

# Trade and Investment in the Philippines

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## ABSTRACT

Developing countries such as the Philippines relies heavily on trade and foreign direct investment (FDI), consequently leading to economic integration, which in its entirety, determines the country's economic condition. As such, we believe that there is a need to further study the impact of these external variables on the competitiveness and efficiency of the Philippine economy.

**Keywords:** economic itegration, international trade, foreign direct investments, Philippines

## I. Introduction

This work provides a sample of studies on trade and investment in the Philippines. The first section reviews the literature on Philippine trade, particularly the evolution of the country's trade policy and their ensuing impact on different sectors and aspects of the economy. The second section looks at the literature on FDI in the Philippines. In particular, the section reviews research done on FDI policies, determinats of FDI and impact of FDI on the economy. The third section looks at studies that tackle economic integration – a consequence of both trade and investment liberalization. The last section identifies important gaps in the literature that may be the subject of future research.<sup>1</sup>

### 1.1. Evolution of Philippine Trade Policy

The literature covering the developments in the Philippines' trade policies is rich. Wignaraja et al. (2010), Balboa & Medalla (2006), Balisacan & Hill (2003), and Austria (2001), Cororaton (1998), and Austria & Medalla (1996) are among the many studies that provide a detailed account of the Philippines' trade regime in different decades.

Philippine trade policy has experienced major shifts throughout the decades. From the 1950s-1970s, the government embarked on an import-substituting trade regime. These decades can be characterized by highly protective tariffs, foreign exchange control measures, and capital market interventions. Realizing the limitations of such a policy, the government shifted the country's trade policy using various liberalization packages. The first half of the 1980s saw the introduction of a Tariff Reform Program (TRP). The program involved the "tariffication" of quantitative restrictions, simplification of the tariff rate structure to a narrower rate range, and

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<sup>1</sup> A literature map is provided in the Appendix.

reduction in the tariff protection. This was followed by two more waves of tariff reform programs in the 1990s – TRP II and TRP III. TRP II was introduced in 1991 and is an extension of the program introduced in the 1980s. Under TRP II, phase-in period and transition rates were included in the tariff structure.<sup>2</sup> TRP III, meanwhile, was introduced by the government in 1994, in response to the private sector's request of lowering tariffs on capital and goods and raw materials to improve their competitiveness.<sup>3</sup> The Philippines' accession to the World Trade Organization (WTO) in 1995 also called for another set of liberalization package to comply with WTO commitments. Among these include the lifting of import restrictions on certain agricultural products, elimination of duties on certain industrial and information technology products and the creation of a four-tier tariff schedule. Further trade policy liberalization was introduced in the 2000s to support the government's commitment to market friendly regulations.<sup>4</sup> For instance, by 2010 duties were eliminated on 99% of products in the Inclusion List of the Common Effective Preferential Tariff (CEPT) scheme of the ASEAN Free Trade Area (AFTA).<sup>5</sup> In 2008, the Japan-Philippines Economic Partnership Agreement (JPEPA) was enforced, which is the Philippines' first bilateral free trade agreement.

## **1.2. Impact of Trade Liberalization**

The push for trade liberalization in the Philippines was primarily due to the failed protectionism and import substitution strategy implemented in the past. Trade liberalization is expected to improve the allocation of resources and bring domestic prices closer to world price, which are in turn expected to deliver sustained economic growth and development. However, with the mixed experience of different countries that have undergone trade liberalization, a recurring question is whether trade liberalization enhances productivity and economic growth, help reduce income inequality and alleviate poverty in a developing country.

### **1.2.1. Productivity**

The focus of many studies on the impact of trade liberalization on productivity stems from the prediction that liberalization of trade influences producer behavior.<sup>6</sup> Foreign competition brought by trade liberalization forces domestic firms to improve their productivity in order to survive. In addition, trade liberalization enables domestic firms to use high-quality imported parts, components and machinery at lower prices; thus, improving their productivity.

On a cross-country study covering the Philippines, Korea, Taiwan, Thailand, Malaysia, Indonesia, and India for the period 1970 to 1991, Urata (1994) investigated the impact of trade liberalization on each country's total factor productivity (TFP). Using tariff rates and the volume of exports and imports to capture trade liberalization, results revealed that for most countries in the sample, including the Philippines, trade liberalization had a positive impact on TFP growth, but the relationship is not always stable or statistically significant. Austria (1998a) and Cororaton

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<sup>2</sup> Cororaton (1998)

<sup>3</sup> Menardo (2004)

<sup>4</sup> Ibid.

<sup>5</sup> Palabyab, Nestor P. "Opening market opportunities in ASEAN: ASEAN Free Trade Area."

[http://www.dti.gov.ph/uploads/DownloadableForms/mac-afta\\_05Nov10.pdf](http://www.dti.gov.ph/uploads/DownloadableForms/mac-afta_05Nov10.pdf) (last accessed November 5, 2012)

<sup>6</sup> Urata (1994)

& Abdula (1999) used the same measures to capture the impact of trade on TFP of the Philippines. The former covered the years 1960 to 1996, while the latter covered 1958 to 1991. Austria (1998a), using cointegration techniques, found that exports had a positive and significant impact on TFP, while Cororaton & Abdula (1999), using multivariate regressions, found that exports only had marginal impact on TFP. Both studies showed negative coefficient for imports. Austria (1998a) explained that the country's lack of manpower skills to operate imported machines and transport equipment has led to declining productivity. Meanwhile, Cororaton & Abdula (1999) explained that this was due to the inappropriateness of the technology adopted by industries and failure to integrate it with the forward and backward linkages of the economy. While Cororaton & Abdula (1999) found that low period differences in tariff rates have negative and significant impact on TFP,<sup>7</sup> Austria (1998) found that tariff rates have an insignificant impact on the country's TFP.

Aforementioned studies generally find that trade liberalization in the Philippines have limited impact on productivity. Moreover, foregoing studies have used macroeconomic data since the Philippines does not have a readily available micro level database to analyze the impact of trade liberalization on productivity. Surveys have to be carried out in order to conduct studies that are based on micro data. Hallward-Driemeier, et al. (2002) used plant-level data for four East Asian economies – the Philippines, Indonesia, South Korea, and Thailand, to examine how the extent of trade openness in markets influence manufacturing productivity. In particular, they investigated whether exporters or firms that are more integrated to broader markets are more productive than non-exporters. The analysis for the Philippines was based on a survey conducted in the late 1990s covering 424 registered firms with at least 20 employees in the food, textile, garment, chemical, and electronic sectors. Using multivariate regressions, the study revealed that exporters are significantly more productive than non-exporters that sell only in the domestic market. In addition, the productivity gaps were found to be larger in the Philippines and Indonesia, which were identified as having less developed domestic markets compared to South Korea and Thailand. The study also showed that greater access to world markets drives firms to undertake investments that increase their productivity.

Aldaba (2010) assembled a firm-level panel dataset of Philippine manufacturing establishments covering an eight-year period from 1996 to 2006 (1999, 2001 and 2004 are missing).<sup>8</sup> The study examined the impact of major trade reforms on the productivity of different types of firms in different sectors, where the classification was based on the sectors' trade orientation – traded sector: purely exportable, purely importable and mixed; and non-traded sector. Greater exposure to international trade due to trade liberalization can drive efficient domestic firms to expand and the less efficient ones to shrink or exit the market. Thus, trade liberalization restructures and reshuffles the resources and activities within and across sectors. Employing a non-parametric approach, results of the study showed some evidence that trade liberalization leads to productivity gains and protection leads to productivity losses. Moreover, aggregate productivity growth in the purely importable sector and mixed sector declined, while aggregate productivity in the purely exportable and non-traded sectors both increased in the period of study.

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<sup>7</sup> In the period of study, period differences in tariff rates barely changed, implying that protection reduced TFP.

<sup>8</sup> With the aid of the National Statistics Office (NSO) Staff

In contrast to other developing countries that have readily available national database of firms (for instance, Indonesia, Mexico and Venezuela), the Philippines does not have such data available. Thus, the work of Aldaba (2010) offered a novel way of analyzing the impact of trade liberalization on productivity in Philippine setting. Although insights provided by studies using macro data are valuable, important relationships may be concealed. Efforts in organizing micro level database in the Philippines such as the one assembled by Aldaba (2010) should be further encouraged as using micro level data may provide more fruitful analysis.

### **1.2.2. Economic Growth**

Several studies focus on the impact of trade on economic growth. The promotion of production efficiency, better allocation of resources and increase in competitiveness of domestic products brought by trade liberalization are among the reasons why the latter is expected to have a positive impact on economic growth.

Using the APEX Model,<sup>9</sup> Cororaton (1996) conducted simulations to investigate how changes in sectoral nominal and implicit tariff rates from 1988 to 1992 affect economic growth. Results show that changes in nominal tariff rate lead to annual real GDP increases by 0.47 percent on average. Using a financial computable general equilibrium (FCGE) model of the Philippine economy, Cororaton (1997) conducted another set of simulations concerning tariff changes with two different exchange rate regimes – fixed and flexible exchange rates. Results revealed that a tariff reduction program implemented within a flexible exchange rate regime has the biggest and exerts a positive impact on output.

Meanwhile, Yap (1997) simulated the changes in tariff from 1993 to 1996 using the PIDS macroeconometric model to investigate the impact on aggregate and sectoral economic output. Results show that aggregate economic output increased as a result of the decline in the average tariff rate. In addition, all major sectors showed output improvement. Nevertheless, effects differ across major sectors – the industry sector benefited the most, while the agricultural sector the least during the simulation period. Using a smaller macroeconometric model, Yap (1997) conducted simulations to investigate the impact on the economy of an across-the-board uniform tariff of five percent. Results reveal that that the policy leads to greater demand for imports, which leads to worsening of the trade deficit. In addition, the increase in the volume of imports does not compensate for the reduction in the tariff rate, resulting to deterioration of the fiscal balance. Results implied that tariff reduction makes macroeconomic constraints more restrictive, which leads to an unambiguous fall in investment and, consequently, in a lower growth rate. In contrast, Tan (1997), employing a partial equilibrium trade model based on input-output framework, found that a five percent uniform tariff has favorable effects. Output can possibly increase as a result of improvement in resource allocation in the tradable sector. In addition, output and income growth can potentially be higher at lower uniform tariff. On a sectoral basis, the growth rate for the manufacturing sector is highest, while the decrease in output is least for agriculture.

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<sup>9</sup> APEX stands for Agriculture Policy Experiments. The model was developed by Ramon Clarete, Peter Warr and their associates. It is a neoclassical, Walrasian computable general equilibrium (CGE) model of the Philippine economy with a well-defined production (or supply) sector, as well as a consumption (or demand) sector. See Yap (2002) for more details.

Focusing on the trade reforms for the period 1995-2000, Cororaton & Cuenca (2000) used a 50-sector CGE model of the Philippine economy and found that over the period, real GDP improves. Nevertheless, variations in sectoral and annual effects exist, depending on the trade reform considered.

### **1.2.3. Income Distribution and Poverty**

Traditional trade theory predicts that trade liberalization would have income distribution effects. In particular, the Heckscher-Ohlin (HO) model predicts that trade liberalization leads to declines in income inequality in developing countries - countries abundant in unskilled/less skilled workers. Nevertheless, the empirical literature shows mixed evidence of this prediction.

Yap (1997) capture the income distribution effects of the tariff change from 1993 to 1996 by incorporating an income distribution model in a macroeconometric model. Results revealed that income distribution deteriorated, possibly due to the difference in impact of the tariff change across sectors. While all sectors registered a positive increase in output, the industrial sector posted the biggest positive increase, while the agricultural sector registered the least. Since majority of households in the lower income brackets in the Philippines still depend on the agricultural sector, the relatively lower output growth in agriculture generates unfavorable income distribution effects.

Meanwhile, using the APEX model mentioned earlier, Cororaton (1996) investigated the income distribution effects of the tariff changes from 1988 and 1992. The results revealed some progressivity in the tariff change during the period, where households in the lowest income bracket enjoyed the highest increase in income compared to the highest income bracket. Furthermore, among the prices of unskilled labor, skilled labor and capital, the price of unskilled labor obtained the highest increase for both fixed and flexible exchange rate regimes. Since unskilled labor usually belongs to the poorest segment of the population, this benefits the poor. Moreover, the price of capital increased faster than the general price of labor. This resulted in some kind of a substitution effect in favor of labor; thereby, implying favorable income distribution effects.

Similarly, Cororaton (1998) and Cororaton & Cuenca (2000) found that the impact of tariff reforms on income distribution was generally positive. Cororaton (1998) used a 34-sector economy-wide model and found that for the period 1990 to 2000, the impact of the tariff reforms on income distribution is generally favorable, especially in the second half of the 1990s. In particular, all income groups enjoyed an increase in their absolute income as a result of the tariff change. Nevertheless, the impact differs across income groups, with the lowest increase in the poorest household. In addition, resource allocation across sectors changed as a consequence of the tariff change, where a general resource movement from agriculture and construction to manufacturing and utilities was observed. Meanwhile, Cororaton & Cuenca (2000) found that for the period 1995 to 2000, the lowest income group registered the highest increase in income relative to the other income groups.

Hasan & Jandoc (2010) showed that trade reforms did not significantly affect income inequality. Using wage decomposition techniques and multiple regression methods, the study examined the impact of trade liberalization on wage inequality in the Philippines for the period 1994 to 2000 - a period over which trade protection declined and inequality increased dramatically. The study suggests that trade liberalization did not significantly contribute to inequality in the country. In particular, results of the study revealed that trade-induced effects on industry wage premia and industry-specific skill premia account for an economically insignificant increase in wage inequality. Changes in economy-wide returns to education and changes in industry membership appeared to be more important drivers of wage inequality. In addition, the impact of trade liberalization on wage inequality was mainly attributed to trade-induced employment reallocation effects wherein decline in trade protection have led to a shift of employment to more protected sectors, especially services where wage inequality tended to be high to begin with.

Cororaton, et al. (2005) focused on the possible impact of free trade and the Doha agreements, in particular, on Philippine poverty using a detailed CGE analysis. Various policy experiments reveal mixed effects. The implementation of Doha agreements was found to slightly increase poverty. In particular, rural households and the agricultural self/un-employed, where the poorest and most populous households in the country belong, are adversely affected due to reduced world prices and demand for Philippines' agricultural exports. Meanwhile, full trade liberalization - that is, free world trade, marginally reduces the poverty incidence. Free world trade increases industrial exports, which favors urban households. The agricultural sector likewise benefits as the cost of competing agricultural imports increase.

#### **1.2.4. Labor Market**

One sector of the economy frequently examined in analyzing the impact of trade liberalization in a country is the labor market. Specific attention is often given to employment and wage effects as these have important welfare implications.

Cororaton & Cuenca (2000) found that tariff reductions from 1995-2000 led to generally favorable employment effects, albeit with apparent gainers and losers across sectors. In particular, a significant increase in industry employment is registered. However, declines were registered in agriculture and services. Meanwhile, Orbeta (2002) analyzed the impact of globalization measured by trade flows, on employment level and structure for the years 1980 to 2000, both at the aggregate and manufacturing sub-industry levels. At the aggregate level, results of the study showed that labor demand increases with higher propensity to export and import. At the manufacturing sub-industry level, greater export propensity has a positive impact on labor demand while import propensity has an insignificant impact on labor demand. In terms of employment structure, at the aggregate level, trade openness does not show a significant impact on the proportion of women workers employed but at the manufacturing sub-industry level, the increase in the propensity to export is beneficial for women workers. In addition, increases in export propensity increase the proportion of low-skilled production workers employed both at the aggregate and manufacturing sub-industry levels. Orbeta (2002) concludes that expansion in exports has increased the demand for workers in the Philippines with basic skills.

Hasan & Chen (2003) examined the impact of trade liberalization on wages and employment in the Philippines' manufacturing sector in the period 1988 to 1997. Results of the study revealed that trade liberalization had fairly modest effects on both relative industry wages as well as employment in the Philippines in the period of study. However, not all groups of workers were left unaffected by liberalization. Workers in capital-intensive industries, especially skilled ones, experienced declines in industry wage premiums. Less-skilled workers in capital-intensive industries, meanwhile, appeared to have to work longer hours as a result of trade liberalization. We also showed that wage inequality in the manufacturing sector has declined and that there was no observed rise in returns to higher education in the period of study.

While most studies on the impact of trade liberalization on the Philippine economy focused on trade in goods, very few research has been done so far on the impact of liberalization in trade in services on the economy. An exception is the study of Amoranto, et al. (2010).

Amoranto, et al. (2010) investigated the impact of services liberalization in banking, telecommunications, and distribution on employment and wages in the Philippines for the years 1991 and 2004. In particular, the study estimated the probability of full-time stable employment and the effect on wages given services liberalization in aforementioned services. Results of the study revealed that in general, liberalization in the services considered in the study had no significant effect on employment in stable jobs for males and females. However, it is associated with decreased wages for females and increased wages for males in full-time salaried work. Among the three industries, liberalization in telecommunications had the greatest effect in terms of reducing employment in stable jobs and in reducing the wages of full-time salaried workers for both males and females. Meanwhile, compared to telecommunications and banking, liberalization in distribution services favored workers in terms of higher wages across different levels of education, except for those in the lowest category of educational attainment (those without education or only elementary education). Moreover, results suggest that services liberalization appear to have potentially harmed the more vulnerable populations that are least educated, and may have shifted employment to more higher skilled males compared to females.

### **1.2.5. Environmental and Labor Standards**

An important strand in the international trade literature is the link between trade liberalization and the environmental and labor standards in a country. Traditional literature suggests that there is race to the bottom among countries participating in international trade. Lower labor and environmental standards lead to lower production costs, which enable exporting firms to be more competitive internationally. Nevertheless, increased awareness of environmental and labor issues and the presence of foreign competitors that produce at higher standards may pressure domestic producers to adopt higher standards. Moreover, some developed countries require certain standards be met and tests be passed by goods exported in their countries; for instance, ISO certification, sanitary and phytosanitary (SPS) standards, and eco-labels. However, studies on this topic for the Philippines are scant.

Aldaba & Cororaton (2001) assessed the impact of trade reforms on the environment and environmental standards using CGE model simulations and industry case studies. Results of the study revealed that trade liberalization does not lead to general environmental degradation, but promotes competition and efficiency. Large export-oriented firms appear to be the promoters of sound environmental practices and are the first to implement environmental management system. The critical role played by technology in controlling pollution is likewise recognized. In particular, introducing changes in technology together with trade reforms lead to significant improvements in the environment.

Meanwhile, Edralin (2000) investigated the position of enterprises regarding social clauses. Social clause espouses that international labor standards (set by the International Labor Organization) be incorporated in international trade agreements to ensure that trade liberalization is accompanied by improvements in conditions at work and not by race to the bottom that exploits labor. On the one hand, better labor conditions are expected to increase the productivity of workers, enabling them to be more competitive. On the other hand, higher labor standards may come at a cost to firms, reducing or eliminating their edge against the lower labor cost in other developing countries. Based on a survey of 125 enterprises in the manufacturing sector, the study revealed that majority from management and union are in favor of a social clause. The profile of enterprises that are in favor are those that are in the chemical products sub-sector, are owned by Filipinos, are registered as single proprietorship, have a large employment size, have medium capitalization, had an average profit the previous year, and have been operating its business for 2-10 years. Meanwhile, enterprises that are not in favor of a social clause are mainly those that are in the textile and wearing apparel and furniture and wood product industries. Small businesses, in particular, are concerned of the lower labor costs in countries such as China and Vietnam. Nevertheless, Edralin (2000) highlights the need for labor standard reforms to ensure long-term competitiveness and that the Philippines gives globalization a human face.

## **II. Foreign Direct Investments**

Most developing countries are capital-scare and have limited access to international financial markets relative to developed nations. Since capital accumulation is recognized to foster economic growth, many developing nations offer incentives to attract FDI as an alternative source of capital. Apart from the inflow of capital, FDI is expected to introduce a myriad of favorable productivity spillovers in the host country – technological advancement, improved research and development, superior management skills, and expanded marketing network, among others. Hence, FDI is expected to promote growth and enhance welfare. Due to these expected benefits, there is vigorous effort by developing countries, the Philippines included, to attract FDI.

### **2.1. Evolution of Philippine FDI Policy**

Many studies have assessed the FDI experience and investment policies of the Philippines. To name a few, Aldaba (1994) provided a very comprehensive discussion of the Philippines' FDI policies and patterns from the 1960s to the 1990s. Aldaba (2006) and Balboa & Medalla (2006) provided a summary of FDI patterns and policies in the 1980s to early 2000s.

Matriano (2002) provided a brief summary of the Philippine FDI experience for the period 1997 to 2001.

Similar to trade policy, investment policy in the Philippines has experienced reforms. Beginning in the 1980s, the attitude of the Philippines toward foreign direct investment has changed considerably (Aldaba, 2006). One of the most important steps undertaken to liberalize investment policy in the 1980s was the passage of the Omnibus Investment Code (OIC) of 1987. The OIC of 1987 simplified and consolidated previous laws and provided two important incentives, namely, the provision of income tax holiday for enterprises engaged in preferred areas of investment and taxable income deductions for the use of skilled and unskilled workers that satisfy certain BOI requirements. Other incentives in the OIC include tax and duty exceptions on certain capital equipment and accompanying parts, tax credits on domestic capital equipment, employment of foreign nationals for technical and advisory positions for a certain period, and simplified customs procedures.

In the 1990s, an important step taken to liberalize investment policy was the Foreign Investment Act (FIA) of 1991, which liberalized existing investment regulations. In particular, foreign equity participation up to 100 percent was allowed in all areas unless the investment is prohibited or limited under the Foreign Investment Negative List. Over time, the negative list was considerably reduced.

In 1994, entry and operations of foreign banks was liberalized. Foreign banks were allowed to acquire up to 60% ownership of domestic banks. The capital market was likewise liberalized with the removal of some foreign exchange controls, including the surrender requirement for export proceeds and Bangko Sentral ng Pilipinas (BSP) approval of forex transactions and capital repatriation.

In 1995, Republic Act 7916 allowed greater private sector participation in the development and management of the country's special economic zones and expanded the activities permitted within the zones. According to the World Bank (1997), the integrated package of policies, streamlined procedures and physical infrastructure offered by economic zones resulted in a net positive economic impact.

By the 2000s, more liberalization efforts specific to FDI were undertaken. For instance, in 2000, the General Banking Law provided a seven-year window during which foreign banks may own up to 100 percent of one locally-incorporated commercial or thrift bank (with no obligation to divest later). The Retail Trade Liberalization was likewise passed in 2000 that allowed foreign investors to enter the retail business and have 100 percent ownership (with minimum equity requirement).

Though substantial progress has been made in liberalizing the country's FDI policy, barriers to foreign investment entry still remain. For instance, due to constitutional constraints, foreign investment is restricted in certain industries – mass media, small-scale mining, private security agencies, and the manufacture of firecrackers and pyrotechnic devices, among others. Limit on foreign ownership remain on enterprises engaged in domestic air transport, public utilities, pawnshop operations, education and employee recruitment, among others.

## 2.2. Determinants of FDI

Despite the steps taken to liberalize investments in the country, studies show that FDI inflows in the country have displayed unstable patterns of growth and the Philippines has lagged behind its neighboring countries in attracting FDI inflows. The FDI experience of the Philippines brings to attention whether the country has the necessary conditions and environment conducive for attracting and maintaining investments. This is a very important question; thus, has been the subject of many research.

Austria (1998b) identified the factors that explained FDI patterns in the Philippines in the 1990s. Factors that attracted FDI in the 1990s include the government's general policy of openness, strong macroeconomic fundamentals, economic recovery and political stability. Meanwhile, factors that inhibited FDI include the militancy of labor unions, inadequate technical and vocational skills of the labor force, high cost of unskilled labor relative to Indonesia, Vietnam or China, slow growth of labor productivity relative to wage increases (primarily due to minimum wage setting), poor infrastructure and lack of competitive support industries.

Aldaba (1994) empirically explored the factors influencing FDI inflows for the period 1973 to 1992. Results of the regression analysis showed that FDI inflows is positively correlated with the stock of public investment, real GDP and the real effective exchange rate; and is negatively related with political instability. Changes in investment incentives were also shown to have no influence on FDI inflows in the period of study. In addition, for the period considered, FDI inflows were shown to be positively related to the effective rate of protection and that most FDI inflows were import-substituting. Aside from analyzing the behavior of aggregate FDI inflows, Aldaba (1994) disaggregated the FDI inflows coming from the US, Japan and the EC6. Results show that FDI inflows from these sources respond differently to different factors considered in the study.

The results of Albuero (1998) showed some similarities with that of Aldaba (1994), albeit working on a different time period. Based on the analysis of FDI inflows for the period 1985-1997, the real exchange rate, effective protection rate and rates of return were shown to have a positive impact on FDI inflows, while the amount of commercial credits has a negative impact on FDI inflows. Bilateral investment treaties of the Philippines, meanwhile, were shown not to have a significant impact on the country's FDI inflows.

Notable is the positive and highly significant impact of effective protection rate in both studies, suggesting that FDI attracted by the Philippines are in general not export-oriented. Albuero (1998) mentions that this is not to undermine the growing importance of FDI in export-oriented sub-sectors (e.g., electronics), but merely shows that FDI attracted in the period covered by the studies are in general not attracted to the exporting sectors of the country.

Balboa & Medalla (2006) provide a descriptive analysis to explain the FDI experience of the Philippines. Based on the work of Banga (2003), they identified three categories of government policies, namely, overall economic policy, national FDI policies, and international FDI policies that affect FDI inflows in a country. The first category includes investments in infrastructure, in particular, environmental and urban management (waste and traffic

management), where the the Philippines is lagging; and industrial power supply, where the Philippines has a high cost compared to other Asian countries. Wage and labor productivity relation likewise fall under this category, where it was identified that the Philippines has one of the highest minimum wages in Asia and yet has one of the lowest labor productivity. The second category includes the tax structure and tax administration in a country. While Aldaba (2006) mentions that the Tax Reform Package in 1986, the Comprehensive Tax Reform Program in 1994 and the Tax Reform Act of 1997 have significant positive impacts on the Philippine tax system, Balboa and Medalla (2006) mention that the Philippines still has one of the highest corporate and value-added taxes compared to its neighbors. Likewise, the Philippines' lack of tax administration transparency and reputation for tax evasion have had negative impacts on the investment climate of the country. Another important policy under this category is fiscal incentives, where the Philippines was identified to have a fairly competitive incentive package vis-a-vis other ASEAN countries. Restrictions and limitations in foreign investments and land ownership also falls in this category. While the Philippines has undergone extensive liberalization with regard to investment and land ownership (Matriano, 2002), Balboa & Medalla (2006) mention that the country still has one of the most restrictive rules compared to its ASEAN neighbors. Related to this, the authors mention that countries with stricter rules on investment and land ownership resulted to more corruption. The third category includes membership of a country in bilateral investment treaties and economic partnerships. As of June 2012, the Philippines has signed 35 BITs, 30 of which have already been entered into force.<sup>10</sup>

While the analysis of Balboa & Medalla (2006) is useful in identifying the policies that could be improved on to promote greater FDI inflows, the study fails to identify which among the policies require the most attention and have the most impact in terms of influencing FDI inflows. With the government's lack of resources, it is imperative to identify which among the identified factors influencing FDI inflows would bring the most impact. ADB (2005) conducted a survey in 2003 in four manufacturing sectors, namely, food and food processing, garments, textiles, and electronics that somewhat addresses this concern. The survey analyzed the relative importance of macroeconomic fundamentals, infrastructure, governance and institutions to investors. Result of the survey revealed that macroeconomic stability, corruption, electricity, tax rates, and economic policy uncertainty are the top five concerns of investors in the country surveyed in the study. A periodic survey similar to the foregoing should be encouraged and should be extended to other sectors (i.e. service, which is growing in economic importance). Such surveys and studies can serve as a monitoring mechanism whether the concerns of investors are adequately being addressed by the government.

Instead of simply enumerating and describing the policies and factors that require government attention, another approach that could be taken is to choose an existing FDI policy and analyze its economic importance vis-à-vis the cost of implementing it. An example of such study is Reside (2006a, 2006b), which focused on fiscal incentives. The results of both studies showed that fiscal incentives are not significant and that fundamental factors are more important in attracting FDI and regional investments in the Philippines. Reside (2006a, 2006b) suggested that government resources should instead be spent on productivity-enhancing goods such as education and infrastructure.

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<sup>10</sup> UNCTAD Investment Instruments On-line Database.  
[http://unctad.org/Sections/dite\\_pcbb/docs/bits\\_philippines.pdf](http://unctad.org/Sections/dite_pcbb/docs/bits_philippines.pdf) (last accessed November 5, 2012)

### 2.3. Impact of Foreign Direct Investments

While it is important to review the country's history of FDI policies and determinants of FDI inflows, it is equally important, if not more important, to investigate the impact of FDI in the country.

In a cross-country study of 9 Asian countries including the Philippines, Dhakal, et al. (2007) investigated whether there is a two-way causality between FDI and economic growth over the period 1980 to 2001. It showed varying results for different countries. For the case of the Philippines, it was revealed that while FDI causes economic growth, the latter also stimulates the former. Thus, there is a two-way causality between the two. FDI-to-growth causality is reinforced by the presence of greater trade openness, more limited rule of law, lower receipts of aid. Growth-to-FDI causality, meanwhile, is strengthened by greater political rights and more limited rule of law.

Instead of looking at the amount of FDI inflows, Choong & Liew (2009) investigated the impact of FDI volatility on economic growth for the ASEAN-5 for the period 1974 to 2005. The study revealed that FDI volatility and economic growth are cointegrated, implying a long-run relationship between the two. In particular, FDI volatility has a significant and negative impact on economic growth of the ASEAN+5, albeit not significant for Singapore. For the case of the Philippines, a 1% increase in FDI volatility is associated with a 0.41% rise in economic growth. Among the countries considered in the study, the Philippines' economic growth is the least vulnerable to FDI volatility. At first look, this may be encouraging since this implies that the country's economic growth is not highly dependent on FDI inflows. However, one possibility for this result is that the FDI inflows in the Philippines may be small relative to that of other countries in the study; thus, the small observed impact on the country's economic growth.

The study of Bende-Nabende & Slater (2003) investigated the impact of FDI on domestic private investment both in the short-run and long-run covering the period 1971 to 1999 for 4 ASEAN countries – Indonesia, Malaysia, Thailand, and the Philippines. The results showed that in the short-run, there is significant crowding in effects for the Philippines and Thailand, insignificant crowding in effects for Indonesia, and insignificant crowding out in Malaysia. The authors suggest that in the short-run, FDI tends to crowd in domestic investment in comparatively less developed countries, but crowd out in more developed ones. In the long-run, it was shown that there is significant crowding in for the four countries<sup>11</sup>.

The preceding discussion shows that the empirical literature on the impact of FDI on the Philippine economy is scant. In addition, aforementioned studies are cross-country wherein the Philippines is just one of the observations; thus, they fail to provide a detailed analysis for the Philippines. One recent study by Agbola (2007) is an exception. The study empirically investigated the impact of FDI on economic growth in the Philippines in the period 1970 to 2006. Results of the study showed that FDI has a positive impact on economic growth of the country. The study suggests that FDI may be more important than domestic private investment in enhancing economic growth. However, FDI is shown to crowd out domestic investment,

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<sup>11</sup> Due to sample size limitations, the authors were only able to do panel co-integration for the entire sample. No specific country analysis was done for the long-run case.

which is in contrast to the findings of Bende-Nabende & Slater (2003). Nevertheless, the study found that FDI can positively influence economic growth by stimulating human capital and infrastructure development.

The precise mechanism of how FDI affects economic growth and domestic investment depends on a myriad of factors, but aforementioned studies are unable to provide a detailed explanation as they use highly aggregated data. Hence, conclusions are at best suggestive. In such case, caution must be made when making policy recommendations. For instance, if evidence of crowding out of private investment is found at the aggregate level, it does not necessarily imply that there is no crowding in at the sectoral, industry and firm level. Moreover, it cannot be concluded that all types of FDI crowd out domestic investment. Likewise, the specific conditions why crowding out is found may be hard to identify; thus, caution must be made in making policy recommendations.

### **III. Economic Integration**

Liberalization in trade and investment throughout the years have led to greater economic integration. Reforms done in the 1980s and 1990s have reduced the inefficiency of domestic industries that were products of past protectionist policies. As a result of liberalization efforts, the country's competitiveness improved that enabled it to participate in international trade agreements.

Austria (2004) mentioned market-led process, institution-led process and private sector-led process as the main drivers of economic integration. Market-led process reflects spontaneous trade and investment flows through international production sharing. Institution-led process is driven by free trade agreements. And private sector-led process is driven by economic zones across geographically contiguous countries in a region.

#### **3.1. International Production Sharing**

International production sharing exploit the comparative advantage of different countries in producing different parts and components of a good. The Philippines participates in this production scheme primarily through the labor-intensive production processes. The studies of Austria (2002, 2003, 2004) reveal increasing economic integration of the Philippines as suggested by its growing intra-industry trade with trading partners. In particular, Austria (2002) showed an increasing intra-industry trade in manufactures between the Philippines and APEC members, especially in semiconductors and electrical machineries. Likewise, from 1990 to 1999, Austria (2003) shows an increasing intra-industry trade in manufactures between pairs of ASEAN economies. Similarly, intra-industry trade in ASEAN priority goods sectors between the Philippines and ASEAN countries from 1997 to 2001 increased, though large variations across sectors and partner countries is apparent, as revealed by Austria (2004). Nevertheless, integration is still considered weak, which can be primarily attributed to the variation in the speed of integration of member countries and stark differences in the level of development of member countries. Austria (2004) likewise mentions the rapid emergence of China as an economic power as an important challenge for the Philippines and the ASEAN in general.

By focusing on the electronics industry, Austria (2008) mentioned that the country has hardly progressed in its participation in the global production chain, as the country remains in the level of assembly and testing – segments that generate the lowest value-added. The primary culprit for the failure of the country to move to higher-value added segments of the production chain is primarily the lack of local support structures in the country; in particular, poor infrastructures and logistics, high power cost, poor quality and unreliable power, high cost of unskilled labor, lack of supplier industries and inadequate technological capabilities that constrain industrial upgrading.

### **3.2. Trade Agreements**

The unilateral and multilateral reduction of barriers to trade and investment has led to greater economic integration across economies. The Philippine government's signing and joining of various agreements is a signal of its commitment to liberalize trade and investment. Numerous studies have been made to estimate the impact of trade agreements of the Philippines.

The ASEAN Free Trade Area (AFTA) is the Philippines' first free trade agreement and was established in 1992. Its primary goal was to increase ASEAN competitiveness as a production base for the world by reducing intra-regional tariffs to 0% to 5% within a 15-year period through the Common Effective Preferential Tariff (CEPT). Pineda (1997) identified the net exporting industries to ASEAN as the primary gainers of CEPT in the Philippines. Meanwhile, using a CGE model and the GTAP<sup>12</sup> model, Todsadee & Kameyama (2010) showed that tradable agricultural and food sectors in the Philippines would benefit from CEPT. However, the study found that the potential gain for the Philippines is unclear. Simulation results for the period 2004-2010 show negative real GDP growth, reduced terms of trade, decline in allocative efficiency, and deterioration of the trade balance in some years.

In contrast, Karim & Othman (2005) shows that the Philippines benefits from AFTA. By creating a big, integrated and efficient market, AFTA is expected to attract FDI inflows in ASEAN member countries. The study of Karim & Othman (2005) reveal that FDI inflows in the Philippines is positively and significantly affected by AFTA. In addition, the study shows that China's accession to WTO has a negative impact on majority of ASEAN countries' FDI inflows, which emphasizes the importance of further strengthening AFTA.

The Asia-Pacific Economic Cooperation (APEC) was established in 1989 as informal Ministerial-level dialogue among 12 countries, of which the Philippines is included. The main thrust of APEC is to promote open trade and investment environment in the Asia-Pacific region. However, it has been subject to criticisms because it imposes no binding obligations to its members. Thus, it may be hard to separate out the effects of APEC on the economy (Drysdale & Armstrong, 2009). Nevertheless, Austria (2001) and Medalla et al. (2009) argue that the Philippines has gained from its participation in APEC. It has established economic ties and networks that not only increased the country's trade and investment from APEC members, but has helped the Philippines in the aspects of trade facilitation (standards and conformance, customs procedures, intellectual property rights, good governance and transparency, mobility of

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<sup>12</sup> Global Trade Analysis Project

business people) and economic and technical cooperation (human resource development, energy, SMEs, agriculture, environment, services, finance and others).

The Japan-Philippines Economic Partnership Agreement (JPEPA) was enforced in 2008 and is the first bilateral free trade agreement entered into by the Philippines. Medalla et al. (2010) provide a comprehensive summary of the studies that estimate the impact of JPEPA on the Philippine economy. Depending on the model used and the assumptions on the success or failure of implementing the different aspects of the agreement, JPEPA can generate a gain in real GDP as low as 0.09% to as high as 3.03%. On the sectoral level, gainers include information, communications and technology (ICT), medical services, tourism and agriculture; and losers include cement and motor parts and components. Nevertheless, the predicted impact on adversely affected sectors may be prevented if technical capabilities of these sectors are linked with existing Japanese manufacturing networks. Moreover, Medalla et al. (2010) emphasize the need for improved standards of Philippine exporters, most especially the agricultural sector, in order to benefit from JPEPA. The inclusion of liberalization of trade in services and investments and other trade related issues (e.g. trade facilitation, dispute avoidance and settlement) are other venues by which Philippines is expected to benefit from JPEPA.

In spite being a member of the World Trade Organization (WTO), Austria (2001) emphasized the value of regional trade agreements for the Philippines. First, they provide an avenue to overcome trade barriers beyond what can be achieved under the WTO at a faster pace. Second, they enhance the country's competitiveness. Third, they enable the country to address international concerns that can only be addressed at a regional level.

#### **IV. Research Gaps**

The literature on Philippine trade and investment is vast. The foregoing has only provided a sample of studies on different aspects of trade and investment in the Philippines. Though numerous studies have already been done, there are areas that remain unexplored and underexplored. Many questions remain unanswered and many issues need further analysis. The following may provide ideas that can stimulate future research.

A topic that is worthy of investigation is the impact on the Philippines of trade and investment liberalization of other countries. For instance, the recent surge of China's trade has somehow affected the competing sectors in the Philippines both in the international market and in the domestic market. Though this has been recognized in some studies (Palanca (2004) provides a comprehensive review), limited empirical investigation has been done. Future studies can refer to Kandilov (2010), which investigated whether the increase in China's exports in the Philippines and in third markets where the two are competitors (US and Japan, for instance) have adversely affected the workers in the Philippines. By stealing the domestic firms' market share, some firms may cut down operations or even exit the market; thus, some workers are necessarily displaced. For these workers, it may be interesting to see whether they experienced relocation effects as workers in the United States of America (USA). Results of such a study have important policy implications as it could have adverse and long term impacts on inequality and poverty.

The study of Amoranto, et al. (2010) on trade in services liberalization is valuable as it provided an initial step towards the analysis of other services (for instance, business process outsourcing and retail trade). A possible extension of said work is to examine the impact of liberalization in goods and services trade on within sector and across sector employment. For instance, liberalization in goods trade may have magnified impact on the labor market through forward and backward linkages. Likewise, if liberalization of trade in goods increased employment in the manufacturing sector, employment in the services sector can also be stimulated as services are inputs to many industries. A related study was done by Clemes, et al. (2003) where possible two-way spillover effects of the expansion of manufacturing and services sectors for the ASEAN-5 for the period 1965-1994 were examined. Results confirm the positive effect of manufacturing sector growth on service sector growth and vice-versa for the whole of ASEAN-5. Future work can update this study and focus on the Philippines.

An underexplored area of study in the trade literature for the Philippines is the linkage between standards and trade. Swann (2010) provided a review of the impact of various standards on trade. For instance, EU standards on clothing and textiles constrain African exports. SPS standards in OECD countries reduce the agricultural exports of non-OECD countries. And strict environmental standards reduce imports of OECD countries. Nevertheless, Swann (2010) suggests that when exporting countries are able to meet international standards, then opportunities for greater market share can be taken advantaged of. For instance, the alignment of domestic standards in the personal computer industry in the Philippines with international standards has allowed domestic firms to provide some of the components for personal computers sold in Europe. Thus, an area worthy of future investigation is to examine whether the exporters in the Philippines in different sectors are constrained or encouraged by standards set in various exports markets. If conformity to international standards is expected to increase market share, then assistance should be given to exporters to help increase their capacity to meet the standards. This will be helpful in improving their long-run competitiveness.

The role of labor union activities and other institutional factors across different industries can be explored when analyzing the trade-labor market linkage. The impact of institutional factors is often ignored in the Philippine trade literature, but may provide valuable insights. It is interesting to examine whether the characteristic of FDI inflows in the country has changed in the most recent decade (2000s). In addition, instead of merely identifying the determinants of FDI inflows in the country, one particular area of future research is to identify the contribution of FDI in the sector and region where they go. For instance, examining the contribution of FDI to national, sectoral and regional employment or labor productivity may be a fruitful exercise.

Some studies investigating the determinants of FDI inflows in the country used simple estimation techniques (see for instance Aldaba (1995) and Albuero (1998), which both used Ordinary Least Squares (OLS) as the estimation technique). Thus, important econometric issues (e.g., endogeneity) may have been ignored. If such is the case, then policy prescription may be amiss. Many studies (see Blonigen (2005) for instance) have shown that the choice of estimation technique can significantly alter the results of an equation trying to explain the determinants of FDI inflows. Hence, a possible future research agenda is to re-estimate the determinants of FDI

inflows in the Philippines using other econometric techniques to verify the results of earlier studies.

Studies similar to Reside (2006a, 2006b) must be encouraged. An analysis of different government policies aimed at attracting FDI should be evaluated in relation to their effectiveness and costs. As mentioned earlier, the Philippines has 35 BITs. However, very few have received attention in terms of detailed policy analysis and whether the goal of each agreement has been successfully achieved. The Philippines has BITs with Switzerland, the United Kingdom, and Australia, among others, but there has been little or no study at all done on the particulars of these treaties and whether the Philippines has taken advantage of them. Thus, this is a possible area of future investigation.

There is a dearth of studies investigating the impact of FDI on the Philippine economy, leaving a considerable area for future research. First, it is interesting to see whether FDI has the same impact on domestic public and private investments. Most studies assume that the mechanism of how FDI affects domestic investment is through private investment only. In particular, MNCs may crowd in domestic investment due to productivity spillover effects and crowd out due to competition (Aitken and Harrison, 1999). However, it is possible that the pursuit for more FDI or pressure from MNCs may drive the host country government to make public investments (Oman, 2000). Second, it may be worth investigating if different forms of FDI have different effects on the Philippine economy. For instance, Calderon et al. (2004) suggest that greenfield FDI<sup>13</sup> is expected to have an impact on the economy through increase in physical assets whereas mergers and acquisitions will more likely affect domestic firms through spillovers. Third, differentiating between the intra- and inter-industry as well as forward and backward linkage effects of FDI may provide valuable information. Arndt et al. (2010) suggest that the impact of FDI on the host country depends on the structure of the industry where they go; thus, it is important to look at the different linkages across industries.

Fourth, it is likewise worth investigating if FDI on the manufacturing and services sectors have different effects on the economy. While the impact of FDI on the manufacturing sector may be limited only in the sector, Fernandes & Paunov (2008) suggest that FDI in the services sector may be more beneficial since services (telecommunications, finance, utilities) are inputs to almost all industries. Fifth, it is interesting to investigate whether FDI has affected supplier and consumer prices in different sectors. The possible effects of FDI on prices are almost absent from the literature but should be studied (Lipsey & Sjöholm, 2005). Sixth, an examination of labor market effects of FDI in the Philippines must be conducted. Many studies have shown that FDI has important effects - both negative and positive, on different aspects of the labor market. OECD-ILO (2008) provided a comprehensive review of the literature on the impact of FDI on wages, labor demand and working conditions in host countries. Important questions found that remain unanswered for the Philippines include the following: Does FDI raise the average wage level in an industry? Is there a foreign firm wage premium? If foreign and domestic firms pay substantially different wages, would this contribute to within industry income inequality? Does the presence of MNCs have any impact on the working practices of domestic firms? Finally, a useful subject of future research is to determine host (Philippine) country characteristics that

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<sup>13</sup> Greenfield FDI refers to investment in new assets.

should be present and policy approaches that should be employed in order to maximize the benefits of FDI.

Liberalization of trade and investment seem inevitable. An important subject of future investigation is to ascertain the circumstances, under which greater economic integration can enhance economic growth and total factor productivity, reduce income inequality and help alleviate poverty across all regions of the country.

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# Appendix

## Literature Map

