	385	1056

Source: NEDA

Programs to promote rural industrialization in areas where infrastructure is wholly inadequate are, at best, empty gestures toward regional sensitivities. Efficient industrialization in such locations is not a realistic policy objective. Especially given current budgetary constraints, the best strategy may be to remedy existing deficiencies in infrastructure in the regional growth poles. Regional infrastructure programs should be focused on those areas where there are the highest potential returns to the investment.

Infrastructure program should not be disguised welfare schemes. It is true that infrastructural development can be a useful short term measure to absorb low cost labor in a socially productive way. However, these short term considerations should not be allowed to stand in the way of a more coherent strategy -

one that delivers infrastructural services.

(a) to locations with real growth potential and

(b) in a way that "completes" packages of services by remedying deficiencies in locations where some of the basic infrastructure is already in place.

More specifically, this means placing a priority on infrastructural development in the regional growth poles rather than in the most distant depressed barangays.

(3) The Current Spatial Distribution of Manufacturing Assets

Historically, Metro Manila has appropriated the lion's share of investment for fixed manufacturing assets.

Because of agglomeration economics, Manila (and perhaps the CIR) has an overwhelming advantage in attracting new firms. Manila acts as an "incubator" especially for small firms. The availability of financial services, traders (who, in effect, reduce the inventory working capital costs of small firms),

Table 8

Distribution of Fixed Assets in Manufacturing

Year	Percentage of Fixed Assets in	
	NCR	Other Regions
1977	39.6	60.4
1983	40.6	59.4

Source: NCSO

specialized input supplies and relatively good information all

make it relatively easy for small firms to set up shop in Manila than elsewhere. Firms which locate outside Manila have to internalize many of the services which Manila's economic infrastructure supplies. Often, it is only the larger firms - which have some discretion over location - that can afford these additional costs of doing business.

However, there is little reason to believe that special fiscal incentives can encourage these larger firms to locate outside Manila. Tax incentives are of only second order importance in location decisions. The only way to encourage greater decentralization of modern manufacturing activity is through (a) the provision of better infrastructure outside the CIR and (b) the reform of trade and agricultural pricing policy

(4) The Excessive Centralization of Administration

The present structure of government severely limits regional autonomy in many ways. First, regions have almost no control over their own fiscal affairs. Regional administration has extremely circumscribed tax power and the regional allocation of national government expenditure is controlled from the center in Manila. The national budget contains only a limited breakdown on regional expenditure and no information on the regional incidence of the tax/tariff structure, or of incentive packages.

Second, there is insufficient decentralization of the government line agencies. While certain parts of MTI exist in all the regions, other agencies which have a profound impact in the manufacturing sector hold shop only in Manila. BOI, TRC, GTEB, and the Tariff Commission have offices only in Manila,

raising the transactions costs for all regional firms which want access to these agencies. To take an example, it is not valid to argue that garments export from Cebu, which represent 2% of the national total, are insufficient to justify a regional office of GTEB. The garments export trade of Cebu has gone into decline ever since the introduction of the quota system in 1979. While one cannot attribute this trend solely to the operations of the GTEB, it is very suggestive of certain biases within the system.

Third, even in those cases where regional offices of line agencies do exist, their function is simply to implement national programs. Genuine decentralization, as opposed to documentation of controlled planned activities, involves the delegation of decision-making authority to regional offices. Independent authority must go further than mere hiring and firing responsibilities. Line agencies in the regions need to be given greater freedom over the allocation of resources to appropriate program design.

Over - centralization of decision-making authority can easily cause:

(a) administrative rigidities which reduce the capacity to respond quickly to client requests,

(b) imprecise program design, based on inadequate regional data and

(c) functional overloading of central government's administrative capability.

Central government should involve itself as little as possible in the actual day - to - day operations of the regional

line agencies. Its responsibility should be restricted to:

(a) setting clean simple objectives for the regional agencies,

(b) monitoring the performance of the regional agencies,

(c) providing specialized assistance, when requested, to the regional agencies,

(d) providing information on a limited range of national programs,

(e) coordinating the efforts, when requested, of the regional agencies,

(f) providing "untied financing" for the regional agencies, where funding could be linked to some performance criteria.

Line agencies have to be left alone to get on with the job of helping their clients and promoting their regions. Central government should take the backseat and adopt a much less interventionist posture.

(5) Regional Development and the Structure of Protection

Although there is almost no information on the effective regional incidence of the current tariff structure, one thing is clear, i.e. Manila appears to have benefited disproportionately from the excessive protection given to final consumer and capital-intensive goods. A further question of interest is whether the tariff system penalizes the regionally-based processing of natural resources.

Table 9 compares the effective rate of protection on three classes of goods - consumer, intermediate, and capital - with the regional distribution of manufacturing in these products.

Table 9

Regional Distribution of Manufacturing's Total Receipts and ERP (1985)

Industry	Percentage Total Receipts in			
	NCR	CIR	ROR	ERP
Consumer - Related	52.1	69.8	30.2	64.4
Intermediate	37.5	49.6	50.4	43.5
Capital Intensive	60.9	80.4	19.6	55.0

Source: NCSO

As the total suggests, there seems to be a general bias in the trade regime towards those items whose production is concentrated in Manila and against those industries where regional production makes more sense. The intermediate sector, which is mostly accounted by wood processing, comprises the majority of ROR's total receipts and yet receives the least protection. Two explanations for this bias come to mind. First, "taxing" primary processors is part of a general policy of extracting the rent from natural resources to pay for "modern sector development". Second, regional producers find it harder to lobby the political institutions and are blocked out of the rent-seeking game.

If the government is really serious about regional

development, then it will have to adddress the "environmental constraints" which today overwhelmingly favor Manila. Agricultural policies must be reformed; infrastructure built in the right places; tariffs liberalized; and administration genuinely decentralized. While the constraints remain in place, programs to assist regional industry are of marginal importance.

2.4.3 The Efficient Participation of Small Regional Firms

Efficient regional industrialization will result from

(a) increased regional income (principally from changes in agricultural policy) which widens the regional market and allows more efficient manufacturers to drive out the small cottage producers, and

(b) a reform of policies which discriminate against manufacturers which rely for inputs on natural resources and indigenous materials. In particular, policies which get agriculture moving will have significant benefits for a regionally dispersed food processing industry.

The development of regional industry will inevitably involve a significant degree of structural transformation. Small inefficient cottage producers will be unable to compete with more modern enterprises and should be allowed to die. The objective of programs should not be to slow down the adjustment process, but to help small producers enter into product lines where they can remain competitive. There is a real danger that small firm regional programs may have a strong anti-adjustment bias. Programs are counter-productive if they assist cottage producers in sectors where their long-run activity would be doubtful in an

efficient industry. Programs, in the regions as in Manila, have to be geared towards assisting small efficient producers to grow to an optimal scale.

Whatever the potential for programmatic intervention, the basic determinant of an improvement in the inter-regional distribution of manufacturing activity is the policy environment. Policies which encourage greater regional specialization and trading are the best way to promote small modern regionally-based firms. Consider the case of the handicrafts industry. Handicrafts is a sub-contracting business par excellence. Not only is regionally based production cheaper, but each region has a comparative advantage in supplying certain product lines. Some regions are renowned for basket weaving, others for shellcraft and yet others for weaving and embroidery. Policies which provide incentives for Manila and Cebu - based firms to develop their handicraft exports are the best way to help the sub-contractors located out in the regions.

The rapid development of the fashion accessories export business is another example of this argument. Although the bulk of final exports are marketed by Manila-based firms, the processing of the indigenous materials - especially the shells - is carried out in Cebu and the beading takes place on a sub-contract basis out in the regional barangays. In other words, there is a chain of transactions which links village - based subcontractors to the final markets. A policy environment which actively supports subcontracting and reduces the taxes on multiple transactions is the best possible way to promote the

regional fashion accessories industry.

Nevertheless, there are certain programmatic interventions which can help the regional handicrafts industry. Working capital programs for "indirect" exporters, some simple technology, and product design assistance all make a difference. Access to a bonded warehouse would facilitate the development of product lines which combine imported and indigenous materials in innovative ways. However, even in the case of this type of assistance, it is far from clear that the logical target group should be the regionally - based subcontractors.

The relationship between Manila and the provinces is not always "parasitic". In the case of the handicraft industry, the two parties to the contract provide very different skills and resources. Where the regions provide the basic supply of the goods, Manila offers access to its source of final demand. Policy should not aim at promoting Manila at the expense of provinces, or vice versa. If policies permit each region to develop its comparative advantage in an undistorted way, then there can be significant gains from trade. Programs which artificially try to create regionally - based manufacturers are unlikely to generate any sustained dispersal of industrial development, and merely add another distortion to the system.

Recommendations

1. The government should continue to sustain recent improvements in the agricultural terms of trade.

2. Fiscal incentives are inefficient instruments of regional policy. The Harvard team makes more substantial recommendations on BOI rules elsewhere in the report. However, a simplification of the rules - coupled with an

emphasis on export promotion and automatic performance - based tax credits - should reduce the transaction costs for regional producers who wish to take advantage of the incentives.

3. Further liberalization of trade policy is the best way to encourage greater decentralization of manufacturing activities. Firms which have to be cost - conscious will move to areas where land and labor costs are lower, provided that the basic infrastructure is in place.

4. Policies and programs should be more supportive of trading activities. Sales taxes, which penalize multiple transactions, can be a major disincentive to inter - regional trade. The promotion of traders is a crucial component of any strategy which seeks to develop the comparative advantages of each region. There are potentially significant gains from greater regional specialization which are lost, if policies make trading difficult.

5. Genuine decentralization of government administration should be accelerated. Regional line - agencies must be allowed greater discretion over budgetary allocations and program implementation.

6. The government should increase the regional coverage of one - stop export processing shops. To be effective, these shops should be able to process export orders without authorization from the Manila - based institutions.

7. The Central Bank should examine ways to reduce the time delays associated with the rediscounting of regional producers' export LCs.

8. The GTEB should examine the costs and benefits of allocating a specific proportion of environmental quotas to regional producers, especially those in Cebu. Garments is a "footloose" industry and there is no obvious reason for its concentration in Manila.

9. Regional firms that participate in Manila events - such as those organized by CITEM - should receive a subsidy to reflect the additional costs of their participation.

10. The government should raise property taxes on Manila - based firms to reflect:
    (a) the costs of congestion, and
    (b) the additional benefits from government services.

11. The government should conduct a study on the effective regional evidence of the present tariff and fiscal system.

12. The government should continue its current efforts to improve

the regional information in the national budgets. The budget should make explicit the regional winners and losers from the incidence of taxes and the allocation of expenditures.

13. The government should look into the possibility of industrial parks in the growth pole regional cities - Cebu, Davao and perhaps Iloilo.

NOTES

1. Taiwan, for example, financed its entire gross domestic capital formation from 1965 to 1981 from domestic savings.

2. Although Korea's formal financial markets had negative real rates on average throughout the 1970s, that its extensive curb market had high real rates made the difference in mobilizing domestic financial resources.

3. Government securities were also eligible to be used as substitutes for agricultural and agrarian reform credit allocation requirements at commercial banks.

Chapter 3: Programs

Chapter 2 has explored the reasons why, in the view of the Harvard team, issues of policy have a pre-eminent place in the effort to move towards an industrial structure in which dynamically efficient progressive small and medium enterprises play a significant role. This chapter explores the ways in which government programs can support these efforts. The first section of the chapter offers a general perspective on program intervention. The second section analyzes existing programs in the Philippines and suggests ways in which they might be upgraded. The third section makes some broader recommendations on how the capacity of the Ministry of Trade and Industry (MTI) to formulate policies and deliver program support may be enhanced.

3.1: A Perspective on Program Intervention

There has been an extraordinary proliferation of public programs for small and medium enterprises in the Philippines. The first impression gleaned by the outside consultant is that small and medium firms are well served: there appears to be a program for every problem. Closer inspection, however, reveals the initial impression to be misleading. Progressive small and medium enterprises in particular, the focus of much of the present report, enjoy few if any benefits from existing programs. Part of the reason for this failure lies in the character of specific programs (the subject of section II of this chapter). But there are two more general reasons: there appears to be little coherent basis for the decision as to where program interventions are appropriate; moreover, once programs are established, the

services that they offer are of little relevance for progressive small firms. Program interventions to a large degree are aimed at improving the situation of less progressive and livelihood enterprises.

Criteria for the Initiation of Programs

Given an appropriate policy environment, program interventions can be effective in addressing two important sets of problems. First, during the process of becoming outward-oriented and thereby shifting to a more rapid path of economic growth, a great deal of structural adjustment necessarily occurs. Changes in prevailing price incentives cause industrial enterprises to alter their mix of products, upgrade their production processes, explore new markets, and invest in new capital equipment. The transition period in which these adjustments take place may be lengthy. It is the view of the Harvard team that price incentives and the associated workings of the marketplace will be the driving force behind an efficient adjustment process. However, where appropriate institutions are not in place or where they are not operating effectively, and when investment and infrastructure facilities fail to emerge apace of changing events, government selective interventions can be helpful in easing the adjustment process. Our interviews with industrial firms indicate that government assistance programs in export marketing, in finance (particularly for export modernization and working capital) and in facilitating firm access to professional, specialized production services could supplement market prices in fostering a smoother transition.

The second role for the government assistance programs is to intervene when the market fails. First, there are times when not all the social returns to specific economic activities can be captured by firms or entrepreneurs and, as a result, a suboptimal amount of the good will be produced from society's point of view. Examples may be some R&D activities where the benefits can easily and quickly be diffused to competitors, or employee training programs, where employees potentially can take their newly acquired skills to other firms in the industry. In such cases, the market will fail to bring forth enough R&D or employee training, and the government has reason to intervene -- either by way of taxes or subsidies to encourage the market to operate in a socially efficient way, or by way of government programs -- to produce the extra amount of R&D or training needed by society. Access to information with respect to export markets offers a related example. Not only can such information, once accumulated, be diffused at low cost to large numbers of firms, the high fixed costs of learning about such markets can themselves deter firms from initiating exports. Here, too, there is a case for program intervention.

Another area where markets may fail to carry out society's will is the equitable distribution of economic benefits. Particular groups may be passed over in the process of economic growth. It is government's charge to address this market failure by helping these groups to participate more fully in the growth process or, if that is not possible for one reason or another, to

redistribute a share of the gains from economic progress to the less fortunate. The risk here is that governments could fall into the trap of trading-off growth for equity. For, in the end, if the economic pie does not grow, there is not much to redistribute to those in need. One way to avoid this trap is to focus on those programs that promote equitable growth. Such is the focus of the present report, given its emphasis on dynamically efficient small firms.

The final place for government to intervene is to offset the market's suboptimal provision of social overhead capital. The private sector, because of the enormous investments that must be made, (and the public good character of social overhead capital with the consequent inability to reap profitable reward by private investors) will not produce needed infrastructure like roads and ports. Hence the government must step in and fund these investments with public resources.

Program Assistance for Small Progressive Firms

In a review of MTI small and medium industry programs, the Harvard team has come up with several general observations as to their character. More specific observations and recommendations about particular programs will come in subsequent sections.

1. First, it should be noted again that the impact of MTI assistance programs and, for that matter the demand for program services among small and medium enterprise client groups, can be severely constrained by an adverse policy environment.

2. Small and medium firm assistance programs currently are aimed at the broadest possible group of small and medium enterprises. As such, programs have tended to become too heavily involved in the "welfare" problems of less progressive and livelihood enterprises. As a consequence, assistance programs have often neglected the "growth" problems of progressive firms.

3. Our finding in No. 2 leads us to recommend that the Ministry needs to develop new programs, or to transform older programs, to meet the needs of <u>progressive</u> small and medium firms. There are several implications that follow from this:

   (i) Programs that aim to meet the needs of progressive small and medium enterprises must be structured differently from programs that address less progressive and livelihood enterprises.

   (ii) Programs that deal with progressive small and medium firms should be staffed with, or have access to, experienced business professionals with specialized knowledge of the sectors in which these firms are active. To the degree that program staff are trained as, say, economists or engineers, and lack insights into the specific business problems of firms, they are unlikely to be able to tailor their assistance in a way that is useful. Even given this business orientation, if support is to be helpful, it needs to be highly specialized in

character. Thus, to cite one example, rather than general and relatively ill-researched descriptions of a wide range of opportunities, assistance in export marketing has to provide the kind of detailed analysis of marketing opportunities, and potential channels of market penetration for narrowly defined groups of products that can be generated only by a staff with specialized expertise.

(iii) Programs for small progressive firms should focus on the interface between firms and their environment, rather than on the internal management problems of enterprises. At present, many programs are designed to address internal rather than external problems of small and medium enterprises. This bias leads program staff to spend an inordinate amount of time (although some time is needed) working to upgrade the management skills of inefficient small enterprises when the need of small progressive firms is for interventions geared towards the external environment. Relevant interventions would include the provision of improved market information, access to working capital finance and material inputs, and changes in economic policies. Indeed, as will become apparent in the detailed review of existing programs in the next section, it is the view of the Harvard team

that selective program interventions can provide dynamic small firms substantial support in negotiating the external environment. However, aside from the most basic management advice, public programs can be of little assistance in helping to navigate the complex, specific, internal problems of individual firms.

(iv) Packages of services can be more effective than programs that offer support only in narrowly-defined activities. A firm that receives support in upgrading technology, for example, could also benefit from assistance in marketing its products overseas. And if it is to begin exporting, it might also require aid in obtaining working capital. The provision of packages of services would enable firms to gain maximum benefit from assistance programs.

(v) Finally, programs should be more selective in determining who participates. In essence, this means that programs aimed at progressive firms should be performance-based. A good example of such performance-based selection of participants is provided by CITEM's marketing programs. Participants are screened on the basis of product quality and several other characteristics. Moreover, participants pay a fee for services.

Similar performance-based screening might be done on the basis of export targets or productivity growth targets after a prescribed number of years of operation.

4. The objectives of programs should be well-defined. At present, the objectives of MTI small industry programs often are not clearly stated; added to this, many programs have overlapping agendas. When program objectives are not clearly stated, and when the lines of responsibility between programs are not clearly delineated, (as often happens when political and commercial objectives of programs are comingled, program managers will find it difficult to set clear directives for themselves and for staff. In such a setting, the ability to manage by objectives is reduced.
5. Programs should be client-centered, geared to provide the kind of assistance that clients themselves find useful. For all that this point seems obvious, it has two implications that are not self-evident. First, it implies a need for ongoing monitoring and evaluation of the performance of programs in relation to their objectives. At present, as a substitute for performance evaluation in relation to clear objectives, program evaluation procedures commonly focus on the size of firms that receive support, rather than the quality of the support itself. Given these evaluation procedures, program officers tend to place disproportionate

emphasis on reaching as large a number of small firms as possible, while neglecting the quality of the support provided in the first place.

A second, perhaps paradoxical, implication of the need for client-centeredness is that it might be desirable for the users of program services to pay for at least a fraction of the costs of their participation. Such payment would ensure that program staff direct their efforts towards firms that have a genuine need for the services they offer. It would also provide a useful way of evaluating whether firms indeed derive any use from particular programs.

3.2: A Critical Examination of Programs for Small and Medium Enterprises in the Philippines

The Harvard team has critically examined four groups of programs in the Philippines -- programs intended to promote the acquisition of technology, finance programs, export marketing programs and programs for the promotion of subcontracting. This review explores the motivation for each group of programs, the relation between the policy environment and the objectives of the programs, and program performance in the light of these objectives. For each group we make recommendations as to what program interventions are desirable and how they might best be achieved.

3.2.1. The Acquisition of Technology

One of the bases for the distinction in chapter 1 among the various classes of participation by small and medium enterprises

was the level of technical efficiency of firms. Technical efficiency encompasses timeliness and reliability of production, minimization of the unit costs of production, and upgrading the quality of the resulting product. Three interrelated sources of improvement in technical efficiency can be discerned:

(a) economies of scale: reductions in unit costs made possible by greater specialization of labor and by engineering economics, both a result of higher production volumes;

(b) technology transfer: the licensing (or appropriation by other means) from abroad of new processes of production or new product designs;

(c) incremental learning: progressive reductions in unit cost, and improvements in product quality through ongoing experimentation and adaptation of existing production processes and of product specifications.

Most economic analysis has focused on (a) and (b) as the crucial sources of improvement in technical efficiency. By the same token, a host of government interventions in the Philippines and elsewhere (interventions that will not be analyzed in this report) have been oriented to the regulation of (b). Increasingly, however, it has been recognized that the institutionalization of (c) within firms is crucial to their attainment of dynamic efficiency.

An increased emphasis on incremental learning brings the impact of policy on technical acquisition to the forefront. For incremental learning to take place, there must be both the opportunity for learning that is afforded by long-runs and the incentive that is generated from the press of competition. The industry studies illustrate vividly the overwhelming impact of

the policy environment in determining the extent to which firms pursue the efficient acquisition of technology.

As will be laid out in some detail in chapter 4, in the rattan industry (and also in the unusual example in electronics of the firm that produced speakers), the press of competition, together with the opportunities for long runs afforded by participation in export markets induced firms to make ongoing efforts at product improvement and cost reductions through technological acquisition and upgrading. By contrast, the introduction of new lines of production via local content programs for electronics and automobile components failed to set in motion a process of dynamically efficient change in firms. As is explained in chapter 4, these local content programs failed to afford firms either the opportunity for long runs, or the challenge of competition from efficient, high quality, low cost producers. In consequence, for the most part, the programs succeeded only in luring firms, with the promise -- at least in the short-run -- of secure markets and high profits, into what turned out to be dead end activities.

The conclusion that policy is crucial is not only that of the Harvard team. The central conclusion of an international research project on Science and Technology Policy Instruments carried out by the International Development Research Centre was that explicit technology programs had far less impact on technological change and the acquisition of technological capability than did general economic policies which affected industrial structure more generally. Even so, technology programs

can play a useful role in support of efforts to appropriate technology. What is the appropriate role of such programs? To what extent is it presently met by the menu of programs in the Philippines? It is to these issues that we now turn.

Table 1 shows that there are no less than 16 agencies in charge of running technology programs for industry; a comprehensive review of each of these programs is beyond the scope of this study. As regards assistance to small firms, the Asian Pacific Centre for Technology and the Small Enterprises Research and Development Foundation have recently compiled a Directory of Technology Promotion Programmes in the Philippines (1986). This document provides a summary description of the activities of 14 government organizations and 9 private agencies. Here we shall focus on two illustrative programs.

The Cottage Industries Technology Centre (CITC). The Cottage Industries Technology Centre under the NACIDA umbrella, is one of two public organizations that we examined whose objective was to look beyond the present activities of Philippine firms and provide specialized support for innovation. (The other organization is the Design Center of the Philippines, analyzed in the discussion below on marketing.)

The main center of the CITC is located in Marikina (NCR). Its specialization lies in rattan, bamboo and wood and, to a lesser extent, ceramics and metals. There are two regional CITCs, one specializing in bamboo craft (Regiona I) the other in fibercraft (Region V).

At present, the technical contribution made by these centers to technological development is poor. They are functioning as training centers, and even the effectiveness of the training provided is doubtful. The technical equipment for the main center in Marikina was donated by the Japanese government. In rattan, bamboo and wood, the center has technology so up-to-date that the machinery is the only type of its kind in the country. The problems for the training courses are obvious. Training on these machines is of little relevance to the producer. Thus, in practice, most of the course time is spent on traditional techniques and very little on the use of the new machinery. The new equipment, which symbolizes innovation, occupies most of the space and catches the eye of the visitor but is hardly ever used.

The failure of the CITC to provide usable support for innovation (and the parallel failure of the Design Center of the Philippines) is not simply the result of management problems within NACIDA. To be successful, a specialized technical assistance organization must know in depth not only what is available on the global menu of technological options in its specific field of endeavor, but also the general commercial potential in the Philippines of these various technologies, and the ways in which these technologies might be consistent with the medium-term strategies of specific Filipino firms. In the view of the Harvard team, it would take public institutional capabilities of a kind that we have not observed within the Philippines (and are rare anywhere in the world) to provide such support.

The Technology Resource Center (TRC). TRC offers two striking contrasts to CITC. First, unlike CITC, the TRC has not emphasized the in-house accumulation of expertise on the global frontier of a particular industry. Second, by all accounts TRC is a highly respected institution.

TRC is a government corporation that was set up in 1977 and operates under its own Charter, under the governorship of the Ministry of Human Settlements. The TRC mandate is to assist in the dissemination, commercialization and application of technology by households, firms and communities. It does so through a variety of programmes.

1. Short training courses on relatively simple production methods are offered backing, e.g., noodle making, production of soap or of stuffed toys. It is generally home businesses or backyard producers who avail themselves of these courses against the payment of a fee.
2. Through its Technobank, TRC offers information on technologies. Technobank's computerized data banking facilites and its on-line information search and retrieval capabilities can be used by entrepreneurs and the general public. The program's data and library acquisition come from around the world; they include descriptions on new technologies, new products, research findings, trade information, etc. Finally, Technobank (re) produces printed materials and videos on appropriate technologies.

3. TRC has financing programs for technological upgrading: The Export Industry Modernization Program and the Agro-Industrial Technology Transfer Program. Their soft term loans are directed mainly on medium-scale enterprises. In addition to financial assistance, consultancy services can be made available on technical and managerial problems.

4. TRC provides assistance to inventors and innovators. It offers a package of finance and consultancy services for launching inventions and improved technologies or products into the commercial stage, i.e., moving from an idea to prototype development and then batch production.

5. Computer services and computer training are provided. A series of recommendations follow from the comparison of the experiences of TRC and CITC. The first recommendations deal specifically with TRC's place within the overall structure of small and medium enterprise programs in the Philippines. At present, TRC cannot reach out into the regions. By and large, its services are restricted to enterprises from Metro Manila. In fact, through its success it contributes to the further concentration of industry in the National Capital Region.

Recommendation 1: While retaining its status as a government corporation operating under its own charter, TRC should be attached to MTI and operate outside of Metro Manila through the MTI regional offices.

In most regions BSMI and, with the internal reorganization,

MTI, more generally is in the process of bringing all government offices which run programs for small producers under one roof--the "one stop shop" concept. TRC should seek to extend its services to the regions through a "piggy-back" operation with BSMI. This would be much easier if TRC were to be attached to the MTI. It would enable both TRC and MTI's regional offices to reinforce each other's programs.

Recommendation 2: The BSMI should abandon its efforts to start up its own Small Business Technology Unit.

The activities of the Small Business Technology Unit so far have been rather limited, because it was only setup in 1985, has only four staff members and was beset by funding constraints. In our view, it does not make much sense for the BSMI to have its own technology unit. For one thing, there is no reason to believe that the BSMI can succeed in developing specialized technical support where CITC (and others) have failed. For another, the BSMI technology unit has already begun to duplicate services that TRC offers.

In the view of the Harvard team, TRC -- and the kind of programs offered by TRC, programs that emphasize the dissemination of readily assimilable information rather than the development of in-house capacity in specific frontiers technologies, represent the most appropriate form of technical support than can be provided by public agencies.

At the same time, however, there is a case for public promotion of innovation by dynamic small firms: through their success, dynamic small firms can function as role models and spur the efforts of other nascent entrepreneurs. The Product

Specialization Program (discussed below in the section on export marketing) suggests a model for promoting specialized assistance to small and medium enterprises of a kind that cannot be delivered directly by a public program.

Recommendation 3: To encourage progressive small and medium firms to further their efforts at technological upgrading:

(a) establish a fund to subsidize the hire of technical consultants by firms; the share of costs paid by the firm should rise with firm size; no subsidy should be provided for firms with more than 300 employees.

(b) Make industry associations -- those who have the capacity to evaluate the quality of any technical assistance provided -- responsible for the administration of the technical subsidy program.

Along with the above recommendations, there is a final, indirect, way in which government programs can support the acquisition of technology. Technical capabilities are embodied in workers, as well as in equipment. However, since workers are free to move from firm to firm, the private incentive of firms to train their staff (and thus the amount of in-house training provided) falls below the social benefits of such training. Thus

Recommendation 4. The Philippine government should encourage foreign donors to extend their efforts at providing specialized training programs for Philippine workers.

3.2.2. Financial Programs

Investigations of credit markets and financial policies of less advanced countries indicate that a relaxation of interest and selective credit controls is a necessary condition for achieving an efficient and expanding flow of financial resources to small and medium enterprises, as we have already argued, but in itself, it is not a sufficient condition. Uncertainties and

high administrative costs faced by financial intermediaries, both public and private, would still lead them not to lend to small enterprise activities, even to those with sound projects and good repayment intentions. Government interventions are often needed to complement the liberalization of financial policies to address shortcomings of an institutional nature and to allay the cost and risk burdens faced by banks. Suggested interventions generally take the form of lending by development banks and publicly backed risksharing schemes available to the private banking system.

Philippine government interventions in financial markets to expand the flow of loanable funds to small and medium enterprises are tailored along these lines. There are direct government lending programs undertaken by the government-owned Development Bank of the Philippines and indirect programs operated through equity finance and rediscounting facilities at the Central Bank. Also there has been, off and on, lending by private sector institutions using the Government's rediscounting facility, foreign donor funds, and loan guarantee or credit insurance (the Industrial Guarantee and Loan Fund - IGLF - and the Guarantee Fund for Small and Medium Enterprises - GFSME and others which have been suspended, such as CIGLF). In addition, by means of other programs such as MASICAP, which now is part of the Small Business Advisory Centers (SBAC)of the Bureau of Small and Medium Industries (BSMI), small and medium firm borrowers were assisted in preparing project feasibility studies and documentation to obtain loans under government sponsored financial programs. Since all these programs have been described and assessed in many

other reports,[1] nothing would be gained by describing them again here (a summary description of all the financial programs and their comparative lending features which was obtained from MTI staff is provided in the appendix to this report). The remainder of this section focuses on a discussion of selected problems and neglected features of current government small and medium enterprise financing programs.

(a) Administrative Costs, Risk and Banker Experience

Transaction costs of bank loans are crucial in establishing commercial credit availability for small and medium firms. Transaction costs which are used to mark-up the cost of financial resources to a bank in order to break even in lending operations are composed of two elements - administrative costs that accrue from loan processing procedures (including screening or credit eligibility evaluation costs) plus an allowance for arrears and/or default risk. More aggressive screening of loan applicants can, of course, reduce the risk of default. Hence, these two cost components are characterized by a trade-off.

Relative to large enterprises, small enterprise loans generally have higher transactions costs. Accounting is inadequate in many small firms and audited statements are not always available, making a traditional assessment of the credit worthiness of a potential borrower difficult. It also does not help matters that small firm managers often come forward with unrealistic financial plans because of inexperience in financial management (our interviews indicate, however, that these problems

are mostly confined to the very small firms and that internal management problems of small and medium enterprises are often overstated by studies which focus on enterprises with 10 or less employees.) Moreover, the size and number of small enterprises requires that loan amounts be small and loans numerous, each of which increases administrative costs because of the relatively large fixed processing requirements per unit lent.[2]

On the risk side, loans to small firms can be quite costly. For example, the World Bank cites arrearages from the money-shop program of PCIB, the "social loans" programs run by some commercial banks in the 1960s and 1970s, and a NACIDA loan program, later run by Philippine National Bank, as "extremely high - in one case 93 percent of loans were in default." These results are probably exaggerated by the fact that many government - sponsored small enterprise credit programs often "push" loan quantities rather than qualities, but the fact still remains that small and medium enterprise lending can be risky even to firms with economically sound projects. Interviews we held with private banks indicated that they estimated the default and arrears risk on small firm loans to be about 30 percent. Data from IGLF loans in the late 1970s show that some banks had less than 5 percent arrears, others had 50 to 90 percent arrears.

Transaction costs of lending to small firms, however, are only in part a function of borrower characteristics. Transactions costs also reflect the experience of financial institutions. To begin, the actual risk of lending to SMEs may be overstated by inexperienced commercial banking institutions. Secondly, and

more important, risks are a function of the information and experience that is accumulated within a banking institution, the banking institution's own policies, and the scale of lending the institution undertakes with small enterprises. Given the historical concentration of commercial bank lending activities in the Philippines on family-owned business groups and, more generally, on the corporate sector, these institutions have acquired neither the capacity nor the information base to effectively serve large numbers of small enterprise borrowers. In this context, borrowers with "good" projects are indistinguishable from others.

One of the objectives of programs like IGLF was to encourage lending by private financial institutions to small firms, by absorbing some of the early risks and costs of developing term lending programs to small and medium companies. As commercial banks gained experience by acting as conduits for government (IGLF) funds, it was argued, transaction costs of loans to small borrowers would fall enough to induce them to begin lending their own resources. Unfortunately, the record shows that the expected rise in private lending has not occurred.

Over the years, with changes in the way IGLF and other such programs were run and with increasing experience of participating banks, arrearages and other measures of program risks have consistently declined - from approximately 40 percent of outstanding loans in arrears in the late 1970s to about 3 percent today. But commercial banks continue to find that the transaction costs of dealing with the small borrower are too

high. The most successful banks participating in these programs were the ones that allocated the most resources to screening prospective borrowers, appraising projects, supervising post-loan activities and collection. It is clear from loan evaluations that, whenever one or more of these necessary procedures is neglected, arrears and defaults increase sharply. The problem, of course, is that the administrative costs involved in performing these activities can be quite high. Banks today, for example, complain about the costs of just one of these activities - post-loan "exhaustion" procedures that are mandated by IGLF in order to collect on loan guarantees. Litigation and/or rescheduling and reappraisal of delinquent loans can be expensive. Some bankers suggest that such high "exhaustion costs" make government loan guarantees much less meaningful.

The truth is that the experience of government programs and of government financial institutions shows that the costs and risks involved in lending to most small enterprises is far greater than the commercial banks will be willing to undertake, given the current structure of the financial system, even when relatively larger interest rate spreads are allowed for. The important exception, as our interviews indicate and other studies substantiate, may be the progressive small and medium firm which has an established track record and perhaps some collateral. Currently, however, lending to these firms is for the most part passed over by private financial institutions due to rigid loan procedures, the stigma attached to small enterprise lending, and the inexperience of bank personnel in dealing with project loans.

Recommendation 1: It should be recognized that at least two distinct groups (not necessarily based on size) of small firms must be served: "less progressive" and small livelihood firms, and "more progressive" enterprises. The first group needs a financial program that nurtures them along through the initial process of growth. This kind of program will be costly in that it requires more pre-loan activities, financial management training for entrepreneurs, and post-loan supervision and collection. The second group of more progressive enterprises is by its nature more sophisticated and, because it has a track record, less risky. Programs for this group thus require less extensive pre-and post-loan stewardship and thereby should have much lower transaction costs.

Many existing government programs and financial institutions have in fact already moved in the direction of serving more progressive, growth-oriented small companies, because the administrative costs, and loan losses that were incurred trying to serve the less progressive and livelihood group got too big. To reduce these costs they have systematically mixed-in more and more loans to progressive small and medium enterprises. Programs have also been initiated like AITTP (agriculture) and EIMP (industry) which are run by the Technology Resource Center (TRC), to finance such things as export modernization. These programs, aimed at the progressive small enterprises, rightly, are more selective as to who participates, require a modicum of collateral, and deal with participating firms on the basis of a well reasoned feasibility study - all of which the more progressive small firm can handle. It is evident that a lot of learning has taken place in government and in participating private banks and, as a result, financial programs for small enterprises are becoming more mature.

Recommendation 2: We would encourage a further movement of existing program resources towards progressive small and medium firms. Unquestionably, such a movement is an efficient use of funds and will help to promote greater dynamic efficiency and economic growth - a sorely needed occurrence after three years of GDP decline. It will also help to advance one of the major aims of financial programs - encouraging private commercial banks to gain more experience lending to modern, growth-oriented small firms.

To promote this experience-building process further,

Recommendation 3: Financial programs should include a component that would fund or subsidize training programs in project feasibility analysis for particular industries in private banks.

While private banks should be encouraged by government financial programs to gain more experience working with progressive small firms and should, in addition, be given more incentives to do so, there is no substitute in this area for striving to make the banking system more competitive. A higher degree of competitiveness will force private financial institutions to look more actively among small and medium enterprises for new customers and to regard initially high transactions costs, that may not be recoverable entirely by interest payments, as an investment in customer development. In such a climate, progressive small firms would have greater access to financial markets. Laboring to develop a more competitive and experienced banking system, however, does not belie the fact that, in the short run, the only viable way to increase the flow of financial resources to progressive small firms will be with the help of government institutions and programs. Efforts to introduce these other measures can only be expected to enhance the present impact of existing programs.

Recommendation 4: Analysis of the financial needs of the progressive group of small and medium enterprises indicates that most financial programs could be made more effective if loans were "packaged" together with professional advice on marketing, technology, and production management. To facilitate such programs, there needs to be an organization in the government that can coordinate the various agencies that would be involved in delivering these professional services.

At present, an organization like TRC brings together some of the components, but not all. The result is that firms must search for pieces of the package from different agencies. This is an inefficient use of valuable time. Ways should be found to streamline and package professional services and loans to progressive small and medium companies.

Financial programming for the less progressive and livelihood group of small firms is more problematic. Foremost, it must be made explicit that the less progressive, livelihood firms need special treatment. Programs and program personnel dealing with progressive small enterprises should be set apart. In progressive small enterprise programs, highly skilled, professional, business-trained personnel are required. In the less progressive, livelihood enterprise programs, younger, less experienced personnel are probably sufficient for program management, together with experienced field staff from organizations like NACIDA and SBAC. Requirements for highly skilled, professional managers and technologists are less in livelihood firm programs because firm-size is normally quite small and production processes are usually less sophisticated. It should be recognized that financing for the large majority of less progressive and livelihood firms will not, in the

foreseeable future, come from private banks because of the extremely high transaction costs involved. It is difficult to believe that transaction costs of lending to these firms will decline significantly. The hope is that some firms from this group will "graduate" into the progressive small enterprise category. At that point, programs such as IGLF can assist private banks to develop a closer relationship with these firms.

Recommendation 5: It is questionable whether government loan guarantees should be used to cover loans to less progressive and livelihood enterprises.

First, the banks probably will not be induced to use such guarantee programs because of the high collection (exhaustion) costs that would be needed to make them viable. If banks did make extensive use of government guarantees, the government budget might suffer. Second, a primary reason for such guarantees is to encourage private banks to gain experience and to reduce transaction costs of lending to small enterprise. Since the transactions cost of lending to less progressive and livelihood firms is not expected to decline substantially in the near term, there is no compelling reason to guarantee loans to this group.

An additional element that must be considered in setting up financial programs for less progressive and livelihood firms is that programs to nurture these firms through the initial growth process will be labor-intensive because of the necessity for extensive pre-and post-loan stewardship. Frequent site visits must be made on a regular basis. Moreover, programs will not only address <u>how much</u> and <u>how to source</u> funds for less

progressive and livelihood firms, they will also have to focus on raising the ability of less progressive and livelihood entrepreneurs to manage their financial resources. Accordingly, the personnel of SBAC (or whomever takes the SBAC function) will continue to play an important role in extending pre-loan and training services to less progressive and livelihood enterprise clientele.

> Recommendation 6: Government should devote additional resources to further capacity-building of SBAC staff to support less progressive and livelihood firms. Private voluntary organizations working in small towns and cities and in rural areas might also be useful in this respect. However, it is often not as easy as it seems to organize and work with PVOs. They are in many cases very independent and have their own agendas. It would be useful to make a study of the possibilities of working with PVOs before getting too deeply involved with these organizations.

A final but important point emerges from a review of existing financial programs that have had some success working with the livelihood subsector.

> Recommendation 7: To insure a modicum of success, loan programs to less progressive and livelihood enterprises must be decentralized as much as possible.

Screening and other costs are minimized at the community level and arrearages decline substantially. A good example of a program that works exceedingly well with less progressive livelihood enterprises at a very decentralized level is the BRI (Indonesia People's Bank) program in Indonesia. This government bank has more than 300 branch offices in provincial cities and 3000 village units making small loans. Hundreds of thousands of loans have already been extended by the BRI program and billions

of pesos; yet repayment rates are well over 90 percent. Several key reasons for the success of this program are:

- decentralized, village level loan making;
- interest rates on loans are slightly above city market rates;
- loans are relatively small and short term (one year maturity requiring monthly payments);
- a bonus system was instituted for bank staff based on profitability of their units. The accounting system was reorganized to make profits and losses explicit.

A similar system might work in the Philippines through DBP and the Private Development Banks. DBP's arrears at branch offices shows that decentralization pays off. While arrears on SME loans outstanding at the head office in 1978 was over 20 percent, it declined to 5 percent at provincial branch offices.

Fixed Assets vs Working Capital Finance

Several reports on Philippine government financial programs have argued that existing programs concentrate too heavily on fixed asset and permanent working capital finance, and, as a consequence, neglecting the provision of short-term working capital. The Harvard team concurs with this assessment. Because small enterprises find it relatively more difficult to support fixed asset structures, they tend to be more labor- and raw material-irtensive in their production techniques. This alone would be good reason for paying close attention to small enterprise working capital problems. Our interviews with firms in six different industries indicate several other reasons.

First, when a small enterprise can obtain program financing for its fixed assets, it does not mean that its financial worries are over. With the additional overhead to support, the firm has an even greater need for larger and continuous quantities of labor and raw materials. Accordingly, the need for working capital finance increases with higher levels of fixed asset financing. If this working finance is not available, a financial stress is placed on the firm. Second, several industries where progressive small firms have a competitive basis, like garments and metal working, have very working capital-intensive production techniques. Provision of timely and adequate working capital finance would allow more new entrants into industry, would allow for greater expansion of existing firms, and, in export areas, would foster greater competitiveness on international markets. The old saying that "fixed asset loans finance capital and working capital finances labor and employment" rings true here.

For these reasons,

Recommendation 8: Financing programs should pay greater attention to working capital.

In programmatic terms, it is also a good bet. The golden rule that people pay back loans in order to get more loans applies very nicely to working capital finance. Because these loans can be extended on a credit-line basis and because they can be related to current sales levels, they are inherently less risky. Figures from the Philguarantee program substantiate this fact. Their loan guarantees for term financing had a 63 percent default rate in the early 1980s, while guarantees for preshipment export

working capital had only an 8 percent default rate (the post-shipment export financing default rate was 0 percent and the default rate for the comprehensive pre- and post-shipment export financing package was 5 percent). In addition, commercial banks have experience with working capital finance, particularly in the export area, and thus are much less wary about getting involved in this type of short-term lending. It would therefore be much easier to develop new programs for small enterprise financing if they concentrated on provision of short-term working capital.

Recommendation 9: There are opportunities for additional programs to provide export working capital to both small enterprise direct and indirect exporters.

In this regard, the domestic letter of credit (LC) financing could be extremely important. The domestic LC has been called the single most important innovation in export incentive administration. It is essential to assuring automatic availability of short-term export loans and free trade status to all firms that generate export value added but do not export directly. Both input - supplying indirect exporters (suppliers of intermediate inputs to final goods exporters) and output - supplying indirect exporters (suppliers of finished export products to trading companies) should be included in the domestic LC scheme.

The main instrument of the domestic LC system is the back-to-back domestic LC. This is an instrument through which the beneficiary of an export LC (or perhaps of a certified purchase order) can take advantage of the credit worthiness of the importer (plus the availability of any export incentives tied to

the export order). When the final-goods exporter has an LC in his favor, the existence of the LC allows his bank to open a second, similar credit account on benefit of the final-goods exporter with the input-supplying indirect exporter or the output-supplying indirect exporter as the beneficiary.

The domestic LC system could be a key element in creating an economic environment in which small enterprises have a greater opportunity to participate. The system breaks the barrier that restricts access to export financing to free trade zones or final-goods exporters. It also stimulates more efficient backward linkages through export expansion, and gives a boost to the development of trading companies specializing in export marketing , which will increase the gains from foreign trade.

The domestic LC system is currently under discussion at the MTI. Because we feel that it would be of particular importance to the development of small and medium firms in export activities, we encourage its adoption.

> Recommendation 10: A domestic LC system could be implemented through selected private banks (and also perhaps through DBP) covered by an expanded Philguarantee program.

Currently only a small proportion of Philguarantee's funds (approximately 5 percent) are involved in pre and post-shipment export financing. For private banks to get involved in a domestic LC system, loan guarantees will be needed in the beginning. Philguarantee staff have gained valuable experience in post export loan guarantee operations and thus could be a valuable source of expertise in setting up a guarantee scheme for domestic

LC's.

3.2.3 Financing Traders

A review of the coverage of existing financing programs indicates that manufacturing activities appear to have adequate access to program resources. Ancillary activities, however, such as trading, seem to have no major financing programs, with the exception of normal export loans under Philguarantee and packing credits.

> Recommendation 11: To achieve greater gains from international trade, to promote domestic regional trade and distribution, and to create additional indirect sources of finance for small enterprises, financing programs for traders are recommended.

Traders play an important part in determining the gains a country can potentially capture from international trade. The gains from international trading activities are divided between producers, consumers and intermediaries (traders) in proportions that depend on the price elasticities of demand and supply and how trade affects the price of the commodity in the exporting and importing country. Given that most developing countries are not large exporters relative to world markets of particular commodities, their exports do not cause international prices to fluctuate radically. Hence, the consumer's share in the gains from trade becomes negligible, and most gain is divided between producers and traders.

The traders' active participation in international trade is crucial. He is usually the one who discovers the difference in the price (or quality) between potential export and import markets and ascertains the scope of profitable trade. He makes

potential exporters and importers aware of the gains possible from trade; establishes the contract; and makes all the necessary arrangements that would otherwise be rendered difficult by lack of personal contact, distance and difficult communications. When the manufacturing firm is small, these arrangements also include the provision of financing, procurement of inputs, arranging for transportation, insurance and dealing with customs. Traders also keep abreast of changing prices and market conditions abroad and, by switching trade in response to these changes, protect domestic exporters or importers. These services require imagination, initiative, knowledge, experience, contacts, and familiarity with local conditions in many countries. Given their value and scarcity, such services have to be remunerated accordingly. Countries like Japan, Korea, and Taiwan (to a lesser degree) have benefited greatly from the international trading companies.

The argument for domestic traders is much the same. An efficient network of domestic traders can facilitate interregional marketing and distribution of goods. In addition, both international and domestic traders can be effective mechanisms for financing small firms. As stated above, traders often provide finance to small producers. Programs to finance traders, therefore, could be an efficient, indirect way to lend to small and medium enterprises. On domestic markets, of course, traders often fit into the small and medium category themselves. Finance programs for trading companies could therefore stimulate more efficient marketing and distribution and enhance employment opportunities.

APPENDIX

COMPARATIVE LENDING FEATURES OF SMI FINANCING PROGRAMS

Features	Industrial Guarantee & Loan Fund (IGLF)	Guarantee Fund for Small and Medium Enterprises (GFSME)	Agro-Industrial Technology Transfer Program (AITTP)	Export Industry Modernization Program (EIMP)	Cottage Industries Guarantee and Loan Fund (CIGLF)
Year Established	1952	1984	1982	1979	1980
Implemeting Agency/cies	CB	MHS	TRC/DBP	TRC/DBP	MTI/NACIDA
Objectives/Targets	To develop financially technically and economically viable CSMIs	Formally called the KKK Guarantee Fund. This provide capital and guarantee to agricultural/ agri-business projects.	To provide financial and technical assistance for cultivation, production and processing of agricultural products;develop domestic and export markets' on non-traditonal products.	To upgrade SMI production facilities,improve their product quality, mass production capability and cost competitiveness, in the export markets.	Promoting and developing cottage,small and medium indsutries by making available the necessary financial assistance.
Purpose of Loan	For acquisition of fixed assets as working capital and for expansion	For fixed assets,working capital and construction of plant facilities,	For working capital	For fixed assets and working capital	For fixed assets and working capital
Amount of Loan	Sponsorship scheme: P150,000 Accreditation Scheme: SSI- P1.7 to P2.0M MSI- Over P2,0M to P5.0M	SSI- P200,00 to P2.0M MSI- P2.0M to P3.0M	60% of project cost (cultivation to exclude) land;70% of project cost (processing)	Maximum of P5.0M for soft term loan, 70% of project cost	Maximum of P100,000.00
Interest Rates to Barrowers to AFIs	23% p.a. SSI - 5.5% MSI - 7.0%	16% p.a. 25% p.a. Interest subsidy - 3%	8.75% p.a.	8.75% p.a.	12% per annum

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Maturity	WC-Max. of 5 yrs. incl. of 2 yrs. G.P. FA-Max. of 12 yrs.incl. of 3yrs. G.P. Restructured loan Max. of 7 yrs.	WC- Max. of 5 yrs. incl. 1 yr. G.P. FA- Max. 10 yrs. incl.2yrs. G.P.	WC-Between 5-15 yrs. with G.P. from 1 to 5 yrs.	FA - Max. of 10 yrs. G.P. of 1-3 yrs.	WC - max. of 3 yrs. FA - Max. of 10 yrs.
Guarantee Coverage Optional					
1.Collateral Short Guarantee	Max. of 25 yrs of the loan				
2.Credit Risk Guarantee	60% of the loan for SSI 40% of the loan for MSI				
Equity Requirements	20%	20%	40% for contribution 20% for processing	30%	Existing Business
Collateral Requirements	Left at the option of the participating banks	Project assisted	100% collateral coverage Collateral evaluation: 90% of the appraised value of land and improvements, 80% of building and 60% of chattels	100% coverage	Real estate mortgage and/ or chattle mortgage on movable properties
Fees	Guarantee fee - 2% p.a. Sevice fee SSI - 1.5% MSI - 1%	Guarantee fee-2% p.a. Origination fee- 3% of initial loan amount	Service fee - 2% of the loan	service Fee - 2%	Guarantee Fee - 2% p.a.

COMPARATIVE LENDING FEATURES OF SMI FINANCING PROGRAMS

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Lending Framework	Sponsoring Banks/AFIs	AFIs	AFIs	DBP	CB-DBP/PNB
Other Assistance Rendered	Project Evaluation/ Supervision	TA/Mgr'l Assistance/Insurance of project assets at borrowers expense	Technical Assistance on production, processing marketing and financing	Industry technology, market information and management consultancy services	
Available Loanable Fund	-	P 397 Million	-	-	P 19.4 Million
Eligible Projects/ Borrowers	Manufacturing concern and those service industries supportive of manufacturing activities like warehousing repair, shops, etc.	Agricultural production, food production non-food (for export)	Financially viable agr-based projects that contribute to the main objective of the AITTP are eligible for assistance. These objectives are technology transfer, domestic and export market development, & livelihood generation		
Status	On-going	On-going	On-going	On-going	Suspended (1982)
Processing Time (ave.)	-	30 days - GFSME 60 DAYS - BANKS	-	-	Max. of 21 days Min. of 10 days

Feature	Philippine Business for Social Progress, Inc. (PBSP)	Philippine Export Foreign Guarantee Corp. (PHILGUARANTEE)	Venture Capital Corp. (VVC)
Year Established	1970	1980	1980
Implementing Agency/cies	PBSP	PHILGUARANTEE	NDC
Objective/Targets	To initiate, sponsor & assist socio-economic development projects aimed at helping the Filipino poor improve their lives.	Provides guarantee assis- to small & medium and large export producers & traders. Known as the P3.0Million guarantee facility.	A joint venture between private commercial banks and the governmentto provide a "start-up"or "seed" money, "venture" of "growth" capital or equity financing to CSMIs.
Purpose of Loan	For working capital	For fixed assets and working capital	For working capital
Amount of Loan	Variable.According to the needs of low income borrowers who do not have access to other commercial credits.	SSI - over P100,000 toP1.0M MSI - P1.0M TO P4.0M.	According to the needs of the business,paying capacity of the applicant and growth potential of the enterprise.
Interest Rates	9% p.a.	Bank Rates	3% per month - lowest 5% per month - highest
Maturity	Variable	Depends on the terms of the bank	Depends on the terms of the bank
Guarantee Coverage	None	50% for new accounts (any sector) 70% for manufacturers, suppliers and exporters 80% service exporters	None
Equity Requirements	None	-	None

Features	Urban Livelihood Financing Program(ULFP)	Agricultural Loan Fund (ALF)	Agri-Small & Medium Industrial Lending Program (A-SMILE)	Small Business Guarantee Loan Fund (SBGLF)
	2. Socialized Credit Scheme (SCS) Maximum of P10,000 per individual member 3. Integration and Develo-ment of Enterprises assistance Loan(IDEAL) Above P250,000			
Interest Rates		18% -23% depending on the participating bank rates	17% per annum	16% per annum
Maturity	MYDAL - 1 year SCS - 6 months	short terms subloans - 1 yr. Med. & long term maximum of 15 yrs.	For SMI loans - up to 1 yr. For Agricultural loans - up to 2 yrs.	Working Capital:Maximum of 4 yrs. inclusive of year grace period Fixed Assets: 7 yrs. inclu-sive of 2 yrs. grace period
Equity Requirements	-	10% of total projects cost for loans of P1 M and 15% of total project cost for loans over 1 M but 20% of total projects cost for loan over P5 M. - may be in cash on in kind including monetary value of framly labor but excludes cost of local used which will be financed exclusively from the sub-borrowers own resources and would constitute a collateral for the subloan	25%	20%

Feature	Philippine Business for Social Progress, Inc. (PBSP)	Philippine Export Foreign Guarantee Copr. (PHILGUARANTEE)	Venture Capital Corp. (VVC)
Collateral Requirements	None	Signatures of officers o companies Guarantee affidavits	Mortgage of real estate and
Fees	None	Service Fee - 2% Guarantee fee - 1.5% p.a. Filing fee - 1/10 of 1% of guarantee accomodation with a min. of P500.00	Investment fee - 2% Controllership fee - 1%
Lending Framework	Accredited banks	Thru Commenrcial banks	
Available Fund	-	-	P50,000
Eligible Projects/ Borrower	-	-	-
Status	-	-	On-going
Processing Time	-	-	2-3 weeks

Features	Urban Livelihood Financing Program(ULFP)	Agricultural Loan Fund (ALF)	Agri-Small & Medium Industrial Lending Program (A-SMILE)	Small Business Guarantee Loan Fund (SBGLF)
Year Established	1981	1985	1986	-
Implementing Agency/cies	TkC	CB/PFIs	DBP	MTI
Objective/Targets	To develop an effective credit and technology delivery system to service that sector of society where traditional credit is not available so that livelihood is generated in that sector, enabling identified and organized financially viable community projects to become self-sustained micro-enterprises through their own capital formation or to become continuing self-reliant micro-enterprises within the community,to effect an overall socio-economic and socio-behavioral change.	To provide short-term,and long-term credit to finance eligible agricultural and agri-business projects.	To provide financial assistance to agricultural small and medium scale industrial projects primarily those located in the countryside.	To provide assisrcredit for small enterprises particularly those with collateral deficiencies, to provide credit for traders and service group supportive of small enterprises, to encourage greater participation of private financial institutions especially those rural-based regional banks.
Purpose of Loan	For working capital/site improvement Machinery acquisition	Finance both seasonal production credit and medium and long-term subloans for fixed assets and permanent working capital,except for land acquisition.	Loan proceeds shall be utilized exclussively to augment project's exixting working capital.	For working capital and fixed assets.
Amount of Loan	1.Micro Emterprises Development Assistance Loan (MEDAL) Range:P10,000 to P250,000	Depends on the project to be financed.	Maximum amount of loan-P500,000 per borrower per project.	MTI to Banks:P1 Million -P5 Million Bank to Projects:P50,000-P500,000

Features	Urban Livelihood Financing Program(ULFP)	Agricultural Loan Fund (ALF)	Agri-Small & Medium Industrial Lending Program (A-SMILE)	Small Business Guarantee Loan Fund (SBGLF)
Collateral Requirements	100% coverage	100% coverage	-First mortgage on titled real estate,buildings,machineries & equipment already owned by the applicant. -At least 30% of the loan shall be secured by real estate collateral.	
Fees		Penalty fee-5% p.a. to commercial banks	2%(.5%) to be based or amount applied for minimum of P300,00 & payable upon filing. The 1.5% shall be based on amount of loan approved and payable at time of release.	Guarantee fee- 4%
Lending Framework	Direct lending-MEDAL& SCS Through AFIs - Relending	Through AFIs	DBP - SSS	Through AFIs
Available Loanable Fund	-	-	-	P400 Million
Eligible Projects/ Borrowers	-	-	-	Garments,gifts & housewares, processed for footwear & leather-wear,furniture, metal & trade services groups supportive of above mentioned projects.
Status	On-going	On-going	On-going	
Processing Time(ave.)				

3.2.4. Marketing Programs

The potential for, and the character of, program intervention are very different for export and for local marketing. Efforts to market products abroad require substantial fixed cost outlays to learn about the character of foreign demand, the channels of access to relevant foreign buyers, and the cost and quality standards necessary to be competitive. Once this specialized marketing information has been gathered, it has the character of a "public good" -- it can be used to support the export marketing efforts of all Philippine firms active in the relevant industry. These two characteristics --high fixed information costs, and the public good character of information -- together imply that there is a clear role for programmatic intervention by government with respect to export marketing. (A directly parallel argument points to a role for government as provider of information on local producers to those foreign buyers who come to Manila in search of sourcing opportunities in the Philippines.)

The arguments with respect to export marketing do not apply to the marketing of products for use within the Philippines. First, no minimum fixed expenditure is needed below which market entry is not possible. To be sure, costs rise as distance from point of production to market, and as the volume intended for sale increase. But these cost increases can be met incrementally, as firms grow and as their market reach expands. Second, given the relative ease of entry and the opportunities for incremental expansion, networks of specialized traders emerge to take on the

function of domestic marketing. As a result, and as is reflected in the recommendations below, the scope for public domestic marketing is highly limited.

(a) Program Interventions in Domestic Marketing

By and large, the marketing efforts of the Government of the Philippines appear to have been responsive to what has just been argued. With the notable exception of the regional stores run by NACIDA, existing programs focus on export rather than domestic marketing. This is as it should be. The performance of the NACIDA stores themselves provides clear evidence of the marginality of public domestic marketing efforts: total domestic sales of NACIDA registered producers in 1985 amounted to P377,370,000. Of those sales, P913,000 were sold through the regional stores -- a mere 0.24%.

Recommendation 1: Government should pull out entirely of domestic trading of cottage products. In Manila the NACIDA stores were closed several years ago and the trade was left to private stores. We recommend that the same be done throughout the country.

It is the view of the Harvard team that the focus of public efforts with respect to domestic marketing should be on support for domestic traders. The domestic trading system has not been a focus of the present effort. Thus,

Recommendation 2: There is need for a detailed study on the structure of the domestic, non-agricultural trading system, with special reference to the obstacles faced by local traders.

Even in the absence of such a study, three further points are worth making, in the form of recommendations:

Recommendation 3: Investment in infrastructure, and the associated declines in transportation and other

transaction costs, represents the single most effective way of promoting domestic trading.

Recommendation 4: The present system of sales taxes acts as a disincentive to trading. A shift from transaction-specific tax levies (irrespective of where in the marketing chain the transaction takes place) to taxation only at the point of retail sale would be desirable.

The final point represents our one qualification to the general proposition that there is no role for public programs in domestic marketing. As long as the national trading system remains underdeveloped, information on regional products and regional markets will be relatively inaccessible to producers and consumers in other regions. Thus

Recommendation 5: There exist opportunities for public programs to aid the promotion of inter-regional sales of non-agricultural products. Information on product and market characteristics is specialized within regions, hence any programs should be designed and implemented at the regional level and not in Manila. The role for the central government should be to provide financial support for such programs.

(b) Program Interventions in Export Marketing

Table 2 below summarizes the major export marketing programs of the Philippine government. This section will review these programs and make recommendations as to how export marketing support might be strengthened. What follows is based on as thorough an inspection of the programs as was possible in the limited time available; although we expect that what we have learned should prove helpful, it should not be taken as the final word on export marketing programs.

The existing programs can roughly be divided into two distinct categories: programs whose purpose is to gather information for use by foreign buyers and Philippine exporters;

and programs whose purpose is to disseminate information to small and medium enterprises. We begin with three sets of programs in the first category.

The Bureau of Foreign Trade. The task of providing up-to-date market information and of reporting new trade opportunities lies with the Bureau of Foreign Trade (BFT). It already provides an impressive array of publications such as the regular " Trade Trends", "List of Foreign Buyers" or Market Guides for Specific Products and Country Profiles. However, the Bureau itself recognizes that the present practice of relying primarily on the work of its Commercial Attaches for information has its problems. Attaches do not always have sufficient trading experience to carry out commercial intelligence; moreover, since they are in charge of the full breadth of export products and procedures, they can rarely develop the specific expertise and provide the specific advice which the manufacturers back home require. More generally, (as the example in chapter 4 of the inability of auto components firms to obtain support in their efforts to export to the aftermarket abroad illustrates) at present there is no agency within the BFT that is charged with anticipating future trends in Philippine exports and providing market intelligence to firms as they endeavor to move into new areas.

Recommendation 6: The market intelligence capabilities of the BFT should be upgraded:

(a) the corps of sector-specific specialists in existing export markets of Philippine firms should be strengthened;

(b) market intelligence should be generated in sectors where Philippine exporters presently have a low profile but where there is potential for expansion;

(c) to achieve this upgrading, the BFT should

establish a well-funded Office for Market Intelligence, staffed by skilled marketing professionals, and headquartered in Manila.

The Design Center of the Philippines (DCP) and the Product Specialization Program (PSP). Product innovation can be crucial for succeeding in some export markets. The Philippines has two programs that aim at the promotion of innovation -- the DCP and the PSP. The thrust of the DCP's work used to be the development of radically new designs. These designs did not give sufficient regard to market prospects and the skill/technology base available in the country. The DCP considered itself a reservoir of designs which manufacturers could then draw upon and adapt to their purposes. Clearly, this was not an effective way of promoting Philippine exports. Gradually the Center has moved a little closer to the market and tested new designs with manufacturers.

Although the Harvard team is encouraged by the new direction of the DCP, we remain skeptical that a public Philippine institution that is not itself subjected to the rigors of the export marketplace can generate marketable (and in fact produced and marketed by private firms) new products at a rate that justifies the outlay of public funds.

Under the PSP, international product specialists are brought into the country to work directly with local manufacturers. The aim is that they find new functions for local materials or adopt designs and techniques to create new products and textures. Financing for most of the product specialist program comes from the "Third SMI World Bank Loan." Expenditure for this program

during 1985 and 1986 was only P5.6 million, repayable in U.S. dollars at 11.6% fixed interest rate (to be reduced to 7 or 8%, but floating.)

Although a number of interviewees reported successful product innovations as a result of the program, there is a need for further evaluation as to whether these benefits justify the costs. At the very least, in line with the suggestion at the beginning of this chapter, users should meet a fraction of the program's costs:

> Recommendation 7: Users of the PSP should pay a fraction of the costs of consulting services; the share of costs should increase the larger is the size of firm; firms with over 300 employees should pay the full costs of any consultant time made available through the program; to offset the present regional imbalance of the program, users outside of Metro Manila should be provided with services free of charge.

CITEM. An alternative to going overseas to study the markets and promote sales is to bring the foreign buyers into the country. This is what CITEM does through its fairs held in Manila. Are they a cost effective way of promoting exports? Do they have any relevance for small firms? Our answer to both questions is yes.

Take the example of the "Gifts, Toys and Housewares Market Week" held in October 1986 at the Philippine International Convention Center. The cost of holding this fair was P3.5 million. However, almost half of the cost was borne by the 168 exhibitors who paid P10,000 each for their stalls. Sales generated (booked orders) by the fair amounted to US$ 13.9 million or P278 million. Thus the costs to the government of

P1.82 million amount to a mere 0.65% of booked orders. At least for this example -- and especially in the context of the relatively weak performances of the BFT, the DCP and the PCP -- the charge that CITEM's operations are too expensive for the government cannot be upheld.

Aside from the benefits for exporters in general, CITEM fairs provide specific benefits to small firms. To be sure, the outlay on a stall is P10,000, a sum that excludes the very small producer. But such producers can rarely cope with export orders anyway. (CITEM's promotion of a joint export marketing group in ceramics represents one creative response to this barrier). For small to medium-sized firms, the cost of P10,000 is not unmanage able. The real barrier is generally not the cost for the stall but whether small and medium firms are ready to export in terms of design, quality and scale. Undoubtedly, some exhibitors are not. But this in itself is not a necessary and desirable part of these exhibitions. They provide for a relatively inexpensive learning process through a concentrated exposure to international buyers.

Along with the international fairs, CITEM in coordination with several other government agencies (BSMI-SBAC, NACIDA, BDT and PSA) also organizes "Regional Market Encounters" within the various regions of the Philippines. The objective of the market encounter program is both exposure to buyers and sales. In 1985, spot sales and booked orders generated were close to P45 million. In 1986, the program was temporarily suspended, but in our view it is important to re-launch it again. Why?

The reason does not just lie in providing a sales outlet. There is a more long-run consideration. The regional market encounters can help foster export consciousness and upgrade local producers to meet international standards. Indeed, the objective is to inspire producers to develop new products and adopt new designs that are of better quality and more suited to the preferences of foreign buyers, exporters, manufacturer-contractors or Manila-based department stores.

Recommendation 8: Subject to the following guidelines, the Regional Market Encounter Program should be re-launched:
(a) the number of regional encounters organized every year must be limited to one per region to maximize dispersal efforts by agencies concerned, and to ensure that the pool of significant buyers willing and able to tour the country is not spread too thin;
(b) to maintain the interest of buyers, and aid the dissemination of new ideas and initiatives, the encounters should focus on the exhibition of new products and new designs.

Information dissemination. The focus of the export marketing programs examined thus far is on the generation of market intelligence and market access for Philippine firms. This final subsection explores programs geared to the dissemination of market information to small and medium enterprises.

There is presently substantial confusion within the Ministry as to what are the relevant lines of responsibility. Prior to the present reorganization, three agencies were responsible for the dissemination of marketing information -- the Marketing Assistance Unit of the Bureau of Small and Medium Industries, the marketing information wing of NACIDA, and the Bureau of Domestic Trade. At present, NACIDA apparently is in the process of being merged with BSMI. Based on our interviews and impressions of the

comparative skills of the BSMI and NACIDA marketing operations, we have more confidence in the BSMI set up. Most of the BSMI staff has first hand experience of what is going on at the regional level; regular field trips are undertaken to each region. In contrast, the NACIDA head office staff saw its function as processing paper work to and from its regional offices or other agencies. With one or two exceptions, no field visits had been undertaken and there seemed to be little understanding of what happened out in the real world. The Harvard team thus supports the apparent decision to give precedence to the marketing efforts of BSMI over those of NACIDA.

What is apparently less clear is the evolving relationship between the marketing assistance efforts of BSMI, those of BDT, and the new MTI regional offices that presently are in the process of taking over the functions of the regional SBAC offices. In the absence of a clearly specified delineation of responsibilities, it is difficult to make specific recommendations on program upgrading. There are, however, two crucial points with respect to the way in which responsibilities are divided.

> Recommendation 9: A single agency should be given sole responsibility for the dissemination of information to firms in the regions.

In principle, this lead could be taken either by BSMI's unit or that of BDT. One risk in the latter case is that the BDT's responsibility for regulation may dampen the enthusiasm of firms to turn to it for promotional support.

Whichever agency takes the lead, it is vital that it have

access to clear lines of communication to its coordinators in the regions. Under the prior organizational structure, BSMI had ready access through the SBACs. In terms of the new structure, however, clearance apparently is required from the wing of the Ministry responsible for regional issues for effective contacts with regional offices.

> Recommendation 10: Steps should be taken forthwith to clarify and simplify the lines of communication between the agencies responsible for marketing dissemination and the regional offices of MTI.

On the assumption that the Marketing Assistance Unit of BSMI will take the lead in dissemination of marketing information, we have two added comments on its activities. The first is relatively minor; the second is more fundamental.

One function of this unit is the production of the "Directory of Verified Producers". This directory covers a total of 900 enterprises which are listed according to both product and region. It is based on the profile of producers elaborated by regional officers and updated twice a year. Production of the directory is funded by MTI, but buyers contribute to its cost by paying P50 per copy. Its purpose is to match buyers and producers. It is difficult to assess to what extent the directory has fulfilled this function. Buyers have apparently found the directory useful, even though there is a common complaint that suppliers cannot provide sufficient volume. So far, there has been little feedback from manufacturers as to how useful the directory is for them since search costs increase with distance from Manila, the directory could prove to be especially useful in

channeling orders to the far away regions. Hence, even though the effectiveness of the Directory of Producers is difficult to monitor, we recommend that this activity be continued. We would however, suggest an improvement which can be implemented at relatively little extra cost. The product classification used for the directory is already broadly compatible with that of the Bureau of Foreign Trade. The work of both agencies could become more effective if they fully harmonized their product listings. Since the BDT had to develop a very detailed product breakdown for its own purposes, it would be useful if the BSMI directory classified their producers by using this more detailed product break down. It would improve the matching functions of both agencies.

Our more fundamental point is that collaboration between BFT and the lead agency responsible for dissemination of information is of great importance in the marketing areas. The information of overseas markets generated by the BFT is of little use unless it is disseminated to all the regions. Thus

Recommendation 11: Collaboration between the agency responsible for the disseminating of marketing information and the market intelligence operations of the BFT should be institutionalized and thereby upgraded.

3.2.5. Subcontracting

As was outlined in chapter 1, the barriers to entry into industry by small and medium firms tend to be lowest if they enter as subcontractors. Thus, at first glance, programs to promote subcontracting might seem to be a useful way for the Philippines to encourage the participation of small and medium firms in industry. Indeed, the Ministry of Trade and Industry has

taken the initiative in two subcontracting programs with the establishment of SUBCONEX in 1985, and the proposed "expansion of subcontracting" component of the Tulong Sa Tao.

For all of their superficial appeal, it is the view of the Harvard team that public programs have no role in the promotion of subcontracting. On the contrary, to the degree that such programs perpetuate ill-considered conceptions of the obstacles faced by small and medium enterprises, their net effect might be counterproductive.

To begin with a point that already has been made in this report in a variety of contexts, it is the policy environment in general, and its impact on competitiveness in particular -- not any specific intervention on the part of government -- that is the single most important determinant of the extent and vigor of subcontracting in particular industries. The industry studies in chapter 4 illustrate vividly the impact of policy on competitiveness and the role of market competition in determining both the strength of the linkage between subcontractor and assembler, and the efficiency of production by subcontractors.

Two of the sectors analyzed -- garments and rattan furniture -- were subjected to stringent competition in world markets; two other sectors -- automobile components and electronics -- were shielded by protective policies from foreign competition. In both the garment and rattan furniture industries, the press of international competition led producer-assemblers to extend their subcontracting networks as a way of reducing costs, and induced them to provide the financial and technical support that was

needed to enable their subcontractors to meet demanding quality, cost and timing schedules. By contrast, the linkages between subcontractor and assembler were weak in both the automobile components and electronics sectors, notwithstanding explicit government policies (especially in the latter sector) for the promotion of subcontracting. As will be explained in Chapter 4, assemblers in these industries lacked any internal incentives to provide technical and financial support to subcontractors; indeed, insofar as evidence of production limitations on the part of local producers of automobile components helped induce the Philippine government to permit assemblers to procure components from their principals abroad, the assemblers' incentives lay in the direction of limiting support to subcontractors.

The conclusion that policy is paramount in determining the vigor of subcontracting in industry does not in itself imply that there is no role for programs. This latter conclusion emerges from scrutiny of the purported objectives of the programs themselves.

SUBCONEX. A subcontracting exchange, SUBCONEX, was set up in 1985. SUBCONEX endeavors to match subontractors seeking work with manufacturers eager to farm out some of their production. It provides this matching function free of charge.

Interested firms register with SUBCONEX and have to provide information on their lines of specialization, type of machinery, capacity, etc. This is fed into a computerized data bank. To obtain computer print-outs, firms only have to visit or write to the SUBCONEX office indicating what their need. SUBCONEX staff

visits the firms upon registration in order to verify the information provided; but find it difficult to keep the data bank up-to-date and to provide information that is sufficiently specific to a problem.

So far Subconex is a relatively modest operation consisting of four MTI staff and a micro-computer. The scheme was initiated in June 1985 and became fully operative in October of that year.

In the view of the Harvard team, the matching efforts of SUBCONEX have not made, and will not make in the future, any impact on the scope of subcontracting in the Philippines. For one thing, (although it should be conceded that the operation is in its infancy) the total number of matches arranged by SUBCONEX in its first year of operation was miniscule relative to overall subcontracting activity in the Philippines over that same period.

The total number of SUBCONEX matches over the year is 147. (This figure does not include re-orders.) The transactions were spread over 30 different product lines/types of services, of which 26 belong to the garment industry and 4 to gifts and housewares. The total value of these transactions was P1,840,000. (The total vaue of re-orders was P1,740,000.) By way of comparison, the value of payments to subcontractors over the course of a year by one of the (large) garments firms we interviewed was in excess of P40 million.

More fundamentally, in thriving and competitive sectors such as garments (which accounted for the overwhelming majority of SUBCONEX' matches) it is in the interests of principals to search out subcontractors themselves, and it is in the interests of

subcontractors to make known their capabilities and offer their services to as wide a range of potential customers as they are able. Such efforts are -- and should be -- part of the normal course of business. The limited information available through SUBCONEX is hardly likely to add to the accumulated knowledge and contacts of those firms for whom the subcontracting marketplace is the very source of livelihood.

Recommendation 1: SUBCONEX should be abolished; its competent staff could be put to better use elsewhere.

Tulong Sa Tao. An "Expansion of the Subcontracting Program" is part of "Tulong sa Tao" (TST), MTI's response to the President's call to all government agencies to develop programs that will generate employment opportunities in the provinces. TST is essentially a new financing program, the lending features of which are not discussed here (see section on credit programs for small firms). Here we merely wish to deal with that component of TST which has direct relevance for subcontracting and the growth of small firms.

P35 million are earmarked for this "Expansion of the Subcontracting Program." The intention is to make available finance to contractors and subcontractors who wish to expand their operations. The project shall be intiated in Regions III, IV and the National Capital Region. SUBCONEX is to become responsible for the preparation and monitoring of the projects. In its present form, the provision of funds is tied to subcontracting operations. There are two problems with this plan. First, insofar as the principals of subcontractors are

large firms, they are not likely to have difficulty in gaining capital to sponsor subcontractors directly from commercial banks. A financial program is hardly likely to be the inducement that tips the balance in favor of subcontracting over direct production. The second and more fundamental problem is that small firms need the flexibility to move in and out of subcontracting: individual contractors may not be able to provide work throughout the year; and subcontractors might find good opportunities and decide to engage in independent production. The program, however, denies this flexibility because it is tied to subcontracting and ties particular contractors to particular subcontractors. It cements a situation instead of providing space for change, growth (or possibly death). For the same reason, the implementation problems are likely to be enormous. The program would be a straight-jacket for operations which need, above all, flexibility. What matters is that firms grow and that jobs are created, not that they come from subcontracted operations.

Recommendation 2: There is no basis for linking a financing program to the specific subcontracting relationship. The subcontracting component of TST should be dropped.

3.3: Enhancing the Promotional Capacity of the Ministry of Trade and Industry

Section II of this chapter has laid out a series of specific recommendations as to what programmatic interventions can -- and cannot -- aid the promotion of modern small firms. This final section will suggest a series of measures to upgrade the capacity of the Ministry -- and the Small Business Development Group

(SBDG) in particular -- to provide such promotional support.

There are two fundamental differences between the present character of the Ministry of Trade and Industry (MTI) and the character of a ministry that would have the capacity to promote dynamic small firms. First, at present the agencies that are charged with the promotion of small firms operate in relative autonomy from the rest of the Ministry. However, as has been observed throughout this report, it is policy that is the primary determinant of the performance of dynamic small firms. In a ministry that had the capability to promote dynamic modern firms, there would be no dichotomy between the formulation of policy and the promotion of small firms; those agencies responsible for small firm promotion would have direct influence in the policymaking process. Second, at present, MTI is staffed largely by generalists; even the Board of Investments, organized in part along sectoral lines, typically has no more than one or two people with specialized, commercial knowledge of the opportunities and constraints faced by firms in particular sectors of industry. An effective ministry would have in-house a reservoir of sector specialists, capable of devising policy, monitoring performance, delivering effective program support along sectoral lines, and negotiating on equal footing with firms operating in the relevant sector.

Moving MTI from where it is at present to where, in the view of the Harvard team, it ought to be cannot be achieved at the stroke of a pen. Industry specialists cannot be created overnight; nor can the Ministry personnel reponsible for small

and medium enterprises, to this point engaged almost exclusively in the design and implementation of specific programs, be expected to immediately become effective contributors to the policymaking process. The four recommendations below, all of which can be implemented immediately, together can provide the impetus for moving the Ministry in the desired direction. These recommendations should be viewed as complementary to the program-specific recommendations presented in the previous section of this chapter.

Recommendation 1: The SBDG should promote one-stop centers to service the needs of small, modern firms.

With the introduction of regional MTIs, the Ministry already has begun to move towards one-stop service centers for small and medium firms. This trend should be encouraged, and the services of these centers should be upgraded as follows: The centers should be viewed as clearing houses capable of:

(a) directing modern small firms to those existing public programs (finance, marketing etc.) that can help address their particular problems;

(b) aiding modern small firms to navigate governmental bureaucratic procedures (central bank regulations, BOI registration, tariff drawback applications etc.)

(c) directing modern small firms to those industry associations and private support services (traders, technical consultants, responsive financial institutions etc.) that might be of assistance.

If implemented effectively -- and if promoted widely among potential users -- these clearing houses could become the 'eyes and ears' of the SBDG; competent field staff, receptive to the ways in which the external environment throws up obstacles for small and medium firms, could feed information back to a head

office, and thereby provide signals as to what might be priority policy changes, changes in bureaucratic procedures, or program interventions for small and medium firms.

> Recommendation 2: The SBDG increasingly should take on the role of active proponent for policy reform in areas where policy has a significant impact on modern, small firms.

Senior and high-quality mid-level personnel, initially together with consultant support, could build on the policy observations in this report (and other policy issues not examined in this document) and work up detailed proposals for changes in policy and in governmental procedures that are outside the domain of the SBDG's specific areas of responsibility. The initial efforts could focus on topics such as "the impact of BOI incentives on the competitiveness of small firms", "trade liberalization and small firm promotion", and "rural infrastructure and the spread of modern small firms".

These efforts would have three functions. First, they would help keep on the agenda of policymaking issues that otherwise might be neglected. Second, even if the initial efforts were not successful in achieving changes in policy, they would upgrade the capacity of SBDG personnel to engage effectively in the policymaking process. Third, they would give added direction to the task of promoting dynamic small firms by strengthening the strategic capabilities of senior SBDG personnel, and by directing information-gathering efforts within SBDG to those areas where they matter most (by contrast to the present practice of indiscriminate accumulation of data of a kind that serves no useful purpose).

Recommendation 3: The SBDG should collaborate with BOI and other interested agencies within MTI in the formation of specialized cells of industry experts. These cells should be under the direct authority of the Minister or relevant Deputy Minister of Trade and Industry.

The long run objective is that each cell be responsible in its specific sector of expertise, for policy and program design, the monitoring of performance of programs and policies, and adaptation of policies and progams as results come in. The development of such cells would not only break down the formal barriers that presently serve to marginalize isues relevant to small and medium enterprises, they would also enable MTI to accumulate the specialized capacity that -- as has been noted time and again in this report -- is the prerequisite for effective policy and program design for dynamic small firms.

The program should begin modestly, with the selection of no more than two or three narrowly-defined sectors, and the establishment of cells for these sectors. Each cell should contain no fewer than five personnel, at least two of whom should have had advanced business training. Once initial studies of specific sectors and their problems have been completed, the cell should be given the freedom to make and (after appropriate consultation) implement policy and program proposals that cut across normal channels of responsibility within the Ministry. Only after sufficient time has elapsed to evaluate the success (or failure) of the initial experiments should consideration be given to the creation of cells for a wider group of sectors.

Recommendation 4: The SBDG institute training programs and training leaves to upgrade its personnel for their new responsibilities.

The skills required for both the formulation of policy proposals and for sustained intervention at the sectoral level are quite different from the administrative tasks that have to date been the province of most SBDG personnel. Policy formulation requires competence in relevant economic analysis; and intervention in specific sectors requires (along with relevant economics) the kind of business background and specialized sectoral knowledge that is necessary for effective communication with firms. The SBDG should offer support for training to those staff that are judged to have the potential to participate effectively in a SBDG that channels its efforts along the lines proposed here.

NOTES

1. Anderson and Khambata, "Small Enterprises and Development Policy in the Philippines: A Case Study" World Bank Working Paper No. 468;" UP-ISSI, "Changes in the Industrial Structure and the Role of Small and Medium Industries in Asian Countries: The Case of the Philippines;" MTI, "A Review of Cottage, Small and Medium Industries Financing Programs" (1986).

2. Processing costs amount to approximately 2 - 3% of loan value for small firms and only about .4 - .5 % for prime companies.

Chapter 4: Policy and the Participation of Small and Medium Enterprises: Analysis of Five Sectors

As should by now be evident, interviews with firms represented a major effort on the part of the Harvard team. The interviews were conducted with firms from five sectors -- garments, furniture, electronics, metalworking and jewelry. In each sector, a relevant sample was carefully selected, stratified by firm size and by the particular mode of firm participation within each sector. The results of these interviews have influenced all aspects of this report; this chapter will highlight at a sectoral level the most striking findings that emerged from the interviews.

The sectors can be categorized into three distinct groups, each of which has its own distinctive lessons to teach. The first group vividly illustrates the character of dynamic efficiency and the ways in which an outward oriented policy environment can facilitate the emergence of dynamic efficiency in two industries, garments and furniture (especially rattan); in addition, the group provides evidence as to the character of (in these two cases primarily complementary) interactions between large and small firms. In sharp contrast, the second group of sectors, electronics and metalworking, reveals how ill-conceived policies of protection, rather than promoting dynamic efficiency, can lead small and medium firms down a dead-end, where they are unable to survive and adapt to an altered environment; from this second group it is possible to glean some insights as to what might be the character of an effective set of policies for the promotion of "infant" industries. The third "group" actually amounts to

only a single industry -- the jewelry industry; this industry represents an extreme example of how misguided policies can undermine an activity in which the Philippines holds the potential to enjoy a strong competitive position worldwide. The next three sections of this chapter will summarize in detail these relevant lessons from each of the three groups.

4.1 Dynamic Efficiency in Outward-oriented Sectors: The Cases of Furniture and Garments

This section examines the relationship between outward orientation and dynamic efficiency in two nontraditional export industries: furniture and garments. Since the mid 1970s, these two industries have seen a rapid growth in their exports. Garments exports, only $250 million in 1977, are projected to reach $1 billion in 1987. Similarly, furniture exports for the half year, up to June 1986, have already surpassed the total 1977 figure of $36 million.

A number of important lessons emerge from the recent experience of these industries. First, the policy environment is the critical determinant of the efficient participation of small firms. An environment which encourages firms to enter the export markets is the best guarantee of a "dynamically efficient industrial structure" -- one where firms cost minimize, learn, and continuously innovate. This behavior stands in opposition to the nature of firm performance in one heavily protected industry segment which this section reviews -- the wood furniture industry.

Second, there appears to be a fairly narrow range of learning opportunities available in production for the domestic market. Neither the rattan furniture nor the garment export industries provided much support to the proposition that firms need to make their mistakes in the domestic market before going into exports. Third, most successful exporting firms do not simply capitalize on the cheap labor available in the Philippines. Where they really score is in the export of products which have a significant skilled labor component.

Finally, the fast growing nontraditonal export industries are those in which small and medium firms can enter and export with relative ease. Efficient production is the key to their participation. By way of contrast, the protected wood furniture industry allows small firms entry, but not in the way that provides incentives for dynamic efficiency. Participation is contingent on a restrictive trade policy environment which allows inefficient producers of all sizes to survive.

This review falls into two parts. First, we analyze the sharply contrasting performance of the rattan and wood furniture industries. The second component of the review examines the principal lessons which emerged from our interviews in the garment export business.

4.1.1. The Furniture Industry

The Harvard team conducted a series of interviews with a representative sample of rattan furniture exporters, based in Cebu, Pampanga and Manila. Firm size ranged from sales (gross

receipts) of $80,000 (50 regular employees) to $3.2M (450 regular employees and 1500 subcontractors). Seventy five percent (75%) of the firms interviewed had gross sales receipts of less than $1M and employed less than 150 workers. Sixty five percent (65%) of the firms interviewed made regular use of subcontractors and twenty five percent (25%) of the surveyed firms began life as subcontractors themselves. While the largest firms were located in Cebu, 25% of the survey was conducted in Manila and Pampanga in order to get some impression of regional variations in the industry.

We also met a number of wood furniture producers, based in Manila and Pampanga. The size of these firms ranged from 50 to 120 in-house employees with average sales of $400,000. All the firms were either already exporting or were hoping to move into export markets, especially given the current domestic economic situation. Those firms which specialized in hand-carved furniture made some use of sub-contractors for the hand-carving. The firms producing mainly straight - line or plywood - based furniture manufactured entirely in-house.

This analysis of the wood and rattan furniture industries is divided into three main sections. The first section makes use of the experience of firms which produce rattan furniture to explain the terms, a "dynamically efficient industrial structure." The second explores the relationship between the policy environment and the relative failure in the performance of the wood furniture industry. The final section presents the main conclusions which emerge from this comparison.

Dynamic Efficiency and Furniture Exports

In the view of the Harvard team, a dynamically efficient industry is one whose firms profit maximize through effectively competing in the market place, not through political rent-seeking. Firms maximize their profits both by reducing costs and by innovation in product design and development. While cost - minimization is a vital aspect in the static efficiency of any firm, the highest returns are likely to derive from the successful introduction of new product and new methods of production. Firms which are consistently able to innovate and to learn are dynamically efficient enterprises. A dynamically efficient industrial structure is one in which firms compete both on price and on innovation. The industry will be characterized by low barriers to firm entry and, in particular, low barriers to firm expansion. The rattan furniture industry is a paradigmatic example of dynamic efficiency.

(i) Static Cost Minimization

The 2 largest cost components in the rattan industry are labor (which range from 20-30% of total cost) and rattan inputs (22-35% of cost). Cost minimization takes place in 6 main ways:

A. The substitution of the cheaper (Tomalin, Kalapi) poles for the more expensive Palasan poles. Due to increasing scarcity, the real price of Palasan poles has risen by 100% in the last 10 years.

B. The importation (by larger firms) of Indonesian poles, which are cheaper on a lineal meter basis

than domestically sourced Palawan poles.

C. Reduction in material wastage through better inventory controls and the development of products, where there is a greater use of the shorter pole lengths.

D. The introduction of incentive system for the employees. Time-in-motion studies complement the (predominant) piece-rate basis of payment to increase labor productivity.

E. The efficient use of subcontractors. Not only does this practice help reduce overheads (which run on average at 20% of costs), but it allows for the specialized division of labor. While some of the larger firms preferred to contract out whole items, others only used subcontractors for certain limited functions (weaving, framing, sanding).

F. The production of semi-finished products for exports. Many firms export only the 'sanded' items. The finishing and upholstery is carried out abroad. Upholstery, in particular, represents a real problem in that the import of textiles has to be channeled through the GTEB.

(ii) Dynamic Profit Maximization

Innovation has proved critical to the success of rattan exports. Since Philippine manufacturers find it hard to compete head-on with mass-produced Taiwanese

product lines, they have had to emphasize design and quality to gain their share of the world market. The growth of the Indonesian rattan furniture industry - competing on the basis of price rather than quality - makes it imperative that Philippine manufacturers continue to move up market. Today, Philippine firms innovate in 4 main ways:

A. The Philippine industry is largely responsible for a change in the international perception of rattan furniture. 20 years ago, rattan furniture was restricted to the kitchen and the summer house. Today, thanks to a number of pioneering companies, rattan furniture has gained wide acceptability in even the most sophisticated dining room. The best rattan furniture is regarded as non-traditional, chic and fashionable. Philippine firms have changed the <u>image</u> of their industry, thereby widening and deeping the market for their products.

B. Simultaneously, firms are constantly improving their designs and <u>developing their products</u> in response to market trends. Many of the firms which we interviewed produced a very wide range of products (as many as 1000). While such a range makes it difficult to increase labor productivity, most of the product lines were derivative of a number of more basic designs. The larger firms are more innovative in their product lines - not

least because of long standing ties with US distributors and manufacturers. Smaller firms tend to copy last year's best selling lines for sale to a more price - conscious market. "Learning-by-copying" is a critical ingredient of industrial development.

The extent to which this type of learning can trickle down through the industrial structure is directly correlated with the dynamic efficiency of the sector. Larger firms earn their profits through higher return - higher risk innovative activities. Small firms learn from the experience of the larger firms and are able to reproduce the same items more cheaply in the following year. The larger firms - with higher overhead costs - are than forced to move on into new designs.

The rattan industry is one in which "learning-by-copying" takes place at an extremely fast rate. Larger firms, in order to retain their competitive advantage, are forced to introduce new designs on an annual basis. Because learning is relatively fast, small firm entry and expansion in the industry appear to be fairly easy. Innovative behavior by large firms is not simply the consequence of external competition from the Taiwanese manufacturers. It also arises out of an extremely healthy domestic structure in the rattan

industry.

Product development in the rattan industry is not a simple question of increasingly intricate or sophisticated design. It also results from the incorporation of new indigenous materials into the product. Mixing materials - rattan, bamboo, tropical hardwoods, leather, marble - is likely to be an important part of design strategy in the years ahead, especially as firms try to minimize on rattan inputs.

C. Firms have gone out of their way to create new markets. There is a great danger for those firms which are too heavily concentrated in the US market. As the Indonesian furniture industry develops, its first target is likely to be the low end US multiples. Many firms - in anticipation of such a development - are already diversifying their sales away from the US volume market and toward Europe and (particularly) Japan. Both the European and Japanese markets are extremely quality/design conscious and it is in these areas where Philippine producers have a significant comparative advantage.

D. Firms are investing to improve their production systems. This is not merely a response to the need to reduce costs, but reflects a decision to introduce new organizing principles into

production. There are 3 classes of firm in the rattan industry: very small cottage firms where the income earned substitutes for wage employment; small firms, using cottage shop production methods, but with a strategy for the acquisition of expanded capability; and larger firms which are beginning to introduce more scientific principles of management into an industry which remains wedded to a craft mentality. While the middle groups of firms are undergoing a process of continuous adjustment to absorb their fixed investments, the larger firms are making truly innovative investments in their production system. Scientific management involves a break with tradition in the furniture industry: a more systematic approach to the acquisition and utilization of information; a rationalization of resource flows within the factory; an end to paternalistic labor relations.

One of the remarkable features of the rattan furniture industry is that it managed to develop almost in the absence of a domestic market. Many firms produce extensively for export and have always done so. What this illustrates is that there are substantial opportunities to "learning by exporting." Despite the competition from the Taiwanese, the Philippines have been able to carve out a distinctive niche in the international rattan furniture market. Exposure to international markets has resulted

in cost-minimizing behavior and a high return to innovation.

The success of the rattan industry is based on the ability of firms to compete as manufacturers. Firms have made use of the Philippines' chief manufacturing asset -- relatively cheap skilled labor. The Philippines can not compete on wage costs alone. Wages are neither as low as in other South East Asian countries, nor are productivity levels as high as those in Taiwan. The Philippine firms have had to compete on quality and design as well as price.

Government Policy and the Performance of the Wood Furniture Industry

The wood furniture industry is composed of two main groups of firms. First, there is a group of fairly large firms. While of these-- particularly those which produce hand-curved furniture --are slowly entering the export markets, the others are using relatively capital-intensive techniques to produce straight-line furniture for the domestic market. Second, there is a multitude of cottage operations which produce individual pieces on a "made-to-order" basis. This latter group remains wedded to a low productivity workshop mentality. Subcontractual relationships between the two groups are almost non-existent and there is little specialized division of labor within the industry.

An important question, therefore, is why the wood furniture industry has failed to break into the virtuous circle of export performance, small-medium firm participation and dynamic efficiency. This section offers some answers by analyzing the way in which government policies have influenced the structure

and growth of the wood furniture industry. There are three contentions:

(1) Despite BOI incentives for furniture exporters, there has been inadequate support for these firms. The overall bias of the system remains weighted toward production for the domestic market.

(2) The combined effect of domestic sales taxes and protective tariffs encourages firms to stay small and to produce "made-to-order" furniture for the domestic market.

(3) The availability of cheap wood - at less than world prices - has enabled wood furniture producers to remain profitable, despite extremely low levels of labor productivity - especially when compared to Korea and Taiwan.

(1) Trade policy and furniture exports

The BOI today offers a number of tax incentives to those firms which choose to move into furniture exporting. For firms which are already existing, there is a tax credit of 10% of net local content on incremental export sales. For those firms which choose to enter the industry as exporters, there is an additional tax credit amounting to 5% of net value added together with the tax free importation of capital equipment. A series of further tax incentives exist for firms which export more than 50% of their output. A critical issue, therefore, is whether these tax credits provide a sufficient incentive for firms to

invest in relatively high risk exporting activities.

Based on our interview with firms in the wood furniture industry, we were able to derive the average structure of costs in Table I.

Our latest data on tariffs suggests that furniture receives 45% nominal production, while metal and chemical products receive approximately 17% nominal production. If -

Table I

% Cost	
35%	Lumber
25%	Other inputs : largely metal and chemical products
40%	Payment to capital and labor

as our interviews suggested - furniture producers pay 20% less than the world price for their lumber, the effective rate of protection for the wood furniture industry is over 100%. In other words, producers for the domestic market appear to earn 2 pesos for every peso earned by exporters.

If, however, domestic sales taxes are included in the calculation, the story becomes more complex. Furniture is considered a non-essential item and is therefore subject to a 20% domestic tax. If we make the conservative assumption that the producers bear the full burden of that tax, then the domestic manufacturer earns only 1.35 pesos for every peso earned by exporters. If the domestic manufacturers

actually pays the 35% corporate income tax and new exporter pays less than 15% (after the tax credits), then the risk-adjusted rate of return begins to shift in favor of exporting.

Domestic furniture producers have, of course, responded to the 20% sales tax by registering themselves as contractors. Since most of their furniture is "made-to-order" on a contract basis, they claim that they should be

TABLE 2

Type of Firm	Sales Tax (%)	Pre-tax Earning (peso)	Corporate Income Tax (%)	Post-tax Earning (peso)
Exporter	0	1	15	.85
Manufacturers	20	1.35	35	.87
Contractor	4	1.75	35	1.13

subject to only a 4% domestic sales tax. At that point, as Table 2 suggests, the post - tax earnings of domestic "contractors" rise sharply above those both of exporters and domestic manufacturers. Of course, to the extent that domestic producers are able to "negotiate out" of paying 35% corporate income tax, the real advantage conferred by BOI incentives is severely eroded. To summarize, there is no compelling evidence that BOI incentives are sufficient to offset the protection received by domestic producers.

(2) Policy and the preservation of a "craft" furniture industry

The wood furniture industry in the Philippines has not

changed significantly over the last decade. As Table 3 shows, the industry is characterized by a few larger modern firms and an extremely large number of small craft operations. The President on the CFIP analyses the situation as a "preponderance of slightly upgraded production units tolerating inefficiency and very limited production output. When export markets were pushed, we found our products non-competitive. Most of them were not up to standards in terms of quality and technology."[1] While not all the blame can be laid at the door of the government, some of the problems are certainly aggravated by policy. There are 4 principal ways in which government policies and programs have hindered the rational development of the furniture industry:

A. The protection given to the furniture industry has encouraged inefficient techniques of production. Firms are not really forced to cost-minimize and, as a consequence, little functional specialization of production has occurred. Despite the existence of many small firms, very little subcontracting appears to take place. Small firms neither have the equipment to produce completed articles on subcontract basis, nor is there any demand for component parts.

Further, the blanket protection given to the furniture industry has really resulted in a misallocation of resources within that sector. It

is highly debatable whether Philippine producers should be encourage to move into straight-line designs. Not only are they relatively capital - intensive, but they also fail to utilize any of the Philippines' traditional skills in furniture production. As the rattan industry shows, larger firms play a critical role as models for the small firms, who can "learn-by-copying". Large firms make an important contribution to the diffusion of new technology through their demonstration effect on the whole industry. Large firm which produce straight line furniture are extremely imperfect models for small firms, who lack access to the capital necessary for retooling.

B. The effective operation of the sales tax provisions offers incentives for firms to remain as small "contractors" producing furniture on a made-to-order basis. As a consequence, no real industry standards emerge. At best, there is only "local information" on the products which have market acceptability. Severe market segmentation gets in the way of competition and reduces the incentive for firms to innovate and develop.

C. Negative rates of effective protection in the electrical machinery sector have reduced small firm access to domestically - sourced improved technology. Large Manila - based firms have the

capacity to import foreign machinery, especially from Germany, Italy and Taiwan. This option is not realistic for small firms, especially given nominal tariffs/sales, taxes/foreign exchange restrictions which make the cost of importing prohibitive. The net effect of trade policy has been to limit the availability of domestic wood-working equipment and to make importing (for small firms) prohibitively expensive.

D. Government programs have been poorly targeted. Elsewhere in this report, we discuss extensively the problem of the "small firm growth trap". The wood furniture industry is a classic example of this problem. Since many producers are very small craft operations and provide employment in the regions (close to the main courses of wood), they have been favored by government agencies (NACIDA, SMED and others). Too many of these programs have been welfare - oriented and have, in effect, subsidized very low productivity furniture suppliers.

Small producers have been able to generate subsistence incomes and have no incentive to improve their products or techniques of production. They are "firms without a strategy". The Harvard Team is not opposed to welfare programs. They are an important part of the government's work.

However it is important not to confuse these programs with the strategic development of a competitive furniture industry. The internationally competitive production of wood furniture will be based in Manila, Pampanga and, possibly, Cebu. A complete change in attitudes will be necessary if the small regionally dispersed producers are to participate in the rationalization of the industry.

(3) Cheap wood and its consequences for technological upgrading

Limited access to raw materials was an almost constant complaint among the furniture manufacturers. While it is extremely difficult to assess the legitimacy of these complaints, the Harvard team reached 5 main conclusions:

A. Access, not price, is the real issue. Prices tend to be below international levels, significantly so for export rejects and 'shorts.' At times, firms find it hard to get the type of wood that they "need" and are reluctant to use substitutes.

B. Cheap wood is not the solution to the problems of the furniture industry. In fact, it may be one of the major problems of the industry in that it enables firms to keep prices down despite extremely low labor productivity. The furniture industry will never be competitive so long as it sees itself as a secondary processor of wood products. Firms have to be in the business of

manufacturing.

C. Firms display a marked reluctance to substitute between different types of wood. They prefer to stick to very traditional designs and to use a very limited spectrum of the available wood types. Despite the claims of furniture manufacturers, narra is not the only type of locally sourced wood suitable for quality furniture.

This reluctance to substitute - to innovate - is yet another indication of the industry's lack of dynamic efficiency. The contract with the rattan industry could not be more striking (see earlier).

D. Government policies which encourage the diversion of wood on to the domestic market at prices less than the FOB value of the wood will not benefit the furniture industry in the long run. The Government should, on no account, subsidize the supply of wood to furniture producers. There is no market failure to justify any such intervention. At the same time, the government must clamp down on technical smuggling by log exporters. The effect of such practices is to discriminate against domestic users of wood and may reduce the potential value added of wood - based exports.

E. There is no real justification for the ban (except for re - export) on log imports. Given the c.i.f.

price of imported logs, it is highly unlikely that many will leak onto the domestic market. Permitting the import of logs is the easiest way to resolve the problems of access for furniture producers. Only those firms which are efficient manufacturers will consider the use of imported lumber.

Firms in the wood furniture industry repeatedly made two arguments in their interviews with the Harvard team. First, continued protection of the industry was necessary so that producers could make their mistakes in the domestic market before going into exports. Second, guaranteed access to cheap wood was a necessary condition for a successful export furniture industry. In our judgement, both claims are wrong.

On the "infant industry" claim, the rattan furniture industry certainly provides no support for the claim that wood furniture manufacturers need to learn by producing designs first for the domestic market. In fact, tha example of the rattan furniture contradicts this claim. It is extremely difficult to imagine what learning wood furniture producers could do by manufacturing for the domestic market. The lessons derived from domestic market production are likely to be completely inappropriate for the export markets. The highly fragmented "made-to-order" domestic market bears little relationship to the international market where design, consistency (especially on the point of the moisture content) and specialized volume production are at a premium.

The best way to learn about exporting is often to try it out, make mistakes and improve. The belief that manufacturers can learn from their mistakes in the heavily protected domestic market is, in the case of the wood furniture industry, an unreliable guide to policy.

As for cheap access to cheap inputs, firms in the wood furniture industry have to survive and compete on their merits as manufacturers. With the limited exception of narra (on which there is a justifiable logging ban), access to wood does not appear to be a substantial problem. Firms which are prepared to pay international prices for their lumber have no difficulty getting adequate supplies of the right quality. The wood furniture industry's preoccupation with cheap inputs is a smoke screen, covering up a deeper set of problems. The efficiency of furniture production is unlikely to be enhanced by further reductions in the price of the basic input. Nor is there anything in the experience of the rattan furniture industry which might support such a claim. Firms have been able to maintain a sustained increase in their exports, despite a rapid rise in the price of rattan poles. The relationship between dynamic efficiency and cheap inputs does not hold very strongly.

4.1.2 The Garments Industry

In reviewing the garments industry, the Harvard team conducted in-depth interviews with a stratified sample of firms, and interviewed also officials at all three major clothing industry association -- the Garment Business Association of the

Philippines, the (embroiders) and the (EPZA exporters) -- as well as export traders. Twenty percent of the firms interviewed operated solely as subcontractors to a single large exporting principal; ten percent combined subcontracting with production for direct sale, both for the domestic; the remaining six firms --- varying in size from (measured by annual sales) $500,000 to $11 million, and, measured by direct employment, from 120 to 1,400 workers (both measures as of the mid - 1980s) -- produced solely for the export market.

The review of the garments industry helped confirm two key propositions advanced in the review of furniture; in addition, it offered important additional insights on the relation between subcontracting and the participation of small and medium enterprises, and on problems of access to imported intermediate inputs.

1. As with the furniture industry, prior production for the protected domestic market offered few learning opportunities that facilitated subsequent entry into exports. All of the firms interviewed by the Harvard team that were engaged in exporting produced exclusively for the export market; fewer than 15 percent had begun their operations by producing for the domestic market. On the contrary, the interviewees unanimously reported that production for local sale was likely to make firms accustomed to low productivity and low quality production standards that could in turn lead to a learned incapacity to export to the lucrative North American, European and

Japanese markets.

2. The structure of the clothing industry provides opportunities for dynamic small and medium firms to enter and participate in the overall expansion of the sector. The vast majority of direct clothing exporters interviewed entered the industry after 1975. While a small portion -- on the basis of a major prior commitment from a foreign buyer -- reach their present scale within a year of entry, about 80% of the firms expanded steadily from year to year, by dint of the skill and initiative of their founder entrepreneurs.

   Three features of the patterns of expansion of these firms are worth noting. First, their owners were able either to draw directly on family resources or trade on prior family connections with a particular commercial bank to raise the necessary investment working finance, although in the case of one firm, finance was sufficiently strapped that -- at least in the initial months of start-up -- cash on delivery by buyers and credit lines by textile wholesalers were crucial to subsequent success. Second, while half of the firms did their initial learning about production and costs by selling to the local market, the other half went directly to exports; not surprisingly, the initial export orders of the latter firms led to losses, that the entrepreneurs characterized as necessary costs of learning, and financed out of their pockets. Third, although all the

firms interviewed suggested that quota barriers had become more acute in recent years, for none of the firms did quota restraints by importing nations, and the existing rules for allocation of quotas (on which more later) by the GTEB severely retard entry. Indeed, a small proportion of the firms studied the patterns of quota availability to their own advantage; one strategy was to target those noncritical quota items that were plausible export opportunities; as an alternative (less common) strategy was to treat critically as a signal of strong demand, finding buyers looking for short-production runs in these items and, thereupon, badger the GTEB for an allocation of returned, unused quota in these categories.

3. A significant fraction of export production is produced by subcontractors. Within the sample, the share of total production that was subcontracted ranged from a low of 25% for one produce, to a high of 90% for another. The (unweighted) average share of total sales that was subcontracted of the firms interviewed amounted to 44%.

   Although some subcontractors are used cyclically (only when orders exceed in-house capacity) all of the firms have cultivated long-term ties, and endeavor to provide a steady flow of orders to their favored subcontractors. The decision to subcontract --- and our interviews suggested a growing trend towards subcontracting in the industry --- is motivated by

the potential for cost savings, a consideration that looms especially large for industry that operates in a highly competitive international environment: although all firms reported that the rate they paid subcontraction per unit produce amounted to at least the minimum wage equivalent of the production time per unit of output, subcontracting saved on overheads, on the cost of monitoring a large direct work force, and forestalled -- a major concern of clothing producers in the present climate -- the risk of a strike that could shut down an entire operation.

The interviews confirmed that, as was explained in general terms earlier, subcontracting minimized the obstacles faced by small firms seeking the clothing industry: all of the exporting principals provided their subcontractors with ready-cut cloth on consignment, thereby obviating the need for subcontractors to uncover their own sources of high quality, low cost textiles, and reducing substantially the need for working capital. Along with easing the working capital contraints, one third of the firms also provided loans for the purchase of equipment to at least some of their subcontractors. In addition -- along with the standard final inspection of the production of subcontractors to monitor quality-- one half of the firms provided technical support in the form of a quality-control supervisor to their subcontractors.

The opportunity for subcontractors to graduate into direct exporting is highly limited. Although, as noted earlier, subcontracting is a way of learning to be a technically efficient producer, it does nothing to help producers overcome two other key barriers to entry into the clothing business. First, subcontracting in no way prepares entrepreneurs to deal effectively with foreign buyers. Second, insofar as entrepreneurs enter into the clothing industry as subcontrators as a result of lack of both own financial resources and access to the financial sector, as the experience of Firm A (summarized below) suggests, in the absence of collateral, even a history of successful subcontracting will not suffice to persuade commercial banks to be forthcoming with the working capital necessary to operate as a direct exporter. Indeed, despite persistent efforts on the part of the Harvard team to come up with a bonafide subcontractor that had successfully made it into direct exporting, not one person interviewed was able to point us to a single such example.

The paradox of extensive, efficient subcontracting and an inability of subcontractors to transform themselves into direct exporters is one basis for the recommendations on subcontracting that were laid out in chapter 3. Insofar as subcontractors seeking to graduate to direct exporting will face precisely the same barriers to expansion as non-subcontracting small and medium

enterprises, it is there that public resources aimed at developing dynamic small and medium enterprises might most fruitfully be expended.

4. Input sourcing and administration. The issue that most exercised garment producers was the nexus of problems associated with the procurement of textile imports for re-exports as finished clothing. The present system imposes substantial direct and indirect costs on the clothing industry and inhibits Philippine exporters in their efforts to improve their performance on world markets. Moreover, in line with the emphasis of the present study, the system places a disproportionate burden on existing and prospective small and medium clothing exporters.

The direct financial cost of navigating the administrative maze surrounding import procurement is not the major burden, even when the unofficial -- grease -- costs are factored in; according to one firm, the standard cost of clearing a shipment throught customs is P850 (official) plus P450 (unofficial). The major cost lies in the additional time that it takes -- because of the administrative burden -- from the conclusion of a purchase order with a buyer to final shipment of the finished clothing. According to one source, to obtain the necessary clearance to import textiles for re-export through the GTEB and the Central Bank, and then, once the textiles are shipped into Manila harbor, to tranship them

with customs clearance from a bonded warehouse to a factory and thence to subcontractors, can add anything from five to seven weeks (and occasionally even more) to the time it takes to fill an import order.

Time delays add to the costs of clothing exporters in at least three ways. First, they force firms to hold larger sums of working capital as a result of longer lead times from input purchase to final receipt of payment. Second, they create a risk of delayed shipment, and the subsequent imposition of price penalties by foreign buyers (as well as -- if delays are endemic -- a reputation of the Philippines as an unreliable exporter). Third, adding to the time it takes from order to delivery, administrative burdens effectively exclude Philippine exporters from the lucrative, high domestic value added, high fashion end of the garment business. In the face of rapidly shifting styles, if a firm is to bid to manufacture fashion clothing, it must be able to guarantee shipment within sixty days of the placement of orders. At present -- given the administrative uncertainty associated with import sourcing -- most Philippine companies cannot accept orders that require delivery in anything less than four months.

As noted, the burden of administrative costs and associated time delays falls disproportionately on small and medium firms and perspective new entrants into the garment industry. Such firms are less likely to know the

ropes of how to clear rapidly textile shipments through customs. Indeed, prior to the establishment of PIE in 1980, lags of almost a year in the payment of tariff drawbacks for re-exported fabric effectively excluded all but a few small and medium enterprises from garment exporting. Small and medium firms have the least access to, and thus are most burdened by the need for, added working capital. Finally, given the shorter runs of the fashion industry, small firms are disproportionately burdened by the delays associated with the procurement of imported textiles.

The administrative burdens described above all are the result of the failure of almost the entire Philippine textile industry to supply fabric at a price and quality suitable for export. As should now be apparent, insofar as it takes substantial time and sophistication to acquire high quality, low cost textile from abroad, the burden of this failure falls disproportionately on small and medium exporters.

Conclusion

Three principal conclusions emerge from our study of the furniture and garments industries. First, export orientation appears to be the best (though not the only) guarantee of dynamic efficiency and a progressive industrial structure. In both the garments and rattan furniture industries, small modern firms have been able to cope with the high fixed costs of exporting and to expand steadily from year to year. Moreover,

the need for large firms to reduce their costs has created widespread opportunities for smaller firms to enter as efficient subcontractors. Second, there appears to be limited potential for learning (at least in these industries) on the domestic market. In both industries, the domestic market is too fragmented to allow long production runs and quality standards do not meet the requirements of the international market. Infant industry protection is valid only in those industries where firms can genuinely learn by producing for the domestic market. Third, to the extent that local inputs are not competitive, the cumbersome procedures which surround imports for re-export impose extraordinarily high burdens on smaller firms. In particular, the time-delays associated with the present rules tie up the limited working capital resources of the smaller firms in an extremely unproductive way.

4.2 Import Substitution and the Promotion of Local Industry: The Cases of Electronics and Metalworking

The focus of this section is on three segments of Philippine industry that were favored by policies for the promotion of import substitution in the 1960s and 1970s. In two of these segments -- electronic components for consumer appliances, and automobile components -- policy took the form of programs designed to pressure downstream assemblers to increase the fraction of their inputs that they procured locally; in the third segment -- radios -- import substitution took the form of direct protection from foreign competition.

There are two criteria by which these -- and other similar efforts to encourage the substitution of local production for imports can be evaluated. The first -- perhaps more familiar, if less compelling from an economic point of view -- focuses on the share of local consumption that is supplied locally; the higher is this share, the greater the supposed degree of success. The second criterion is not local production per se, but the degree to which local producers -- perhaps with the help of initial protection against import competition -- are able to become competitive on world markets; as has been noted repeatedly in this report, such competitiveness is not viewed as an end in itself but rather a measure of the degree to which firms in a particular industry have evolved in a dynamically efficient direction.

As will become apparent in the course of this review, by both criteria, efforts at import substitution must be judged a failure in the sectors examined here. If the first criterion is used as the yardstick of success, this failure might be attributed in part to insufficient sustained commitment to policies of import substitution on the part of government. A lack of government resolve in enforcing protection is not, however a sufficient explanation for failure in terms of the second criterion, insofar as firms that had succeeded in becoming dynamically efficient would have been able to withstand declines in protection of local markets, and might perhaps themselves have graduated to export markets.

This review will describe the evolution of the three seg-

ments from the early 1970s to the present, and will probe the reasons for the failure of the import substitution. Although one conclusion of the team is that automobile components production (indeed metalworking more generally) has more potential in the Philippines context than does electronics, the interviews were conducted first (and in greater depth) in the electronics sector. The results from that sector will thus be spelled out in most detail; the presentation of the metalworking results will be primarily for the purposes of corroborating the lessons from electronics, with the addition of a few findings that are specific to metalworking itself.

4.2.1. The Electronics Industry

Small and medium enterprises have played a substantial role in both radio assembly and components supply. TV assembly has been dominated in the Philippines (as elsewhere) by larger firms; it is included for this review primarily for the purpose of clarifying the evolution of market conditions faced by local suppliers of components.

The review examines the role and impact of various policies of protection that were put in place to support the three segments of the industry, including the Electronics Local Content Program (ELCP) of 1975-1978, and contrasts these with the kinds of policies that might more effectively induce the emergence of a dynamic, internationally competitive Philippine electronics industry. The next section of this review lays out the experience of each of the three segments in the 1970s and early 1980s, the section thereafter explores the reasons for the failure of these

segments of the industry to develop, followed by an illustration based on the experiences of three firms.

Information for the review is drawn both from interviews and from prior studies of the ELCP. Interviews were conducted with government officials, with the present and former heads of both the Consumer Electronics Producers Manufacturers Association (CEPMA) and the Manufacturers of Electronic Components Association (MECA), and with a carefully selected sample of radio and TV assemblers and manufacturers of electronics components.

Protection and the Development of the Philippine Electronic Industry

In the 1970s, both the assembly of radio and TV equipment, and the manufacture of components for this equipment enjoyed substantial protection from import competition. By the early 1980s, however, government commitment to protection began to wane.

Radio and TV Assembly Table 3 presents data on the volumes of TV assembly in the Philippines between 197x and 198x. Three features underlying these data are worth noting. First, high protection induced foreign suppliers of TVs to the Philippines to establish local assembly operations well before the ELCP of 1975. Second, local assembly of TVs declined precipitously after 1981. This decline was partly a result of an overall decline in local demand, partly a consequence of a 1980 decision on the part of the Marcos administration to permit the duty-free importation of TVs for local sale by a favored client of the President, partly of an increase in smuggled (and thus also duty-free)

imports of TV sets, and partly a result of the shift from ELCP to the Progressive Electronics Export Program. This last shift, made in response to the foreign exchange crisis of 1983, permitted imports only by those companies that were able to earn their own foreign exchange; in consequence, those assemblers whose operations were geared solely for the local market were unable -- at least legally -- to obtain necessary imported components. Third, insofar as TV assembly for the local market was divided among eight or more firms -- including National, Sanyo, Sharp, Sony, Hitachi, Philips, Radio Wealth and Zenith (none of whom at any point controlled more than 15-20% of the market)-- even at the peak of the local market, no firm was able to realize anything like the economies of scale that would make it possible to compete in the international market.

By contrast with TV, at first sight the assembly of radios might seem to provide greater opportunities for small and medium enterprises to play a leading role in the development of an industry capable of competing on the world market. For one thing, unlike the assembly of TVs, there are no overwhelming diseconomies of small scale in radio assembly. Small and medium firms have played a significant role in the industry in Hong Kong, Taiwan and even the USA: in the Philippines they have long been suppliers of cheap radios to low income sections of the population. For another thing, the Philippine market afforded local producers the opportunity to achieve high volumes of production, and thereby -- insofar as the experience of Philippine producers paralleled that in other countries -- improve productivity and

quality while simultaneously lowering unit costs. As with TVs, the importation of completely built up radios had been banned in the late 1960s: according to one interviewee, as of 1978, local demand was in excess of 700,000 units annually. At least three firms, including one wholly local operation, were each able to achieve runs of 200,000 units indeed, the largest local firm (which had begun assembling radios in 1966 with a workforce of only 20 employees) was able, over a period of years, to sell over million units of its most popular model.

Yet for all these advantages, far from being able to penetrate foreign markets, in the early 1980s the Philippine radio assembly business turned sour. By all accounts the small scale assemblers were all but decimated (no official statistics on this key segment of the business are available). One of the two leading foreign subsidiaries had by 1984 pulled out of radio assembly entirely; the leading local producer was forced to cut its workforce (which at its peak had numbered over 200) in half; a third, smaller, assembler saw its volumes decline by two-thirds, from 20,000 units in 1975, to only 6,000 in 1986. In part, the reasons for the failure of the Philippine radio manufacturing industry to take off parallel those for TV assembly: Declines in demand, a loss of import protection in the early 1980s, an increase in smuggling that offset whatever protection did remain and a ban -- except for those companies with diversified products, including some exports lines -- on legal component imports. Unlike TV assembly, however, the opportunities of the 1970s might in principle have represented a foundation on which

at least a small number of local radio manufacturers could have built and thereby become internationally competitive. Yet, for reasons that will shortly be analyzed, none did.

Electronic components and the ELCP As with radio and TV assembly, although some scattered components production had begun spontaneously, it was protection that provided the key impetus to the Philippine electronics component industry. The Electronic Local Content Program (ELCP) was introduced in 1975 to induce assemblers of radios and TVs to increase the fraction of their components that they procured locally. Three kinds of policy support were provided to local suppliers of components. First, many components enjoyed relatively high nominal tariffs. Second, for some components, an absolute ban was placed on importation (although exceptions were sometimes made, in which case the importer was subject to tariff duty). Third, the program stipulated a list of components (many of which were subject anyway to substantial import tariffs, or import bans) to be procured locally. In 1976 and 1977, firms complying with the local content program were subject to sales tax amounting to 7% of the value of their sales, while non-complying firms had to pay sales taxes of 40%.

Partly as a result of the ELCP program, in the 1970s a wide range of components were manufactured locally, including picture tubes for TVs, tuners for radios and TVs, transformers, coils, printed circuit boards, wiring and shaped metal and plastic parts such as metal chassis for radios and speakers, cabinets and knobs. Nonetheless, even at its peak, the extent of localization remained quite limited. For one thing, all sophisticated elec-

tronics components, such as integrated circuits, transistors, resistors and most capacitors continued to be from abroad since there were no local suppliers. For another, the import content of many components produced locally was high: to cite two extreme examples, imported inputs accounted for approximately 80 percent of the value of picture tubes and transformers (by contrast for reasons that will become apparent later, imported inputs -- excluding the costs of licensed technology -- accounted for 5% of the value of the speakers produced locally by one company). Even so, for reasons that are not evident, high tariffs were imposed on the imports of many of the components that were not produced locally, reducing the effective protection on the locally produced items in which they were included.

A striking provision of the ELCP was the requirement (albeit qualified by a series of exceptions) that assembling firms procure components from independent firms rather that integrate vertically. Numerous authors have noted that in practice, this provision frequently was circumvented through the establishment of 'sister' companies. However, the four independent component suppliers interviewed for this study all reported receiving orders that would not have been placed were it not for the ELCP. Indeed, although the transactions between assemblers and these component suppliers have been described elsewhere (Hill,1981) as subcontracting, the relationship was substantially more arms-length than the subcontracting relationship described earlier in the garments and furniture industries. Aside from the provision of product specifications and, on occasion, arranging visits to

the factories of foreign principals, the assemblers provided almost no technical assistance to their suppliers (Hill, Watanabe). Moreover, not only were 'subcontractors' responsible for coming up with working capital for their operations, the principals also were reported to insist on favorable terms of payment, on one occasion as much as 120 days after delivery.

In the face of the dependence of the electronics components industry on local assemblers, it is hardly surprising that as the volumes of TV and radio assembly in the Philippines began to decline, so did the derived demand for electronics components; this decline in demand was exacerbated by a progressive withdrawal of policy support for the ELCP (and thus a continuing decline in the sales tax differential between complying and non-complying firms) as well as by the ubiquitous problem of smuggling. No disaggregated data are available on the resultant mortality rates of Philippine component supplying firms, but by all accounts, the squeeze on the industry was extensive. To cite some examples, four nonintegrated firms interviewed by the Harvard team, one (a producer of TV picture tubes) currently is producing no output, a second is presently managing sales amounting to only one-tenth of its peak sales values, while a third has cut its number of employees in half.

Accounting for the Failures

The introduction to this discussion of industries engaged in import substitution laid out two criteria for evaluation of successful policy -- local content and dynamic efficiency -- and suggested that the latter was the economically more relevant

criterion.

Why did all but one (despite persistent questioning, no other successes were reported to the Harvard team) firm in the Philippine radio assembly and electronics components industries fail to become dynamically efficient during the period of protection from competition?

The central reason lies in the way in which import substitution was pursued: the key policy measure for both radio assembly and components production was the imposition of very high tariffs -- sometimes even bans -- on competing imports. While this protection achieved (at least in part, and until it was undermined both by subsequent policy measures and by smuggling) the objective of getting local production underway, it also had a further, undesired consequence: the levels of profits that radio producers/assemblers and components suppliers were able to enjoy behind protective walls were so high that firms had little incentive to improve their productive efficiency.

In the case of radios, as one interviewee put it, when "the local market was large and profitable enough, why bother to get into the headaches of export?" To be sure, there was substantial competition among local radio assemblers. And, especially in the huge market for radios for low income consumers, the focus of much of this competition was the price of the product. However, shielded as they were by protection from the press of increasingly technologically-sophisticated imports (and, according to three of the four radio assembler interviewees, faced with a domestic market that was anyway resistant to innovation), there

was little pressure on local assemblers to upgrade the quality of their radios. Instead, non-price competition for market share centered on continual changes in the packaging and style of the product: according to one interviewee, not one of his lines had been marketable for any longer than three years. Even the success of the radio product noted earlier that achieved sales of over 1 million units can be attributed to flashy design: this "James Bond" radiophone had the outward appearance of an attache case but, opened into a combined radio/record player. The result of this combination of short runs, fixation with external design appearance, and inattention to quality was that -- for all of the potential learning possibilities of supplying a large domestic market-- not a single local radio producer/assembler was able to become competitive on world markets.

As for suppliers of components for the consumer electronics industry, here too, for as long as it lasted, protection offered a highly profitable alternative to learning to become dynamically efficient. In the face of high tariffs and sometimes outright bans on the imports of particular components, assemblers of radios and TVs often had no option but to place orders with local suppliers at prices that -- no matter how short the production runs, and thus how high the unit cost -- would be sufficiently profitable to induce a local components suppliers to manufacture the item. The net result, as two of the illustrations in the next section reveal, was the emergence of a Philippine components supply industry populated by firms that specialized in custom production of a host of diverse products, rather than the compe-

titive supply of a limited range of items.

The socially unproductive (if privately profitable) pattern of short, high-cost production runs was magnified by the way in which the Board of Investments implemented the ELCP. The BOI's role seems to have been solely to determine which products were to be reserved for local production (and even here, according to numerous interviewees, in the TV industry in particular, in the absence of internal specialized competence, the BOI was often dependent on the advice of local subsidiaries of foreign firms that favored procurement from their parents in Japan). Thus, according to interviewees subsequent to the initial determination of protection, there were no efforts either to limit the number of assemblers or to pressure the assemblers to standardize at least a fraction of their inputs, and thereby provide component suppliers the opportunities for long runs with their associated learning and scale economies. The inevitable consequence was the virtual collapse of the local components supply industry as assemblers became freer to import components (and as smuggling intensified).

A Tale of Three Firms

A review of the strategies of three of the component supplying firms interviewed by the Harvard team, a discussion of the reasons that these strategies were chosen, and the diverse responses of the firms to the crises of the 1980s, serves to illustrate both what can be the impact of public policy on firm behavior, and what kinds of enterprise responses and governmental support can enable firms to become dynamically efficient over

time.

Three strategies and their consequences. All three firms entered the electronics component industry -- the earliest in 1960, the remaining two in 1969 -- with five or fewer employees. The first two, Firm A and Firm B, followed precisely the type of strategy highlighted earlier: both firms produced custom-made components on the basis of designs supplied to them by their assembler clients. Dozens of different products have thus far been produced in the sixteen years of the firm's lifetime, ranging from coils, transformers, metal parts and printing circuit boards to custom designed radio, TV and stereo sets for assemblers. Meanwhile, Firm B produced a wide variety of plastic and metal parts (for example knobs, chassis, cabinets) for assemblers of appliances, as well as car mufflers for participants in the Progressive Car Manufacturers Program.

In order to supply parts of suitable quality, both Firms A and B invested in upgrading their technical competence. Firm A (which was producing the relatively more complex components) upgraded by recruiting engineers; at its peak it had ten engineers engaged in-house in product development. The owner-entrepreneur of Firm B at first adopted a more informal approach to technical upgrading, reading widely and, wherever possible (sometimes, upon request, in factories in the host country of Firm B's client assemblers) observing how more experienced factories produced equivalent products; then in 1975, he sent his son to Germany for a year's training in plastics processing. Yet for all these efforts , given the short-runs (some orders accepted

by Firm B were for as few as 250 pieces) in neither firm was there much emphasis on process innovations that could reduce the unit production costs of particular items.

The strategy of Firm C was different. From its inception, Firm C specialized in the production of a single product -- audio speakers for radio, TV and stereo systems. Moreover, from the start, the owner-manager of Firm C, cognizant of the advantages of specialization, sought to persuade its customers to standardize their product designs around a relatively small number of high quality and competitively priced speaker models. By 1973, four years after initiating production, the firm shifted from batch production to mass, assembly-line manufacturing; by 1977, annual production amounted to over 700,000 speaker units.

As with Firm B, in its first six years of operation, Firm C depended on informal channels of technology acquisition, learning as much as possible from plant visits abroad (as well as from careful scrutiny and analysis of the technical specification provided by multinational firms as they began to place orders with the firms). Then in 1976, the company concluded a 5-year licensing agreement with a Japanese speaker company (which was also the supplier of Firm C's imported components). At the end of the five years (and with the advantage of continued technical support from the Japanese company), Firm C had reached the world technological frontier for its varieties of speakers.

<u>The consequences.</u> The precipitous decline in the local production of radio and TV sets in the early 1980s led, in turn, to reduced derived local demand for the components supplied by

Firms A, B and C. Yet the impact of this decline has been quite different for the three firms.

In response to the crisis, Firm A, one of the new components suppliers of its kind that did not go out of business, cut back to a skeleton staff of only 15 people; sales volume fell from almost $1 million in 1979, to barely $100,000 in 1985; the firm's owner had long geared operations for ready expansion and contraction depending on market demand. Indeed, although he had no plans to close down the firm (it had begun to gear its limited production to printed circuit boards), the owner volunteered that "at this time the Philippines would do better putting its money in agribusiness than in electronics".

The 1980s experience of Firm C was almost diametrically the opposite of Firm A's. The firm's determined efforts at upgrading technology and reducing costs paid off when in 1978 it won (at the initiative of a foreign buyer; the firm's entrepreneur had not at that point begun to seek out orders from abroad) its first export order, with more orders following thereafter.

The import content of the initial export orders was substantial: only four of the twelve components (and of course assembly of the speakers themselves) were produced locally. In time, however, as a way of reducing unit costs further, Firm C began to look for ways to procure locally a higher proportion of the speaker's value. For the most part, local subcontractors, able at the time to enjoy higher margins elsewhere, were not interested in meeting Firm C's high volume, high quality, low price orders. In response, the company integrated upstream itself; by 1986 it

was manufacturing in-house -- by now in-house skills encompassed assembly, metalworking, machine tooling, prototype design, dye-making and even printing -- ten of the twelve speaker components.

When the crisis of the early 1980s came, Firm C barely was affected. By 1980 annual export orders were already approaching 500,000 units. By the mid-1980s, with production averaging about 500,000 units monthly, 70 percent of sales were geared for the export market. By then the firm was employing over 500 workers.

If Firm A represents an example of a firm that was all but destroyed by the economic crisis and policy changes of the early 1980s, and Firm C an example of a firm with a strategy that shielded it almost entirely from crisis, Firm B represents an example where a crisis finally induced an effort to grope towards a dynamically efficient strategy. As the firm's owner manager put it, "supplying a ready market at a profit is an easy decision, even where the long-term prospect is not good, and you learn only manufacture and not marketing." With the collapse of the 'ready market' Firm B was forced to cut its workforce in half, from 300 to 140 workers. In addition, the firm finally was forced to develop a marketing strategy of its own. It has begun to develop new plastics products for retail markets, and also to explore new markets for its auto mufflers.

The initiative with plastics products is still in its infancy and, though apparently promising according to the firm's owner, has not yet yielded concrete results. But the direct marketing of mufflers has proceeded further. In 1983, Firm B, marketing itself as 'the only Philippine muffler maker selling to

the new-car assemblers', opened its own muffler replacement center. On the basis of success of the first center, it opened a second replacement center in 1985, and plans to open more centers in the future. At the same time, the firm's owner began to explore the possibility of exporting mufflers. The lack of experience with export markets (and indeed with export marketing in general) made the initial going difficult, but, at the time of the interview with the Harvard team, the firm had won five small export orders, and apparently was on the brink of signing a long-term contract for the export of 10,000 mufflers per month.

Accounting for the differences. What are the reasons that the three firms responded so differently to set of policies that shaped the electronics industry in the 1970s and 1980s? One reason is that policy had different effects on the three firms. Although in principle all three firms enjoyed substantial protection against import competition, in practice the protection for Firm C was lower than for the others. Although the importation of 4 inch speakers, Firm C's staple product in the early 1970s, was banned, such speakers could nonetheless be imported upon payment of a 70 percent tariff duty (and with side payments -- under the guise that the imports were of 3 and 7/8 inch speakers). Since speaker components were themselves subject to 70 percent tariff duties, in practice, Firm C enjoyed only negligible effective protection.

A second reason has to do with the financial bases of the three firms. According to the firms' owners, while Firms B and C (especially the former) were forced to operate under relatively

tight financial constraints, Firm A had ready access to funds. Firm C, faced with a shortfall of funds relative to its local competitors in speaker production early on, made the decision that its competitive edge lay in quality and in production economies. As noted, the strategy was spectacularly successful; aside from its export successes, Firm C today also controls (according to its owner) 80 percent of the Philippine speaker market.

Firm B, the most capital constrained of the three, based its expansion on commercial borrowing (available to it only after 1968, once the owner had -- by taking advantage of NACIDA's tax credits -- retained sufficient profits to invest in real estate and thereby supply the banks with collateral). Once it became apparent to the firm's owners that the decline in business of the early 1980s was likely to be long lived, in order to maintain payments on its loans, the firm had no option other than to pursue new avenues of business. Firm A, by contrast, was not as highly leveraged and could more readily contract with the downturn and await a recovery, while its proprietor lived in the interim off husbanded resources.

A third reason for differences in the responses across firms had to do with the accidents of the products with which each firm began its operation. Audio speakers appear to lend themselves more readily to the strategy adopted by Firm C than the components manufactured by Firm A and B: opportunities for standardization across assemblers were perhaps greater; the rate of technological change of speakers is moderate, making it possible to catch up with a world frontier that advances relatively slowly;

and the production process is relatively labor-intensive, offering at least one advantage on world markets to a Philippine manufacturer.

The final, most intangible, reason for differences in response has to do with the character of the entrepreneurs themselves. There is no way of knowing how each entrepreneur would have behaved in different circumstances: had the owner of Firm A instead run Firm C -- and vice versa -- what would have been the results? What is clear however, is that the general thrust of policy in the 1970s favored the type of behavior followed by Firm A.

4.2.2. Metalworking/Automotive Parts

The focus of this review is on small and medium firms at the high quality end of the metalworking industry. As noted, one purpose of the review is to explore whether the findings from the electronics industry as to the impact of local content and other protectionist policies are corroborated in a different sector; as will be seen, the impact of these policies in metalworking parallels closely their impact in electronics. A second purpose is to delineate problems and opportunities that are specific to relatively skilled metalworking firms.

Interviews were conducted with the Presidents of the Consolidated Automotive Parts Producers Association (CAPPA), the Metalworking Industries Association of the Philippines (MIAP) and the Federation of Automotive Industries, as well as with a carefully selected sample of firms. Over two-thirds of these firms met the

quality standards of, and supplied original equipment (OEM) to the automobile assemblers, although less than one-third specialized exclusively in automobile parts.

Automotive Components and the Progressive Manufacturing Programs

The history of the PCMP and its sister programs is well known and will not be repeated here. Both the secondary literature and our interviews confirm that the experience of suppliers of components to automobile assemblers parallels closely that of electronics components suppliers. Rather than relate this experience in detail, five key ways in which the two experiences of the two sectors paralleled one another are summarized below.

1. As all metalworking interviewees attested, the local content program did provide learning opportunities and incentives to upgrade the quality of production.

2. The program provided no opportunities for economies of scale and the associated learning. Indeed, all of the firms produced a wide variety of low volume and thus high cost components for the assemblers. The low volumes were in part a consequence of small local market size, in part a consequence of the proliferation of assemblers and auto models offered by each assembler, and in part a consequence of the assemblers' decision to avoid being beholden to a monopolist seller by sourcing each component from more than one supplier. One firm attested that at the peak of the program it was producing over two hundred different components for the various assemblers. The multiplication of low volume products was exacerbated for other firms (a small fraction only in a belated response to a recognition that the

PCMP was in crisis, the remainder as a long-term strategy) by their decisions to diversify their production and produce other metal lines along with automotive components.

3. As has been documented exhaustively by Watanabe (1979), automobile assemblers in the Philippines provided only weak technical support to their subcontractors. None of the firms interviewed reported any direct technical assistance -- apart from testing product quality and providing the design specifications needed for production -- from the procuring assemblers. About one-third of the components suppliers did, however, invest heavily themselves in technology acquisition; these investments included licensing agreements with Japanese producers.

4. As will be explored in more detail in the next section, the decline in the 1980s of orders via the PCMP forced all the firms interviewed (the sample was necessarily drawn only from firms that survived the downturn) to begin to develop new production lines (and new markets) which held the potential of relatively long runs. Indeed, even before the collapse of PCMP orders, the two most progressive firms were in the process of (one had long been established in) cultivating such markets.

5. About half of the surviving components suppliers were endeavoring to move into export markets. These efforts were hampered by a lack of marketing skills, a shortage of working capital, and difficulties in tariff-free procurement of imported inputs. None of the firms that were interviewed received any effective marketing assistance from the export marketing programs.

Specific Obstacles and Opportunities

Along with the similarities summarized above in the experience of small and medium fims participating in the PCMP and of electronics firms, three distinctive features of the former group must also be highlighted.

1. Local capabilities. Unlike the electronics industry where indigenous capabilities remain underdeveloped, there is a substantial reservoir of metalworking skills in the Philippines. This assertion might appear paradoxical to anyone who has surveyed the local industry, with its preponderance of backyard shops, and reconditioned equipment. Resolution of the paradox is to be found in the distinction between product quality and product volume. Although there are a few metal components that can be produced only on highly sophisticated equipment, by all accounts, as long as a customer is willing to pay the price (determined price-cutting by auto assemblers often forced components suppliers in turn to take short-cuts in cost and thus quality), local metalworking shops have the skills -- and equipment -- needed to produce a wide range of products at a quality comparable to metal fabricators anywhere in the world. What local shops do not have is the volume of orders that would justify the purchase of modern, automated equipment capable of producing high volumes at a rapid pace. Indeed, the economics of the Philippine metalworking industry at present dictate that firms organize their production around the flexibility of relatively inexpensive, low volume, labor-intensive equipment. On the basis of the interviews conducted, the Harvard team has little doubt that, were Philippine

metalworkers afforded the opportunity of winning high volume orders, the appropriate entrepreneurial response -- and associated upgrading of equipment -- would be forthcoming.

2. Potential for market diversification and expansion. The OEM market for new automobile components provides little opportunity for independent initiative by Philippine suppliers of automobile components. On the domestic front, the range of opportunities is defined entirely by the character of the PCMP and the decisions of assemblers. Internationally, too, opportunities for independent entry are highly limited. Auto assemblers worldwide cultivate their own network of quasi-integrated components suppliers. To become part of the network it is necessary to produce in very high volume, with very short lead times. No sane Philippine entrepreneur would voluntarily make the investment needed to enter this market without a firm commitment to purchase by a multinational assembler (on which more momentarily). Yet for all of the difficulties of OEM, the range of opportunities is substantially wider for the producers of automobile components and other metal products than it is for electronics firms.

Within the Philippines, producers of auto parts can sell their wares to the replacement aftermarket as well as to assemblers of new vehicles. To be sure, local producers of quality auto components must compete in the aftermarket not only with imports, but also with local suppliers of low cost, inferior substitutes. Even so, the opportunities appear substantial. To cite some examples, one of the firms interviewed has, since its inception in the 1960s, consistently made over 80 percent of its

sales (which totalled over $3 million in 1985) in the aftermarket; a second firm recently has begun to make inroads of its own into this market. On the basis of the skills and volumes obtained in this aftermarket (and from OEM sales) both of these firms presently are exploring opportunities for export onto the aftermarket abroad. A third firm has plans -- and installed capacity -- to enter the export market directly, bypassing the local aftermarket. The export market appears wide open to any firm capable of producing a product competitive in cost and acceptable in quality. The products targeted for export by the three firms are mufflers and radiators, both relatively labor-intensive in construction.

Not only do producers of auto components have the opportunity to sell to the parts aftermarket, they also can readily diversify into any number of machined metal parts. This is not the place to lay out in any detail the kinds of products in which Philippine metalworking firms might have a competitive advantage; even so, two points seem worth highlighting. First, given the high costs of machine downtime, local metalworkers able to respond rapidly with quality replacement parts, have an inbuilt advantage in the custom-made spare parts market, although this is not an advantage that can readily be translated into exports. Second, on international markets, the Philippines is likely to have a comparative advantage in the long-run in skilled labor-intensive metal products. One of the firms interviewed, an experienced, high-quality local tool and dye producer has plants to initiate exports of dyes in the near future. The supply of skilled dye

makers is still relatively scarce; but, if nurtured, exports of metal dyes (and other skill-intensive metal products) could in the long run become a significant source of relatively high wage (by Philippine standards) employment in an export industry.

3. Access to raw materials. A number of firms reported high tariffs on their imported inputs (and/or high margins -- sometimes seven times fob costs -- on the part of metals traders). One entrepreneur, searching for potential export products, reported that the in-factory costs of the raw materials of one product that he analyzed (locally procured steel and chromium plating for a metal multi-purpose opener) were in excess of the price in Hong Kong of the fabricated product. A second firm had plans -- subsequently abandoned -- to produce lathes locally; it was faced with tariffs (or excesses of local cost over fob import price) of 30 percent on copper, electric motors, capacitors and centrifugal switches, and of 17 percent on pig iron and laminated steel. Complete lathes could be imported upon payment of duties on only 10 percent.

From a policy perspective, two features of these complaints seem worth pursuing further. First, it is obviously undesirable that trade liberalization proceed in such a way as to leave metalworking firms saddled with (as is apparently the case in the above two examples) negative effective rates of protection; such a perverse pattern of protection could destroy the local industry in short order. Yet insofar as the phasing of liberalization involves initial reductions in protection on final metal products and only subsequent declines in protection on basic metal inputs,

this is precisely what could be taking place. This is an issue that requires further disaggregated study.

Second, in principle drawback schemes and other tax credits ought to ensure that no exporting firm is saddled with negative effective subsidies on exports. Yet by all accounts the procedure for drawback reimbursement is too cumbersome (and takes too long) to be worth the effort, and tax credits tie up working capital -- with its associated cost -- for the entire fiscal year; moreover small and medium metalworking firms have no access to bonded warehouses. Under these circumstances (especially given the low profit margins on sales in exports, high raw materials share of total production cost, and inevitable cost disadvantages of Philippine firms in the early stage of learning about exporting), there is no way that metalworked exports from the Philippines will be able to take off.

4.2.3 The Promotion of Infant Philippine Industry

The 1970s saw efforts to promote a very wide range of infant metal and electronics industries in the Philippines. As of 1986 these efforts must, for the most part, be adjudged a failure. Even so, some valuable lessons for the formulation of policy to promote industry in the Philippines have emerged from the studies of the two industries.

The industry studies have guided the analysis and recommendations with respect to trade policy that were laid out in chapter 2. Here it will suffice to repeat the two key lessons. First, the analyses of metalworking and electronics confirm that protection for infant industries can be desirable, as long as it is

limited to products where the Philippines has the potential to achieve dynamic comparative advantage in the long run, and as long as protection is geared to fostering this dynamic comparative advantage rather than providing shelter for inefficient industries. Second, if policies of industry promotion are to be effective, it is necessary for the relevant government ministry to have in-house a cadre of personnel with both the technical capabilities and political backing to design these policies and ensure their proper implementation.

Along with these general observations, the industry studies also provide a basis for evaluation of the comparative potential of the metalworking and electronics industries in the Philippines. The opportunities for dynamic expansion appear more substantial in the metalworking than in the electronics industries. The electronics review revealed that with the exception of vertically integrated in-house operations of multinational firms, almost no firm genuinely involved in electronics production (as opposed to production and assembly of plastic or metal parts used in electronics products) gained the strength in the 1970s to make the transition to international competitiveness in the 1980s; instead, for reasons explored earlier, Philippines electronics firms were all but wiped out. Although the transition to exporting by metalworking firms also has been limited, the interviews suggest that the combination of wider local (and foreign) market opportunities and a stronger foundation of indigenous skills could yet provide a base for a dynamically efficient metalworking industry in the Philippines. This conclusion is reinforced by

recognition that technological change has been especially rapid in the electronics industry in the 1970s; for all of the efforts at local promotion, it is plausible to conclude that Philippine electronics firms are at least as far behind the global technological frontier in 1986 as they were in the mid-1970s.

Second, although local assembly of electronics products may be viewed as desirable for its own sake, given the above, there does not appear to be a case for (even with more effective policy design and implementation than in the 1970s) systematically pressing for added local content in finished electronics products. By contrast, given effective policy design and implementation, there is a case (some detailed recommendations are laid out in the appendix to this chapter) for such an effort in the automobile, truck and motorcycle industries. The purpose of these programs should not be the expansion of local content per se, but rather the creation of opportunities for long production runs -- and thereby the promotion of dynamic efficiency through learning -- in new production items.

4.3: The Jewelry Industry

The fate of the Philippine fine jewelry industry offers an extreme illustration of how government policies can arrest industrial development. Policy, instead of supporting the growth of a potentially major export earner has forced an entire industry underground. Only a complete reversal of policy in this area will be sufficient to restore business confidence in the value of legitimate operations. The view of the Harvard team is that the comparative advantage of the Philippines (the

manufacturing sector) lies in its relatively cheap skilled labor. The jewelry industry - where labor skilled in production and design is critical to international competitiveness - exhibits all the characteristics of an activity in which the Philippines has a competitive edge. Products where the skilled labor content is high, must form the heart of any coherent strategy which seeks to encourage non-traditional exports.

The basic story of the underground jewelry industry is by now well-known. Highly distortionary policies raised the return to smuggling. Domestic producers could compete with the jewelry, imported through "informal" trade channels, only by operating their businesses outside the tax system. This report focuses on 2 main issues. First, why did the government lead itself down a path of increasing contradiction in its treatment of the jewelry industry? Second, what have been the real costs of government policies for the domestic jewelry industry? What are the implications of these policies for cost minimization by the firm and for dynamic efficiency in the industry?

4.3.1: The Problems with Policy

Why, then, have government policies been so distortionary and negative in their effort? There are four main reasons, each of which will be discussed in more detail below. First, the government lacks real expertise in industrial - policy formulation. Generalists, who do not understand the complex operation of specific markets, are unlikely to realize the allocative implications of their policy rules. Second, consumption taxes are an extremely poor instrument with which to

address problems of income distribution or ostentatious spending. Third, tariff policies can not be made on the assumption that the Philippines exists in a vacuum. The tariff structure in the Philippines interacts with that of other - especially neighboring - countries. When the policy environment in the Philippines becomes too dissimilar, firms find it hard to compete effectively. Fourth, government needs to understand the relations between the overall policy environment and the real value of its incentive packages and program.

The Need for Government Expertise

Jewelry is not a simple consumption good which can be treated like any other manufactured item. In fact, jewelry exhibits many of the qualities of money. First, it is a highly liquid asset whose value can be easily realized. Second, it represents a form of investment. In much the same way as in the real estate market, holders of precious jewelry expect its value to rise over time. Jewelry has its own implicit rate of return. Especially in periods of high inflation, jewelry is regarded as a safe form of wealth holding. Third, people hold jewelry for speculative reasons. Sales of jewelry tend to rise when the price of gold is low, not simply because individuals want to "consume" more jewelry. Rather, it is a good time to invest in a particular type of non-monetary asset.

Policy, meanwhile, treats jewelry like any other manufactured good. Production is, in theory, subject to a 50% sales tax since jewelry is regarded as a non-essential

consumption item. And domestic producers receive the dubious benefit of tariff protection. The effect of of these policies is to establish an environment which is unconducive to investment in domestically produced jewelry assets. The effect of the tax and tariff regime is not only to increase the costs of "consuming" jewelry. The more important consequence is to reduce the implicit rate of return on Philippine jewelry and to make investment in foreign - produced jewelry more attractive. To summarize, the imposition of taxes on non-essential consumption has had its principal effect on the domestic production of investment assets.

The formulation of appropriate policies for the jewelry industry requires a deep understanding of the complex workings of international gold, precious gem and jewelry markets. Policies which attempt to assimilate jewelry with all other manufactured goods, display a systematic lack of knowledge on the part of the government. There are two general principles here: first, correct policies require expertise; and second, inadequate specialization within the government not only results in poor policies but also undermines the legitimacy of those policies. The government has almost completely lost the confidence of the jewelry industry, which now does business underground subject to constant bureaucratic harassment.

The Real Costs of Sales Taxes

The structure of sales taxes in the Philippines

reflects four (4) major objectives:

(a) the need to generate revenue, made especially significant by the weakness of the direct tax system (re: taxes on income);

(b) a desire to provide some extra protection for domestic products;

(c) the need to make a gesture on the issue of income distribution and;

(d) a belief that "non-essential" items have a lower price - elasticity of demand. Wealthy families who want to buy luxury items will continue to do so, even if the price is higher.

The case of the jewelry industry very neatly exposes the faults in the system. Jewelry is, of course, regarded as a "non-essential" consumption good, and is therefore subject to a 50% sales tax. The key question, therefore, is whether a 50% sales tax is consistent with the above set of objectives.

It is clear that sales tax on jewelry has generated little or no revenue. While some firms pay the retailers' sales tax, there is systematic avoidance of the much steeper manufacturers' sales tax. Arguments based on revenue generation ring somewhat hollow when confronted with the reality of the jewelry industry. In any event, if non-distortionary revenue generation were the real issue, then a single rate of sales tax across all industries would be far more rational.

Nor does a differential sales tax provide a serious answer to the problems of income distribution. In the first place, it is pure hypocrisy to impose one tax on jewelry (50%) and a different tax on, for example, luxury clothing (0%) or on any other "up-market" item which happens to fall within a zero-rated category. Rather, it is an empty gesture to make jewelry the sacrificial lamb of "ostentatious living." Second, if income distribution is the real concern, then the appropriate response is to impose differential rates in a progressive income tax system. It is simply not possible to sneak income redistribution through the back door of consumption taxes. The only effect - in this case - has been to penalize a potentially major dollar earner.

In a closed economy, of course, there is some justification for imposing higher sales taxes on those goods with a low price elasticity of demand. But, in an open economy, where "smuggling" and "overseas travel" provide the informal channels for the tax-free importation of jewelry, the price elasticity argument is no longer valid. Any tax on jewelry which is higher than the "implicit risk premium" for smuggled items inevitably forces the jewelry industry underground, if it is to remain competitive.

The jewelry industry simply cannot be regulated in the same way as other tradeable goods. First, the particular characteristics of jewelry make informal "free trade" channels entremely easy to organize. One estimate, offered

to the Harvard team, suggests that these informal channels account for 80% of the domestic jewelry market. The annual value of jewelry, smuggled into the Philippines, may be as high as 500 million pesos! Second, jewelry cannot be treated like any other consumer good. It has too many of the qualities of a short-term asset and needs to be treated specifically as such.

Tariff Policies in a Vacuum

There is an enormous danger in the assumption that tariff policy in the Philippines can be articulated independently of the policies in other countries. The jewelry industry provides a perfect example of the problem. Nearby countries - especially Hong Kong and more recently Thailand - organize their jewelry industries along free trade lines. As a consequence, tariffs in the Philippines have done nothing to reduce the duty-free flow of jewelry into the country. Again, the only effect has been to force the domestic jewelry industry underground.

A small open economy, such as the Philippines', is constrained in its ability to fix prices in a manner that deviates too significantly from international prices. Jewelry, where the barriers to smuggling are extremely low, is a perfect example of this fact; but it is not the only example. Smuggling in textiles, electronics and even bulkier items, such as cars, is rampant. When there is easy access to goods at international prices, high tariffs simply encourage "abuses" of the import system. There are real

limits in the ability of a country to go it alone! The government should recognize these limits rather than imposing overly-restrictive tariffs and then turning a blind eye to smuggling. The current "logic" simply discredits the whole customs apparatus and discourages the rational allocation of resources.

Incentives in a Vacuum

One argument of the government against liberalizing the jewelry industry is that, for legitimate exporters, there already exist a set of adequate incentives. The claim is that, for firms which export, BOI provisions together with PITC create an essentially free trade regime.

The presumption underlying this claim is that the current policy environment makes it conducive for firms to comply with the regulations. The reality is somewhat different. The jewelry industry, to remain competitive, has been forced underground. The existence of BOI incentives is premised on the notion that policies are compatible with the legitimate operation of businesses. Policies and BOI incentives are a double-edged sword for the jewelry industry. Policy has forced the industry underground and incentives are available only for those firms with a full set of tax receipts.

There is a general principle at stake here. If the government is really committed to the promotion of export industries - and to exports in general - then tax breaks

have to provide meaningful incentives. If production for the domestic market remains more profitable, despite BOI incentives, then questions have to be asked about the government's commitment to export promotion. Unless incentives make the risk-adjusted after-tax rate of return equal (as a minimum condition) in the domestic and export markets, then they have next to no effective value. In the case of the jewelry industry, BOI incentives are not sufficient to offset the adverse effects of the overall policy environment.

There are 3 general lessons for policymakers from their experience with the jewelry industry.

(1) The effects of policies must be constantly monitored. Negative sum policies, where the industry loses and there are no gains to government, must be avoided. If the rules and regulations have negative sum outcomes, then fine tuning will be required. However, modifications of policy should not take place in the absence of consultations with the industry. The current circumstances of the jewelry industry are the result of policies which are completely inconsistent with the workings of the market.

(2) The government needs to be clear about its policy objectives. The sales tax on jewelry has raised almost no revenue and has done nothing to affect income distribution or consumption patterns. Policy instruments must be targeted toward specific objectives. Inhibiting the development of the domestic jewelry industry does not

contribute to improved social welfare.

(3) The government needs to pay more attention to the overall consistency of policy. The two halves of the tax and subsidy system cannot be analyzed in isolation from each other. The combined effect of tariffs, taxes and incentive packages forms the overall policy environment. Firms do not simply respond to a more limited sub-set of signals.

4.3.2 : The Costs of Government Policy for the Jewelry Industry

Highly distortionary tax and tariff policies have not only forced the jewelry industry underground; they have also increased the costs of doing business in 5 main ways:

(a) Firms are unable to acquire gold from the Central Bank. "Underground gold" is often less than the highest quality which forces a reduction in the alloy content of the jewelry.

(b) Smuggled gemstones are often inferior in quality and higher in price than those available in the international markets.

(c) Firms have no incentive to improve their production techniques. In some respects (e. g., casting, rolling) the industry remains fairly primitive and labor productivity is low.

(d) Underground firms cannot, of course, acquire commercial bank loans for working capital. Short-term credit requirements are high in the jewelry industry, given the value of inventories and work-

in-process. "Curb" market rates for the jewelry industry can go as high as 60% per annum and financing charges accounts for between 5-10% of total costs, despite extremely low fixed capital requirements.

(e) The incentives for employee theft are high because of the large black market for gold. Meycauayan jewellers reported that a 10% allowance for gold loss (given to the employees) had now become a standard industry practice.

Increases in the cost structure of individual firms translate into a loss of dynamic efficiency for the industry as a whole. The policy environment has arrested the development of the jewelry industry by:

(a) Encouraging firms to stay artificially small (or to subdivide operations) to avoid bureaucratic harrassment.

(b) Reducing specialization within the industry. In Hong Kong, for example, there are firms which specialize in supplying karat gold in different purities and forms, jewelry castings and findings, polishing and electroplating services to the jewelry industry. In the Philippines, this is not possible and firms do all production in-house.

(c) Increasing the outflow of trained "plateros" to competing countries. Nevertheless, the industry is already taking the initiative to set up

training schools to improve the local supply of skilled workers.

(d) Limiting export opportunities. It is clear that firms smuggle jewelry out of the country in much the same way as they smuggle it in. Unreported exports may account for ten times official figures. However, the underground nature of the jewelry industry prevents firms from developing a systematic approach to the sustained penetration of export markets. As in other activities, there are tremendous opportunities for "learning by exporting" in the jewelry industry. Exposure to best practices and the latest designs is critical for the industry's development.

Despite all these problems, the jewelry industry displays great potential for dynamically efficient operations. First, entry is relatively easy. The initial fixed capital requirements are low and new firms are able to supply the lower end of the market, where quality and design may be less important than price. Second, "learning by copying" is also easy and provides an opportunity for small firms to grow and expand over time. Third, larger and more modern firms (with around 30 employees) already exist in the jewelry industry. These larger firms already benefit from more professional management and will be important role models for a legitimate jewelry industry . The larger firms, interviewed by the Harvard team, already possessed a commitment to innovative design, and tend (even today) to

emphasize the production of jewelry with intricate mounted settings - that part of the market where the Philippines' advantage in relatively cheap skilled labor becomes more important.

4.4: Appendix to Chapter 4

The purpose of this appendix is to summarize those insights and recommendations specific to individual industries that emerged in the course of interviews. Insofar as the development of sector-specific recommendations was not part of the brief of the Harvard team, the list below is not intended to be -- and should not be taken to be -- comprehensive.

The Wood Furniture Industry

Four main issues emerged in the Harvard team's study of the wood furniture industry. First, tariff protection appears to have left the industry in an extremely uncompetitive shape. Second, cheaper inputs are no solution to the problems of the industry. Third, if the industry is to adjust and to become more efficient in the medium term, then changes in the policy environment need to be complemented by a few well-targeted government programs, which help firms to improve their technological capability and to design products suitable for export. Fourth, resource misallocation is not simply the consequence of the present tariff structure. The operation of sales taxes magnifies the distortions in the overall policy environment. Accordingly, the Harvard team would recommend:

1. There should be an accelerated reform of the tariff

protection given to the furniture industry. The nominal rate of protection should be, at most, 20%.

2. Under no circumstances should the furniture industry receive a logging concession. Rather there should be no tariff and no quantitative restrictions on the imports of lumber. In our estimation, only the more efficient (probably exporting) firms will pay the CIF price for lumber imports.

3. (a) The government should conduct an investigation within its own agencies to ascertain the genuine capacity which exists to support

   1) technological development in the wood furniture industry,

   2) export marketing of wood furniture products

   3) realistic product designs for wood furniture.

   The agencies involved in these three functions have to work in a highly coordinated manner if wood furniture is really going to penetrate export markets.

   (b) The government must expand training facilities and subsidize apprenticeships in the furniture industry. The comparative advantage of the Philippines is its relatively cheap <u>skilled</u> labor. Training must be relevant not simply for today's domestic market, but for the higher standards of tomorrow's export market.

4. The sales tax provisions are in need of reform. A flat rate of 15% would be preferable to the current structure, which merely encourages firms to become low productivity "custom-made" furniture suppliers.

B. The Rattan Furniture Industry

The chief policy problem which faces the rattan furniture industry is the diminishing domestic availability of the basic input - rattan poles. The evidence on this issue, however, remains highly fragmentary. Claims about the medium - term domestic supply of rattan poles appear to be based on wholly inadequate information. The Harvard team therefore recommends that :

5. The NRDC complete a thorough inventory of available rattan suppliers.

6. To conserve domestic supplies of rattan in the short run, the government should look for ways to encourage firms to meet their current needs by importing rattan poles. One scheme might involve certain limited working capital subsidies for importing firms.

In addition, the Harvard team is somewhat skeptical about the present system for allocating "rattan concessions." the system appears to favor the larger firms (who in any event are best positioned to import their rattan pole requirements) and cannot be properly supervised, we therefore think that:

7. The "legal fiction" of rattan concessions should be ended. However the government should think carefully in permitting NRDC to monopolize the supply of rattan poles. A better scheme might involve:

   a) A competitive auction for annual concessions, subject to a maximum concession for any firm or trader,

   b) A tax levied on manufacturing firms in proportion to

their sales coupled with the abolition of the current licensing regulations for rattan furniture manufacturers, and

c) The use of revenues generated from (a) and (b) to finance a semi-public/semi-private company, which can invest in replanting rattan. Initial tax rates will have to be sufficiently high to allow a planting schedule which can produce a yield consistent with the medium term needs of the rattan industry.

Garments

In the course of interviews it became apparent that issues relating to the allocation of critical quotas were central to the structure and performance of the Philippine garments export industry. Items that fall in the critical quota category are those that are subject to binding import restrictions in foreign markets; possession of these quotas is sufficient to assure a firm of foreign demand for the relevant product. Rather than review in full the intricacies of the quota allocation system, this section will simply summarize the key findings and recommendations with respect to small and medium enterprises that emerged in the course of interviews.

On the basis of the discussion of the clothing industry in the body of this chapter, it is plausible to conclude that the present system of allocation of quotas does not represent an unsuperable obstacle to potential new entrants, and that given the formidable skills required to effectively navigate the international arena ef-

forts to re-allocate quotas to, say, subcontractors might not only harm the putative beneficiaries, but could even undermine the dynamic efficiency of the industry as a whole. Even so, we believe that, on the margin, the present system of quota allocation, with its disproportionate emphasis on prior performance does discriminate against small and medium enterprises. Thus we propose the following:

> Recommendation 1: The rules for allocation of export quotas should be altered to add to the opportunities for new entrants as follows:
> (a) some small fraction of unused existing quota be reserved for allocation to new entrants, until 120 days prior to expiry;
> (b) some fraction of increments to existing Philippine quotas be reserved for new entrants, and not be entirely distributed among existing firms;
> (c) productive experience gained as a subcontractor by a quota applicant be included in those measures of historical performance that serve as one criterion for quota allocation.
> (d) some fraction of existing and incremental quota be reserved for allocation to firms outside Metro Manila, in Cebu in particular. (See Chapter 2.4 for discussion).

Along with the above four proposals, we commend on grounds of regional equity the recent decision to provide disproportionate weight in quota allocation to production subcontracted to firms outside of Metro Manila.

Metalworking

The recommendations here focus exclusively on ways to support local producers of vehicle components. The first set of recommendations addresses the issue of progressive manufacturing programs for vehicle assemblers; the second focuses on the local aftermarket for vehicle parts.

Given effective policy design and implementation, there is a case for the introduction of redesigned progressive manufacturing programs in the automobile, truck and motorcycle industries. The

purpose of these programs should not be the expansion of local content per se, but rather the creation of opportunities for long production runs -- and thereby the promotion of dynamic efficiency through learning -- in new production items.

> Recommendation 1: For new progressive programs to be successful, the following criteria must be met:
> (a) strict upper bounds should be imposed and enforced on the number of assemblers and number of models per assembler;
> (b) local content requirements should be enforced only on those components where Philippine producers have the potential to become dynamically competitive over time;
> (c) in order to monitor the performance of, and provide support for, local component producers, at any point in time, the number of components for which infant industry type support is provided should be kept highly limited;
> (d) any infant industry support for local components suppliers be contingent upon the attainment of performance targets, in particular of export targets that escalate over time; these exports should be targeted towards both overseas OEM and aftermarkets. All infant industry support should be for a temporary of time only;
> (e) as a condition for their continued operation in the Philippines, local assemblers be mandated to procure -- at prices equivalent to their home country costs -- and export components manufactured by independent Philippine producers for use in new automobile assembly abroad.

Turning to the second recommendation, the producers of automobile components presently are pressing the government to provide protection against import competition in the components aftermarket. Consistent with the general thrust of this report, the Harvard team is opposed to any blanket provision of protection. At the same time, the team believes that, under carefully circumscribed conditions, protection can provide opportunities for learning that can be a springboard into international markets. Thus

Recommendation 2: For not more than six components at any one time, limited protection should be provided against import competition. The import tariff should not exceed 50 percent; such protection should be contingent upon the attainment of pre-specified export targets; in no case should its duration exceed three years; it should be targeted to relatively low cost, labor-intensive items.

Jewelry

Based on interviews with jewelers in Manila and Meycauayan, and on secondary literature, the Harvard team has reached several principal conclusions:

(1) Jewelry cannot be treated like a normal manufactured consumer good. Because of its qualities as a highly liquid short-term asset, it is inappropriate to assimilate the jewelry industry with the rest of the manufacturing sector. For the jewelry industry to thrive in the Philippines, it requires special treatment.

(2) The policy environment has arrested the development of the jewelry industry. Nevertheless, the industry already exhibits the embryonic forms of dynamic efficiency and could become a major export-earner for the country. Although hard figures are difficult to obtain, there is no reason that the Philippines should not be able to emulate the success of Hong Kong, which exports over $500 million of finished jewelry each year.

(3) The jewelry industry in the Philippines appears to have a sustainable long-run comparative advantage. The

government must provide a policy environment in which industries that are skilled labor-intensive can grow and expand. The jewelry industry is one such industry. That the industry already pays twice the minimum wage (average across the interviewed firms) is unambiguous evidence of the jewelry manufacturers' competitiveness in international markets.

(4) A policy environment which is supportive of the jewelry industry could help in the development of a whole series of related activities, where again skilled labor is at a premium. Here, we mention just a few of the possibilities:

(a) the production of silver cutlery and tableware.

(b) the production of high quality watch cases and bracelets: the development of more watch assembly

(c) the production of "findings" for up-market clothes and shoes.

(d) the supply of clasps and other components for the fashion accessory exports.

The basic point is simple: the policy environment should help the Philippines capitalize on the available pool of skilled labor trained in precision work with precious and semi-precious materials. This is especially the case given the potential for SME participation in these industries.

1. Jewelry is quite unlike other manufactured goods. It is not simply a consumption good, but is also a highly liquid, easily smuggled investment item. In light of the

policy environment present in the other South East Asian countries, the Harvard team recommends that the government should completely eliminate:

(a) the tariff on jewelry imports

(b) the tariff on materials, including gemstones, needed for jewelry production.

The present system of tariffs and taxes do little to raise revenues, do nothing to address the problem of ostentatious living, and merely encourage tax evasion.

NOTES

1. p.5, Furniture (1.1 March, 1986).