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## The economic argument for constitutional reform

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**The Economic Argument  
for Constitutional Reform**

*by*

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# The Economic Argument for Constitutional Reform

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**Gerardo P. Sicat\***

## *Abstract*

The Philippines requires the revision of the economic provisions of the Constitution if it is to become a major recipient of foreign investment flows like other high growth economies in East Asia. These economic provisions were adopted in 1935 and have helped to reduce the country's ability to achieve a strong economic development record for seven decades. Reforming these policies can be undertaken by making the specific policy issues the subject of ordinary legislation rather than through constitutional provisions that are hard to change. The most obvious benefits of such a constitutional reform are increased foreign investments, higher rate of economic growth and employment; rising incomes for the population; and sustaining the fight against poverty. The less obvious benefits affect the macroeconomic fundamentals of the country: reduction of the fiscal deficit; lessening of the external debt burden; improvement of trade and payments and stabilization of the peso; increase of the saving rate; and improvement of the country's financial markets.

Key words:

Constitutional change, Foreign investments, Economic development, Philippine economy, Macroeconomic fundamentals

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\* The author is Professor Emeritus of Economics, University of the Philippines. This paper was presented before the seminar on "Constitutional Change and the Economy" of the Philippine Economic Society during its 43<sup>rd</sup> annual meeting on November 23, 2005, at the AIM Conference Center.

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Gerardo P. Sicat\*

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## Introduction

The country is in the mood to revise the Constitution. If the public discussion of the subject is to be judged, such reform is designed to adopt changes in the political structure: a shift to parliamentary government and adoption of a federal structure of government. The motivation behind the mood to change the basic document is improve the country's collective performance especially in decision-making to solve the nation's economic problems. A direct method of raising that collective performance is to amend the economic provisions that contain specific legislation embodied in the constitutional document that limits forms of foreign direct investment in several significant sectors.

These limitations have been in the organic law since 1935 despite changes that amended the country's original independence constitution. These specific economic provisions today operate like a high dam to reduce the amount of foreign direct investments that enter the country. The dire need for foreign capital to accelerate the

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country's economic performance requires the timely focus on this issue. Any retouch of the country's constitutional make-up that fails to tackle this issue correctly will fail to alleviate the economic performance. To make the economic argument for such a reform to be pressed in the nation's agenda is the objective of this paper.

## **Constitutions and the national economy**

Constitutions are mainly used to define the basic political institutions of nations and their goals and ideals. This means that constitutions provide the statements about their political structure, the duties of their officers, the relationship of state and local governments, the political and duties rights of citizens, and the economic goals of the nation. Constitutions are therefore the documents for the statements of general principles and objectives of a nation. They are not the place for detailed approaches to specific issues and questions.

During their period of rapid growth, the East Asian nations were not hampered by their political constitutions in undertaking legislation regarding the attraction of foreign capital. They legislated the laws that were needed to enable the country to attract foreign investments. They undertook specific restrictions on foreign capital as they saw fit for their national interest, but they had the essential flexibility to make adjustments in these provisions without being strictly guided by limitations contained in a constitutional document that was not as easily changed. They were therefore free to pass laws that fitted their nation's needs at the precise moment of need.

In our particular context, the constitutional framework defines specific boundaries about what foreign capital can do and cannot do. Foreigners cannot own land. They have to adjust their investments, without prospects of owning land, except through mechanisms that involved majority control of the land by Filipinos. Foreign capital is restricted to 40 percent equity contribution to corporations if these companies are to engage in public utilities and in the exploitation of natural resources.

The Philippines is uniquely one of the few countries with very strict rules on foreign capital written in the basic law of the land. The detailed restrictive provisions were written down in 1935. They have since remained to manage that issue despite major amendments of the Constitution. Such specific provisions have hobbled the country in the quest to strengthen the national economic performance. Because of the immense influence of the constitution in our nation-building and education, these provisions also sidetracked the nation into economic policy frameworks for decades that limited our economic achievements.

Given the history of our past mistakes, these provisions have now become binding constraints to the growth and productivity of the economy. They limit our actions. If we want to catch up with our neighbors in the high growth region of East Asia and Southeast Asia, we need to improve the constitutional framework where it hurts us. The main challenge we face in the constitutional change area is to unshackle the nation from the economic provisions that had guided our economic policies for decades. This will enable us to compete effectively with our neighbors. (Of course, we have to take care of other policies affecting our economy, but those policies are within the control and reach of parliamentary legislation.)

## The *original sin* of Philippine development strategy

It is fitting to associate these binding constraints regarding foreign investment policy in our Constitution as the *original sin* of our national economic strategy. These limitations were imposed upon us when the 1935 Constitution was adopted. Because Claro M. Recto was the chairman of the Constitutional Convention and Manuel L. Quezon was the foremost politician of those times, they are the two leaders who have to claim the honor for adopting them as the principal basis of control of foreign capital inflows into the country. For this reason it would be fair to call that original sin, those laws that stipulated restrictions on the role of foreign capital, as the Recto-Quezon<sup>1</sup> barriers to constitutional reform in our economic policies.

For many decades, the Recto-Quezon barriers have become the defining element of the policy concerning the attraction of foreign capital inflows into the economy. As time went on, they became binding constraints upon the way the country could grow in view of the scarcity of domestic capital. For that reason, they should have been removed long ago from the Constitution. They helped to arrest the further expansion of foreign direct investments in our country. But these constitutional provisions have so poisoned our thinking as a nation in many ways that no one questioned the damage that they have done to the nation. In fact, generations of leaders have stood by them.

Such provisions created a beachhead for a particular kind of nationalism in economic matters. This nationalism supplied the essential restrictions to shield Filipino enterprises from competition and endow them with many forms of preferential subsidies. As a result, many enterprises failed to make a head way in competitive markets. They prospered only where that national protection played a role in propping them up. Nationalism need not foster this kind of economic direction.

Other countries have nationalistic policies that encourage their enterprises and citizens to do better in competition with other countries. As a result, their industries became their provider of new markets and new opportunities. Such enterprises became competitive on a world stage and it brought a high sense of national purpose and greater pride in their national accomplishments.

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<sup>1</sup> Claro M. Recto, the president of the Constitutional Convention, was the foremost nationalist of his time, and the Constitution was his shining moment of fame. Recto encouraged the legislation of specific ratios detailing the role of foreign capital in some critical sectors. By doing this, he probably recognized that such direct provisions could spark an education of the nation in placing further economic restrictions on foreign capital in order to promote Filipino enterprise. This idea was one of foreign capital being a substitute for Filipino capital. In the study of strategic games, this was like a case of a zero-sum game. Manuel L. Quezon was the dominant politician of the times. He led the fight for the enactment of a law on Philippine independence. His ultimate goal was to win the presidency of the emergent transitional government. He was eventually elected President of the Philippine Commonwealth, the transitional political structure prior to full grant of independence in 1946. The detailed provisions on foreign capital in the Constitution could not have passed without his support and encouragement. Quezon said the most graphic and quotable rhetoric of Philippine populist politics during the fight for independence: "I prefer a government run like hell by Filipinos than one run like heaven by Americans." It was Recto who said that he preferred to borrow for economic development rather than have foreigners direct investment.

The brand of Philippine nationalism fostered dependence on the state to provide restrictive and highly protected environments for Filipino enterprises. Preferential advantage in credit and other resource allocations favored nationals. Such support became part of the working culture of domestic businessmen. The state was expected to provide the necessary protective shield rather than a direct stimulus to make them competitive on their own. The practice of popular politics in an elective democracy further fed on this tendency. During the period of expiration of the Laurel-Langley Agreement, when parity rights for Americans were about to end, Filipinos businesses became busy acquiring good businesses at bargain prices.<sup>2</sup> Faced with such easy and advantageous opportunities that were provided by the state, Filipino enterprises began to believe that when they faced trouble, they could depend on the state for rescue and refinancing. Such belief was however shattered when the nation faced economic crises that could no longer afford the generosity of protective trade and industrial policies.

Restrictive nationalism misled the government to extend enormous support to its nationals through exchange rate regulations, tax incentives, credit incentives. The necessary stimulus to force these enterprises to become competitive in the market was often softened by further concessions to help them further. Periodic restructuring, refinancing and other kinds of support made it difficult to implement true economic redirection of the Filipino enterprise during the early decades of development. These actions in fact encouraged a slack attitude on the part of the enterprises to postpone hard lessons in business.

### **Leaving specifics of economic policy to ordinary legislation**

Reform of the economic provisions requires a simple act of removing the provisions on foreign capital from the Constitution and placing them within the ambit and control of the legislature. But putting this in place is difficult. Many enterprises that have flourished under the regime of restrictive economic policies fostered by the constitutional provisions are ranged against this amendment of the constitution. To push this provision requires the vision of a national leader who sees the future clearly and who can articulate the need for such an amendment. The country is still in need of such a leader.

There is need to remove the Recto-Quezon barriers in the constitution, for they have become iron economic laws for the reason that for seven decades, they have continued to remain within the constitutional framework. A simple remedy to the problem is to remove the economic strictures from the language of the constitution. By doing so, it would be possible for the legislative branch to pass the necessary laws to deal with the specific economic issues regarding foreign capital. Such a proposal would abolish the Recto-Quezon barriers from the constitutional text.

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<sup>2</sup> The divestment of many American enterprises during the period of adjustment was a clearcut case of this. The divestment mechanism was private purchase. But the sellers (Americans) had limited choice except to sell out to nationals. Under this setup, there were cases that were the equivalent of fire sales because there were no other buyers but Filipino nationals. The divestment of American capital toward the termination of the Laurel-Langley Agreement was a major activity in the economy during the late 1960s to the early 1970s, although this began earlier after independence.

Specifically, the amendment to the Constitution means simply to delete those specific provisions that delimit actions on the role of capital in sectors of the economy. Then, the legislature is empowered to enact the appropriate laws governing the following issues:

- Land ownership by foreigners;
- Fixed equity ratios between foreign and domestic capital in the matter of public utilities and natural resource exploitation by corporations in the country.

It is even important to extend this approach to the issue of citizenship.<sup>3</sup> The *jus sanguinis* (by blood) principle of citizenship has been cumbersome and has reduced the citizenship route as a means of contributing directly to the economy. The replacement of this principle with the *jus soli* (by place of birth) principle makes it more flexible to use the citizenship route to encourage entrepreneurs and foreign capital to contribute via the citizenship route. The 1987 Constitution, which has supplanted the 1935 Constitution and the 1973 Constitution, contains even more provisions that attempt to micro-manage the nation's economic policies. The ideal solution is to clean up the Constitution along the same lines proposed here. Focus of the amendments refers to the Recto-Quezon barriers to capital, for these provisions have done the most damage.

This change conforms to the changes in constitutional style that have taken place in many countries. Most countries have simple and non-intrusive provisions on economic matters. Other countries have simply made their constitutions simpler and without specific references to economic issues in detail. After the collapse of the Soviet Union, many countries whether or not in that sphere of influence adjusted their constitutions toward mainstream lines that were also simpler in coverage. The effort toward simpler constitutions was to reduce the demands on governments to solve all kinds of economic and social welfare questions in the Constitution.<sup>4</sup> These simpler constitutions made it so much easier to implement economic policy effectively.

The case will now be made for the amendments regarding the economic provisions of the Constitution. These economic effects are premised on the proposition that there no other problems prevent the flow of foreign investments. For instance, this could mean that the conditions of the nation with regard to law and order do not deteriorate any further or there are no unsettling political issues that cause a worsening of the economic environment.

## **The obvious economic benefits**

A discussion of the obvious economic benefits of making these changes in the economic provisions shows the benefits are obvious.

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<sup>3</sup> The discussion of the economic implications of the economic provisions is thoroughly discussed in G.P. Sicat (2005), "Reform of the Economic Provisions of the Constitution: Why National Progress Is at Stake," UPSE Discussion Paper 0510

<sup>4</sup> On this point, see G. P. Sicat and L. Makasiar Sicat, "An International Comparison of Constitutional Style: Implications for Economic Progress," UPSE Discussion Paper 0412.



**Increase in foreign capital inflows, hence more investments in the economy.**

The first major benefit of the constitutional reform will be an increase in the flows of foreign risk capital in the economy. This will supplement domestic capital that is generated at home. New investments will add to those that can be supported by domestic saving. Initially, this will enlarge the flow of foreign capital in land investments, in the participation of foreign capital in public utilities and in the exploitation of natural resources. This will not only raise the potential for the expansion of output in these sectors but also for the increase of productivity in the economy. Another result will be a reduction of the unit cost of production in the economy. The level of competition will rise.

The fear that the increase in the volume of foreign direct investment will displace Filipino participation in the economy is often self-serving. This line of argument has been used so often to deflect the shortcomings of domestic enterprises. Often, it is to retain a monopoly position over certain activities. Many Filipino enterprises look for opportunities to reduce their costs as when they face competition. Filipino enterprise will have to adjust their business methods to improve efficiency. They will find niches of activity that will enable them to thrive and grow. There will be room for growth in new areas. With the entry of more foreign capital, a lot of complementary activities available to domestic enterprises will be opened.

There are already a lot of Philippine enterprises that are in place that need capital infusion but are unable to do so. Some of these enterprises are saddled in debt and their enterprise is weakened heavily by the burden of debt that they could hardly make any improvements in their enterprises. These companies are very well placed to seek out foreign partners who could infuse new capital into their activities. Such infusion is essential to the improvement of their services.

Some of these companies are in fact in such dire straits and are willing to sell out to new actors who could take over their ventures. The net result for the nation will be an expansion of services and the improvement of the quality of these services. Through the force of competition enforced by the government regulatory frameworks, the unit cost of the production will fall. The country's consumers will enjoy a reduction the real cost of these services.

**Increase of employment and income.**

With more capital in the economy, there will be a surge of gainful employment. Incomes will rise among the workers who find steady jobs increasing in their midst. This is an important and very desirable outcome. With the inflow of foreign risk capital into the country, depending on the nature of the firms that come – whether they are in labor-intensive sectors or in capital intensive sectors – they stimulate the generation of new jobs. The flow of new capital will induce investments in some capital-intensive sectors. However, these investments will induce the creation of jobs across sectors of the economy because such investments open up new labor-intensive activities in the agricultural, industrial, service and trade sectors.

As an example, some of the expansions in economic activity through the entry of foreign direct investment have led to havens of vibrant commerce in previously dormant cities. One such example is the influence of the Texas Instruments investment that first located in the country in the late 1970s in Baguio City. With a current payroll of about US \$20 million per year – or PhP 110 million – in that city, Baguio has been converted from a sleepy tourist city into a thriving all-year place of commerce. Through the multiplier effect, the impact on the increase of demand for goods and services has been continuous. Such example is multiplied over in areas where foreign direct investments have come into the country, converting areas of despair and problematic economic futures for some regions into places of local prosperity and improved expectations for the people.

#### **A superior means of fighting poverty.**

The rise of incomes and employment is surely the most effective way of fighting poverty. Creating incomes through steady jobs raise the ability of workers to provide for the future of their families. They buttress the family budgets with the means to raise consumption standards. This efficiently augments the living standards of worker families. There are other effects such as those that secure for them improvements in their housing. Thus, homelessness does not become a problem. This eventually makes it easier to clear the slums that have marked our cities and the towns of the countryside. Parents also strengthen their resolve to send their children to school. This means that parents will be more able to take care of their children and help prepare them for their future.

The government is often guilty of inventing so many wasteful programs trying to address the problem of poverty. Some of these programs are the product of direct intervention programs that depend on government subsidy or foreign aid funding. The programs terminate when government funds run dry or when foreign aid money eventually ends. The country must find opportunities to fight poverty at home on terms that are affordable by the nation's finances. Inability to solve the poverty problem often reduces a capable nation into mendicancy and aid dependence.

Ownership of land by foreigners will raise investments in the land – through agriculture, tourism ventures where land is an important component, housing and land estate projects, and so on. Allowing their participation in the exploitation of natural resources opens the possibility of large, integrated forestry estates that will repopulate our bare mountains with trees, create logging on plantation basis and help to increase the production of pulp, and control environmental degradation by reducing soil erosion in the upland at the same time that we create economic goods out of those land resources. The enlargement of foreign participation in our public utilities will improve the service and make possible a much more efficient domestic economy. All these will produce jobs that are lasting, that will lift a lot of people out of poverty and assure that their children will have a better future as they get the means to provide for their families.

When the country is experiencing the growth of new and productive enterprises, they bring the economy forward with a lasting impact. They not only reduce the number of people in poverty. The entry of capital provides new jobs. And the generation of these jobs reduces the demands on the government to provide subsidies for people who are

poor and looking for job support. In fact, when jobs are being generated, the government would be strengthened to have the opportunity to render more effective support to those programs designed to help the poor rise from their condition because government finances are also improved.

In short, the provision of more foreign capital in the economy will have a very lasting impact on the country's poverty reduction program.

**An effective weapon against the brain drain of highly qualified Filipino professionals.**

The most effective counter to the brain drain is to have well capitalized companies that are on the frontier of development and technology to be present in the country. An economic policy that obviously emphasizes the attraction of cutting edge foreign companies will provide excitement for talented Philippine professionals and even those with only average talent to look for jobs in their homeland. The so-called Philippine advantage in human resources is so well known, and yet if we read the reports of newspaper accounts and common discussions, our Department of Labor seems to be looking and advertising job opportunities that are found elsewhere, but not at home!

The developed countries are short-handed with high and critical human talent. They institute laws to encourage the immigration of professionals into their lands – our doctors, engineers, accountants, Filipinos with specialist knowledge in critical fields of study. In addition, opening of limited period contracts for these professionals have encouraged the outflow of these important human capital as OFWs. Most educated and middle income families have a member or several of them working in a foreign country today. Many of them have emigrated to countries where their future is at least more secure.

An economist sees the brain drain as a migration of jobs because economic opportunities are dictated where capital and technology abound. Add to this the high incidence of unemployment and insecure economic opportunities in the future and we have a brain drain. This is the story of the Philippines economy in the postwar period, accentuated by the political and economic crisis of 1983 to 1986.

But let's look at what has happened over a sustained period in places like Singapore, Hong Kong, Taiwan, and South Korea today – and some other places in South East Asia where talent is in demand, for instance in Thailand and in Malaysia. They encouraged the flow of foreign capital for they did not have enough of it to stimulate their economies initially. These countries succeeded in attracting a large volume of foreign capital to supplement their development effort. The result was a shortage of professional talent to employ in their thriving economies. This made them import the professional talents from any place where the supply was found. Uniquely, our inability to bring in foreign capital to stimulate a high level of growth left us with our educated manpower having fewer jobs available. This explains today why our professionals are looking for job opportunities in these other countries.

The opportunities that we should provide for our young should go beyond the so-called program of poverty reduction. We must find opportunities for our talented people, our intellectuals, our artists, our engineers, and our scientists at home. The need to open the economy for more direct investments will enrich the opportunities available to our educated professionals who will find jobs in these companies. It will become an effective counter to the brain drain.

### **The less obvious economic benefits: Improvement of macroeconomic fundamentals**

The less obvious economic benefits are understandable to experts. In the next discussion, some of these benefits are discussed. Together, they improve the country's macroeconomic fundamentals. When these fundamentals are improving, a lot of other good things follow. They re-enforce confidence in the country's prospects for further growth. They create expectations that are dominantly optimistic. In turn, they bring in a new round of additional benefits.<sup>5</sup>

#### **Reduction of the fiscal deficit.**

The reduction of the fiscal deficit is one effect of an improved economic regime in which there is a large presence of foreign direct investments.

Since most of the foreign capital that flows into the country often get some kind of tax incentives, it is likely that the immediate effect of the incentives will not immediately raise tax collections. The argument for giving them tax and other fiscal incentives is based on the theory that fiscal perks help the decision to invest in the country. These incentives are offered because generous fiscal incentives are offered in other countries considered to be competitors. Calculations about the benefit of fiscal incentives are controversial. But once the steady flows of investments happen, there are beneficial aspects to the presence of a large volume of capital in the country that makes fiscal incentives less important. Economies of scale due to the agglomeration of many companies helps to reduce the cost of entrants in investment areas. Some of these types of investments would be that enable the country to attract other foreign investments. A country achieves this status only after the economy has achieved a quantum level of popularity for foreign investors because of a track record of good business experience.

When large inflows of direct foreign investment happen, there are other developments that help to improve the tax base, however. Other economic activities that complement these investments open up. Supplier companies grow, and some of these are industries that include both new foreign capital and Filipino capital discover ties business with good outcomes with these foreign companies. These new activities are directly linked to services that are critically needed by the foreign companies: transport,

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<sup>5</sup> All these benefits will be felt for instance in a country's sovereign credit rating from junk to investment grade and will lift the credit ratings as well of private companies because their fundamentals will also rise. Improvements in credit ratings will lead to a reduction of the interest bill for the country. This brings in a new set of benefits. Saving in interest expenses enables the country to reduce the deficit or to free resources for other types of important development expenses.

telecommunications, water supply, and other kinds of infrastructure support. All the above are needed by an expanding economy. Some of these activities will stimulate a rise in the tax base simply because the range of complementary enterprises will not necessarily qualify for fiscal incentives.

I will therefore extend the examples I have already made. Eastwood IT (Information Technology) Park in Quezon City was once a deserted textile factory site a few years ago. When the IT park was established and its success began to get established, a secondary spark of new development of commercial, industrial and services sector arose. The IT park has become a haven for employed workers and professionals. They helped to provide a new population of workers with good income and with a demand for leisure and other supporting services. A growth of residential housing was stimulated. Land values and taxes within the immediate vicinity benefited the Quezon City government.

A similar buttressing of incomes and leisure activities has occurred in Makati where many investments in IT enabled back office operations, including call centers, have located. Not all the growing commerce in the Makati area and the continuing prosperity of the Glorietta Malls of the Ayalas in Makati is due to the strength of commerce in the domestic economy and the high incomes of the established Makati crowd. It is due to the growing contributions of call centers and other foreign risk investments in the back office operations arising from the telecommunications revolution. The same comment can be made about the strong growth of new activities around the Calabarzon regions where there are PEZA industrial parks. The same is true in Cebu.

All these have raised the tax base of the overall community. They have raised the potential tax collections available from existing taxes and when these are raised, as in the case of the VAT increase in taxes, they help to strengthen the tax revenues of the government. Hence, there is much additional impetus to help reduce the fiscal deficit from the revenue side.

The expenditure side of the national government budget is the other side of the issue of the fiscal deficit. Even if we assume that the government is just undertaking the same intensity of public expenditure with respect to the current potential revenue intake of the government, the burden on public expenditure will be lessened when the volume of investments in the private sector are efficient and profitable. The gains are reflected in the reduction of potential public expenditure arising out of contingent liabilities related to the financial debt of private enterprises. This translates into major benefits that help *to reduce the fiscal deficit*.

Foreign direct investors will not burden but help to improve the country's external debt position. These firms have access to their own country capital markets and to the world capital markets on a broader front. The liabilities that they incur when they borrow are for their own account. The government is not obligated to support them in their financial needs for credit. As their investments in the country grow, they do not constitute a threat to the country's overall net public liability in foreign borrowings because they can take care of their own accounts.

During the economic crisis (such as financial crisis of 1997-9), these companies were also vulnerable to a financial squeeze. Such financial difficulty arose from changes in demand for their product in their export markets. Financial stresses arising from the Philippine condition do not necessarily disturb them much. More important to them conditions related to public disorder and uncertainty. Delicately, what disturbs them often relates the introduction of new government regulations that restrict the mobility of their economic operations.

In such cases, they are prevented from exercising their various moves to protect their own position as operating companies in the country. These firms take care of their own internal finances, either by borrowing from their home companies or through access to the international banking system. As a result, they do not impose additional burdens on the government and the government has no need to absorb new liabilities as a result of any failure of a foreign company to adjust, as what had happened in past experience in the country.

#### **Lessening of the external debt burden.**

While the improvement of the fiscal deficit will eventually reduce the internal debt service burden for the nation, a reduction in the external debt service strengthens the country's balance of payments position. I will now explain what could happen if the country's burden from the Recto-Quezon barriers in the Constitution are dealt with.

Foreign companies operating in the country rely on their own access to the world's capital market, including their own home capital market. This is premised on the existence of a payments system that is free from governmental interference. This is also premised on the growth of a large volume of foreign direct investments flowing into the country.

The external debt service for the country is measured as the amount of debt servicing of the country's external debt. Sometimes, this is expressed as a ratio of the amount of debt service to be paid to the GDP or output capacity of the nation. The country's external debt becomes lighter in relation to the whole debt capacity. It happens this way.

It has been explained that the amount of financing that foreign companies undertake is on their own account and have no dependence on support from the Philippine government. In short, they will pay for their obligations. If the company is in some trouble maintaining payments, it has access to a parent company that undertakes financial rescue. The Philippine government is not be obligated to render any rescue. This is so unlike the situations in the past when, facing financial problems because of crises arising from payments and other economic difficulties, Philippine firms would turn around to the country's government financial institutions and seek a rescue operation. Because of political and other factors, the government was often forced to render a rescue. In short, it became involved in the exposure to support the operations of failing companies. This is the story of the entanglement of the Philippine government with the rise in the debt service operations related to Philippine companies.

In the case of the foreign companies, the financial package that is undertaken to support their operations is often through the international capital market. The amount of equity (or the economic value of the firm) that is staked in the enterprise supports the collateralized portion of a large debt transaction. In case of debt issues arising from such situations, the liability falls on the company or on parent companies of the investor. In the end, there is no major cost to the government in case of the failure of the foreign company to meet their financial obligations. And so the country's debt service burden is confined mainly to those related to the government's external debt exposure.

Although reflected in the debt service, in general the debt service due to foreign direct investments is taken care of by the foreign investor and does not contain any contingent liability on the part of the government. The country's debt service is a level like  $x$  percent of GDP. If the debt service of foreign direct investment is a equivalent to  $r$  percent of GDP, then the element representing debt service for which some accountability associated with the government's responsibility is lower. It is only be  $x - r$  percent of GDP. In short, the debt service would be smaller than it appears to be by the amount of debt repayments for domestic firms that are foreign direct investments.<sup>6</sup>

#### **Improvement of external trade and payments (and stability of the exchange rate).**

When the country decided to allow foreign direct investments engaged predominantly in exports to locate in the country, the rise of export earnings of the manufacturing sector in the Philippines became significant. For years the country had difficulty to find export winners under a policy of import substitution and high tariff protection. We got little out of that policy of import substitution and high protection of industry. What we got out of it were bumpy macroeconomic starts and busts similar to a roller coaster ride with the people's destiny at risk. And, for added burden, that episode in our history led to the serious waste of the country's credit and saving resources in support of firms had no internationally competitive capacity.

When we undertook the decisive step of further liberalizing the industrial and trade regime, the export winners in manufacturing were found. After opening up the invitation of foreign investments to companies with 100 percent foreign equity, success in the export of electronics goods marked the country as one of the players in that industry in East Asia. Foreign direct investments will further build up the country's comparative advantage in export manufacturing provided that other elements of policy – such as those relating to the labor market (minimum wage and other issues) and those pertaining to continued trade promotion are further sustained. An improved foreign investment environment will further boost the environment for the entry of foreign risk capital in manufacturing for exports. The net effect of this will improve the external trade balance in favor of the Philippines

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<sup>6</sup> This argument implies that the government would not allow debts of foreign companies to become contingent liabilities of the government by not extending guarantees. Guarantees for foreign investment, at least in the case of American companies, are available for political risk through the OPIC system. In general, the foreign investor would seek guarantees from the international financial system. Hence, this is a likely outcome of a policy of giving greater freedom for foreign direct investments to enter the economy.

The current debate on Constitutional change relates to the economic provisions linked with public utilities, exploitation of natural resources and the ownership of land. Increases in foreign investment that affect these areas will fortify the export performance further. When the costs of services from public utilities are reduced, the country's comparative cost structure for exports will improve further. Foreign investment in land and in the exploitation of natural resources will increase the export performance of agriculture and natural resources. Productivity of the countryside will happen, and a lot of idle lands in the country can be brought to production and higher productivity. A liberal entry of foreign capital – whether this is encouraged in the field of improved investments in public utilities or in the exploitation of natural resources – would lead to an expansion of the country's export performance. The country would then become export-pulled in its development strategy.

Some of these investments in the land by foreign companies will help accelerate the accomplishment of objectives of the land reform program. When ventures in land investments are increased, land use involving land reform recipients would expand in variety of market arrangements. An additional benefit is the open more commercial opportunities opened for land reform beneficiaries. Among these are potential business cooperation among land reform cooperatives and foreign investors engaged in agricultural operations.

When the export sector pulls the country's economic progress, the domestic currency strengthens. The country earns a lot of foreign exchange from exports, raising its holdings of dollars and other foreign money. This fortifies the country's reserve of international money. The balance on current accounts of the country strengthens to a position of surplus rather than deficits (the latter being the outcome of a development that is essentially protectionist and based on import substitution). Also, as a country entertains a flow of foreign capital, the country also accumulates holdings of dollars. So, the holdings of the country's international reserves come from the expansion of export industries and from the further inflows of foreign risk capital.

The history of East Asian success in long term development demonstrates this path through the buildup of export industries and then the increased widening of domestic enterprises supplying inputs to these export industries, further raising the sophistication and integration of the economy. When these countries switched their economic policies toward the world economy from their initial policies,<sup>7</sup> they discovered that they generated huge trade surpluses that enabled them to expand their markets and strengthen their international payments position. Foreign direct investments provided the boost in this integration process.<sup>8</sup> The inflows of foreign direct investments into these economies

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<sup>7</sup> In the case of Hong Kong and Singapore, they did not have to switch their policies because they had adopted policies that allowed free trade and free capital flows from the beginning of the post-war period. Like the Philippines and other developing countries, Taiwan and South Korea first had tight economic controls and rigid import substitution policies at the beginning. When they learned that they could make enormous gains out of freeing their economies, they allowed greater freedom of trade and payments later.

<sup>8</sup> That today, South Korea and Taiwan is more dominated by the investments of their nationals mainly reflect the enormous success of these two countries. Initially, they favored foreign direct investments to come to their export processing zones and in other operations in the economy. Eventually, the local producers, who were initial subcontractors to the foreign direct investors, became very efficient. They



helped to push their economic growth high. In time, they were able to successfully build their own basic industries through domestic capital as their confidence and expertise were built up from their initial achievements.

These events might have caused their currencies to strengthen. Sometimes, these countries artificially avoided the strengthening of their currencies in order to continue expanding their export markets and earn more foreign currency. In short, they even feigned weakness of their own currency to enable them to build up more surpluses. This is in fact the story of China's success today as it was for the early East Asian tigers. China is generating huge export surpluses and the renminbi (the Chinese currency) has become strong as a result. A common issue between China and her large trading partners (US, Europe, and Japan) is that the latter want China to appreciate the renminbi because they suspect that the Chinese are artificially weakening their Chinese currency to continue reaping export success.<sup>9</sup>

This type of development can happen in the Philippines. In fact, it is happening in the case of Filipino firms that have discovered that they could exist in a competitive world and do well on their own, and sometimes in joint ventures with the foreign partners. One example: the Concepcion industries that manufacture air conditioning and appliances. For years, the Concepcion brothers were champions of tariff protection and import substitution. Now, they are winners in the export of air conditioning equipment and other appliances. They have changed their tune on industrial development.

#### **Increase of the national saving rate and strengthening of domestic investment by Filipinos**

There will be a positive impact on the generation of national saving. As saving increases in the economy, the fund needed to finance domestic investments – be they private investments or public infrastructure – will increase.

Foreign companies, once they are allowed to operate in the country become registered firms working in the country. In this sense, they become domestic firms subject to the country's regulations. Even though they are foreign firms, they are also domestic firms like Filipino companies. As they earn their incomes from their economic activities, the foreign firms operating as domestic companies generate a flow of profits. Such incomes are split into four parts: taxes, earnings that they might distribute to their parent company, earnings that they would plow back into the business for maintenance and expansion, and wages and other bills paid in the country.

*Taxes.* Even though the company may enjoy tax exemptions, such tax exemptions are not total. They still have to pay taxes, including those that are due to the local

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gained more substantial subcontracts over time and, eventually, they became big enough on their own to become independent players in manufacturing. In many cases they bought out the original investors because they became even better than some of the foreign investors.

<sup>9</sup> When the Chinese undertake such a revaluation, the renminbi will reflect its market strength and all calculations about China's GDP, etc. will leap frog to indicate that their level of development had risen very high. Today, China's GDP per head by dollar measures is still considered low. But not when the revaluation takes place.

communities. Hence, there are taxes to be paid, which are either national taxes or local taxes. Eventually, some tax exemptions are not perennial. In time, the companies will pay taxes, and so a stream of new direct tax payments could be expected within the future.

*Incomes and retained earnings.* The company's income after taxes include an amount that might be transferred to the parent company as earnings of the parent through the investment. For the moment of time when these are still retained in operations, they represent a financial pool available within the domestic market. For these sums are often used as treasury funds that could be intermediated in the country's capital market. More important, however is the amount of net income that the companies retain in their investments. If the investment is profitable and the country's investment climate remains bright, these amounts could be rechanneled back to the firm. These savings are immediately plowed back as investments to the firm. In this context, the retained earnings are associated with new investments that arise out of the domestic operations of a firm in the country. Even if the accounting of this retained incomes were later reclassified and reported as foreign saving, the reality is that earnings were generated within the economy. It is as if an engine of new saving was directly utilized for domestic investment.

*The saving of workers.* Foreign direct investment generates a wage bill that is paid to those it employs as workers. The wage bill could be enormous for some companies. Even among small foreign companies, the wage bill is not likely to be a trivial sum. In addition to the incomes that go directly to the workers, there is a portion of the wage bill that is paid to the Social Security System (SSS), the Pag-Ibig Fund for housing that enlarges the forced saving of the national economy, the contributions for Philhealth and other fees that companies are required to pay to match labor employment. Employed workers also contribute to the increase of saving through the forced withholding of their incomes into the SSS system which the companies are required to remit to the system. In addition to these arrangements, often the more well to do companies encourage their employees to build up provident funds for their own employees that are separate from the government saving schemes. The provident funds of many companies could accumulate to a large of savings that are then intermediated within the country's financial system.

All these funds enhance direct saving schemes that are designed to help workers have a more stable future. But the savings that are accumulated become part of the total saving of the national economy. Such funds become useful sources of financing the economy's further development. The powerful impact of the contributions of foreign direct investments to national saving does not end here.

Consider the wage bill paid to all workers, net of taxes. These represent the disposable incomes of all employed workers. Workers with rising incomes have a high marginal propensity to save that is higher than their average saving propensity. Even though workers belong to the lower end of the income class stream, when their savings are pooled together, they become substantial. The growth of SSS and GSIS pension fund contributions represent large sources of saving from worker's contributions. As workers improve their lot through their employment, they raise the amount of investments in household durables and housing. The workers themselves enroll in various schemes that allow them to buy consumer durables and to improve their housing situation on financial

terms. Hence workers get pre-committed to various savings schemes that require them to keep paying the saving installments.

As incomes rise, saving will also rise out of the portion of increasing real income. High saving rates of economies in East Asia often reflect not only a specific tendency to save out of normal incomes. When the real wages of workers rise, the additional saving often indicates a rise of saving far higher than their normal saving rate – in short, the marginal savings generated are higher. In the East Asian context, the high rate of national saving that is often observed is likely to arise out of the high marginal saving rate. Given the high rates of growth of these economies, it is easy to understand that these economies produce high saving rates.

#### **Beneficial effects on the country's capital markets.**

The expansion of the volume of foreign investment has a large impact on the country's financial system. Foreign companies enlarge the volume of financial transactions in the country. Their presence requires an upgrading of financial services to undertake a wide range of financial services. When they transact with local companies, they require banking and other services. When they make payments of their wage bills, they require a standard of services related to banking that is often different from the simple arrangements that are adequate for small domestic companies. In some cases, the foreign companies are induced to perform like all domestic companies. They can even participate more fully in domestic financial activities. They can park their excess assets in domestic financial institutions.

But the best evidence of the impact of the country's financial system is associated with the growth of the capital market. Foreign investments that are 100 percent owned do not participate directly in the stock market unless their parent companies are listed in the regional exchanges. But their operations have a profound effect on the profitability and growth of purely domestic companies that rely on the facilities of the stock exchange to raise capital.

Before the war and immediately after, the Philippine stock exchange was one of the most dynamic exchanges in the region. Although the stock market was thin, it had a listing of companies that were traded at the exchange. In spite of this, the Philippine stock exchange was more substantial than the stock exchanges found in the region of Southeast Asia.

But the Philippine stock exchange failed to expand as fast as the other stock exchanges in the region once their phase of growth had accelerated. The reason was that during the same period, the era of Philippine import substitution and restrictive economic policies was in place. Today, Hong Kong, Singapore, Taiwan, Seoul, Bangkok and even Jakarta exceed the volume of the Philippine stock exchange. In part, this was due to the bumpy growth of the domestic economy. More than that, the entry of foreign risk enterprises in these economies expanded the capital markets of these countries. The expansion of their stock markets is just an aspect of their economic developments and how they have surpassed the Philippine economy in many dimensions.

The entry of foreign risk capital will increase the access of the country to the international capital markets in greater volume and efficiency without having to increase its exposure in liabilities. As already stated, the big foreign companies have a wider access to the world capital markets. The exposure to the foreign direct investors links the country to a wider net of international capital markets than would be possible under the old regime of selective promotion and high protection of industry. But aside from these, they develop new relationships with local financial companies and the volume of their treasury funds are mobilized in part to participate in domestic transactions related to keeping a good earning on their excess funds.

The other evidence is the country's experience related to financial liberalization in the banking sector. The liberalization took the form of mandatory capital increases for the banks but the element of opening of banking to foreign investment was thrown in as a possible point of release for the undercapitalized domestic banking system. This development was in two stages: during the 1970s and then the 1990s, when domestic banks were required to raise their capitalization and the monetary authorities encouraged a program of mergers of banks so that they could become stronger bank, with a system of bank branches rather than many small banks.

At independence, Philippine banking was restricted to Filipino citizens with the exception of four foreign banks that were allowed to continue their operations in the country. The situation was similar to the highly restrictive industrial and trade regime. Domestic banks could not offer the range of services needed by domestic users, much more for more sophisticated large investments like foreign firms. The small banks often preferred to do business with these foreign enterprises because they were assured of more stable banking relations that produced profits. These enterprises provided lower risks of failure to repay compared to other domestic enterprises that had financial problems because of their business problems. In those days, foreign banks could not invest in local banks.

When the country opened up the banking system and other financial services to some foreign investment, the local banking scene became much more efficient. The quality of banking services improved. This was in part due to economic consolidation of the banks through mergers, acquisitions, and the forced improvement of capital equity that was required as part of the reforms and the encouragement of competition among the banks. The entry of foreign capital in domestic banking has led to an increase of efficiency and competitiveness of the overall banking system.

Today, the banking is healthier than in the past, and a major reason for this state of affairs has been the infusion of foreign capital in the domestic banking system. This has also meant that many of the local banks are thriving well rather than badly as a result of the entry of foreign capital. The Philippine banking system, with the participation of foreign capital equity, is so much stronger today.

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## Annex : Further Readings on Constitutional Issues from the Present Author

The present author's thinking on Constitutional issues is the product of studies that he is undertaking on the problems of Philippine economic development. Some of the articles below are (deliberately) not yet published, but they may be accessed in the internet through the website of the UP School of Economics:

<http://www.econ.upd.edu.ph>

Once on the website, try to access the Discussion Papers, or search by author's name.

Gerardo P. Sicat, *Philippine Economic and Development Issues*, Anvil, 2003. See *Appendix to chapter 33*, on the historical background of the policy affecting foreign direct investment. [This book is volume III of his textbook, *Economics*, Anvil, Manila, 2003].

Gerardo P. Sicat, "The Market, Social Policy and Economic Performance," *AKI Quarterly* (La Salle University), Vol. 2, No. 2, October-December 2004.

Gerardo P. Sicat, "Reform of the Economic Provisions of the Constitution: Why National Progress Is at Stake," UP School of Economics Discussion Paper 0510, September 2005

**Abstract:** The Philippine Constitution contains many strong restrictions targeted against the flow of foreign capital in specific areas of economic activities. These restrictions were the same ones that were incorporated into the nationalistic provisions of the 1935 Constitution when its framers were anticipating future political independence. This paper discusses the beneficial aspects of lifting or liberalizing these restrictions on foreign capital in the Philippine context. Specifically, the restrictions relate to the prohibition of foreign individuals to engage in land ownership, in the exploitation of natural resources, and the ownership of public utilities. Corporations are allowed to participate in these activities only if they have equity ownership only to the maximum extent of 40 percent. In other words, foreign capital can only be a strict minority participation in corporate enterprises to be allowed in these economic activities. These provisions have hurt Philippine development over the years. Despite the liberalization of many aspects of the economy, including those in the area of trade, industry, and other aspects of the economy, these economic restrictions continue to hold because they are part of the Constitutional document. Some of these provisions of the Constitution could be relaxed through more liberal citizenship rules. But the basis of citizenship – *jus sanguinis* or blood relations – is also very restrictive. The need to improve the performance of the Philippine economy requires that these restrictions be examined and reformed. A direction of such reforms would be to place them out of the Constitutional framework – as is the case with most modernizing countries – and put them within the realm of ordinary legislation. In this way, they can be debated more openly and the policies could be suited up to changing conditions and the need for change of the economy.

Gerardo P. Sicat, "A Federal Structure Is Costly and Does Not Guarantee Progress," UP School of Economics Discussion Paper No. 0511, December, 2005.

**Abstract:** The paper discusses the suitability of the federal form of government as a replacement for the centralized structure of government in the context of Philippine economic and political conditions. The answer is depicted in the title of the essay. In providing a review of the main question, different countries in East Asia and countries are assessed. In all of them, economic performance is not due to the form of their government but to the use of correct economic policies. The federalist program proposes seeks to divide the Philippines into separate states to form a federal union. This is contrary to the historical experience of modern and successful federal states where the separate states first evolved as self-governing regions before they decided to form a federation. There are many disadvantages of the federalist proposal in the context of existing Philippine conditions. Changing to a federal structure does not promote international competitiveness since the restrictions on the movement of specific factors of production – foreign direct investment in some sectors in this case – will continue to exist without an amendment of the economic provisions that is not in the federalist agenda. A federation will strengthen the power and political hold of local political dynasties and warlords and this can result in the incidence of monopolies. A federal form of government can create the basis for balkanization of an increasingly divided nation. The nature of central-local government sharing of burdens and resources is a continuing agenda whether in a unitary or federal government. Even in a federation, these problems will not go away. The condition of an impoverished central government is due to the inability to improve the economy's performance. In the Philippine context, this is due to the restrictive economic provisions of the Philippine Constitution.

Gerardo P. Sicat, *Philippine Economic Nationalism*, UP School of Economics Discussion Paper 0201, January 2002

**Abstract:** Not seeing that the power of taxation of the state is the true expression of national patrimony in economic matters, the framers of the 1935 Constitution introduced provisions on the use and disposition of land and natural resources vesting exclusive rights of exploitation to citizens. This also meant restricting foreign investments in public utilities. The provisions were not revised but even elaborated in subsequent revisions of the Constitution. These provisions set a train of restrictive economic policies that helped to compound the mistakes of early industrialization policies. By tying the hands of future generations of Filipinos to deal with specific economic issues in their own time, the Constitutional provisions provided barriers against solving economic problems with realism as called for by changing times and exigency. Judged as the most likely to succeed in the early years after independence among many East Asian economies, the Philippines became the economic laggard among a group of highly performing economies during the second half of the last century. The brand of economic nationalism that was fostered was exploitative and heavily protectionist in character. It built an economic and political framework that discouraged competition, enhanced monopolies and inefficiencies by nationals, inhibited the growth of international trade and hence postponed by a large margin of time the growth of economic specialization based on comparative advantage. A new kind of nationalism based on principles of competition and comparative advantage is needed. This will be helped greatly by the removal of stringent Constitutional provisions that affect foreign investments. An enlarged regional free trade within ASEAN and accession to the World Trade Organization are factors that will help to sustain this new ethos which will strengthen economic and national aspirations.

Gerardo P. Sicat and Loretta Makasiar Sicat, *An International Comparison of Constitutional Style: Implications for Economic Progress*, UPSE Discussion Paper 0412.

**Abstract:** Using the United States constitution as yardstick for its essential simplicity and completeness in describing the structure of government, the constitutions of twenty-two countries were studied for their language style, brevity and coverage of provisions. Most constitutions of later years have expanded coverage of institutions and the rights of citizens. The outcome is that constitutions became much longer because of broader content but also because they also cover details of institutional processes and structures. The expansion of concerns of constitutions also incorporated economic and social guarantees of citizens in addition to the guarantees of political rights and individual freedoms. Countries with simpler constitutional frameworks have experienced relative constitutional stability more than countries with long and detailed constitutions. The systemic collapse of socialist states in the 1990s brought about some return to constitutions that are simpler in coverage and which incorporate a balance of political and economic and social rights, including protection of property rights. The last part of the study comments on the implications of these constitutional structures to economic progress.

Gerardo P. Sicat and Loretta Makasiar Sicat, *“The Constitution and Economic Progress: When “More Is Less and Less Is More”*, UPSE Discussion Paper 0413

**Abstract:** This study postulates some relationship between the attributes of constitutions – the style of constitutions regarding brevity, coverage, and presence of economic and social guarantees – with economic factors and the economic performance of countries. Utilizing quantifiable measures of these constitutional characteristics, these economic determinants are used to explain the differences in the economic performance of countries. A simple statistical model is set up to quantify this relationship. Expanded coverage and the presence of extensive social and economic rights in constitutions do not guarantee good economic performance. Extensive coverage of constitutional provisions tends to create a downward effect on the level of economic performance. Excessively detailed constitutional style provides a constraining effect on the level of economic performance. On the other hand, competitiveness of the economy, an economic attribute, raises economic performance.