An Overview of THE PHILIPPINES STRUCTURAL ADJUSTMENT PROGRAM

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THE PHILIPPINES' STRUCTURAL ADJUSTMENT PROGRAM

SUMMARY

The Philippines' Structural Adjustment Program was initiated in 1980 to correct the import-substitution and capital-intensive biases of postwar trade and industrialization policies that had been chiefly responsible for the relatively weak performance of the economy in providing new productive jobs, particularly in the manufacturing sector, since the 1960s. The program's initial phase focused on instituting policy reforms to promote greater local industrial efficiency and international competitiveness, and to improve the country's balance of payments. The reforms effort was phased over time and concentrated on a few sectors to provide the economy sufficient time to adjust to the new policy framework. The first phase involved major policy changes mainly in trade (i.e. tariff reductions and realignment, and import liberalization), industry (restructuring and rehabilitation programs for selected industries) and finance (elimination of interest rate controls).

The current, second phase of the program involves the revision of the investment incentives system, continues the trade reforms started earlier and initiates a review of policies in the energy sector as well as in public resource management. The third phase, expected to start in early 1984, may introduce further reforms in the energy sector, address additional issues on public finance, and initiate policy reforms in the agricultural sector. Support for the program has been primarily provided by the World Bank through structural adjustment loans (cash transfers) that have amounted to $503 million for the first two phases. Meanwhile, the Bank has also provided complementary (credit-type) loans totalling $439 million to specific GOP

industrial and financial sectors (e.g. Textile Sector Program, Industrial Finance Project, and the Third Small and Medium Industry Development Project) which need to adapt to the reforms instituted under the Structural Adjustment Program.

The GOP has steadfastly implemented the policy reforms under the program so far. However, a sluggish world economy has adversely affected expectations and local industries have been slow to undertake the restructuring opportunities fostered by the new policies and loan funds. Therefore, it remains to be seen if the overall program will be effective in achieving its objectives. End Summary.

I. Background

The 1950s and 1960s pattern of industrial investment has been a major cause of the Philippines' current productivity and employment problems, and relatively weak macroeconomic performance. This is because postwar trade and industrialization policies provided strong protection for selected domestic industries, and placed controls on imports and foreign exchange to curb the consumption of "non-essential" imports in response to severe balance of payments (BOP) problems in the '50's. The industrial sector responded well to these policies during the early '50s, with manufacturing output growing by about 12% yearly. In the 1960s, however, the size of the domestic market and its purchasing power started to limit manufacturing production expansion and the sector's output growth declined to only 5%. While virtually complete import substitution was achieved in consumer goods industries and strict import restrictions were gradually relaxed, excessive protection through high tariffs led to high-cost production, inefficient use of resources, very limited export development, and overconcentration of industry around Manila. Furthermore, GOP incentives favored relatively capital-intensive industries, causing manufacturing employment to grow slowly.

By the late '60s, the economy was again faced with a rapid deterioration of the balance of payments, mostly due to the heavy dependence on imported inputs by the manufacturing sector. Although an extensive set of import controls was reintroduced, there was a growing awareness that exports, particularly manufactured exports, needed to be more actively encouraged if the BOP problem was to be checked. Likewise, measures were clearly needed to accelerate industrial output and employment growth and to encourage more efficient use of resources by domestic industries.

Consequently, an Industrial Incentives Act was instituted in 1967, providing fiscal incentives (e.g. tariff exemption for imported equipment, accelerated depreciation, reinvestment allowances) for industrial investment in preferred areas. The Act also created the Board of Investment (BOI) to determine the preferred areas eligible for investment incentives through an annual Investment Priorities Plan and to administer the granting of incentives. Additional fiscal incentives (e.g. tax credit for import duties and domestic taxes paid on inputs) were made available for export production under an Export Incentives Act enacted in 1970. The latter is also administered by BOI, which prepares an annual Export Priorities Plan listing products eligible for incentives.

Moreover, related policy reform measures were adopted by the GOP. These included the floating and subsequent depreciation of the peso in 1970 and the introduction of various export promotion measures design to give selected exporters of nontraditional manufacturers access to duty-free imports. Programs to promote small- and medium-scale industries were also adopted, and the Ministry of Industry was established in 1974. Notwithstanding the significant increase in manufactured exports in the '70s as a result of these selective promotion measures, domestic manufacturing employment and output growth improved only marginally as the greater part of the sector was oriented to the domestic market and affected by severe inefficiencies.

Thus, instead of being the dynamic sector growing much faster than the rest of the economy, manufacturing's performance has not been significantly better than GNP growth in the 1970s and early 1980s. Manufacturing still is a heavy net burden on the balance of payments despite the growth of labor-intensive nontraditional exports. Employment in manufacturing has remained virtually constant at around 10-12% of total employment since the early 1950s, and industry remains heavily concentrated in Metropolitan Manila.

The GOP undertook an extensive review of its economic problems in the mid-70's with ILO and World Bank (WB) assistance, and issued comprehensive reports in 1974 and 1976.1/ This was augmented with further detailed industrial analyses fostered by Bautista and Power in 1979.2/ As a result of these works, the GOP initiated a structural adjustment program in 1980 to correct the import-substitution and capital-intensive biases of postwar trade

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1/ These documents are: Ranis, et. al., Sharing in Development, ILO (1974), and World Bank, The Philippines: Priorities and Prospects for Development (1976).

2/ Bautista, Power, et. al., Industrial Promotion Policies in the Philippines, Philippine Institute for Development Studies (PIDS), 1979.

and industrial policies. The program has been focused on policies (e.g. tariff reforms, trade liberalization, investment incentives, interest rates, exchange rate, etc.) which have the greatest potential for creating industrial efficiency and international competitiveness, and for improving the balance of payments. Basically, it has been aimed at accelerating manufacturing output and employment, sustaining the high growth of manufactured exports and increasing their backward linkages, promoting efficient import substitution and encouraging regional dispersal of industry. These objectives are to be achieved initially through major reforms in the industrial, financial and trade sectors. Since the preparation and implementation of the reforms require considerable time and resources, the program has been phased and concentrated on a few sectors at a time. Support has been provided by the World Bank in the form of new assistance of a cash transfer nature called Structural Adjustment Loans. Phasing has also been important to provide the economy, in particular industrial plants, sufficient time to adapt to the new policy framework.

II. First Phase: Structural Adjustment Loan I (SAL I)

The initial phase of the program has focused on trade, industrial and financial policies which have been a primary cause of low efficiency and suboptimal allocation of investment in the private sector. It covers major trade policy reforms, principally involving the restructuring of the tariff system and import liberalization, some industrial sector restructuring and key financial sector reforms. The World Bank has provided a $200 million loan in 1980 to support the first phase of the program, disbursed in two tranches. The release of the second tranche has been contingent in the satisfactory progress in implementing the tariff reforms and the liberalization of import licensing. The SAL has been directly geared for balance of payments support, with the proceeds used mainly to finance imports of industrial raw materials, intermediate and investment goods, and spare parts authorized as "eligible" by the GOP and the World Bank. The mechanism has been for the loan proceeds to reimburse 100% of the CIF cost of the imports after the Central Bank gives evidence that these have been paid for and imported. The pesos generated by the sale of the foreign exchange have then been used to finance GOP development expenditures. SAL I has financed around 5% of total merchandise imports in 1980.

Under the initial phase of the structural adjustment program, the peak nominal tariff rates for all industries have been reduced from between 70% and 100% to a ceiling rate of 50% by 1982. The protective tariff rates for imports affecting 14 major industries are being realigned to achieve greater uniformity in protection over a five-year period. Such tariff adjustments will reduce average effective protection for the manufacturing sector from 44% to 29%, and will bring the overall rates of effective protection for the economy from 36% to 23% by 1985. A three-year program for the removal of the majority of import restrictions has also been adopted. Of the 1,304 restricted items, more than 70% have been liberalized during 1981-83. The liberalization of most of the remaining import items will be made during the second phase of the structural adjustment program.

The GOP has also implemented industry sectoral restructuring and rehabilitation programs designed to help existing industries produce at lower costs, improve efficiency and increase competitiveness in order to adjust to policy changes. A program for restructuring the cement industry is underway, mainly involving the conversion of cement plants from oil to coal fired kilns, upgrading of equipment and the phasing out of some obsolete plants. A similar rehabilitation program was initiated in 1982 with $157 million World Bank assistance for the textile industry to modernize its equipment and enable it to become more efficient. (Note: It appears that the GOP may cancel $100 million of this loan because it is not being utilized, due mainly to the sluggish world textile market.) Increased financial and technical assistance to small and medium scale industries continues to be provided by the GOP through the WB-supported Third SMI Development Project for the $132 million approved in June 1982.

Reforms in financial sector policies and institutions have been introduced since 1981, aimed at increasing savings and the availability of long-term finance as well as reducing fragmentation and inefficiency in credit institutions. Towards these objectives banking legislation has been changed; interest rates have been deregulated, resulting in positive real interest rates for the first time since 1978; fiscal incentives for term lending and equity investment have been provided; and, a lender-of-last-resort facility have been established by Central Bank. These financial sector reforms have also been the basis for the May 1981 Industry Finance (APEX) loan ($150 million) provided by the World Bank.

III. Second Phase: SAL II

The second phase of the structural adjustment program extends the reform program in the industrial sector through an overhaul of the incentives and promotion system, continues the ongoing trade policy changes and initiates reforms in the energy sector and in public resource management. It is presently being implemented with $302.3 million in loan assistance of a cash transfer nature from the WB, again to be disbursed in two tranches. The first tranche of $202.3 million has been made available when the loan became effective (April 1983). The second tranche of $100 million is contingent on satisfactory progress with respect to the continued implementation of the first phase of the reforms program, in particular the tariff restructuring and import liberalization, and the measures to be implemented for the second phase, particularly those related to trade, industrial incentives and promotion, energy, and public resource management policies. There are several parts to the program:

A. <u>The Incentives Reform Program</u>. Together with the protective trade regime, the incentives system in the Philippines has been a major cause of inefficient use of capital, low labor absorption and regional concentration of manufacturing industry. It has also enabled the BOI to exercise excessive control over private investment decisions by effectively regulating entry into industry. Under the structural adjutment program, the incentives system is being revised to correct its shortcomings, and to allow market forces to play a greater role in guiding industrial investment decisions, while limiting the role of GOP intervention to the identification and treatment of distortions in market indicators. These distortions may take the form of institutional imperfections, policy-induced distortions or inadequate market information.

The new incentives are specifically aimed at compensating investors more directly and fully for market imperfections. The new incentives are also related to industrial performance (e.g. tax credits based on value added) rather than mere investment per se, or the use of capital. A rigorous economic evaluation is to be used in the selection of industrial activities eligible for incentives, which will be available for a maximum period of ten years. While the Board of Investments (BOI) continues to administer the reformed fiscal incentives system to assume a greater role in industrial planning and policy formulation, its regulatory functions are expected to be substantially reduced. This is because the new incentives system, together with the on-going trade and financial reforms, will over the longer term considerably minimize the policy-induced market distortions and thus reduce the need for BOI to control expansion of industrial capacity.

With the recent reforms, the total number of fiscal incentives is reduced from twenty to eight. Of these eight, two are major new incentives; the other six are available in the previous system but are substantially modified. A summary list of the BOI fiscal incentives is provided in Table 1. The reduction in the number of incentives and the substantial simplification of administrative procedures under the new system will make it easier for smaller, regionally dispersed firms to avail of these incentives.

The GOP has estimated that the impact on budget revenues of the new fiscal incentives systems is approximately equal to that under the previous system. This assessment is based on estimates of the revenue forgone if the new incentives had been available to BOI-registered enterprises in 1980. However, the new system is considerably more cost-effective than the previous one since it is performance-oriented, therefore, the revenues forgone are directly related to the contribution of recipient enterprises to the economy. Thus, any increase in budgetary costs of the system are going to be more than compensated by increased manufacturing sector value added.

B. Trade Policy Reforms. In conjunction with the incentives reform program and as a follow-up to the on-going trade liberalization program, the GOP is instituting three more policy reforms in the trade area. First, it has adopted a minimum nominal tariff rate of 10% to complement the movement toward greater uniformity in the structure of protection resulting from the reduction of peak tariffs (from a high of 100% to a ceiling of 50%) which was implemented in 1981-82. The minimum tariff will encourage the growth of potentially efficient import-substituting industries which have been discriminated against under the prevailing tariff restructuring, and will tend to limit the potential negative effects of the on-going tariff cuts on the balance of payments and government budget. This minimum nominal tariff rate will be used as a policy guideline for the second phase of the tariff reform program whichwill be implemented after 1985 when the current round of tariff realignment will be completed.

Likewise, the majority of the remaining import restrictions (on 363 items) will be eliminated, though in several phases to allow time for local industries to adjust, and to spread out the adverse balance of payments effect. A substantial proportion of these restrictions apply to luxury items, the liberalization of which could lead to significant additional imports. It is anticipated that higher internal taxes on both imported and domestically-produced luxury items will be introduced simultaneously to discourage non-essential consumption.

Finally, the differential treatment of foreign and locally produced products under the Philippine indirect tax system will be phased out as part of the overall realignment of the structure of protection. Instead, greater progressivity will be introduced to discourage non-essential consumption and restrain the expansion of luxury imports arising from lower tariffs and import liberalization. The comprehensive reform of the indirect tax structure will involve: (a) removal of the advance sales tax; (b) introduction of a second-stage sales tax; and (c) restructuring of excise taxes. The implementation of these tax changes will be phased to provide a transition period for both producers and consumers.

C. <u>Program Development in Other Areas</u>. The GOP intends to extend the adjustment program to other sectors of the economy. In particular, under SAL II, some issues in the energy sector will be addressed and further improvements in public resource management will be initiated. Agricultural policy will be reviewed and an appropriate reform program formulated in time for the third SAL, expected in 1984.

In the energy sector, an action program will be formulated to adjust the structure of power tariffs and to make appropriate changes in retail and ex-refinery petroleum product prices. The overall level of energy investment will be reviewed. While emphasis will remain on the development of geothermal, coal and hydro resources, increased attention is to be given to the development of non-conventional energy sources such as dendro-thermal, mini-hydro, coco-diesel, and biomass, and their economic and commercial feasibility will be studied. The GOP also plans to study the potential for cogeneration in industrial plants, prospects of energy diversification in the transport sector, and options for rural electrification and financing.

A study of public expenditures and their financing will be undertaken with World Bank assistance, primarily to seek measures to improve the efficiency of public expenditure programs. The study will cover public investment as well as recurrent expenditures, particularly analyzing the size and broad sectoral composition of public invesment in light of limited resource availability. The balance between capital and recurrent expenditures will be re-examined to ensure efficient use and adequate maintenance of a growing stock of public investments. The study will also include an initial overview of public non-financial corporations and prospects for improving their internal cash generation. A more detailed study of these corporations might be undertaken subsequently.

A separate study on GOP financial corporations and preferential credit allocation policies will be made to review the role of GOP in the financial sector and assess the budgetary implications of current policies. Likewise, a review of the tax system will be undertaken, in particular to assess the impact of recent fiscal reforms, e.g. the tariff realignment and the elimination of the advance sales tax. On this basis, new tax measures might be formulated to improve the elasticity and equity of the revenue system and to further improve the tax administration.

IV. Third Phase: SAL III In Preparation

The third phase of the structural adjustment program will introduce further reforms in the energy sector, address additional issues of public finance, and initiate reforms in agricultural policy. While the agricultural sector's overall performance has been quite satisfactory relative to other sectors in the economy, some major sectoral issues have emerged over the last few years. There is the need for further diversification and promotion of commercial export crops to increase the contribution of the sector to the balance of payments. There are also strong indications that Philippine macroeconomic policies have discriminated against agriculture. Notably, past trade policy has resulted in an average effective protection for agricultural activities substantially below that for the manufacturing sector, while pricing and exchange rate policies have also had a negative impact on incomes of farmers. Also, the institutional framework for agricultural policy formulation and implementation suffers from serious fragmentation. The GOP intends to initiate studies in these areas to arrive at a comprehensive program for agricultural policy reform by 1984. The GOP is reportedly seeking a $300-$350 million loan from the World Bank to support this next phase of the program.

V. Potential Benefits and Costs of the Structural Adjustment Program

Since the structural reforms introduced thus far would require several years to bring about the necessary improvements in efficiency and productivity and as a result of the slow world economic recovery, Philippine economic growth is expected to improve only marginally, possibly at a rate less than 5% per year, during the 1983-85. In the medium-term, however, the structural improvements in the allocation and efficiency of resource use should make it possible to restore higher economic growth without causing undue difficulties on the balance of payments. Annual GNP growth is expected to accelerate to 6.5% during 1986-90 mainly as a result of an improved performance of the manufacturing sector due to the restructuring of domestic industries and the expansion of manufactured exports. Furthermore, the new measures would also improve the labor intensity of investment and thus create many new job opportunities. In the manufacturing sector alone, employment intensity should increase as a result of the higher share of labor-intensive nontraditional exports in manufacturing value added and the greater labor intensity of domestic industries because of the reorientation of trade and investment incentives. The greater efficiency of investment would limit the need for substantial additional domestic savings and allow consumption to grow at a higher level.

The World Bank loans provide the GOP quick-disbursing foreign exchange at favorable maturities which will help the economy meet the substantial financing requirements that it faces during the life of the structural adjustment program. For one, the WB loan of $302.3 million for the second phase of the reforms program would finance about 4% of the Philippines merchandise exports and meet about 8% of the country's gross external capital requirements in 1983. Another major impact of the structural adjustment program and World Bank's support is to assure potential international financing sources on the soundness of the GOP's economic policies. The GOP's performance and adherence to the program is then very important since it is a major consideration in any assessment of the country's creditworthiness, and therefore, its access to funds from foreign capital markets at reasonable terms.

On the other hand, the structural reforms program has its own risks and problems. First of all, there are the usual difficulties in estimating the potential quantitative effects of the program on the overall economy. The GOP and WB projections on what the policy reforms may achieve during the decade are based on a set of reasonable assumptions. Neither the magnitude nor the timing of the long-term benefits and transitional disruptions, however, can be predicted with certainty. Thus, while the final economic benefits from the reforms are expected to be substantial, the length and difficulty of the adjustment process is less definite.

Inevitably, the program has adverse impact on the operations of certain industries and sectors, particularly those which have been highly protected under the previous trade regime. The lowering of import tariffs, specifically, is giving the business sector some difficulties considering that most of the country's big corporations are import-substituting industries. Several (mostly inefficient) import-substituting industries are likely to fold up in the face of stiff foreign competition, and this would possibly result in the layoff of thousands of workers. According to Business Day (June 14, 1983), the "transitional unemployment" resulting from the program would involve at least 5% of the current manufacturing labor force, or some 100,000 workers. As a result, the program is already meeting considerable resistance from the private sector. This resistance will undoubtedly increase over time as the effects of the additional policy reforms are felt and if the present economic recession continues.

The external economic environment is also a crucial factor in the successful implementation of the structural adjustment program. It affects the growth prospects for the country's exports and ability to obtain foreign capital. An unfavorable world economic condition could thus adversely affect the pace of the program implementation and delay the realization of its benefits.

So far, the GOP has shown a strong commitment to the reform program by implementing the first phase of the program inspite of the extremely adverse economic conditions during the past few years, and by continuing to prepare appropriate policy measures necessary for the succeeding phases. Moreover, several measures are being taken to offset some of the adverse short-term effects of the program: the industrial rehabilitation and rationalization programs are being implemented to help firms adjust to the more competitive environment; the flexible exchange rate policy is being maintained to protect the balance of payments and avoid pressures to revert to high tariffs and import controls; the reforms are announced in advance and implemented in stages to allow the private sector time to adjust to the new policies. Since subsequent World Bank assistance to the program and, possibly, to other GOP development projects is strongly tied to the satisfactory implementation of the policy reforms, it is likely that GOP's commitment to the structural adjustment program would continue in the future.

TABLE I

PHILIPPINES

SECOND STRUCTURAL ADJUSTMENT LOAN

SUMMARY OF THE NEW BOI FISCAL INCENTIVES

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

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

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

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

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

Note: A pioneer industry is one in which, in addition to being important to national economic development, involves the manufacture or production of commodities or raw materials that are not being produced on a commercial scale in the Philippines, or one which uses a new design, formula or process for producing or transforming raw materials into finished products.