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Chapter 5

Measures of Protection in the Philippines, 1950–71

As has been repeatedly brought out in the last three chapters, the Philippine government employed a wide variety of trade and payments measures as well as fiscal and monetary policies to attract resources to the manufacturing sector and to assist agriculture. These included such devices as exchange controls, protective tariffs, differential sales and compensating taxes, and exemptions from the payment of both domestic taxes and taxes imposed on imported inputs. Although the over-all picture of special incentives provided to the industrial sector is obvious, it is difficult to gain a clear view of the magnitude and relative differences among sectors in these incentives merely from an enumeration of the various policies. The purpose of the present chapter, consequently, is to analyze quantitatively the combined incentive effects of the different policies in terms of various pertinent measures, including effective exchange rates, implicit rates of protection, and effective protective rates.[1]

EFFECTIVE EXCHANGE RATES

One very useful measure of intersectoral differences in the incentives provided by an industrialization program is the effective exchange rate (EER) for various types of transactions, i.e., the number of units of local currency actually paid or received per dollar of a given international transaction. In addition to taking account of the different exchange rates applicable to various types of transactions, the EERs calculated here include the differential impact on these transactions of tariffs, discriminatory sales or compensating taxes,

special foreign-exchange taxes, exemptions from various domestic taxes, subsidized borrowing rates, and margin-deposit requirements on imports. What the concept of EERs does not include, however, is any estimate of protective effects over and above these measures that are caused by quantitative restrictions on the volume of foreign exchange available for a particular import.[2] But, if both c.i.f. and domestic prices are available, the ratio of the domestic price (net of normal distribution costs) of an imported commodity minus its c.i.f. import price (in local currency) to the c.i.f. import price, i.e., the implicit rate of protection, can be used to indicate the impact of either quantitative restrictions or explicitly protective measures. This section contains information on EERs; the next section contains an analysis of the pattern of implicit protection among exchange-control categories.

Tables 5-1, 5-2, and 5-3 contain sets of EERs between 1949 and 1971 for various commodity groups classified according to their degree of essentiality as determined by the exchange-control authorities (the Central Bank).[3] Table 5-2 contains price-level-deflated effective exchange rate (PLD-EERs), which are obtained by dividing the EERs in Table 5-1 by the Philippine wholesale price index. The exchange rates adjusted for purchasing power parity (PPP-EERs), shown in Table 5-3 are calculated, except for exports, by multiplying the EERs in Table 5-1 by the ratio of the U.S. wholesale price index to the Philippine wholesale price index. The export figures are estimated by multiplying the export EERs in Table 5-1 by the ratio of the index of unit values (in dollars) for Philippine exports to the Philippine wholesale price index.

Only from 1960 to November 1965 and again from February to May 1970 were there differences in the nominal exchange rates applicable to different categories of commodities. These differences are summarized in the appendix to this chapter, together with the unified rates that applied in the other years. Also specified in the appendix are the tariffs and other taxes or subsidies employed in calculating the effective exchange rates shown in Table 5-1.

There is considerable variation in the number of commodities included in each of the exchange-control groups listed in the tables, and it must be emphasized that the figures are presented as being typical of the commodity categories rather than as actual averages for the groups. The tariffs and other taxes used in calculating EERs for nonessential consumer goods are unweighted averages for Valdepeñas's 32-commodity sample of such goods.[4] Between 1949 and 1961 the essential producer goods category is represented by an unweighted average of Valdepeñas's sample of 53 goods.[5] From 1962 on, however, the degree of protection on mechanical and electrical equipment is used to represent the category.[6] Tax or subsidy rates for some of the other categories are also based only on a few representative commodities. The tariff and other taxes applicable to thermos bottles are used to represent the semi-

TABLE 5-1

Effective Exchange Rates, 1949–71
(pesos per U.S. dollar)

Category	1949	1950	1951	1952	1953	1954	1955	1956	1957	1958	1959	1960
Imports												
Consumer goods												
Nonessential	2.05	2.05	3.39	3.39	3.39	3.34	3.68	3.86	4.12	4.17	5.06	6.97
Semiessential	2.05	2.05	2.42	2.42	2.42	2.37	2.38	2.60	2.40	2.67	2.83	4.38
Essential	2.00	2.00	2.03	2.03	2.03	2.04	2.04	2.11	2.10	2.10	2.16	2.24
Producer goods												
Nonessential	2.05	2.05	2.42	2.42	2.42	2.36	2.38	2.51	2.50	2.52	2.67	4.25
Semiessential	2.00	2.00	2.37	2.37	2.37	2.37	2.37	2.45	2.48	2.50	3.07	3.10
Essential	2.00	2.00	2.37	2.37	2.37	2.37	2.38	2.48	2.48	2.51	3.09	3.12
For "new and necessary" industries	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.03	2.03	2.08
Exports												
Traditional	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.22
New	2.24	2.24	2.24	2.24	2.32	2.32	2.32	2.32	2.32	2.32	2.30	2.51

(*continued*)

TABLE 5-1 (*concluded*)

Category	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970	1971
Imports											
Consumer goods											
Nonessential	7.02	10.04	11.24	11.10	11.95	11.69	11.77	11.91	11.94	17.67	19.26
Semiessential	4.46	4.95	5.54	5.47	5.65	5.49	5.53	5.61	5.62	8.33	9.11
Essential	3.15	3.74	4.24	4.24	4.29	4.29	4.29	4.29	4.29	6.48	7.04
Producer goods											
Nonessential	4.28	6.55	7.45	7.38	7.90	7.75	7.79	7.84	7.87	11.74	12.81
Semiessential	4.04	4.06	4.53	4.46	4.45	4.34	4.38	4.43	4.44	6.60	7.23
Essential	4.06	4.42	4.89	4.86	4.99	4.92	4.93	4.97	4.95	7.43	7.62
For "new and necessary" industries	2.92	3.44	3.90	3.90	3.90	3.90	3.90	3.90	3.90	5.89	6.40
Exports											
Traditional	2.68	3.15	3.52	3.52	3.90	3.90	3.90	3.90	3.90	5.15	5.76
New	2.95	3.37	3.72	3.72	4.13	4.13	4.17	4.17	4.17	6.54	7.26

SOURCE: See text.

TABLE 5-2

Effective Exchange Rates Deflated by the Wholesale Price Index, 1949–71
(pesos per U.S. dollar; 1955 = 100 for the wholesale price index)

Category	1949	1950	1951	1952	1953	1954	1955	1956	1957	1958	1959	1960
Imports												
Consumer goods												
Nonessential	1.87	1.92	2.84	3.09	3.12	3.26	3.68	3.74	3.83	3.75	4.49	5.94
Semiessential	1.87	1.92	2.02	2.21	2.23	2.31	2.38	2.52	2.24	2.40	2.51	3.73
Essential	1.82	1.88	1.70	1.86	1.87	1.99	2.04	2.05	1.95	1.89	1.92	1.98
Producer goods												
Nonessential	1.87	1.92	2.02	2.21	2.23	2.30	2.38	2.43	2.32	2.27	2.37	3.62
Semiessential	1.82	1.88	1.99	2.18	2.20	2.32	2.37	2.38	2.30	2.25	2.72	2.64
Essential	1.82	1.88	1.99	2.18	2.20	2.32	2.38	2.41	2.30	2.26	2.74	2.66
For "new and necessary" industries	1.81	1.87	1.67	1.82	1.84	1.95	2.00	1.93	1.85	1.83	1.80	1.77
Exports												
Traditional	1.82	1.88	1.67	1.83	1.85	1.95	2.00	1.94	1.86	1.80	1.77	1.89
New	2.04	2.10	1.87	2.05	2.10	2.26	2.32	2.25	2.16	2.09	2.04	2.14

(*continued*)

TABLE 5-2 (*concluded*)

Category	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970	1971
Imports											
Consumer goods											
Nonessential	5.70	7.76	7.92	7.47	7.87	7.38	7.09	6.98	6.95	8.60	8.10
Semiessential	3.62	3.82	3.90	3.68	3.72	3.46	3.33	3.29	3.27	4.06	3.83
Essential	2.56	2.89	2.99	2.85	2.82	2.71	2.58	2.51	2.49	3.16	2.96
Producer goods											
Nonessential	3.47	5.06	5.25	4.97	5.20	4.89	4.69	4.59	4.58	5.72	5.39
Semiessential	3.28	3.14	3.19	3.00	2.93	2.74	2.64	2.59	2.58	3.21	3.04
Essential	3.30	3.42	3.44	3.27	3.28	3.10	2.97	2.91	2.88	3.62	3.21
For "new and necessary" industries	2.37	2.67	2.75	2.62	2.57	2.45	2.34	2.27	2.26	2.87	2.69
Exports											
Traditional	2.18	2.43	2.48	2.37	2.57	2.46	2.35	2.28	2.27	2.51	2.42
New	2.39	2.60	2.62	2.50	2.72	2.72	2.51	2.44	2.43	3.18	3.05

SOURCE: See text.

TABLE 5-3

Effective Exchange Rates Adjusted for Purchasing Power Parity, 1949–71
(pesos per U.S. dollar; 1955 = 100 for underlying price indices)

Category	1949	1950	1951	1952	1953	1954	1955	1956	1957	1958	1959	1960
Imports												
Consumer goods												
Nonessential	1.67	1.79	2.94	3.12	3.12	3.25	3.68	3.87	4.07	4.04	4.85	6.42
Semiessential	1.67	1.79	2.10	2.23	2.23	2.30	2.38	2.60	2.37	2.58	2.71	4.03
Essential	1.63	1.75	1.76	1.88	1.87	1.99	2.04	2.11	2.07	2.03	2.07	2.06
Producer goods												
Nonessential	1.67	1.79	2.10	2.23	2.23	2.29	2.38	2.51	2.47	2.44	2.56	3.91
Semiessential	1.63	1.75	2.06	2.20	2.19	2.30	2.37	2.46	2.45	2.42	2.94	2.85
Essential	1.63	1.75	2.06	2.20	2.19	2.30	2.38	2.49	2.45	2.43	2.96	2.87
For "new and necessary" industries	1.63	1.75	1.74	1.83	1.84	1.94	2.00	2.00	1.98	1.97	1.94	1.91
Exports												
Traditional	n.a.	2.57	2.46	2.00	2.47	2.18	2.00	1.96	1.93	1.89	2.15	2.34
New	n.a.	2.88	2.76	2.24	2.86	2.53	2.32	2.28	2.24	2.32	2.47	2.65

(*continued*)

TABLE 5-3 (*concluded*)

Category	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970	1971
Imports											
Consumer goods											
Nonessential	6.13	8.37	8.52	8.05	8.65	8.39	8.07	8.15	8.43	10.81	10.51
Semiessential	3.53	4.13	4.20	3.97	4.09	3.93	3.79	3.84	3.97	5.10	4.97
Essential	2.75	3.12	3.21	3.08	3.11	3.08	2.94	2.93	3.02	3.96	3.84
Producer goods											
Nonessential	3.73	5.46	5.64	5.35	5.72	5.56	5.34	5.36	5.56	7.18	6.99
Semiessential	3.53	3.38	3.43	3.24	3.22	3.16	3.01	3.02	3.13	4.04	3.94
Essential	3.55	3.68	3.70	3.53	3.61	3.52	3.38	3.40	3.49	4.54	4.16
For "new and necessary" industries	2.55	2.87	2.96	2.83	2.83	2.78	2.66	2.65	2.74	3.61	3.49
Exports											
Traditional	2.61	3.10	3.66	3.62	4.00	3.90	3.97	4.09	3.98	5.57	5.62
New	2.88	3.32	3.86	3.82	4.24	4.13	4.24	4.37	4.26	7.08	7.08

n.a. = not available.
SOURCE: See text.

essential-consumer-goods group and the rates for canned milk and antibiotics, the essential-consumer-goods category.[7] Nonessential producer goods are represented by loudspeakers; and semiessential producer goods, by aqua ammonia.[8] Producer goods used by "new and necessary" industries cover those producer goods that were exempted from paying import taxes throughout the period.[9] Finally, new exports cover those manufacturers who received tax-exempt treatment and loans at below-market interest charges, and the traditional export group is represented by such agricultural exports as sugar, copra, and coconut oil.

The Structure of Effective Exchange Rates, 1949–71.

A consideration of the changes over the period in the differential incentives provided for the local production of nonessential consumer goods, essential consumer goods, producer goods used in "new and necessary" industries, and new exports not only brings out the types of measures included in the estimates of EERs in Table 5-1 but also indicates the basic nature of Philippine protectionist policies. Since there was a unified exchange rate in the Philippines until 1960, differences in EERs among various types of transactions up to that year are due only to differences in taxes or subsidies applicable to those transactions. In 1949 and 1950, American goods still entered the Philippines duty-free, and the sales or compensating tax was not yet discriminatory between imports and domestic production. The only barrier to importation was and 80 per cent margin-deposit requirement on luxury and nonessential items. On the basis of a 12 per cent interest rate and an average three-month holding period for the deposit, this is equivalent to an additional import cost of 2.4 per cent. The EER for nonessential goods was, therefore $1.024 \times P2.00 =$ P2.05 per dollar. In Table 5-1 this rate is listed for nonessential consumer goods, while the official rate of P2.00 per dollar is given for essential consumer goods and producer goods used in "new and necessary" industries.

The EERs in Table 5-1 on new exports are to be interpreted as equal to the official rate plus the subsidy rate on annual sales for producers of these products. It is assumed that these firms could borrow from such government institutions as the Development Bank of the Philippines at 2 per cent below the free-market rate. From 1949 through 1962, assistance to firms producing new exports consisted of exemption from a varying proportion of internal taxes and duties on imports of capital goods, as well as easy financing terms (see the appendix to this chapter for more details). In 1949 and 1950 the combined tax and borrowing subsidy to producers of new exports was 12.2 per cent, a figure that yields an EER per dollar of P2.24 ($= 1.122 \times P2.00$).

The pattern of a high degree of protection from import competition to domestic producers of nonessential goods and a low degree of protection to

local producers of essential consumer goods and essential producer goods began to emerge by 1951. Tariffs were still not being imposed on U.S. imports because of the preferences granted American goods, but the base of the sales tax on luxury items was changed to grant protection to local producers equivalent to a 50 per cent duty. A slight degree of protection, 1.75 per cent, resulted from similar sales tax changes for essential consumer goods. In addition, the special 17 per cent excise tax on sales of foreign exchange was levied in 1951, but with essential consumer goods and capital goods for "new and necessary" industries being exempted from this tax. Thus, in addition to the protective effects of the 80 per cent margin-deposit requirement ($0.024 \times P2.00 = P0.05$), the EER for imports of nonessential consumer goods exceeded the official figure of P2 per dollar both because of the discriminatory sales tax ($0.5 \times P2.00 = P1.00$) and the 17 per cent special excise tax on foreign exchange sales ($0.17 \times P2.00 = P0.34$). The combined impact of these taxes is an EER of P2.00 + P0.05 + P1.00 + P0.34 = P3.39 per U.S. dollar. The EER for imports of essential consumer goods in 1951 was $1.0175 \times P2.00 = P2.03$ per dollar. Since no import taxes were levied on producer goods for new industries, the EER for this group remained at P2.00 per dollar. Imports of a dollar's worth of nonessential consumer goods, therefore, cost Philippine importers nearly 70 per cent more than a dollar's worth of producer goods for new industries. Various tax exemptions and low-cost borrowing privileges extended to firms producing new exports again amounted to 12.2 per cent of sales and maintained an EER of P2.24 per dollar.

The protection provided local producers of nonessential goods continued to rise throughout the 1950s for several reasons. Most important were the gradual reduction in the degree of preferential treatment for U.S. goods and the substantial increase, in 1957, in tariffs on luxury goods. As these occurred, additional protection was provided by the discriminatory sales tax, which was based on the c.i.f.-plus-duty price of imports. The special 25 per cent margin fee on foreign exchange was also introduced in 1959. On the other hand, essential consumer goods were subject only to a rather modest tariff and a small discriminatory sales tax, while essential producer goods for "new and necessary" industries were not subject even to those taxes.[10]

During the early part of the decontrol period, 1960 and 1961, the increase in the cost of a dollar from 2 pesos to 3.0 pesos acted to raise the EER for nonessential consumer goods, whereas the gradual decline in the special import tax (the replacement for the tax on foreign exchange) and in the margin fee operated to reduce it. On balance, however, this rate rose from P5.06 per dollar in 1959 to P7.02 in 1961. In 1962, the decline in the margin fee on foreign-exchange sales, from 15 per cent to zero, was more than offset by the additional depreciation of the peso to P3.90 per dollar, the rise in the average statutory duty level for the sample of goods in this category from 51

per cent to 83 per cent, the increase in the proportion of Philippine tariffs applicable to American goods from 50 per cent to 75 per cent, and the introduction of a special time-deposit requirement for imports. As a result, the EER for nonessential consumer goods jumped to P10.04 per dollar. This rate increased somewhat further in 1965 when the share of Philippine duties applicable to U.S. goods rose from 75 per cent to 90 per cent, producing a stronger upward impact than the decline in the special import tax. Throughout the rest of the 1960s, variations in required margin deposits against imports were the only cause of changes in the EER for nonessential consumer goods, and did not significantly affect it. However, in 1970 the depreciation of the peso to an average of nearly P6 per dollar again brought about a substantial rise in the EER for nonessential consumer goods.

As is indicated in Table 5-1, until 1961, when the exchange rate for imports of essential consumer goods was increased above the traditional level of P2 per dollar, the EER for these goods rose only slightly, while the rate on producer goods for new industries remained unchanged. Fixing the exchange rate at P3.90 per dollar, in mid-1962, acted to raise the EERs for these two classes of imports significantly. Other forces influencing the level of EERs in that year were a reduction in the statutory duty rates on many essential consumer goods, the rise in the proportion of tariff rates that were applicable to imports from the United States (relevant only for essential consumer goods, since imports of producer goods for new industries were exempt from import duties), and the elimination of the margin fee on sales of foreign exchange (applicable only to producer goods for new industries, since essential consumer goods were exempted from this charge). The net impact of these factors was an increase in the EERs for essential consumer goods to P3.74 per dollar and for producer goods used in "new and necessary" industries to P3.44 per dollar. The EER for essential goods again rose in 1963, but then changed little until 1970. The rate for "new and necessary" industries remained at P3.90 per dollar from 1962 to 1969.

The EER that applied to new exports increased in 1960 due to a rise in the official exchange rate for new exports to P2.30 per dollar. This increase, coupled with tax and interest subsidies, which declined somewhat from 1959, brought about an increase in the effective rate for this category from P2.30 to P2.51 per dollar between 1959 and 1960. Through the mid-1960s, the main factors affecting this rate were increases in the exchange rate applicable to export transactions, first to P3.5 per dollar in 1962 and then to P3.90 per dollar in 1965. The Investment Incentives Act of 1967 provided a slight increase in the EER, but the major increase after 1965 occurred in 1970 with the peso depreciation and the increase in export subsidies associated with the Export Incentives Act of 1970.

As is clearly brought out in Table 5-1, the Philippine government em-

ployed exchange-rate, fiscal, and monetary policies to increase sharply the peso costs of importing so-called nonessential consumer and producer goods. In the late 1940s and early 1950s nonessential consumer goods tended to consist of items consumed only by the higher income groups, while nonessential producer goods tended to comprise the raw materials and capital goods needed to produce these nonessential consumer goods. As the 1950s progressed, however, these categories were used more and more to protect from import competition those commodities that government officials decided could be produced domestically in acceptable quality and without incurring unreasonably high costs. As noted in Chapter 2, one exchange-control category, namely, unclassified items, consisted of commodities which in the opinion of government officials were in adequate local supply and whose importation was, therefore, virtually banned. Many items in the nonessential groups were given even greater protection by shifting them into this unclassified group.

TABLE 5-4

Relationships Among Effective Exchange Rates for Various Exchange-Control Categories, 1950–70

Ratios of Categories[a]	1950	1955	1960	1965	1970
NEC to EC	1.02	1.80	3.12	2.78	2.72
SEC to EC	1.00	1.55	1.87	1.32	1.28
NEC to TX	1.02	1.84	3.14	3.06	3.43
SEC to TX	1.02	1.19	1.93	1.45	1.62
NEC to NX	0.92	1.59	2.78	2.80	2.70
EC to NX	0.89	0.88	0.89	1.04	0.99

SOURCE: Table 5-1, above.

a. The abbreviations stand for the following exchange-control categories: NEC, nonessential consumer goods; EC, essential consumer goods; SEC, semiessential consumer goods; TX, traditional exports; and NX, new exports.

As is clearly expressed by the data in Table 5-4, between 1950 and 1960 the EERs among exchange-control categories changed in such a manner that there was a strong incentive to shift resources from the production of essential items and export products to the production of nonessential and semiessential goods.[11] The most important point to be made about the decontrol efforts in the early 1960s and developments during the rest of the 1960s is that they did not restore EERs for the various groups of imports to those observed prior to the exchange-control period. However, the incentives favoring

the production of nonessential and semiessential consumer goods relative to essential consumer goods and exports were generally weaker in 1970 than in 1960.

Real Changes in Effective Exchange Rates, 1949–71.

The price-level-deflated effective exchange rates (PLD-EERs) in Table 5-2 as well as the purchasing-power-parity-adjusted effective exchange rates (PPP-EERs) in Table 5-3 also bring out the protective aspects of Philippine trade policy as well as the adverse effects of this policy on exporters. Except for essential consumer goods and essential producer goods used in "new and necessary" industries, the real peso cost of a dollar's worth of imports, i.e., the PLD-EER, increased substantially during the 1950s. For the sample of nonessential consumer goods, the rise between 1949 and 1959 was 140 per cent,[12] while for essential consumer goods, the increase was only 5 per cent. On the other hand, the domestic purchasing power of a dollar's worth of exports actually decreased 3 per cent between these years. Of course, these relationships ignore changes in world market prices. Using changes in U.S. wholesale prices to indicate the international purchasing power of a dollar, the PPP-EER (i.e., the EER multiplied by the ratio of U.S. wholesale prices to Philippine wholesale prices) for imports of nonessential and essential consumer goods increased by 190 per cent and 27 per cent, respectively, between 1949 and 1959. As previously noted, in order to indicate changes in the quantity of Philippine exports needed to earn a dollar, the unit value (in dollars) export index of the Philippines is used rather than the U.S. wholesale price index. The ratio of this price index to the Philippine wholesale price index multiplied by the effective exchange rate for traditional exports, i.e., the PPP-EER, decreased 16 per cent between 1950 and 1959 (24 per cent between 1950 and 1956), indicating that the domestic purchasing power of exporters was considerably poorer at the end of the decade than at the beginning.

The elimination of exchange controls reversed this downward trend in the purchasing-power position of exporters. For example, the PPP-EER for traditional exports increased 44 per cent between 1959 and 1962. The impact of the exchange-rate liberalization on producers of import substitutes cannot be completely determined from Tables 5-1, 5-2, and 5-3 because of the existence of quantitative import controls in 1959. However, wholesale prices of such items as nonessential and unclassified consumer goods (see Table 5-6, below) increased less than wholesale prices in general between 1959 and 1962, whereas the opposite is true of essential producer goods. Moreover, the price increase in producer goods shown in Table 5-6 understates the actual cost increase of these goods for producers who imported them directly, since the 1959 wholesale price of producer goods shown in the table includes the

windfall gains associated with quantitative controls. Thus, the liberalization measures shifted production incentives in favor of exporters and against producers of manufactured consumer goods in the nonessential and unclassified categories.

One important consequence of these shifts in incentives (which was discussed in Chapter 3) was the relative movement of resources into export production and out of food production. The result was a substantial increase in food prices and therefore a significant rise in the wholesale price index for all items, especially between 1962 and 1965. Since nominal EERs increased for all categories of import commodities as well as for exports between 1962 and 1965, and U.S. wholesale prices rose only moderately, this significant rise in Philippine wholesale prices caused the PPP-EER for several import groups actually to decline between these years.

Between 1965 and 1969 the PPP-EERs for all import categories declined, while those for exports did not change. The development efforts of the Marcos administration as well as the election-related program of monetary and fiscal ease of 1969 caused Philippine wholesale prices to rise somewhat relative to U.S. wholesale prices and thus brought about a decline in the real cost of imports. The ratio of the dollar price of Philippine exports to U.S. wholesale prices did not change significantly. However, the floating of the peso in early 1970 and its consequent depreciation sharply increased the PDL-EER and PPP-EER for both imports and exports.

The main point that emerges from an overview of the more than twenty-year period covered in Table 5-3 is the very significant increase in the real costs of importing commodities, especially nonessential goods. By 1971, the PPP-EER for nonessential consumer goods was more than six times as high as in 1949, while the PPP-EER for nonessential producer goods was over four times as high in 1971 as in 1949. On the other hand, the domestic purchasing power of traditional exports was only 2.2 times as high in 1971 as in 1950. The widening of the gap between the real costs of importing nonessentials and the domestic purchasing power of traditional exports occurred during the period of exchange controls in the 1950s. For example, the ratio of the PPP-EER for nonessential consumer goods to the PPP-EER for traditional exports rose from 0.7 in 1950 to 2.3 in 1959. Even the disparity in 1959 underestimates the ratio of the consumer costs of importing to the real rewards of exporters, since importers were able to add on a scarcity windfall gain to their import costs due to the existence of exchange controls. The 1960 level of 2.7 for this ratio more accurately reflects the true differential, since the exchange rate on nonessentials was raised in that year to eliminate much of the windfall gain accruing to importers. During the rest of the 1960s and into the early 1970s, the gap between real importing costs and real export rewards narrowed. The ratio of the PPP-EERs for nonessential consumer goods to tradi-

tional exports was only 2.2 in 1965 and 1.9 in 1971. However, the ratio is still much higher than it had been during the immediate postwar period, indicating the continued existence of a pattern of incentives strongly favoring import-substituting investments in nonessential lines relative to the expansion of traditional (and even new) exports.

IMPLICIT RATES OF PROTECTION

Although EERs after 1962 provide a good indication of the relative incentives made available to different types of manufacturing activity, as already noted, such rates prior to that time underestimate the levels of protection because of the existence of exchange controls. What is needed for estimating incentive effects of import controls when quantitative restrictions are binding is a comparison of domestic and import prices. Unfortunately, in the case of the Philippines, unit-value import prices for individual commodities computed from the most detailed import data available from the Central Bank vary so much over time as to cast serious doubt on the validity of the quantity figures for particular items. However, adequate c.i.f. and domestic comparisons for certain commodities do exist for the years 1950 and 1951 because special studies of this relationship were made by the government in connection with price control efforts of that time. The implicit protective rates obtained from this data can then be tied in with time-series information on price changes to indicate changes in the pattern of implicit tariffs over time.

Table 5-5 contains price comparisons for a selected list of items as of December 1951. As is indicated in the table, the range of implicit protection was very wide, going from nearly 400 per cent to almost 700 per cent on such luxury items as oranges, cigarettes, and salt to quite moderate levels on evaporated and condensed milk. On the other hand, as can be seen from Table 5-1, the protection afforded a given import bundle of nonessential consumer goods by explicit fiscal and monetary measures in 1951 was only 70 per cent, i.e. $[(3.39/2.00) - 1.00] \times 100$.[13] The comparable figure for essential consumer goods was 2 per cent.

Domestic price behavior of the imported commodities included in the wholesale price index is shown in Table 5-6 on the basis of essentiality categories. As is indicated in the table, after the Korean War boom the government permitted prices of both essential consumer goods and essential producer goods to drop from their 1951 peak levels. But the high levels of the less essential consumer and producer goods were left unchanged. In a sense the government was able to use the temporarily high prices of the early 1950s as an umbrella under which to carry out its discrimination among commodity groups without facing consumer complaints that prices were actually being increased.

TABLE 5-5

Implicit Protection on Selected Commodities, December 1951

	Retail Price	C.I.F. Import Price	Excess of Adj. Retail Price[a] Over C.I.F. Price
Essential consumer goods			
Corned beef (12 oz.)	P0.90	P0.39	111%
Salmon (lb.)	1.13	0.47	120
Sardines (14 oz.)	0.53	0.31	51
Milk, evaporated (can)	0.39	0.29	14
Milk, condensed (can)	0.65	0.47	18
Flour, wheat (kilo)	0.59	0.26	107
Average[b]			70
Nonessential consumer goods			
Cocoa, Peter's (half-lb.)	0.96	0.40	120
Oranges (doz.)	1.93	0.38	388
Coffee, roasted (lb.)	4.00	1.01	276
Cotton cloth, dyed (yd.)	1.65	0.54	186
Cotton cloth, printed (yd.)	1.50	0.62	122
Cigarettes (pkg.)	0.85	0.16	411
Apples (doz.)	1.40	0.46	184
Salt, refined (lb.)	0.65	0.08	694
Average[b]			297
Essential producer goods			
Galvanized iron, corrugated (sheet)	10.55	6.37	46
Kerosene (can)	4.13	0.76	423
Diesel fuel oil (liter)	0.19	0.08	118
Gasoline (liter)	0.24	0.05	360
Average[b]			236
Nonessential producer goods			
Cocoa seeds (ganta[c])	6.00	2.80	93
Starch (kilo)	0.75	0.33	107
Average[b]			100
Unclassified items			
Onions (kilo)	0.55	0.20	155
Garlic (kilo)	1.61	0.41	273
Average[b]			214

SOURCE: Central Bank of the Philippines, *Annual Report*, 1951, p. 18.

a. In calculating implicit rates, 20 per cent of the c.i.f. import price is subtracted from the retail price, since on most items, the price control authorities allowed this margin between retail and import prices.

b. Unweighted averages.

c. This measure, which is peculiar to the Philippines, equals 3 liters.

TABLE 5-6

Wholesale Price Indices[a] for Imported Commodities Classified by Degree of Essentiality, 1951–70
(1949 = 100)

	1951	1955	1959	1962	1966	1969	1970[b]
Essential consumer goods (EC)	128	107	125	183	208	214	322
Nonessential consumer goods (NEC)	155	163	281	308	325	348	488
Unclassified consumer goods (UC)	134	127	188	212	211	234	312
Essential producer goods (EP)	160	136	156	188	197	205	257
Semiessential producer goods (SEP)	130	132	201	222	241	252	328
Unclassified producer goods (UP)	173	106	142	158	165	160	183

SOURCE: Central Bank of the Philippines.

a. The 1970 essentiality classification of the Central Bank was used to divide the items included in the wholesale price index into the various groups. The number of items used to compute the simple means in each group are as follows: EC—11 for 1951 and 1955 and 16 thereafter; NEC—26 items for 1951 and 1955 and 39 items thereafter; UC—6 items for 1951 and 1955 and 17 items thereafter; EP—16 items for the entire period; SEP—4 items for 1951 and 1955 and 15 items thereafter; UP—13 items for 1951 and 1955 and 26 items thereafter. Semiessential goods and semiunclassified producer goods are not included because the sample size for these items was too small.

b. As of September.

After 1955, however, all prices again rose with the result that by 1959 prices of essential goods were again at their 1951 levels. Prices of nonessential consumer and producer goods continued to rise to new highs, with the degree of discrimination between nonessential and essential consumer goods widening from 56 in 1955 to 156 in 1959. Moreover, since the Central Bank's index of c.i.f. import unit values for total imports actually declined about 2 per cent between 1951 and 1959, it seems that the increases in wholesale prices of imported goods in the Philippines between 1951 and 1959 reflect changes in the degree of implicit protection rather than increases in c.i.f. costs.[14]

It is difficult to estimate average levels of implicit protection by exchange-control groups because of the wide variations in the degree of protection among commodities and the small size of the sample in Table 5-5. However, if this sample is representative, implicit rates of 200 per cent or more in 1951

were not unusual for nonessential consumer goods. Since, as is indicated in Table 5-6, prices of this group of items rose about 80 per cent between 1951 and 1959, levels of implicit protection of 400 per cent or more apparently existed at this time for some items.[15] The protection from explicit fiscal measures on this category of goods was 149 per cent, and this implies that windfall gains of over 200 per cent were being made on these commodities.

A more comprehensive estimate of the degree of protection of nonessential consumer goods in 1959 can be made by working backward from the behavior of import prices and domestic wholesale prices for this category between 1959 and 1962, when import controls were completely dismantled. The remarkable thing is that, whereas the peso cost, inclusive of all taxes, of a dollar's worth of nonessential consumer goods rose by 98 per cent over this period (Table 5-1) primarily as a result of the devaluation of the peso, the wholesale price index for these goods rose by only about 10 per cent (Table 5-6). This disparity is indicative of the large windfall gains which had been accruing to importers and traders in 1959 and which were eliminated with the freeing of imports from controls. In contrast to the explicit protection of 149 per cent, i.e. $[(5.06/2.03) - 1.00] \times 100$, provided by fiscal and monetary measures for nonessential consumer goods in 1959 (Table 5-1), the implicit protective rate at that time can be calculated at about 361 per cent.[16] Similar calculations for essential consumer goods and for essential producer goods give implicit rates of protection in 1959 of 30 and 88 per cent, respectively.

A third method of estimating levels of implicit protection in the 1950s is to compare wholesale prices of comparable items in the Philippines and the United States. The results for a selected list of goods for which this comparison was possible are presented in Table 5-7. If it is assumed that costs of shipping from U.S. wholesalers to Philippine wholesalers equals 25 per cent of the U.S. price, the protection on evaporated milk in 1959 amounts to 14 per cent, a figure comparable to that in Table 5-5.[17] For such nonessential consumer goods as canned cherries, canned asparagus, canned peaches, and coffee, the implicit protective rates on the basis of the same kind of calculation were 426, 374, 159, and 197 per cent, respectively, in 1959. On the other hand, in the essential-producer-goods group, the 1959 protective rate on standard American newsprint was only 16 per cent; for sodium bichromate, 31 per cent; and for blasting caps, 75 per cent.

It is clear from these three estimates that exchange controls added greatly to the degree of protection provided by explicit fiscal and monetary measures. In 1959, for example, implicit protective rates of 400 per cent were not uncommon for nonessential consumer goods, whereas the average explicit degree of protection in 1959 for this category was around 150 per cent. For the essential-consumer-goods group, average implicit and explicit protective rates in the same year were roughly 30 and 5 per cent, respectively.

TABLE 5-7

Selected U.S. Wholesale Prices and Wholesale Prices of Comparable Imported Goods in the Philippines, 1949–65
(U.S. dollars[a])

Description[b]	1949	1956	1959	1962	1965
Evaporated milk (EC), case of 48, 14½ oz. tins					
Philippines	7.20	7.96	9.28	7.47	8.08
United States	—	6.00	6.52	6.07	6.31
Canned cherries (NEC), doz. cans					
Philippines	—	—	12.00	7.14	7.66
United States	—	—	1.82	1.81	1.86
Canned peaches (NEC), doz. cans					
Philippines	—	—	8.75	4.97	5.26
United States	—	—	2.70	2.42	3.07
Canned asparagus (NEC), doz. cans					
Philippines	—	10.62	13.88	8.10	8.74
United States	—	2.41	2.34	2.50	2.62
Coffee (NEC), 1 lb. tin					
Philippines	—	2.34	2.64	1.41	1.44
United States	—	1.00	0.71	0.64	0.80
Cocoa beans (NEP), lb.					
Philippines	0.44	0.75	1.08	0.53	0.55
United States	0.21	0.27	0.31	0.21	0.21
Denim (UP), yd.					
Philippines	0.44	0.52	0.60	0.40	0.51
United States	0.31	0.36	0.37	0.38	0.35
Standard American newsprint (EP), ton					
Philippines	—	171.00	194.00	136.00	168.00
United States	100.00	130.00	134.00	134.00	132.00
Sodium bichromate (EP), lb.					
Philippines	—	0.20	0.21	0.14	0.18
United States	0.10	0.13	0.13	0.13	0.13
Potash muriate, basis 58–60% K_2O (EP), ton					
Philippines	—	93.00	106.00	64.00	86.00
United States	29.00	23.00	20.00	23.00	24.00
Blasting caps, ordinary (EP), 1,000					
Philippines	—	32.00	48.00	45.00	30.00
United States	—	20.00	22.00	23.00	24.00

SOURCE: Philippine data from Central Bank of the Philippines; U.S. data from U.S. Department of Commerce, Bureau of Labor Statistics.

a. The conversion rate was 2 pesos to the dollar for 1946–59 and 3.90 pesos to the dollar for 1962 and 1965.

b. EC = essential consumer goods; NEC = nonessential consumer goods; EP = essential producer goods; NEP = nonessential producer goods; UP = unclassified producer goods.

The relative protection afforded the different commodity categories remained essentially the same between 1962 and 1969, since the ratio of non-essential-consumer-goods prices to essential-consumer-goods prices and that of essential-producer-goods prices to essential-consumer-goods prices in 1969 were 1.63 and 0.96, respectively, compared to 1.68 and 1.03 in 1962. Absolute levels of implicit protection also did not change appreciably, as wholesale prices of imported goods increased in roughly the same proportion as import unit values.

A comparison of the change in EERs and the change in wholesale prices of imported goods between 1969 and 1970 suggests that some windfall gains due to exchange controls may have existed in 1969, because wholesale prices rose less than the peso prices of foreign commodities. This seems to hold particularly in the essential-producer-goods category for which, even assuming no rise in c.i.f. prices, the peso cost of imports increased 50 per cent, whereas the price index rose only 25 per cent. However, an examination of the individual prices in this index reveals that many are reported as unchanged between 1969 and September 1970 (and some even since 1966). One suspects that for many of these specialized capital goods, many wholesalers did not sell any of these items between the time the exchange rate was depreciated, in February 1970, and September 1970 and thus reported the price as unchanged from its 1969 level. Simply removing items for which there was no price change at all between 1969 and 1970 raises the price index in 1970 from 257 to 298 —a 45 per cent increase over the 1969 level. For other items, there probably were sales by some wholesalers, but the price index for the item is still biased downward because of the absence of sales by others.

EFFECTIVE PROTECTION

Some of the effective protective rates (EPRs) for the Philippines calculated by John Power are shown in Tables 5-8 and 5-9.[18] Power's estimates include the effects of the discriminatory sales or compensating tax[19] in addition to import duties, but not the effects of the margin fee on foreign exchange, the special import tax, or the margin requirements for letters of credit—measures that also provided protection against imports in 1965.

Power points out that the negative effective rates for canned meat and dairy products (Table 5-8) were obtained because of duty-free imports of these items made in 1965 by the National Marketing Corporation, a government organization whose function was to help maintain adequate supplies of essential consumer goods at low prices. He is somewhat skeptical about the accuracy of the negative rates for such manufactured items as stationery but suggests that production inefficiencies may be so extensive in some industries as to result in negative effective rates at world market prices.

TABLE 5-8

Nominal and Effective Rates of Protection in Import-competing Manufacturing Industries in the Philippines, 1965

ISIC Code	Industry	Nominal Protection	Effective Protection
2014	Canned meat	5%	−70%
2024	Dairy products	1	−26
3832	Vehicle engines, parts, bodies	18	4
3621	Agricultural tractors	14	5
3622	Farm machinery, except tractors	16	5
3392	Lime	12	7
3632	Metal-forming machinery	12	8
3412	Iron and steel foundry products	10	7
3196	Agricultural chemicals	15	13
3111	Inorganic acids, alkali, chlorine	18	10
2056	Flour mill products	15	12
3651	Industrial pumps and compressors	16	14
3192	Pharmaceutical preparations	25	22
3319	Structural clay products	19	21
3113	Compressed and liquified gases	24	25
3092	Processed rubber	27	23
3646	Woodworking machinery	15	27
3199	Inks and dyes	30	34
3211	Petroleum refinery products	13	42
3511	Packers' cans	25	49
3021	Tires and inner tubes	51	52
3591	Metal barrels, drums, etc.	40	59
3641	Rice-milling machinery	41	65
2712	Paper and paperboard products	31	59
3831	Trucks and buses	29	75
3321	Glass containers	45	81
3322	Flat glass and mirrors	44	77
3198	Polishing preparations	51	91
3411	Steel mill products	29	88
3731	Batteries	50	92
3734	Electric wires and wiring devices	20	103
3114	Fertilizers	16	72
3551	Wire nails, brads, and spikes	29	107
3992	Fabricated plastic products	74	156
3532	Architectural metal work	60	151

(*continued*)

TABLE 5-8 (*concluded*)

ISIC Code	Industry	Nominal Protection	Effective Protection
3923	Eyeglasses and spectacles	98	165
3312	Clay tiles	102	243
3749	Sewing machines, household	78	318
3531	Structural iron and steel	81	335
3115	Plastic and resin materials	69	485
3732	Electric lamps	125	2,320
2641	Metal furniture	104	784
2721	Stationery	71	−2,600
3742	Industrial refrigerators and air conditioners	101	−447
2911	Leather	105	−461
2316	Jute mill products	110	−3,154
3722	Household radios, phonos, and TV	147	−604
3951	Jewelry	252	−323
	Average[a]	30	59

ISIC = International Standard Industrial Classification.

SOURCE: John H. Power, "The Structure of Protection in the Philippines," in Bela Balassa and associates, *The Structure of Protection in Developing Countries* (Baltimore: Johns Hopkins Press, 1971), p. 275.

a. Nominal rates are weighted by output and effective rates by "derived" free-trade value added.

The averages presented in Table 5-9 again confirm the disadvantageous position of export producers compared to domestic producers of import-competing manufactures. Power's 1965 estimates of EPRs are −19 per cent for the former group and 59 per cent for the latter. EPRs for various export industries that I calculated for 1965 are as follows: veneer and plywood, −14 per cent; lumber, −11; coconut and copra, −6; abaca and other fibers, −12; metallic mining, −16; and brewery and malt products, −9.[20]

A time series of EPRs by exchange-control categories, which is derived from tariff data and input coefficients collected by Valdepeñas[21] and also includes the effect of the other nontariff measures included in Table 5-1, is shown in Table 5-10. The manner in which these were derived is explained in detail in the appendix to this chapter. Briefly, the nominal protection (penalty or subsidy in the case of exports) is taken to be the percentage by which the EER in any year (Table 5-1) exceeds the EER for producer goods used by "new and necessary" industries in that year. Between 1949 and 1959, the

TABLE 5-9

Average Rates of Protection[a] in Philippine Manufacturing, 1965

Industry Group	Nominal Protection	Effective Protection
Exports (excluding sugar)	−8%	−19%
Import-competing	30	59
Non-import-competing[b]	26	83
Sugar	35	183
All manufacturing	2	48
Except exports	28	71

SOURCE: Power, *Protection in the Philippines*, p. 278.

a. Nominal rates are weighted by output and effective rates by free-trade value added.

b. Non-import-competing industries are defined as those in which imports amount to less than 10 per cent of domestic production.

lowest EER rate was generally the official rate of P2.00 to the dollar.[22] Since the EER equals the peso purchase price of a dollar's worth of goods rather than the selling price of these goods—the latter figure exceeds the former if imports are quantitatively restricted—the nominal protection on output is an underestimate of the actual (implicit) level of protection during the period of import controls from 1949 to 1960.

The calculation of EPRs over time highlights the biases previously pointed out against the production of export commodities and essential goods and in favor of nonessential goods. In 1961, for example, the effective protection afforded domestic producers of nonessential consumer goods relative to producers of goods used by "new and necessary" industries was 230 per cent, whereas it was 39 per cent for firms specializing in essential producer goods. The unfavorable exchange rate for exporters together with the protection on the imported inputs they used caused the EPR for traditional exports to be significantly negative in that year. Moreover, the discrepancies in effective protective rates remain very large even after the decontrol effort and throughout the rest of the 1960s and early 1970s.

SMUGGLING AND OTHER MEANS OF EVASION

Open smuggling has long been a serious problem in the Philippines because of the physical features of the country, and no analysis of protection in the

TABLE 5-10

Effective Protective Rates, 1949–71
(per cent)

Category	1949	1950	1951	1952	1953	1954	1955	1956	1957	1958	1959	1960
Imports												
Consumer goods												
Nonessential	5	5	114	114	114	110	141	154	179	178	183	349
Semiessential	4	4	23	23	23	19	19	34	18	37	31	149
Essential	0	0	−7	−7	−7	−7	−8	−5	−6	−7	−18	−15
Producer goods												
Nonessential	5	5	24	24	24	17	19	28	26	25	5	173
Semiessential	0	0	19	19	19	19	21	22	24	24	51	52
Essential	0	0	19	19	19	19	20	23	24	24	52	50
For "new and necessary" industries	0	0	0	0	0	0	0	0	0	0	0	0
Exports												
Traditional	0	0	−15	−15	−15	−15	−16	−19	−19	−20	−43	−27
New (subsidy)	23	23	23	23	31	31	31	31	31	27	25	40

(*continued*)

TABLE 5-10 (*concluded*)

Category	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970	1971
Imports											
Consumer goods											
Nonessential	230	337	332	326	365	354	357	363	365	354	362
Semiessential	61	54	53	50	56	50	52	54	55	51	57
Essential	−9	−2	0	0	0	1	1	1	1	2	5
Producer goods											
Nonessential	56	169	174	171	198	191	193	195	197	193	203
Semiessential	40	21	14	12	12	12	13	15	15	14	14
Essential	39	28	25	25	28	26	26	27	27	26	19
For "new and necessary" industries	0	0	0	0	0	0	0	0	0	0	0
Exports											
Traditional	−45	−37	−38	−38	−22	−20	−21	−22	−21	−43	−33
New (subsidy)	2	−4	−9	−9	12	12	13	13	13	21	26

SOURCE: See text.

country is complete without a discussion of this subject. American cigarettes, textiles, narcotics, and firearms appear to be the most important items smuggled into the country. In addition, a significant volume of copra and illegally cut logs is exported without passing through proper channels. The value of smuggled goods is, of course, very difficult to estimate. An estimate from the government's Anti-Smuggling Action Center places the annual value of smuggled cigarettes at about $37 million in the 1962–65 period and $9 million from 1966 to 1969. Although estimates of the influx of other smuggled goods are not available, the Anti-Smuggling Action Center does report the value of confiscations of these other goods. If the ratio of the total volume of cigarettes smuggled to the volume of cigarettes confiscated holds for these other goods, the total value of smuggled goods, including cigarettes, comes to about $19 million in both 1966 and 1969, or around 2 per cent of total imports.

More important than pure smuggling is so-called technical smuggling. This involves exporting or importing through regular ports but incorrectly valuing, declaring, or classifying the commodities. Underinvoicing of exports and overreporting of imports are well-recognized means of transferring funds abroad. Similarly, declaring imports to be in commodity categories with lower tariffs than those which actually apply and undervaluing imports are familiar methods for avoiding the payment of import taxes.

A comparison by George Hicks of export and import values as reported in Philippine statistics with exports and import values based on the statistics of the country's major trading partners is reported in Table 5-11. On this evidence, both exports and imports were generally undervalued during the 1950s and 1960s, presumably because of the importance of smuggling and the underinvoicing of both exports and imports. In the late 1950s it was estimated by Central Bank authorities that the country was losing at least 10 per cent of the annual dollar receipts from exports because of undervaluation and misdeclaration of the latter.[23] Clearly, the overvaluation of the peso during this period created a strong incentive for exporters to engage in these actions.[24] The degree of export undervaluation decreases after the 1962 devaluation (and is less than import undervaluation), consistent with the expected relationship between the exchange rate and the extent of underinvoicing of exports.

Undervaluation and misclassification of imports in categories where tariffs are high or exchange controls tight have also been serious problems for certain commodities. Textiles are the most frequently cited case. Ayal found, for example, that in 1965 the value of imports of textiles from the United States and from Japan as reported by the Central Bank was $6 and $9 million, respectively. At the same time, exports of textiles to the Philippines from the United States, as reported by the U.S. embassy, were $29 million and from

TABLE 5-11

Official Philippine Exports and Imports as Percentages of Totals Estimated from Statistics of Major Trading Partners, 1950–68
(computed from f.o.b. values in U.S. dollars)

Year	Exports	Imports	Year	Exports	Imports
1950	101.7	n.a.	1960	93.6	93.8
1951	97.2	n.a.	1961	86.3	89.1
1952	98.1	n.a.	1962	90.2	95.3
1953	98.3	n.a.	1963	101.7	82.9
1954	94.4	99.1	1964	98.7	90.8
1955	92.5	101.7	1965	99.0	87.3
1956	91.3	92.9	1966	94.0	87.6
1957	85.2	92.3	1967	89.7	87.4
1958	102.8	98.2	1968	91.5	89.0
1959	100.1	91.4			

n.a. = not available.

SOURCE: George L. Hicks, "Philippine Foreign Trade, 1950–1965: Basic Data and Major Characteristics" and "Philippine Foreign Trade Statistics: Supplementary Data and Interpretations, 1954–1966" (Washington, D.C.: National Planning Association, Center for Development Planning, 1967; mimeo.), except for 1966–68 which are from George L. Hicks and Geoffrey McNicoll, *Trade and Growth in the Philippines* (Ithaca: Cornell University Press, 1971), p. 46.

Japan, as reported by the Japanese government, were $36 million.[25] A similar extensive degree of undervaluation also existed in 1966.

To test the hypothesis that the degree of import undervaluation is positively related to the height of duty levied on an item, a comparison was made of 1967 f.o.b. import values, supplied by the Philippine Central Bank, and f.o.b. export values of the same items, from the U.S. Department of Commerce, for a sample of 62 commodities. The resulting regression equation was $y = -1.65 + 14.70x$, where y = ratio of U.S. data on U.S. exports to the Philippines to Philippine data on Philippine imports from the United States, and x = 1969 ad valorem percentage tariff rates in the Philippines. The t value for the coefficient of x is 4.27, which is significant at the 1 per cent level, and the coefficient of correlation (r) is 0.48. Thus, the hypothesis that the higher the tariff the greater the degree of undervaluation is supported by the statistical analysis. Moreover, the degree of undervaluation increases very sharply as the duty rises.

In addition to commodities being imported without the payment of import taxes because of open or technical smuggling, many dutiable items are imported without being taxed because of legal exemptions. Imports of capi-

tal goods in industries registered with the Board of Investment have already been mentioned in Chapter 3. Exemptions of this sort are deliberately designed to foster growth in high-priority industries. Other sectors, organizations, or items that are specifically exempted from certain import taxes for reasons of growth, employment, or equity include fertilizer manufacturers, the textile industry, the petroleum industry, private development banks, agricultural cooperatives, cottage industries, government entities, the National Power Corporation, the National Waterworks and Sewerage Authority, the Philippine National Railways, Philippine Airlines, various electric authorities, the Philippine Virginia Tobacco Association, the Rice and Corn Administration, the National Marketing Authority, personal effects of foreign residents, and donations from abroad to local charitable, religious, and civic organizations. As the customs commissioner has pointed out, goods normally taxed that are imported under special tax-exemption laws frequently are not used for the purpose for which the exemption is granted but, instead, find their way into regular market channels.[26]

As long as some import flows continue through proper channels, domestic prices will be unaffected by the various measures described above to avoid import taxes.[27] Rather than being hurt by a decrease in protection, domestic producers are adversely affected mainly through a loss of markets because of these various illegal activities. However, there also are many dutiable items in the Philippine import statistics on which no import duties are collected because of legal exemptions. In these cases not only do domestic producers lose markets to smugglers and others who illegally channel goods into commercial markets, but also the price of the product is depressed by these activities. The height of the tariff and other taxes on imports then incorrectly measures the protection given local producers. How important this point is for measuring the general contours of Philippine protectionism is not known.

Another important effect of an overvalued exchange rate is to increase the use of imported capital goods by local producers. Since capital goods imports are favored by exchange authorities, importers find that it is easy to make windfall gains by transferring funds abroad through overinvoiced purchases of these items. The highly specialized nature of most of these items makes overinvoicing hard to detect, and the ability to borrow at below-market interest rates makes this activity doubly attractive. In a scenario common in the Philippines, high protection plus subsidized loans and guarantees are provided for a potential import-competing activity; later, it is discovered that the high duty encourages so much smuggling of various sorts that the market left is too small to take advantage of all the economies of scale. Excess capacity develops because the capital goods are purchased in expectation of a larger market than in fact materializes. In addition, some producer-importers appar-

ently have no intention of trying to run a successful business. Instead, they arrange with foreign exporters to overreport the value of their capital goods imports and thereby transfer some of the borrowed funds to accounts abroad. They are unable to repay the funds borrowed from such organizations as the Development Bank of the Philippines, but still end up with the funds transferred abroad as a gain. However, inflated capital-output ratios and excess capacity are the price that the country as a whole pays.[28]

SUMMARY

All the measures of protection analyzed in this chapter bring out essentially the same story. Beginning in 1950 and 1951 the Philippine government undertook a policy of sharply curtailing imports of consumption goods in order to favor the importation of the raw materials and capital goods needed for industrial development. This is very apparent from the behavior of the various EERs as well as the EPRs, all of which indicate a sharp increase in the protection of nonessential goods relative to essential goods and exports in 1951. The import-cutback program coupled with the economic prosperity associated with the Korean War caused the implicit protection on essential consumption goods to rise more than the government wished, but by 1953 the government seemed to have mastered the technique of providing high protection to nonessential goods while still permitting liberal imports of essential consumer and producer goods.

For the rest of the 1950s, beginning with 1953, when the Central Bank became the sole manager of the system of import and exchange controls, the protection and subsidization provided to domestic industries producing nonessential consumer and producer goods continued to widen relative to the production of essential commodities and export products. Protective rates for a number of nonessential consumer goods seem to have doubled during the 1950s. Of particular significance is that the domestic purchasing power of a given quantity of exports declined steadily in those years.

The dismantling of the exchange-control system during the early 1960s did not represent a significant liberalization in the sense of sharply reducing the differences in production incentives among the various import sectors. For example, in 1963, the real effective exchange rate, i.e., the PPP-EER, of imported nonessential consumer items was 2.65 times as large as that for imported essential consumer goods, and the PPP-EER for nonessential producer goods was 1.52 times as large as that for essential producer goods. These figures are higher than the same ratios in 1959, although the 1959 figures do not include any scarcity premiums due to exchange controls. The gap in

incentives between traditional exports and import-competing sectors also remained high.

From 1963 through 1969 the relative protection between essential and nonessential consumer goods as well as between essential and nonessential producer goods remained the same. However, the real cost of imports in absolute terms declined somewhat between 1963 and 1969. Nevertheless, this cost was still between 1.7 and 5.0 times larger than in 1949. One encouraging development after 1963 was the shift in incentives in favor of firms producing new exports. Between 1963 and 1969 the PPP-EER for new exports increased in contrast to the general decline for import transactions. However, this rate still remained low compared to those in the import-competing sectors.

The 1970 exchange crisis brought about further substantial increases in both nominal and real effective exchange rates. These rates declined somewhat in 1971 but were still at record heights. To sustain an economic expansion by foreign borrowing, much of it of a short-term, limited nature, it was eventually necessary to raise the real domestic costs of importing and again to shift production incentives in favor of exporters.

APPENDIX: CALCULATING EFFECTIVE EXCHANGE RATES AND EFFECTIVE RATES OF PROTECTION

Data Used in Calculating Effective Exchange Rates, by Exchange-Control Category, 1949–71.

Exchange Rates

The EER for a particular exchange-control category and year is obtained by increasing (decreasing) the applicable official exchange rate by the various trade taxes (subsidies) that must be paid on transactions of this type. The exchange rates (in terms of number of pesos per U.S. dollar) used in the calculations are as follows:

1949–59—P2.00 for all groups;

1960—essential consumer goods and essential producer goods, including those for "new and necessary" industries, P2.08; semiessential producer goods, P2.10; traditional and new exports, P2.22; nonessential consumer goods, semiessential consumer goods, and nonessential producer goods, P2.83;

1961—essential consumer goods and essential producer goods, including those for "new and necessary" industries, P2.92; semiessential producer goods, P2.93; nonessential consumer goods, semiessential consumer

goods, and nonessential producer goods, P3.0; traditional and new exports, P2.68;

1962—all groups except traditional and new exports, P3.44; traditional and new exports, P3.15;

1963–69—all groups except traditional exports and new exports, P3.90;

1963–64—traditional and new exports, P3.52;

1965–69—traditional and new exports, P3.90;

1970—all groups except traditional exports, P5.89; traditional exports (taking account of the 80-20 split between the old and new exchange rate), P5.57;

1971—all groups P6.40.

Tariffs

From 1946 to 1955, when a free-trade arrangement was in effect between the United States and the Philippines, no duty is included. From 1956 to 1971, the nominal duty levels in the Philippines were multiplied by the following percentages in order to reflect the increasing proportion of the nominal duty that was applicable against U.S. goods: 1956–58, 25 per cent; 1959–61, 50 per cent; 1962–64, 75 per cent; 1965–73, 90 per cent. The nominal tariff rates used for the various categories are shown in the accompanying table.

	1956	*1957–61*	*1962–71*
Consumer goods			
Nonessential	18%	51%	83%
Semiessential	35	40	40
Essential	15	12	9
Producer goods			
Nonessential	20	25	100
Semiessential	15	22	29
Essential	22	22	25

Producer goods for "new and necessary industries"—same as for essential producer goods.

Excise Tax and Margin Fee on Sale of Foreign Exchange

For all groups except essential consumer goods and producer goods for new industries (both of which were exempted from these charges): 1951–54, 17 per cent; 1955–58, zero; 1959, 25 per cent; 1960, 24 per cent; 1961, 16 per cent; 1962–71, zero.

Special Import Tax

For 1949–54, zero; 1955–56, 17 per cent; 1957, 15.3 per cent; 1958, 13.6 per cent; 1959, 11.9 per cent; 1960, 10.2 per cent; 1961, 8.5 per cent;

1962, 6.8 per cent; 1963, 5.1 per cent; 1964, 3.4 per cent; 1965, 1.7 per cent; 1966–71, zero. (Exemptions are the same as above.)

Protective Effect of Sales or Compensating Tax

The discriminatory aspect of the sales tax on imports arises because the base on which the tax is levied is greater than that for domestically produced commodities and also because the sales tax was levied not only on the import duty, but also on the special import tax in effect from 1955–65. The protective effect of the sales tax was determined by multiplying the sales tax rate by the sum of 1 plus the special import tax rate plus the tariff rate on U.S. imports, and then multiplying this product by the sum of 1 plus the rate by which the import valuation base exceeded the valuation base for comparable domestic goods. The sales tax rate was then deducted from this result to obtain the net discriminatory effect.

The sales tax rates for the various commodity groups are as follows. Nonessential consumer goods: 1949, 30 per cent; 1950–71, 50 per cent; semiessential consumer goods, essential consumer goods, nonessential producer goods, semiessential producer goods, and essential producer goods: 1949–50, zero; 1951–71, 7 per cent. The special import tax rate and the relevant tariff rates have already been given in this appendix. The size of the valuation base for imports as compared to domestically produced goods is as follows: nonessential consumer goods—1949–50, 1; 1951–71, 2; semiessential and essential consumer goods—1949–50, 1; 1951–71, 1.25; nonessential and semiessential producer goods—1949–50, 1; 1951–71, 1.25; essential producer goods—1949–50, 1; 1951–71, 1.25; essential producer goods for "new and necessary" industries—1949–71, exempt from the tax.

Margin-Deposit Requirements

Estimates of the protective effect of the various margin requirements for importing are shown in Table 5-12.

Subsidy on New Exports

In estimating the net subsidy for producing new export commodities, it was assumed that such industries could borrow from government organizations such as the Development Bank of the Philippines at 2 per cent below the market rate. Assuming an incremental capital-output ratio of 2, this implies a 4 per cent subsidy on output. For the 1949–62 period, the subsidy effect of the various tax exemptions for these industries was taken from a study by the Philippine Chamber of Commerce, reported in *Official Proceedings,* Fifth Annual Convention of Manufacturers and Producers, Volume VIII, 1958; for the period thereafter, it was estimated from a sample of firms analyzed by the Board of Investment. The figures used are as follows: 1949–52, 8.2 per

TABLE 5-12

Protective Effects of Margin-Deposit Requirements, 1949–71
(per cent)

	1949–53	1954–57	1958	1959	1960–61	1962–65	1966	1967	1968	1969	1970	1971
Consumer goods												
Nonessential	2.4	0	6	3	0	4.0	0	2.25	5.7	6.5	6.0	1.5
Semiessential	2.4	0	6	3	0	2.25	0	1.1	3.1	3.25	0.6	1.5
Essential[a]												
Producer goods												
Nonessential	2.4	0	3	3	0	2.25	0	1.12	2.25	3.25	0.6	1.5
Semiessential	0	0	3	3	0	0.75	0	0.75	2.25	2.44	0.6	1.5
Essential	0	0	3	3	0	0	0	0.37	1.32	0.78	0	0
For "new and necessary" industries	0	0	1.5	1.5	0	0	0	0	0	0	0	0

a. The rate was zero throughout the period shown.

cent; 1953–58, 12.1 per cent; 1959, 10.9 per cent; 1960, 9.1 per cent; 1961, 6.1 per cent; 1962, 3 per cent; 1963–66, 2 per cent; 1967–69, 3 per cent; 1970–71, 7 per cent.

TAX ON TRADITIONAL EXPORTS

An export tax of 10 per cent was levied on traditional exports beginning in May 1970. The tax was continued in 1971.

Calculation of Effective Rates of Protection by Exchange-Control Category, 1949–71.

The commodities included in each group are the same as those included in the estimates of EERs by exchange-control category. The protection (penalty or subsidy in the case of exports) on the output of a particular import category for a specific year is equal to the percentage by which the EER in that category exceeds the EER for producer goods used by "new and necessary" industries in that year. The protection on inputs for all categories except semiessential producer goods after 1956, producer goods for "new and necessary" industries, and new exports is assumed to equal the degree of protection on essential producer goods. For semiessential producer goods after 1956, the protective rate on inputs is the same as the protective rate on essential producer goods except for the tariff component of this protection. For 1962–71 the duty component is the duty on inputs into aqua ammonia as reported by Valdepeñas,[29] namely, 4.4 per cent. For 1957–61, 3.9 per cent is used as the duty component of the protective rate on inputs.

The protection on inputs used in "new and necessary" industries and for new exports is assumed to be zero.

The formula for the effective rate of protection is

$$\frac{t_j - \Sigma a_{ij} t_i}{1 - \Sigma a_{ij}},$$

where t_j is the tariff rate on any output, t_i is the tariff rate on any output used as an input in the production of the jth output, and a_{ij} is the value of the ith output used to produce a unit value of the jth output at free-trade prices. The various a_{ij} coefficients also are based on data from Valdepeñas.[30] His tariff-inclusive a_{ij}s are corrected to obtain free-trade a_{ij}s and then combined to obtain unweighted averages of these coefficients for the appropriate categories. The averages are as follows: nonessential consumer goods, 0.47; semiessential consumer goods, 0.39; essential consumer goods, 0.35; nonessential producer goods, 0.56; semiessential producer goods, 0.19; essential producer goods, 0.50; producer goods for "new and necessary" industries, 0.50; traditional exports, 0.44; new exports, 0.48.

NOTES

1. Estimates of domestic resource costs—which is a measure of the value of domestic resources (at opportunity cost prices) employed in earning or saving a dollar of foreign exchange (in the value-added sense) when a good is produced domestically—are not included in this study, although such estimates were made for other country studies in the series of which this study is a part. Underlying Philippine data did not seem sufficiently extensive or accurate to warrant including these DRC estimates.

2. See Appendix A for definitions of the various concepts employed in the project of which this study is a part.

3. Since imports from the United States were so significant, especially during the years when tariff preferences were substantial, the tariff rates used in calculating effective exchange rates in these tables are those applicable to imports from the United States, i.e., they take account of the tariff preferences extended to American goods. In 1950, for example, imports from the United States amounted to 75 per cent of all Philippine imports. This percentage had fallen to 42 per cent by 1960 and 29 per cent by 1970.

4. See Vicente B. Valdepeñas, Jr., *The Protection and Development of Philippine Manufacturing* (Manila: Ateneo University Press, 1970), Table 6.1, pp. 82–85, for a listing of these commodities.

5. See loc. cit. for a listing of these commodities.

6. Valdepeñas's choice of sample was influenced by his objective of obtaining detailed information on duties for inputs used in producing various goods. He was able to obtain such information from confidential files of the Tariff Commission that were assembled in response to requests for tariff changes after the devaluation of 1962. Since requests and studies for tariff changes tend to occur for items for which there is an above-average chance of a tariff increase, Valdepeñas's sample tends to exaggerate the tariff increases classified by essentiality categories after 1962. This is confirmed by an analysis of all tariff changes between 1957 and 1970 classified by standard commodity groups. This upward bias could be especially misleading in the essential-producer-goods class, and a more representative item was therefore picked for the post-1962 period. The upward bias is also present, it should be noted, in the nonessential goods category (where a correction is not made for the post-1962 period), but it appears that duties were in fact raised on a larger proportion of all items in this group than on the essential-producer-goods group.

7. Two difficulties with tracing EERs over time are the shift of items from one exchange-control category to another and the establishment of new categories. Thermos bottles, for example, are included among the 32 items in Valdepeñas's list of nonessential consumer goods, which is based on the 1953 classification of imports by the Ceneral Bank. When the semiessential category was created, in 1957, this item was transferred out of the nonessential-consumer-goods class.

8. Loudspeakers were also classified as a nonessential consumer good, and aqua ammonia as a nonessential producer good, in the 1953 classification system.

9. The list of goods in this category narrowed over time as more producer goods were produced locally with the aid of a high degree of protection.

10. The 1959 EERs for the types of goods mentioned in this paragraph were computed as follows. The average tariff for the sample of goods included in the nonessential-consumer-goods group was 51 per cent in 1959. Since U.S. goods were subject to only 50 per cent of the duty in that year, the cost-increasing effect of the tariff was $0.5 \times 0.51 \times P2.00 = P0.51$. The 25 per cent margin fee and the special import tax, which had

decreased to 11.9 per cent, added P0.74, i.e. $(0.25 + 0.119) \times$ P2.00, to the official peso cost of a dollar's worth of goods. The sales tax further increased the cost of importing, since, as noted in the appendix to this chapter, it was required that the 50 per cent tax be levied on twice the cost of imports. Whereas the sales tax on a domestically produced nonessential consumer good costing 2 pesos was 1 peso, the tax on a comparable imported good was $0.5 \times (1.000 + 0.374) \times$ P2.00 $\times$ 2.0 = P2.748, or P1.748 more than the domestic good. Finally, the required margin deposit of 100 per cent (assumed to be for a three-month period and at a forgone annual interest rate of 12 per cent) added 3 per cent, or $0.03 \times$ P2.00 = P0.06 to the official cost of a dollar's worth of imports. In total, these measures added P3.06 $(0.51 + 0.74 + 1.75 + 0.06)$ to the official P2.00 cost of a dollar and brought the EER to P5.06 per dollar for nonessential consumer goods. Imports of essential consumer goods, on the other hand, were impaired only by a modest tariff (6 per cent) and a 2.3 per cent discriminatory effect from the sales tax. The EER per dollar for this category of imports was, therefore $(0.06 + 0.023) \times$ P2.00 + P2.00 = P2.17. Imports of producer goods for "new and necessary" industries were exempt from all charges except the margin-deposit requirement, and the EER in 1959 was P2.03 per dollar. The value of the internal tax exemptions for new export industries was 10.9 per cent in that year, and the interest subsidy on output was assumed to remain at 4 per cent throughout the period (see the appendix to this chapter). This 14.9 per cent subsidy on sales yields a figure of P2.30 per dollar for the EER for new exports, i.e., 1.149 $\times$ P2.00.

11. The actual shifts in the structure of production are analyzed in the next chapter.

12. Again, it should be noted that this figure is an underestimate of the increase in the market cost of imports because of the existence of exchange controls in 1959.

13. The explicit rate of protection is taken to be the percentage by which the EER for a particular category exceeds the EER for producer goods for "new and necessary" industries.

14. The Central Bank stopped publishing import unit values by detailed commodity groups after 1955.

15. Let x be the 1951 c.i.f. prices of nonessential goods, $2x$ the implicit protection on these goods, and $3.0x$ the 1951 domestic price. Since this price increased 0.8 between 1951 and 1959, the 1959 price is $5.4x$. Dividing this by x, the 1959 c.i.f. price, gives 5.4 or 440 per cent $[(5.4 - 1.0) \times 100]$ as the rate of protection in 1959. Changes in c.i.f. import unit values are not taken into account in the calculation, since this index actually declined slightly between 1951 and 1959.

16. The steps in the calculation are as follows: (a) The peso cost of a dollar's worth of nonessential consumer goods in 1962 was 1.98 times as large as in 1959, i.e., 10.04/5.06, whereas the import unit value (in dollars) index in 1962 was 1.04 times its 1959 level. The peso cost of a given bundle of nonessential consumer goods in 1962 was, therefore, $1.98 \times 1.04 = 2.06$ times its 1959 cost. Put the other way around, the peso cost of a given bundle of nonessential consumer goods in 1959 was 1.00/2.06 or 0.49 of its 1962 level. (b) Since the wholesale price index for nonessential consumer goods was 308 in 1962 (Table 5-6) when there were no exchange controls and thus no windfall profits, the cost of these goods in 1959 including the effects of all fiscal and monetary measures and expressed in terms of the wholesale price index was 151, i.e., 0.49×308. (c) Thus, the c.i.f. cost of these goods in 1959 equaled 151 less the effects of the fiscal and monetary measures. Since the effects of these measures provided a protective rate of 149 per cent, the c.i.f. import cost expressed in terms of the wholesale price index was 61, i.e., letting x be the c.i.f. import cost, $1.49x + x = 151$. (d) Because the cost in terms of the wholesale price index was 61 in 1959 while the actual wholesale price index

in 1959 was 281 (Table 5-6), the level of implicit protection in that year was [(281/61) − 1] × 100 = 361 per cent.

17. This figure would be the implicit rate in 1959 because the wholesale price of the product was the same in 1959 as in 1951.

18. John H. Power, "The Structure of Protection in the Philippines," in Bela Balassa and associates, *The Structure of Protection in Developing Countries* (Baltimore: Johns Hopkins Press, 1971), pp. 271–280. Input-output data for the manufacturing sector were obtained by Power from the 1965 Survey of Manufactures, made available by the Philippine Bureau of Census and Statistics, whereas input-output data for nonmanufacturing sectors were based on the Philippine Census of Manufactures for 1961.

19. It appears, however, that Power's correction for the discriminatory effect of the sales tax is excessive. He compares the tax levied on the marked-up value of imports with the tax levied domestically on "the portion of the manufacturer's price that represents inputs not already taxed (for the most part, value-added plus electricity, fuel, and depreciation)" (Power, "Protection in the Philippines," p. 271). While it is true that a particular domestic manufacturer pays on this base, the prices of previously taxed inputs are already inflated, and they cut into the protection on value added. His measure of the degree of preference provided domestic producers would be correct only if no tax had been levied on these inputs. However, except for such items as automobiles, jewelry, toilet preparations, sporting goods, refrigerators, synthetics, silk and wool fabrics, television sets, combination radio and phonograph sets, luggage, and furniture, where the sales tax is between 30 and 50 per cent and the markup between 50 and 100 per cent, the exaggeration of the protective effect of the sales tax by Power is not very significant. The sales tax for most nonluxury items is only 7 per cent; and the markup on imports, 25 per cent. Thus, for a commodity for which value added plus electricity and fuel amounts to 40 per cent of its total value, the exaggeration of the implicit import tax would amount to only five percentage points.

20. The 97-sector, input-output transaction table for 1965 together with tariff and sales-tax data were kindly supplied by Tito A. Mijares, the director of the Philippine Bureau of the Census and Statistics.

21. See the appendix to the chapter for the source of these data.

22. In 1958 and 1959 the lowest rate for imports was P2.03 to the dollar.

23. Cited by F. H. Golay, *The Philippines: Public Policy and National Economic Development* (Ithaca: Cornell University Press, 1961), p. 151.

24. In the case of imports, however, it is suggested by the data in Table 5-11 that the incentive to overvalue imports as a means of shifting funds abroad was outweighed by smuggling and by the incentive to undervalue the goods in order to reduce customs duties.

25. E. B. Ayal, *The Philippine Cotton Textile Industry* (Center for Development Planning, National Planning Association, Field Work Report 24, January 1968).

26. *Central Bank News Digest,* August 31, 1971, p. 5.

27. It is assumed that foreign prices are the same regardless of the volume of Philippine imports.

28. For a discussion of the welfare effects of smuggling, see J. Bhagwati and B. Hansen, "A Theoretical Analysis of Smuggling," *Quarterly Journal of Economics,* May 1973.

29. *Philippine Manufacturing.*

30. Ibid., Table 6.2, pp. 91–96.