

Our most urgent problem—the jobs deficit*

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It's not the fiscal deficit that is our most urgent problem. With 10 million Filipinos looking for work,² it's the jobs deficit that should be worrying the government most. To say so is not to take anything away from the seriousness of the fiscal crisis. Make no mistake: the growing deficit is an imminent threat to the economy. It must be dealt with resolutely. Now. But it is important to keep the right perspective, lest we repeat the mistakes—ours as well as other's—of the recent past. Lest we win the battle, but lose the war.

That we are facing high and rising unemployment has an important implication: In searching for solutions to our fiscal woes, the employment goal must take primary consideration. The government's top priority now is to protect jobs and livelihoods. It should avoid destroying them; it must continue creating them.

From this perspective, government's solution to the fiscal crisis is wanting. We argue that its tax-cum-spending-cut approach to the fiscal problem threatens jobs and livelihood. Moreover, the government adamantly refuses to see the key culprit, and ignores a solution that is staring it in the face, namely, higher import tariffs.

To begin with, there is no getting around the fact that raising taxes and slashing government spending dampen aggregate demand and threaten employment. The most likely to pass of the proposed measures (because they are the most convenient) that can make a dent on the deficit are also the most dangerous to growth and employment.

Consider the following: higher power tariffs, a squeeze on local government spending³, two-step increase in the VAT rate of 2 percentage points each, additional tax on petroleum. However each measure may be individually justified, they have one thing in common: they all reduce total demand in the economy.

It should be pointed out that raising taxes involves more than moving purchasing power from firms and households to the government sector. Given that interest payments constitute a growing share of government expenditures, higher taxes to pay for the debt represent a drain on aggregate demand.

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How can measures that dampen demand attract investments that will create jobs? The official response is appealing: restoring fiscal balance will ensure *investor confidence*⁴ and protect *future* growth and employment. Never mind if along the way, the economy stumbles into a recession, the very thing balancing the budget seeks to pre-empt. But there's the rub. For if indeed government is successful in taming the deficit and allaying investors' fears, but the economy plunges into a recession anyway because demand has been battered, what then?⁵ Then we would have won the battle against the fiscal deficit, but lost the war on joblessness.

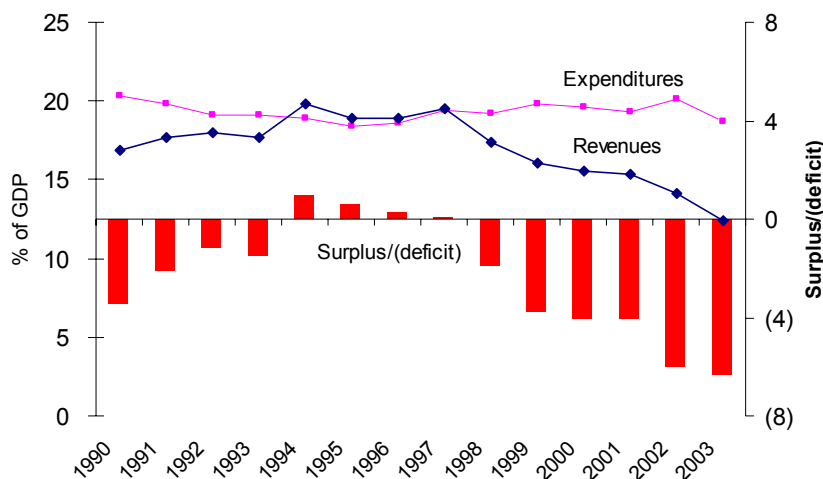
Is there a way out of this dilemma? Is there a solution to the fiscal crisis that is compatible with job creation? The answer is yes. But to appreciate this, it is necessary to lay down a longer view of our fiscal condition.

Turning point

Most accounts of the fiscal crisis begin with 1997, the year the government last posted a surplus. Since there was no appreciable change in government spending around that period, the deterioration in the fiscal balance can be traced to the revenue side. The total tax effort (total tax revenues as a percentage of GDP) declined from 17% in 1997 to 12.4% in 2003, or a loss of 4.6% of GDP. Thus, we may add, the government squandered in six years what took all of the previous 12 years (1986-1997) to build up.

This account is true, but it is not the whole truth.

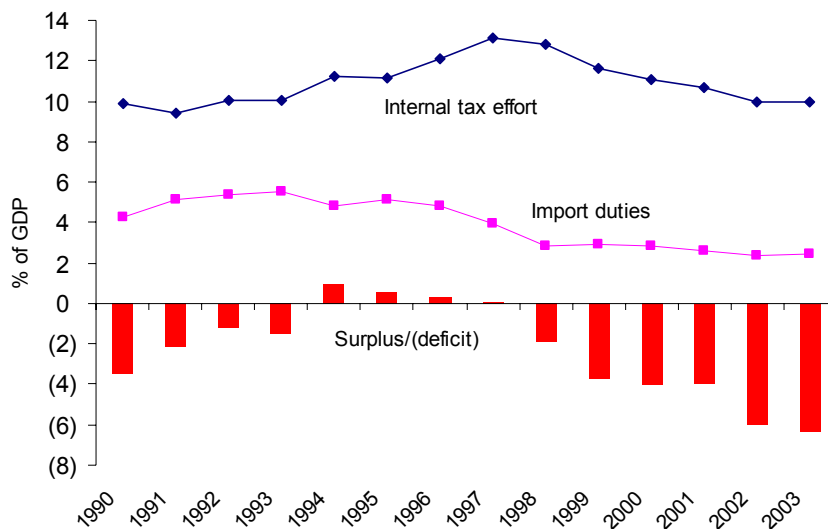
Chart 1: What caused the fiscal turnaround? Declining revenues



A longer view of the fiscal balance since the 1990s reveals that the turning point for the current deficit cycle was 1994. (Chart 1) Coming from the 1990 recession, the fiscal deficit (NG deficit as a percentage of GDP) gradually improved up to 1994, largely on the back of rising revenue effort (total revenues as a percentage of GDP). But by 1995, the government's financial position came under pressure—this despite slightly lower expenditures (as a percentage of GDP). The pressure clearly came from the revenue side.

Turning to the revenue side, a few points are worth noting. (Chart 2) First, there was a surge in non-tax revenues, a large part of it coming from privatization proceeds. But this lasted no more than two years, 1994 and 1995. (For lack of space, we ignore the issue of non-tax revenues) Second, the internal tax effort (local tax revenues as a percentage of GDP) was improving—and continued to improve up to 1997, understandably so since the economy was on the upswing. Normally, the economic boom that lasted up to 1997 would have improved government's fiscal position. Instead, as early as 1995 it began to deteriorate.

Chart 2: What caused the decline in revenues? Falling import duties



Third, the reason the fiscal position began to deteriorate in the mid 1990s was the sharp drop in import tariff revenues. This was the price of aggressive import liberalization which went into full swing around this period. Alongside the reduction in tariff rates, the government went into a frenzy giving away import tariff exemptions to exporters, firms in special economic zones, bonded warehouses, and so on—all part of trade liberalization.

The speed of liberalization can be gleaned from the following:

- ❖ The weighted average tariff fell from a peak of 32% in 1993 to 22% in 1997, a reduction of 10 percentage points in four years.
- ❖ In a span of six years, import duty collections dropped from 31% in 1991 of the country's total dutiable goods import to a mere 17% in 1997.
- ❖ The share of non-dutiable imports to total imports rose from 12% in 1986 to 37% in 1990 and 49% in 1997.

The impact on fiscal revenues was staggering:

- ❖ The share of customs collections to total government revenues shrank from 36% in 1993 to 23% in 1997, a loss of 10 percentage points.
- ❖ Import duties and taxes as a percentage of GDP came down from a high of 5.6% in 1993 to 3.9% in 1997, or a decrease of 1.7% in only four years.

All this shows that, owing to the import liberalization program, government's fiscal position was already headed towards deficit territory by the time internal revenue collections fell in 1998. True, falling internal tax effort accounted for the major share of the loss in total revenues during the period 1997-2003. Even so, Customs revenue losses escalated as tariff reduction continued unabated despite the onset of the 1998 recession and the anticipated deterioration in local tax collections.

Table 1: Change in revenue as % of GDP

	1994-1997	1997-2003	1994-2003
Total revenue	(0.4)	(7.1)	(7.5)
Local taxes	1.9	(3.2)	(1.3)
Import duties and taxes	(0.9)	(1.5)	(2.4)
Non-tax revenue	(1.4)	(2.5)	(2.6)

Source of basic data: Bureau of Treasury

Table 1 summarizes how the current fiscal crisis evolved in the last 10 years. During the period 1994-1997, import duties accounted for the decline in the total revenue effort (the large contribution of non-tax revenues to the change in the revenue effort is due to the one-time surge in 1994) (col. 2). During the period 1997-2003, local tax revenues accounted for the deterioration in the total revenue effort. (col. 3), but bleeding at the Bureau of Customs grew more profusely. For the 10-year period 1994-2003, tariff reduction accounted for the bulk of the loss in total revenue effort. (col. 4)

Revenue impact

A more accurate estimate of the impact of tariff reduction on fiscal revenues must take into account the impact of tariff rates on import demand. A lower tariff rate, which lowers the price of imports, raises the total demand for imports while a higher tariff rate reduces it. It does not necessarily follow, however, that a lower tariff rate results in lower Customs revenues. Nor do higher tariffs always bring in higher revenues.

What happens to total Customs revenues depends on the responsiveness of import demand to changes in the tariff rate. There are two possibilities. Total revenues may fall with a fall in the tariff rate if the increase in import demand is induced by the lower tariff rate is not sufficient to offset the lower tariff rate per unit of import. That is, imports are price inelastic. The other possibility is that total revenues *rise* with a lower tariff because the higher volume of imports induced by the lower tariff more than offsets the lower tariff per unit of import. That is, imports are price elastic.

Whether imports are elastic or inelastic with respect to price is an empirical issue. That is why it is necessary to go into the exercise of estimating the responsiveness of import demand to changes in import prices, which include the tariff rate. Our estimate of the demand for imports holds that the level of imports is a function of the level of economic activity and the relative price of imports.⁶ The latter is a ratio of the world price of imports in peso terms and the effective tariff rate.

Table 2. Foregone revenues from trade liberalization, 1994-2003

	P billion	% GDP
1994	2.1	0.1
1995	17.7	0.9
1996	18.5	0.9
1997	48.3	2.0
1998	70.8	2.7
1999	76.8	2.6
2000	99.9	3.0
2001	122.3	3.4
2002	136.0	3.4
2003	136.0	3.2
98-03		3.0

Source of basic data: Bureau of Treasury

As expected, the results show that the demand for imports is positively related to the level of domestic economic activity, and negatively related to the relative price of imports. More important, the results show that imports are inelastic with respect to price. This means that a lower tariff rate (hence lower import prices) results in lower total revenues from tariffs.

Using our estimate of import demand, we calculate the foregone revenues from the tariff reduction program. Table 3 shows that revenue loss from the tariff reduction program, which took effect in 1991 with a four-year phase-in period. Foregone revenues refer to the additional revenue that would have accrued to government if tariff rates were kept at their 1992 levels. Revenue losses began to balloon in 1995. Foregone revenue from the program rose from close to 1% of GDP in 1995 to a high of 3.4% of GDP in 2002. Its average 3% of GDP in 1998-2003 only slightly lower than the decline in the local tax effort in the same period. (Table 1)

The potential revenue intake from a partial reversal of the trade liberalization program can be gleaned from the table below. (Table 3) As before, our estimates take into account the fall in import demand as a result of a higher tariff rate. We estimate additional revenue under three scenarios: high, which assumes a reversal to 1992 tariff rates; medium, which assumes a return to 1996 tariff levels; low, which assumes a uniform 1% import surcharge. For example, every percentage point surcharge on imports generates P20 billion in revenues or one-half of 1% of GDP. Reverting to 1996 tariff levels will generate P 95 billion in additional revenues for government or 2.2% of GDP. Note that this is close to the amount, estimated at 2.5% of GDP, necessary to stabilize the public debt.⁷ Finally, a return to 1992 tariff levels would generate P136 billion in new revenues or 3.2% of GDP.

Table 3. Estimated revenue intake

Scenario	P billion	% GDP
High	136.0	3.2
Medium	95.0	2.2
Low	19.9	0.5

Author's estimates

High--1992 tariff rate, Medium-1996 tariff rate; Low-1% surcharge

In view of the massive potential revenue intake from higher import tariffs, the silence on the part of government and the lack of enthusiasm among perceptive observers and commentators on this issue is rather surprising, to say the least. The argument that a reversal of trade liberalization would put the country in violation of its World Trade Organization (WTO) commitments is pure baloney, as the data will show. (Table 4) Indeed, even with a full and complete reversal of the tariff reduction program in the 1990s⁸, the Philippines should be able to keep its status as a WTO member of good standing!

Table 4. Average bound and actual tariff rates, 2003

Sector	Average Final Bound Rates (%)	Average Actual Nominal Rates (%)
Agriculture	36.95	11.85
Mining	14.86	2.47
Manufacturing	23.45	6.94
OVERALL	25.98	7.51

Source: Tariff Commission

In sum, aggressive import liberalization by our own policymakers and the resulting loss in customs revenues is what drove us into the current fiscal mess. Now, whether it is desirable to reverse the import liberalization program involves larger questions of economic policy. But there is no denying the key role it played in the evolution of the current fiscal crisis⁹—and the massive potential for relief from higher tariffs.

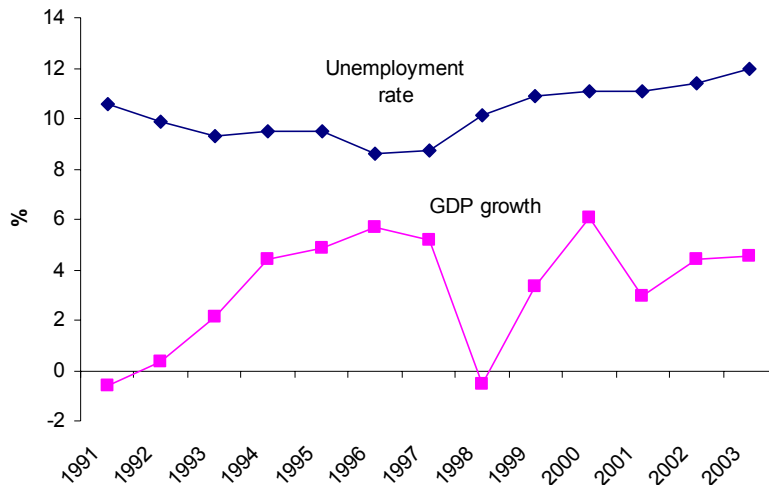
Protecting jobs

The larger policy question in relation to tariff reduction is the impact on jobs. From this perspective, the need to quickly lower unemployment presents even more pressing reason to reverse the program. The case for raising tariffs to protect existing jobs and create new ones is straightforward. Raising tariffs makes imported goods more expensive relative to locally produced goods, thereby raising domestic demand. The resulting increase in domestic production generates additional employment.

The country's experience with import liberalization since the 1990s indicates that declining tariff rates may have exacerbated unemployment. The record since the early 1990s, a period of aggressive import liberalization, reveals a perverse link between GDP growth and unemployment. (Chart 3) For example, there are two growth episodes, 1993-1995 and 1999-

2003, spanning a total of eight years, when GDP growth is accompanied by *rising*, not falling, unemployment.

Chart 3: Weak link between GDP growth and unemployment



What explains rising unemployment during these periods of economic expansion? A major factor at work was import liberalization. Imports as a percentage of total supply of goods and services in the country rose from 27% in the early 1990s to a high of 39% in 1997, declining to 35% in 2003. The flood of imports occasioned by the tariff reduction program represented massive job creation—abroad.

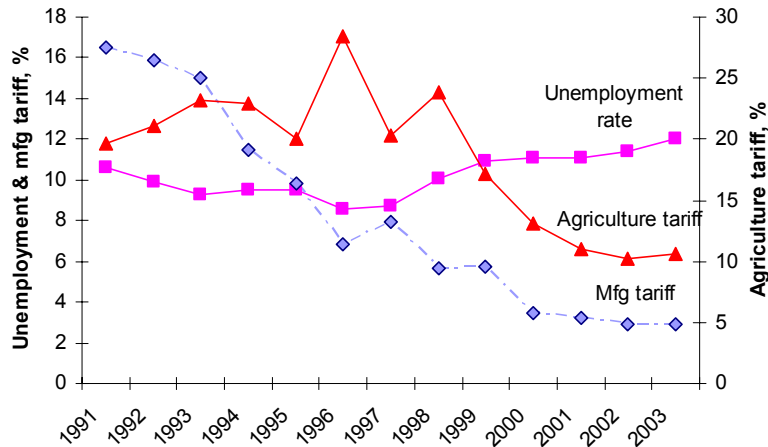
The detrimental impact of import liberalization may be gleaned from Chart 4. In particular, movements in the average tariff level for agriculture seem to be driving the unemployment rate. A higher tariff in agriculture reduces unemployment while a lower tariff raises joblessness. It was only in 1998 when this pattern was broken. In that year, the combined negative impact on unemployment of the severe drought and the economic recession nullified the positive effect of a higher tariff rate.

A simple statistical test shows a highly negative and significant relationship between the unemployment rate and the average tariff rate in agriculture.¹⁰ This is quite plausible given that a significant portion of the labor force is found in the sector. This should give pause to those eager to open up the sector to import competition: The impact on joblessness and poverty can only be staggering.

The biggest tariff cuts in the mid-1990s took place in the manufacturing sector and varied widely across industries within the sector. A detailed analysis of the performance of

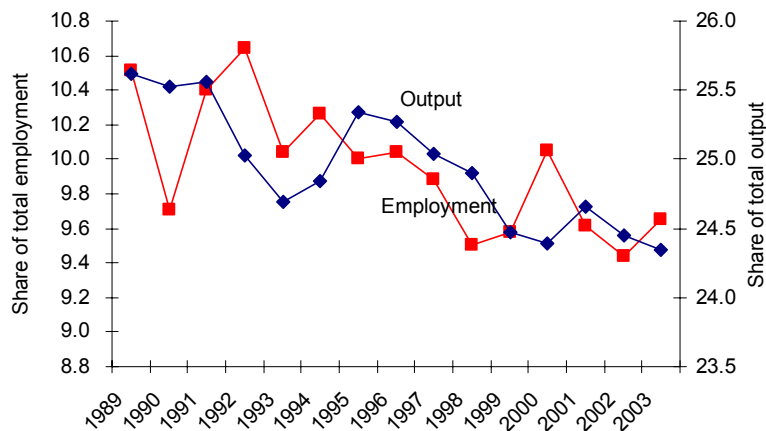
these subsectors during the period of drastic trade liberalization is necessary to reveal the impact of tariff reduction on employment. Pending such detailed analysis, it is still instructive to look at aggregate trends in the manufacturing sector.

Chart 4: Falling tariffs worsen unemployment



Our final chart presents the share of manufacturing to total output and employment for the period 1991-2003. The chart illustrates the continued decline in the importance of manufacturing in terms of output and employment. Notable is the decline in the share of manufacturing employment to total employment from 1992 to 1997 followed by a fall in the share of manufacturing to total output from 1996 onwards. The early to mid-1990s was a period of rapid overall growth. But the declines coincide with the period of sharp manufacturing tariff reduction. Note too that the fall in employment leads rather than lags the fall in output share. The falling share in terms of both output and employment indicate deindustrialization.

Chart 5. Share of manufacturing to total output and employment



Stretching back to the 1980s, deindustrialization in the 1990s can be traced to aggressive trade liberalization. The opening up of the sector to import competition lowered the price of import-competing manufactures relative to products of non-tradable sectors, including construction and services. Consequently, investments moved to the non-tradable sectors resulting in higher output and employment growth there. While the share of the non-tradable sector, especially services, grew in terms of output and employment, the share of import-substituting manufacturing industries shrank.

Our rendition of the observed decline in the importance of the manufacturing sector jibes with an account that places greater importance on an overvalued exchange rate at least prior to 1998. The latter story however fails to explain the fact that the process of deindustrialization showed no clear signs of reversal despite the sharp and sustained devaluation of the peso since 1998.

Usual objections

There are at least four objections to raising import tariffs. One, it breeds corruption, smuggling and rent-seeking. Two, it hampers efficiency and economic growth. Three, it discourages labor-intensive export industries, thereby undermining job creation. And four, it does not create additional jobs but simply moves them around.

First, notwithstanding the corruption, rent-seeking and smuggling then, import duties represented 5.6% of GDP in 1993 compared with 2% in 2002. Nor has import liberalization stamped out corruption and smuggling.

A more important point raised by proponents of import liberalization is that tariffs lead to monopolies and lack of competitiveness in the protected sectors, thereby encouraging rent-seeking. A study by the Asian Development Bank (ADB), however, finds that the mark up rate of Philippine firms, interpreted as the degree of monopoly, increased by 50% between 1980 and 1999. It concludes that the substantial economic reforms which opened up the economy to foreign trade and investment in the last two decades have met little success.¹¹

Second, with regard to efficiency and economic growth, our own experience hardly inspires confidence in trade liberalization as a pillar of development strategy. Growth in the 1990s pales in comparison with growth in the 1950s to 1970s, decades marked by protectionism, rent-seeking, and 'inefficient' policies by conventional standards. In terms of firm 'efficiency', a study by the Philippines Institute for Development Studies (PIDS) concludes that "much work still needs to be done as the share of inefficient establishment remains significant."¹² More telling is that trade liberalization has not translated into industrial growth, the excuse being: "Gains from trade reforms are more long-run in nature and may not already be apparent."¹³ This after 20 years of trade reforms!

Third, it is argued that raising tariffs creates a bias against exports and hinders the production of labor-intensive export goods where the Philippines holds a comparative advantage. The empirical evidence, however, has not been kind to this view. Average annual growth rate of merchandise exports has been declining since the mid-1980s, from 11.3% in the second half of the 1980s, 9.7% in the first half, and 7.3% in the second half of the 1990s. The country has been quite successful with electronics production for exports, notwithstanding warnings that we have among the highest wage rates in the region. But its contribution to job creation has been dismal.

The fourth objection says that raising import tariffs creates jobs in protected industries but destroys those in other industries. Referring to Argentina before the 2002 crisis, prominent economist and foremost trade theorist Paul Krugman explains this point in relation to demands to protect jobs with tariffs or import quotas:

"The conventional response to such demands is to say that they are not really about creating jobs, only about shifting them around: a tariff can add employment in one industry, but at least as many jobs will be lost elsewhere as a result. And this is surely true in the United States, where the inflationary pressures created by protectionism for some industries would force the Federal Reserve to raise interest rates and thereby crowd out as many or more jobs in others."

He then goes on:

“But in a country that has high unemployment because of inadequate demand and that cannot do anything to increase demand, because it fears capital flight, this argument is simply wrong. Right now a tariff would increase employment in Argentina, and to pretend otherwise is intellectually dishonest.”¹⁴

Our choice: protect or perish

Krugman raises another point that is relevant to the current debate on the fiscal crisis, namely, the threat of capital flight. One way of dealing with the fiscal deficit without risking higher unemployment is to monetize the deficit, which means that the central bank prints new money which it lends to the national government to cover the deficit. On the one hand, monetizing the deficit raises aggregate demand (there's more purchasing power around and interest rates are lower), hence avoids a contraction in the short run. On the other hand, it leads sooner than later to a devaluation of the peso, which could trigger capital flight, practically closing off this option. Our own economists warn us, thus:

“...monetizing the deficit requires some form of capital controls. Only in this way would the government be able to source its foreign-exchange needs; otherwise the mere threat of a large depreciation and run-away inflation would lead to a massive capital flight and rapid loss of reserves. The Philippines, however, has historically been unable to implement such controls effectively—not even under the Marcos regime, so that the possibility of massive capital flight cannot be fully discounted.”¹⁵

This point is crucial from the perspective of growth and employment *under conditions of unrestricted capital flows*. With financial liberalization, the government loses a key policy tool to increase demand and avoid recessions, namely, monetary policy. Likewise, an aggressive devaluation that would make exports more competitive while protecting domestic industries from imports becomes increasingly risky. The only way then that the government can increase demand without risking capital flight is to raise import tariffs, as Krugman points out. The lesson is clear: In a world of capital mobility, countries facing high unemployment have few choices—protect or perish.¹⁶

The long view

There is a short-term cost to raising import tariffs, namely, that it hurts consumers, among them workers. True, raising tariffs will mean higher consumer prices immediately, perhaps fewer choices for everyone. Moreover, there is an adverse supply-side effect of

higher tariffs as imported raw materials, intermediate inputs, and capital equipment become more expensive, potentially hurting output and employment. In our view, in a situation of insufficient demand the positive impact of higher tariffs on the demand side outweighs the negative impact on the supply side.

Nonetheless, these very real costs must be weighed against the gains from increased demand for local goods, higher investments, more jobs, and eventually better wages. Considering the often conflicting demands of lowering unemployment and closing the deficit, raising tariffs is the nearest the country can come to a free lunch.

To sum up, raising tariffs addresses the fiscal deficit in a way that is compatible with what should be our overriding goal: job creation. Beyond the current crises, protecting and nurturing the domestic market, combined with a credible industrial policy, will resume the task of rebuilding domestic productive capacities¹⁷, and laying down a stronger basis for future growth.

Notes

¹ I am grateful to Joseph Y. Lim for critical insights and for technical advice in running the estimates. Thanks to Cristina Morales and Ma. Teresa Diokno-Pascual for penetrating comments. Also to participants of the roundtable discussion on the fiscal and unemployment crises during the conference on “Liberalization, Macroeconomic Policy and Development Options in Asia” 1 October 2004 sponsored by the International Development Economics Associates Network (IDEAS) and the Action for Economic Reforms (AER), SEAMEO Innotech, Diliman, Quezon City. All errors are mine.

² As of July 2004, there were 4.4 million unemployed Filipinos and another 5.6 million employed but wanting more work.

³ Besides the proposed cut in IRA releases, the DBM is poised to put an end to support for devolved services, and guaranteed borrowings by local governments through automatic deduction in LGU debt payments.

⁴ Keynes’ “animal spirits” conveys the mysterious and untamed nature of “investor confidence”.

⁵ With some manipulation, a simple accounting model of the economy [$Y = C + I + G + (X - M)$] leads to a useful identity [$(M - X) = (I - S) + (G - T)$], where Y is total output, C is consumption, I is investment, G is government expenditure, T is taxes, X is exports and M is imports. This latter identity says that the current account deficit is equal to the sum of the investment-savings gap and the fiscal deficit. Holding the current account deficit constant, a lower fiscal deficit, by way of higher taxes and lower government spending, implies a lower investment-savings gap. The latter is achieved by reduced private sector investment and consumption—in other words, an economic contraction.

⁶ Summary result, annual values, 1986-2003

Dependent variable: Ln Imports in real terms	t	P > t
Ln GDP in real terms	9.46	0.000
Relative price of imports	-3.95	0.001
Dum9303 (post liberalization)	2.93	0.011
Constant	-7.24	0.000
No. of observations	18	
P > F	0.0000	
R-squared	0.9679	
Adj R-squared	0.9610	
Dickey-Fuller test for unit root		
z (t)	-3.579	
p-value for z (t)	.0062	

⁷ de Dios, Emmanuel. et. al. “The deepening crisis: the real score on deficits and the public debt” UP School of Economics Discussion Paper, August 2004.

⁸ This would mean nullifying Phase III of the Tariff Reduction Program (TRP-III).

⁹ Bacate, Marife et. al. "The Bello, et. al. critique: Biased and economically unsound," *Philippine Daily Inquirer*, 19 September 2004. The authors cast doubt on such conclusion by merely raising the possibility that imports are price elastic but do not bother to verify whether this is in fact the case.

¹⁰ Summary results, annual values, 1991-2003

Dependent variable: unemployment rate	Eqn 1	Eqn 2	Eqn 3
GDP growth rate			
T	-0.32	-2.32	-2.69
P> t	0.753	0.042	0.025
Ln Working Age Population			
T		3.7	1.22
P> t		0.004	0.253
Ave nominal tariff in agriculture			
T			-4.32
P> t			0.002
Constant			
T	20.06	-3.33	-0.67
P> t	0	0.008	0.52
P > F	0.7527	0.0128	0.0003
R-squared	0.0094	0.5818	0.8641
Adj R-squared	-0.0807	0.4981	0.8187
Dickey-Fuller test for unit root			
Z (t)	-3.765	-2.569	-0.58
MacKinnon approx p-value for Z(t)	0.877	0.0996	0.0033
Number of observations	13	13	13

¹¹ Felipe, Jesus. "Competitiveness, Income Distribution and Growth in the Philippines," ERD Working Paper Series No. 53, Asian Development Bank, June 2004.

¹² Austria, Myrna. "Liberalization and Regional Integration: The Philippines' Strategy to Global Competitiveness," PIDS Discussion Paper 2001-09

¹³ Medalla, Erlinda. "Trade and Industrial Policy Beyond 2000: An Assessment of the Philippine Economy," PIDS Discussion Paper No. 1998-05.

¹⁴ Krugman, Paul. *The Return of Depression Economics*, W. W. Norton & Co. New York, 1999, pp 157-8.

¹⁵ de Dios et. al. Certainly, the BSP is a far more effective regulator today than under the Marcos regime.

¹⁶ Krugman rejects this conclusion. In the same paragraph quoted above, he insists: "This does not mean that Argentina—or Israel, or Hong Kong, or any of the many other economies in somewhat similar positions—should become protectionist; but it does mean that we had better start trying to find ways to get them back to more or less full employment, or the rationale for free-market policies is going to start to wear increasingly thin." The "ways to get them back to more or less full employment" remain to be spelled out.

¹⁷ Ocampo, Jose Antonio. "Development and the Global Order" in *Rethinking Development Economics*, edited by Ha-Joon Chang, London: Anthem Press, 2003.