

*An Industrial Policy
for the Philippines:*

Correcting Three Decades of Error

**Action for Economic Reforms
– Industrial Policy Team**



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FRAMEWORK PAPER

An Industrial Policy for the Philippines: **Correcting Three Decades of Error**

Jenina Joy Chavez

Joseph Anthony Lim

Nepomuceno Malaluan

Manuel Montes

Ma. Cristina Morales-Alikpala

Rene Ofreneo

Victoria Viterbo-Quimbo

Action for Economic Reforms - Industrial Policy Team
Quezon City, Philippines

Please direct all correspondence about this framework paper to chavezjoy@gmail.com.

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An Industrial Policy for the Philippines: Correcting Three Decades of Error

The year 1986 was a historical conjuncture of profound transition for the Philippines. In February of that year, the country ousted a strongman that had held the reins of political power for nearly 21 years, the major portion of which was under Martial Law.

The February 1986 events, popularly known as the *People Power Revolution*, were the culmination of a long struggle to recover democratic institutions. There was as well a shared analysis that the Marcos regime prevented broad-based economic development, with both public and private resources concentrated among favored allies of Marcos through corruption and cronyism.

Such common aspiration and shared analysis found approximate formal expression in the post-Marcos Constitution ratified in February 1987. Drafted by a commission assembled by installed President Corazon Aquino from various sectors and political persuasions, the post-Marcos Constitution embodied a comprehensive project of democratization and development.

In terms of democratization, the 1987 Constitution sought to recover and enrich the democratic rights of citizens, improve the system of check and balance, and strengthen the mechanisms for government accountability.¹

In terms of development, the vision of economic prosperity with social justice was deeply ingrained in the 1987 Constitution. Article XII (National Economy and Patrimony), Section 1 provides:

“The goals of the national economy are a more equitable distribution of opportunities, income, and wealth; a sustained increase in the amount of goods and services produced by the nation for the benefit of the people; and an expanding productivity as the key to raising the quality of life for all, especially the underprivileged.”

¹ Among the new provisions were: proscription against torture and detention excesses; larger opportunities for direct people’s participation in governance; stringent limitations on the President’s Martial Law powers; fortified power and independence of the judiciary; strict term limits for elective offices; requirement for declaration of assets, liabilities and net worth of public officials; very strong Office of the Ombudsman; among others.

The State shall promote industrialization and full employment based on sound agricultural development and agrarian reform, through industries that make full and efficient use of human and natural resources, and which are competitive in both domestic and foreign markets. However, the State shall protect Filipino enterprises against unfair foreign competition and trade practices.

In the pursuit of these goals, all sectors of the economy and all regions of the country shall be given optimum opportunity to develop. Private enterprises, including corporations, cooperatives, and similar collective organizations, shall be encouraged to broaden the base of their ownership.”

In the immediate years after the ratification of the Constitution and the reconvening of Congress, the process of implementing the democratization and development project began in earnest. The years 1988 to the early 1990s were years of major legislations to operationalize the democratization mandates of the Constitution.²

The development aspect, however, was less straightforward. While the Constitutional vision of sustained growth and industrialization with social justice was clear, the path to be taken towards achieving such vision was really a matter of policy. The strategy of choice that emerged in the following years was to rely more on the market and to restrict government intervention in the economy to a minimum.

Thus, the Philippines adopted a comprehensive economic liberalization policy that systematically opened up

² Among the key pieces of legislation were Republic Act 6713 (Code of Conduct and Ethical Standards for Public Officials and Employees) approved in February 1989, which spelled out the standards in the performance of duties by government officials and employees. It also provided the rules and guidelines on the disclosure of assets, liabilities and net worth. RA 6770, or the Ombudsman Act, was passed in November 1989 and provided for the functional and structural organization of the Ombudsman. RA 6735 (Initiative and Referendum Law) approved in August 1989 laid down the mechanism for the exercise by the people of their opportunity to directly propose or enact laws. Still, there were a number of democratization mandates that missed the boat. For instance, the advocacy for the passage of a Freedom of Information Act to complement the constitutional right to information is still ongoing to this day.

trade, privatized government assets, and allowed private participation in public infrastructure projects, among others. One of the casualties of this policy track was industrial policy.

Nearly three decades hence, we argue in this framework paper that the Philippines needs to reintroduce an industrial policy if the country is to realize the Constitutional vision of sustainable economic prosperity and industrialization with social justice.

Liberalization and the Hollowing-out of Industry

The focus on the political struggle against Marcos left the immediate post-EDSA administration with no set economic policy agenda. The task of quickly putting together “an internally consistent package of reforms for economic recovery and growth” was taken on by a group of economists under the auspices of the Philippine Institute for Development Studies, in cooperation with the National Economic and Development Authority (NEDA) and the University of the Philippines School of Economics. Their work, completed by 1 May 1986 and titled *Economic Recovery and Long-Run Growth: Agenda for Reforms*, provided an important basis for the 1987-1992 Medium Term Development Plan of the administration of President Corazon Aquino, and constituted the underlying framework of economic policy direction since.

One of the key guiding principles of the framework relates to the economic role of government – that government should intervene only when it can do better. This general principle becomes definitive when ranged against the areas that the authors believe government can play a role in (such as redistribution of wealth, regulation of structural monopolies, and spending for infrastructure and social services), and those that it must withdraw from. The idea was “*to achieve a more liberal and more neutral policy regime that allows for growth, yet leaves it to private initiative to explore and reveal the areas of true economic promise, with a minimum of government direction and intervention*”.

Such, in turn, will lead to long-run growth:

“As distortions are removed and the debt burden is reduced, we fully expect formerly penalized sectors to make larger contributions to growth. The implementation of these reforms will, therefore, naturally lead to a development strategy that is employment-oriented and rural-based. The government should support this course of evolution by redirecting its infrastructure programs towards the rural areas. In the same manner, for trade and industry,

we expect industrial growth and restructuring to occur which rely on competitiveness both at home and abroad, and are supportive of rural development.” (Alburo et al. 1986, ii)

Thus, alongside agrarian reform as the main redistributive program, the post-EDSA administrations adopted measures, often institutionalized by legislation or administrative action, centered on trade liberalization, deregulation, and privatization.

Even as privatization and deregulation had their impact on narrowing the area of government action, we focus our discussion on trade liberalization given its close relationship with industrial policy and the economic outcomes we are dealing with at present.

Alburo et al. (1986) devoted a chapter on “Trade and Industrial Policy”. The key measures proposed were the liberalization of the trade regime through the removal of all quantitative restrictions, reform of tariffs to move towards an interim goal of a range from 20 to 30 percent, and a final goal of uniform tariff of 10 percent. On industrial policy, the key measures proposed were: the phase out of export incentives; the phased liberalization of the products covered by the Progressive Manufacturing Program; the shift away from free trade zones; and doing away with direct intervention (price schemes, subsidy on inputs, etc.), and replacing them with indirect initiatives such as providing training and information, easing supply bottlenecks and improving infrastructure.

In terms of actual implementation of trade liberalization, in 1986 the Aquino administration lifted the import restrictions on 975 of 1,798 restricted lines. The number of remaining restricted lines was reduced further from 823 lines in 1986 to 477 restricted lines by 1989 (Mangabat 1998). Then on 20 July 1991, President Aquino issued Executive Order 470 which provided for a phased adjustment of tariffs from 1991-1995 towards final rates clustered around 3 percent, 10 percent, 20 percent, and 30 percent covering 95 percent of all tariff lines. This brought average nominal tariff from 28 percent down to 20 percent at the end of the period. (Tariff Commission)

In 1995, the Philippines acceded to the World Trade Organization. Under this agreement, the Philippines bound 63 percent of tariff lines to tariff ceilings generally 10 percentage points above the 1995 applied rates. It also committed to replace quantitative restrictions with tariffs. (Tariff Commission)

After 1995, the government pursued its unilateral march towards even deeper liberalization. It started implementing a new tariff reform program to achieve a uniform

level of tariff of 5 percent by 2004. By 1997, average nominal tariff was down to 13 percent. In 2001, the tariff reduction schedule was modified to achieve a tariff band of 0 to 5 percent instead of a uniform 5 percent, excepting only a limited number of sensitive agricultural products. The completion of this final target was only interrupted by a deceleration of implementation in 2002, owing to the large government deficit and the pressure for protection from a number of producers.

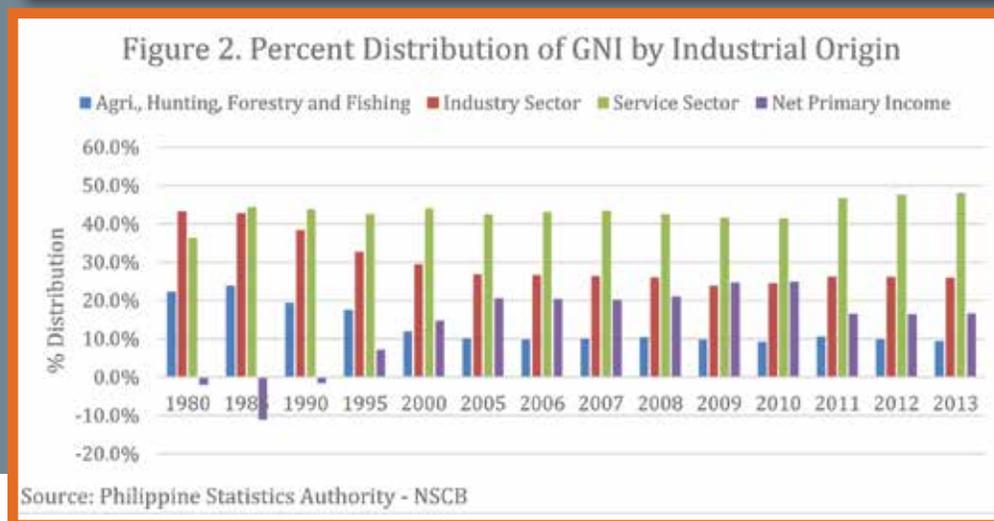
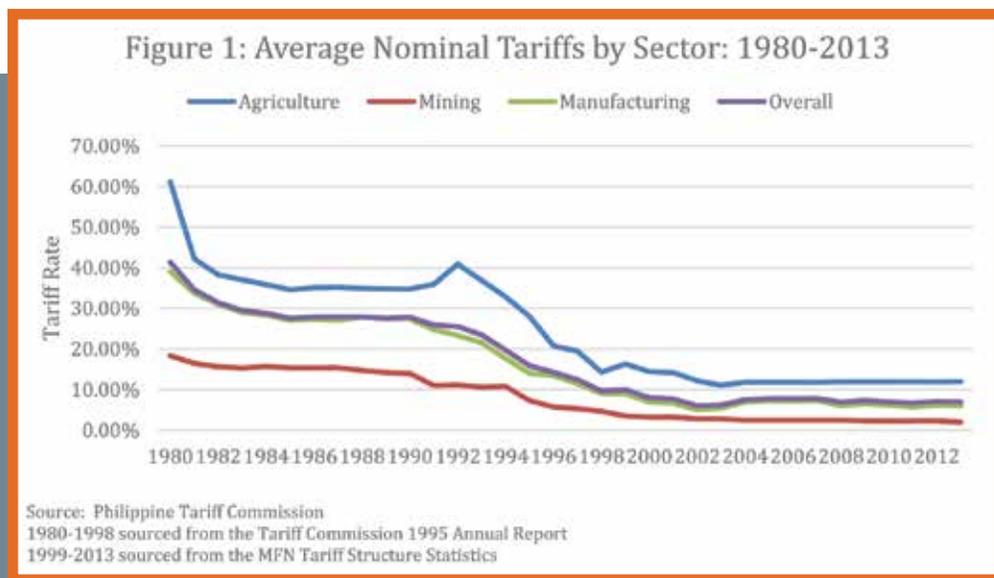
As of 2013, average nominal tariff stood at 7 percent. In terms of sectoral distribution, agriculture has average nominal tariff of 12 percent, mining has 2 percent, and manufacturing has 6 percent. **Figure 1** shows the pattern of trade liberalization from 1980 to 2013.

As regards the measures categorized by Alburo et al. as falling under industrial policy, the free trade zones and the fiscal incentives were not phased out as recommended. However, with the abandonment of directed

manufacturing objectives, the free trade zones and the fiscal incentives became tools mainly for the attraction of foreign investment rather than to support an underlying industrial promotion program.

Nearly three decades since taking the liberalization path, we now know that the anticipated industrial growth and restructuring based on competitiveness have not occurred. Instead of industry taking off from improving resource allocation, resources (both capital and labor) trooped to the non-tradable services sector. From 1985 to present, the services sector has proved robust in terms of share in GNI, while the shares of agriculture and industry have dropped. (See Figure 2)

Another stark response has been for labor to leave the country for work overseas. This was the direct outcome of jobs being destroyed and incomes depressed in both agriculture and industry. **Figure 2** shows the unmistakable rise in the contribution of Net Primary Income in



the structure of the Philippine economy from 1985 to present.

While movement in the exchange rate (peso depreciation) would have provided a price-correcting mechanism, as envisioned in the Albuero et. al. framework, the unintended result of labor being driven out of the country has prevented the price correction. Instead, the ever-increasing remittances of overseas workers push the peso value upwards, squeezing the tradable sectors even more.

Ramon Clarete, a leading exponent of trade liberalization, acknowledges the divergence between predicted and actual outcomes of trade liberalization. Clarete (2005) summarized the prediction of the 1995 to 2000 deepening of trade liberalization as follows:

“The ex-ante assessment of tariff reforms from 1995 to 2000 by Habito and Cororaton (2000) yielded a cumulative impact on real GDP of 2.3 per cent. The results indicated a relatively smaller drop in the number of jobs in both the agriculture and services sectors. However, this was more than compensated for by new jobs created in the manufacturing sector. Thus, overall, not only did real GDP increase, but also the inequality of its distribution declined, the poorest quintile income group receiving the largest share of the GDP growth.”

In contrast, Clarete (2005) summarized the outcomes on production and employment as follows:

“The services sector is leading in creating jobs for the Philippine labor force. Contrary to the results obtained from simulating the effects of trade reforms using models of the Philippine economy, industry rather than making up for the observed reduction of jobs in agriculture and services in the ex- ante analysis, has turned out in this ex-post assessment of the effects of these reforms to be part of the problem. According to the results from the simulations, trade liberalization should have resulted in resources of industries rendered uncompetitive moving into those that were given a boost by lower import restrictions. However... the shares of the various manufacturing sectors to total manufacturing production barely changed, indicating that resources hardly moved.”

More recent assessments of the Philippine economy show the same restructuring results. Norio Usui (2012) of the Asian Development Bank points out a number of structural weaknesses of the Philippine economy despite its recent favorable growth performance. These include the weak link between growth and labor indicators, declining fixed investment, and limited diversification of export products. The main weakness he identifies, however, is the sluggish transformation of the economy, in particular, the stagnant industrialization.

Aldaba (2013) observes that after more than twenty years of liberalization, the overall performance of the manufacturing industry has been weak, the export base has become less diversified, and the share of industry has stagnated with missing middle and with weak linkages

Industrial Policy: From Whether to How

The Philippine experience post-EDSA demonstrates how a development strategy of leaving the economy mostly to market forces with minimum government intervention can lead to disastrous results. Particularly in developing countries like the Philippines, price changes do not often “clear” markets where only private parties participate. Price competition can be ruinous in private markets, making it unprofitable to supply goods society needs. In other cases, because only a few suppliers are involved, monopoly prices prevent more widespread access to important products.

The preferred approach by mainstream economists of eliminating all subsidies and government interventions is based on the theory that relying on the private sector to determine investment destination ensures that only those sectors that can be sustained in the long-term will be invested in. It also avoids government losses when some of these ventures fail.

While almost no one can complain about efforts to minimize government losses, and that for the most part private markets serve most of society’s economic needs, investment in new ways to produce goods and the adaptation of new technology in key sectors are often too risky for private companies to undertake. If the essence of development is the introduction of more efficient production and the movement of labor from less productive to more productive jobs, then, as has been the record in the last quarter century, investment will congeal in areas that will only make commercial sense internationally, but have weak impact on higher productivity and better jobs domestically. Latin America continues to de-industrialize, falling back to reliance on commodity export earnings (Cimoli, Ferraz and Primi 2009). In

the Philippines that followed the route of eliminating subsidies and minimizing government intervention, the export structure has become even less diversified than before liberalization.

In practice, the range of policies associated with abolishing any trace of industrial policy - removing government subsidies and the ability of the government to regulate, import liberalization, and privatization of government enterprises – cannot be done in one shot or in a “big bang”. Based on World Bank studies (Winters 2000), trade liberalization takes five to six years for employment and new industries to emerge, and does not even guarantee that new sustainable enterprises will emerge. Too many neoliberal exercises in capital redeployment have resulted in the destruction of capital. In many countries and as experienced in the Philippines, it has resulted in the redeployment from manufacturing to retail trade and construction as the main dynamic sector of the economy. Trade liberalization makes old capital obsolete but does not by itself provide financing to create the capital for new industries and employment to respond to liberalization.

A blanket approach to eliminating government participation in the economy, unguided by an analysis about which sectors could become a source of growth (and which sectors are unlikely to be growth poles), has made the path to introducing new and more productive activities more difficult.

Thus, the backdrop of the country’s industrial outcome proceeding from past policies, and its impact on overall development objectives, has revived interest in industrial policy. In our view, the question should now shift from whether the Philippines should undertake an industrial policy, to how the Philippines should undertake industrial policy.

Industrial policy is the kind of analysis that governments might be able to afford in attempting to identify key sectors whose presence is “strategic”. What is a strategic sector requiring government support depends on the level of development of the country. For example, in some countries seeking to begin exporting agricultural products, a strategic intervention could be introducing the necessary domestic skills, equipment and coordination among private suppliers to ensure that goods meet sanitary standards in importing developed countries. These same capabilities can be useful in creating new products.

In addition to market failures, there is another reality: governments are often beset by private sector requests

for favors, such as favorable tariff or tax treatment, or subsidies. Even in the richest countries, government subsidies are a “way of life” – consider for instance the subsidies for fossil fuel exploration provided by the United States in the name of energy independence.³ Industrial policy is in fact a way to economize on government interventions in markets and in providing favors to certain sectors (Memiş and Montes 2008). Industrial policy can provide the means for explicit sectoral targets and priorities, and it provides governments with guidelines on which sectors deserve access to public resources that would otherwise get raided to support strong private lobbies.

Horizontal and Vertical Interventions

The challenge is to agree on the scope, criteria, and instruments for industrial policy.

On this matter, state interventions in the economy can be classified into two categories: (1) Horizontal intervention – in which the intervention benefits all sectors equally; and, (2) Vertical intervention – in which specific sectors receive state support in the form of tariff protection, subsidies, etc.

Mainstream economists are wary of any government intervention for a range of reasons, beginning with the costs associated with raising taxes needed for state intervention, to the resulting distortions in private incentives. However, they object less to horizontal intervention because according to them it still allows the price system to determine which sector should obtain private investment.

Some interventions are clearly sectoral, such as support for the development of a pharmaceutical industry. Education for citizens is horizontal intervention and not industrial policy, but government interventions toward building educational and technical institutions in specific areas of expertise and technology can be accused to be a part of industrial policy because it is sectoral. However, many interventions classified as horizontal also have different impacts across sectors. For example, maintaining a competitive exchange rate is often considered horizontal, but because industrial sectors differ in terms of their dependence on imported inputs and access to foreign markets, even exchange rate policy favors some sectors over others.

³ While the US has recently criticized China for restricting the export of rare earths, critically needed in the production of electronic products and cellphones, it has a little known prohibition on the export of crude oil in the name of energy independence; the US requires a license for any exports of unrefined oil.

IPS and IPL

Hausmann, Rodrik, and Sabel (2007) suggest another classification of state interventions between (1) “industrial policy in the small” (IPS) to solve market failures, improve productivity, and upgrade the technology content of existing sectors; and, (2) “industrial policy in the large” (IPL) to make strategic bets to introduce new economic sectors and industries.

Mainstream economic policy has two bases to be suspicious of IPS. First, most economic models are based on convex technologies both in production and consumption, which privileges a belief that market failures are rare. But while there might be an argument for a smaller possibility of market failures in advanced economies, Memiş and Montes (2008) suggest that developing countries are particularly prone to market failures.

For example, many important products require minimum economic scale for production, making many markets prone to monopolization or to non-existence in developing countries. Even in advanced countries, market failures can have economy-wide impact either on efficiency and/or on growth. The global economy is still working out the costs of the deregulation and “internationalization” of the financial sector in advanced economies, a fate already experienced by the Southern Cone countries in their crises beginning in 1981 and the East Asian countries beginning in 1997. The privatization of power supply and transmission in the United States and in the Philippines in ways that disregarded the “natural monopoly” features of the sector has also been costly.

The second reason mainstream economic policy is suspicious of IPS falls under the vast policy field called “good governance”. The threat to development prospects and the actual costs of government failure is typically considered to exceed the actual cost of market failure. The cost of government failure is often associated with the fiscal costs, and not netted against the cost of market failure, which is more difficult to estimate. These estimates often ignore positive externalities in failed government interventions. More important, in many policy conjunctures, the most decisive role of “good governance” is the threat that increased government economic activities, including in response to market failure, will mobilize corruption whose proliferation will condemn poor countries to underdevelopment.

Analysis (for example, Khan 2006) suggests, however, that the perception is mistaken and that “good governance” is neither a prerequisite for development nor for government intervention. To the extent stated above

where industrial policy provides governments with guidelines on which sectors deserve access to public resources that would otherwise get raided to support strong private lobbies, industrial policy can actually be a useful tool in constraining corruption.

If market failures are more prevalent in developing countries, the logical conclusion must be that developing country governments must build and maintain the capacity to evaluate, design interventions, and undertake actions in these critical areas. This requires a viewpoint that outcomes of unregulated, liberalized markets can be the subject of research and evaluation from the point of view of efficiency and development. The most important candidates where such evaluations must be carried out are in the social and infrastructure sectors of the economy: (1) the provision of health, education, housing and other services to households; and, (2) energy, water and sanitation, communications, transportation, financing, irrigation, waste disposal and other services.

The deliberate and substantial retreat of developing country governments in these sectors have often provided one-time relaxations in fiscal constraints but impose continuing demands for government intervention and constraints to investment, exporting efforts, and risk-taking in the private economy. While the private can take responsibility for these sectors in certain developing countries, government regulation will still be needed not only to avoid excessive private returns (because their outputs are the inputs and cost items in manufacturing and other downstream sectors) but also for the sake of efficiency since minimum scale economies often apply. Universal access can also be important to spur investment in areas with high potential returns.

With regard to “industrial policy in the large”, dire warnings from mainstream economics about the prohibitive cost of failures are often associated with the belief that government is incapable of “picking winners”.

This judgment, however, is really not a technically grounded view. For one, even as many governments publicly disavow any interest in sectoral intervention, they are subject to extensive lobbying on the part of the private parties for procurement, subsidies and protection favorable to their enterprises. Governments are “doomed to choose” politically (Memiş and Montes 2008, and Chang 1996) and technically (Hausmann and Rodrik 2006). A public intention to undertake industrial policy gives the advantage of the existence of criteria, in addition to just political intimacy with government officials, against which to evaluate requests for government support.

For another, this view about government inability is derived from the logic that the private sector is able to pick “winners”, or is at least better able than the government to choose “winners” and avoid “losers”. It is thought that the private sector has greater incentive to be prudent in avoiding “losers” because it is betting its own resources, while government officials are betting with taxpayer resources. This is an arguable assumption. Private companies, especially large ones, are often characterized by internal hierarchies more rigid than inside governments, making them prone to wagering enormous resources in projects based on the judgment of a narrow coterie of high executives.

Finally, the argument that the cost of failed projects is only to the account of the private sector, and not to the public or society at large, is questionable. The entry into new sectors involves capital investment and the diversion of labor, land and other resources. The aftermath of failed new investment projects even by the private sector can have long-term impact that the economy as a whole must bear. The rapid expansion of residential and office building investments by the private sector in Thailand and the Republic of Korea in the 1990s using resources borrowed from abroad not only fueled the build-up of a system-wide debt crisis but also left behind excess capacity that takes years to reverse.

The losses from failed projects, whether by the public or the private sector, can be offset to some extent by new capabilities introduced through the project that could be subsequently deployed in other sectors. This would be the case in truly new economic activities. If the development strategy stance insists on reliance mainly on the private sector responding to “undistorted” market signals, the likelihood is lower that new projects undertaken will feature new innovations that can be useful in other sectors.

There is some basis to argue that the government’s choice sets are simpler than those confronting the private sector and that, with the proper design, the government could devolve to the private sector more complex decisions in sectoral development. The unavailability of reliable energy or finance at reasonable cost, for example, can doom or at least make sectoral choices more expensive under IPL. The state thus has the prior responsibility in IPS interventions before IPL interventions. Still, this does not absolve the government from continually building and updating its in-house capability to evaluate industry and technological trends. Nothing should prevent government from giving out sectoral or enterprise advantages even while it has yet to fulfill its fundamental responsibilities in industrial policy in the small and in macroeconomic policy.

When the government is involved, whether consciously or not, in choosing which sectors to support, the key action is not about “picking winners” but that of dumping losers. Government support must always have a stop date from the very start, based on experience in other countries or technical considerations. Government must develop the capacity to remove benefits and support to sectors or specific ventures when their trajectory is veering away from continued improvement.

In making IPL choices, countries will need to live within their means. Public resources devoted to subsidizing and protecting sectoral initiatives must be within the state’s long-term financing and deficit program, with prudent exploitation of external financing. This can be tricky when the capital account is already liberalized. With open capital accounts, the very countries perceived by international financial markets as indeed “living within their means” become victims of capital surges. Depending on the fiscal and monetary response, this can lead to exchange rate appreciation and high⁴ domestic interest rates or both and also impose deficits in central bank operations (Montes 1997). Thus, a “development-oriented”⁵ macroeconomic policy is a pre-requisite for minimizing the cost of industrial policy.

A second consideration in making IPL choices is that support for sectoral development must balance the need to signal the availability of long-term support against the need to monitor and withdraw government support from projects that are proven failures. The setting of benchmarks will be useful. Because IPL projects go beyond infrastructure projects, many will by nature have strong private sector participation. The setting of incentive-compatible targets, such as requiring export performance, serve as monitoring and decision mechanisms.

Finally, if industrial policy is to work, it must not only identify specific sectors, but also pay attention to the availability of financial resources when capital is redeployed. Thus, there is recent resurgence of interest in development banking institutions that had been shut down in many countries under structural adjustment programs. Brazil’s BNDES (Banco Nacional de Desenvolvimento Econômico e Social), for example, has built a reputation of providing finance to new technologies and new economic activities, both in industry and agriculture.

⁴ See also Akyuz 2012. This paper originally published in 1992 foresaw the perverse impact of open capital accounts even when fiscal and trade deficits are under control, as in the case of the East Asian countries before the 1997 crisis. This means that the so-called errors in “sequence of liberalization” as the excuse for failures of past liberalization reforms has little theoretical basis.

⁵ See Chapter 5 of United Nations 2010.

What Sectors Government Should Assist

There are a few modest guidelines on identifying candidate sectors for industrial policy. Typically, these have the potential for higher labor productivity than currently available in society. These are also sectors characterized by increasing or constant returns to scale in which the private sector could not profitably enter on its own without state support (Memiş and Montes 2008). Assisting production enterprises to enter these sectors and increase their scale as rapidly as possible in order to slide down the unit cost curve is a key indicator of industrial policy. One reason why so-called industrial policies in the 1950s-60s failed is because they paid too little attention to increasing volume in order to obtain the benefits of declining unit production costs.

The other reason for the failure of the old industrial policy strategy, as economist Raul Prebisch had the occasion to observe, is that the old industrial policy had been occasion for increased inequality while attempting to serve only domestic markets. Aside from finance, industrial policy cannot succeed unless complemented by exchange rate and domestic incomes policy.

Industrial policy applies not just to sectors in manufacturing but also to sectors in agriculture and services. Because agriculture is often described as production on a fixed land area, it is often associated with diminishing returns to scale. This is not necessarily true, particularly when new crops and production methods are being introduced as part of the upgrading effort. Depending on the country situation and the sector involved, diminishing returns can begin to kick in at much higher volumes. The introduction of new technologies in a specific agricultural sector could start a process of increasing returns. Even with a total fixed land endowment, the benefits of improved productivity can be important as the technology is disseminated to replace an old technology.

In the last decade, economists have begun to take seriously the idea that the kind of products a society produces (and exports) determines its prospects for development. This fully overturns the mainstream economics view that is agnostic with respect to what products states should promote. The empirical analysis suggests that by entering certain product sectors, countries find it easier to expand into other “nearby” products and sustain their growth. Usui (2012) applies this methodology to the Philippines. His analysis suggests that the determined agnostic stance of policy with respect to manufacturing has favored the movement of labor directly from agriculture to services, including business process operations and overseas employment, which has constrained the

growth of labor productivity, particularly in comparison with the other countries in the region.

Industrial policy is about building a set of private sectors, in sizes and capacities large enough to be competitive internationally. In building private sectors, states are confronted with the problem of non-existent or weak capital allocating mechanisms. The orthodox prescription has been to require building private capital markets first so that capital can be redeployed. In actual practice, successful countries have not waited to build capital markets, but have redeployed capital through the operations of the state. The critical role of the state-owned enterprises and so-called “government-linked enterprises” (GLEs) in East Asian success indicates that government economic participation is often required when the private pools of capital are too small to create enterprises large enough to compete internationally.

Why Try Industrial Policy at All

There are already special sectoral interventions existing because of private sector lobbying. One could keep technocrats busy trying to shut down all of these interventions or fending off proposals for new ones. In contrast, industrial policy permits countries to embed these sectoral interventions in an overall program, with the possibility to evaluate proposed subsidies and protections. Such a program will be the outcome of a political process, but the difference is that the identification of preferred sectors is undertaken in a more transparent manner.

There is a Dutch saying that if you don't aim, you will surely fail. Productivity upgrading requires technological upgrading which private markets are often unable to afford by themselves. Orthodox approaches can condemn economies not only on dependence on foreign capital but also in diminishing returns sectors, which will not provide for wage and employment increases in the medium-term.

Usui (2012) suggests that it will be difficult to meet poverty reduction objectives without industrial development. We argue that industrial development is impossible under a fully neutral government policy regime. It is less a matter of whether certain interventions fail or succeed; private sectors experience these kinds of successes or failures all the time. The winners provide permanent new more productive sectors to the economy; losers create new capabilities that can be used in other sectors.

How much industrial policy a country will undertake depends on a society's ambition. The orthodox answer is “Don't even try it” or perhaps “Don't try this at home” or “Government sectoral intervention will surely fail”.

But if a society seeks to upgrade its production, reduce poverty, and increase incomes, it has to try to undertake industrial upgrading, even at the risk of failure. As has been the experience within the private sector itself and in many developing countries, failures leave new capabilities and a clearer view of what is needed in future efforts.

Trade liberalization was proposed for all countries, no matter the level of development. Unlike trade liberalization, industrial policy will be different for each country situation and will have to build capabilities on top of existing capacities and endowments.

Institutional Requirements

Even as the theoretical and empirical justification for industrial policy is clear, the institutional and organizational mechanisms to undertake industrial policy need to be explored thoroughly.

Definitely, there is no one-size-fits-all set of political and social institutions and governance framework for industrial policy. In fact there is no one-size-fits-all for the type of industrial policy itself.

Ohno (2009) shows how different East Asian ‘Miracles’ undertook different industrial policies under different organizational and institutional arrangements. It is important for the industrial policies undertaken to be suited to the organizational institutions and political power relations in the country. The industrial policy must be in tune with the human skills and education and potential capabilities of the economy. Indeed, the planning of industrial policy and the institutions and relationships that are involved in industrial policy are actually one and the same set of processes.

The following lifts heavily from Ohno (2009) in the cases of Japan, Korea, Malaysia and Thailand.

Japan and Korea. Japan’s and Korea’s strategy of high government profiles in industrial policy and licensing privileges for large domestic firms (employing the infant industry arguments) differed from Taiwan’s reliance on technology licensing and linking large multinationals to efficient small and medium domestic firms for technology transfer.

Japan and Korea shared some similarities in having super-ministries in charge of industry, giving licenses to large conglomerates (zaibatsus, chaebols) for special privileges in return for fulfilling strong performance indicators, and relying on imitating foreign advanced technologies instead of relying on multinationals and

foreign direct investments. They differed in that Japan relied on its super-ministry for organizational leadership whereas Korea was more dependent on the personal leadership of Park Chung Hee and his promotion of the Economic Planning Board under a Deputy Prime Minister he hand-picked. They, however, used similar protective devices such as credit subsidies, export subsidies, technological support and promotion, and infant industry protection.

Japan’s institutional capacity for industrial policy from the late 1950s to the 1970s consisted of a super-ministry, the Ministry of International Trade and Industry (MITI), which implemented the medium and long term plans formulated in cooperation with the Prime Minister’s Office. The role and functions of the MITI consisted of:

- a) Inter-ministry coordination of industrial policies especially with the Ministry of Finance and the agencies under the Prime Minister’s Office: the Economic Planning Agency, the Land Agency, etc.;
- b) Deliberation councils where the MITI and industries agreed on an industrial vision, discussed industrial policies including finance and technology, generated cooperation among firms and industries on common strategies, shared information, negotiated and built consensus, and sometimes provided the venue where MITI flexed muscle with the private sector firms; and,
- c) Business officials, government officials, academia and the media were active in the deliberation councils to generate best results and overall societal support for the strategies.

Korea’s political institutional structure for industrial policy consisted of the following:

- a) The Economic Planning Board (EPB) was the super-ministry for industrial policy in charge of development, investment and budget planning, aid management, and monitoring. It was headed by a Deputy Prime Minister directly reporting to the President;
- b) The President was the real power behind economic planning using the Deputy Prime Minister as titular head of the Economic Ministers’ Council, and the State Council;

- c) These councils were in effect deliberation councils that consisted of strong cooperation and collaboration between the state and the big business sector (the chaebols) especially in export promotion, economic briefs, promotion of critical industries and the like. The President was very active in these deliberation councils;
- d) The Korean Development Institute (KDI) was very active in providing academic support and ideas to the medium and long term economic plans, industrial policies and policy analyses. It was critically linked to the entire state planning and industrial policy structure; and,
- e) More so than Japan, Korea's initial industrial policy, despite reports of widespread corruption, was performance-based with good performing industries and firms given further rewards, and those not performing given penalties and withdrawal of privileges.

Malaysia. Similar to Korea, Malaysia had a strong personal leadership of promoting industrial policy under Prime Minister Mahathir. In the 1980s, Mahathir developed industrial visions with the 'Look East Policy' in the 1980s and the Industrial Vision 2020 announced to the Malaysian Business Council in the early 1990s.

The industrial policy involved multi-layered inter-ministerial coordination:

- a) The Industrial Coordination Council (ICC) – chaired by the Minister of International Trade and Industry (MITI) with members from seven other ministries including the Economic Planning Unit (EPU), the Department of Finance, the Central Bank, fifteen business representatives from the Chambers of Commerce, industry associations – coordinated the activities of industrial policy;
- b) The Industrial Policy and Incentive Committee (IPIC) made up of the eight ministries planned and operationalized incentive schemes; and,
- c) The public-private cooperation worked through the Public-Private Cluster Working Groups and the Strategic Thrust and Initiative Task Force (STITF). The focus was on eighteen industrial clusters and crosscutting issues.

Unlike Korea and Japan, Malaysia involved multinational firms in technologically driven industries such as electronics. Unlike the Philippines, Malaysia had gone up the technological ladder in electronics – going into micro-chips and more sophisticated products. Malaysia's strategy included consultations with Malay, Chinese and Indian political parties and communities and included regional development in the cluster-corridor strategy of development.

Taiwan. Taiwan's industrial policy followed quite a different approach and concentrated on technological licensing and the participation of hi-tech multinational corporations (MNCs). The strategy consisted mainly of building the capacities and efficiencies of cost-competitive small and medium firms to act as suppliers to the hi-tech multinational firms. (Fuller 2002)

The strategy included building the necessary infrastructure and R&D requirements to achieve technological upgrading and linking Taiwanese firms to strategic customers. The outsourcing of MNC input requirements became a major source of technological learning of Taiwanese firms. Through time the small and medium firms were able to learn sophisticated technologies from the MNCs and became major exporters themselves. Taiwan's strategy was complemented by promoting the education of engineers and scientists abroad.

The Taiwanese bureaucracy had the special feature of including strong state technology institutions in the state industrial policy planning and implementation. The Industrial Technological Research Institute (ITRI), and under it, the Research Service Organization (ERSO), played a key role. The Science and Technology Advisory (STAG) also played a crucial role in industrial policy.

It must be pointed out that engineers, scientists and lawyers played very important roles in the industrial planning and policy bureaucracy of Taiwan and Korea. (Chang 2009)

Thailand. Finally, we look at the case of Thailand. Thailand does not have a strong state structure for industrial planning and industrial policy. But in the 1980s, industrial policy was achieved in the form of regional development.

The regional development strategy consisted of:

- a) Large scale infrastructure building and setting up of industrial zones;
- b) The Eastern Seaboard Development Program (ESDP), which created the most dynamic region in Thailand where high

value goods and Japanese multinationals (automobiles, electronics) and other high-tech export firms moved to;

- c) The setting up of the Joint Public-Private Consultative Committee where government and business collaborated and strongly participated in; and,
- d) The Rural Development Committee.

In the 1980s, the Thai Prime Minister himself chaired the committees, and these committees were managed by the National Economic and Social Development Board (NESDB). Within the NESDB, the Secretariat of the ESDP was formed. Subcommittees chaired by ministers of key agencies were formed that planned and implemented the regional development of the Eastern Seaboard and the promotion of the chemical fertilizer and petrochemical industries, and educational and social programs.

Institutional Possibilities in the Philippines

What are the possibilities, challenges, and constraints to putting in place workable institutional and organizational mechanisms to undertake industrial policy in the Philippines?

The Philippines has the technical capabilities, potential institutional structure and knowhow to undertake selected and well-thought out industrial policy for critical and progressive industries. These can be further harnessed by building government capacity in industrial planning and technological policy.

Even the poorest developing countries have ambitions to establish university capabilities in science and technology. Particularly in poor countries, relating investments in the disciplines of natural sciences to the requirements of agriculture and manufacturing is a worthy allocation of scarce resources to unlimited needs.

One analytical way to think about industrial policy is the discussion on building of “national innovation systems” which involves tying together the activities of universities, government agencies, research institutions, and private companies in the introduction of new products. How rapidly the volume of new production increases determines how quickly new products become commercially viable and can compete with older products.⁶

⁶ United Nations 2011, Chapter 5 applies this framework to the issue of building ‘green industries’.

One concern is how the free trade agreements that we have signed restrict any venture into industrial policy. However, there are always policies that are not included in the free trade agreements, as well as vague interpretations of the agreements. This is why, just like Korea and Taiwan, international lawyers, engineers and scientists would be some of the critical people needed in the bureaucracy.

The biggest constraint now for the Philippines is in the political will and mindset of the government and the private sector. On the part of government, its implementation of a minimalist government framework for decades has calcified not only perspectives but also institutions and laws. On the part of the private sector, big capital has adjusted to the incentives and resulting economic structure. If we look at the country’s 40 richest people, they have all diversified away from agriculture and manufacturing into services and non-tradables, particularly utilities, property, retail trade, and infrastructure. It is likely that there will be resistance to the new incentives that will be introduced by an industrial policy.

The issue of leadership, whether of the organizational or personal kind as shown in the Asian “miracles”, will be a key factor. Industrial policy needs strategic planning and implementation where continuity is key. The feasibility of this being sustained will be difficult in the Philippine political system characterized by frequent elections and stringent term limits. Will a properly functioning party system be able to address this? Can management and administrative capacity for industrial policy within the bureaucracy be developed independent of personal leadership?

In a way there has to be a political, social and economic transformation of the Philippine society. But this only means we should start somewhere, and now.

An immediate way forward is to build a broad coalition for industrial policy. This will have to involve representatives from labor, business, the academe, and segments of the bureaucracy and political leadership that may be more open to industrial policy. A broad coalition will be critical in helping provide continuity in the face of quick political transitions. Equally important, a coalition is needed to balance the various interests affected by industrial policy, and provide a counterweight to the danger of government failure.

We also support the ‘roadmaps’ and industrial policy planning exercise recently initiated by a unit of the Department of Trade and Industry, with the qualification that an industrial policy coalition will have to engage this exercise actively.

Industrial policy is a 'learning by doing' process and, as long as there is emerging political will and constituency for it, the process may generate its own institutional and organizational mechanisms based on the requirements of the program.

Recovering the Path to Development with Social Justice

One key outcome that the restructuring of the Philippine economy has produced is the deterioration of the quality of employment for the greater majority. In addition to high rates of underemployment, there is also a high level of informality of jobs. The leading employers, services (employing 20.7 million or 54% of workers) and agriculture (12 million or 30.1%), are characterized by much lower productivity and income than industry/manufacturing. (NSO 2014)

There is also a trend towards informalization of employment associated with insecurity and low labor standards. Comparing the Updated List of Establishments and the Labor Force Survey, in 2012, only 21 out of every 100 employed workers are in formal establishments. Over 30 million Filipinos work under informal employment conditions. According to the Informal Sector Survey 2008, informal employment comprises of (1) own-account

workers and employers employed in their own informal enterprise, (2) contributing family workers, irrespective of whether they work in the formal or informal sector, (3) employees holding informal jobs, whether employed by formal enterprise, informal sector enterprise, or as paid domestic workers of the households, and, (4) own-account workers engaged in the production of goods exclusively for own final use by their household. Informality even in the formal sector is also high. Formal sector jobs are also associated with informal conditions, in particular, the absence of formal contracts, benefits and social protection. (NSO 2012a, 2012b, and 2008)

Thus, in addition to pursuing general social programs such as in health and education, we believe that an industrial policy will play a crucial role in facilitating the upgrading and transformation of more productive sectors. In the process, this will create better quality jobs for Filipinos presently excluded from the narrow base of the country's economic growth.

True industrial policy is purpose-driven for meeting social objectives. The vision of sustained growth and industrialization with social justice embodied in the 1987 constitution remains very relevant today.

The time to correct three decades of policy error is now.

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The AER Industrial Policy Team

The AER - Industrial Policy Team (AER IP Team) aims to contribute to the development of a policy agenda to address weaknesses in the country's industrial outcomes. The objective of this initiative is to present an accurate and comprehensive picture of the state of industry and employment in the country, and what this means for people's lives and livelihoods. The AER IP Team believes that an industrial policy will play a crucial role in facilitating the upgrading and transformation of more productive sectors, in the process creating better quality jobs for Filipinos presently excluded from the narrow base of the country's economic growth.

Through research and analysis, roundtable discussions and consultations, the AER IP Team seeks to test specific ideas on industrial policy and gauge various groups' openness to them. Overall, the team believes that a constituency for industrial policy can be developed, particularly within the labor sector, segments of industry, public interest groups, and the academic community. At the same time, the team seeks to constructively engage the Government's Manufacturing Roadmap process, and sees the need to cultivate relations, exchange perspectives, and find common ground with reform-oriented

sections of the bureaucracy and political leadership that may be open to industrial policy.

The AER IP Team does research and policy analysis on the quality of growth, employment, the institutional infrastructure for planning and program implementation, and does specific industry studies. It has a Special Project on *Localizing Industrial Development Planning*, with pilot areas in the Yolanda-stricken areas in Eastern Visayas for 2014-2015, which seeks to respond to the challenge of maximizing rehabilitation resources towards a socio-economic outcome that is more inclusive, resilient, sustainable and equitable. Specifically, it calls for planning and targeting for quality employment and strong agro-industrial base, as well as for a politically active constituency that will engage this process.

The AER IP Team maintains and aims to develop grounded partnerships and engagements with research organizations, social movements, industry groups, communities, universities, and government entities towards the development of appropriate and need-sensitive responses to industry and employment challenges.

The AER Industrial Policy Team

The AER Industrial Policy Team is composed of the following Trustees and Senior Fellows of Action for Economic Reforms:



Chavez, Jenina Joy

Jenina Joy Chavez coordinates the AER Industrial Policy team. She was a Senior Associate and Philippines Programme Coordinator with the regional policy research and advocacy organization Focus on the Global South until 2011. She works on the political economy of industrial policy, the nexus of economic policymaking and public health, and regional social policy. She volunteers for the Solidarity for Asian People's Advocacy on the strengthening of the social dimension in regional integration and the democratization of ASEAN processes to include non-state actors; and the Right to Know. Right Now! Coalition on the campaign for the passage of the People's Freedom of Information Act.



Lim, Joseph Anthony

Joseph Anthony Lim is a Professor at the Ateneo de Manila University, teaching International Economics and Macroeconomics. Prof. Lim attended the ADMU (BS Management Engineering, Magna Cum Laude 1974), the Massachusetts Institute of Technology (MS Operation Research 1976), and the University of Pennsylvania (PhD in Economics 1995). He has long been contributing to the macro-analysis of Philippine economic performance. He was a Policy Adviser on Debt and External Finance for Developing Countries at the Bureau for Development Policy, United Nations Development Programme in New York from 2002 to 2004; and taught at the University of the Philippines School of Economics from 1978 to 2005.



Malaluan, Nepomuceno

Nepomuceno Malaluan is Co-Director of the Institute for Freedom of Information, a partnership program between AER and the Philippine Center of Investigative Journalism; and Co-Convener of the Right to Know. Right Now! Coalition, a campaign coalition of more than 150 organizations that is at the forefront of the campaign for the passage of a Freedom of Information Act in the Philippines. He is one of the founding Trustees, and presently Corporate Secretary, of AER. He is a lawyer with academic background in economics, and leads the AER Industrial Policy Team research on the problems that confront the electricity sector.



Montes, Manuel

Manuel F. Montes (“Butch”) is Senior Advisor on Finance and Development at the South Centre in Geneva. He was previously Chief of Development Strategies at the United Nations Department of Economic and Social Affairs (UN-DESA), where he led the team that produced the World Economic and Social Survey 2011, *The Great Green Technological Transformation*. Before that, he held various positions at the United Nations Development Programme and the Ford Foundation; and taught at the East-West Centre in Honolulu and the UP School of Economics. He holds a PhD in Economics from Stanford University. His recent publications have been in areas of macroeconomic policy, development strategy, income inequality, climate change financing and industrial policy.



Morales-Alikpala, Ma. Cristina

Ma. Cristina Morales-Alikpala is the Acting President of AER. She obtained her Bachelor’s Degree in Management Economics from the Ateneo de Manila University and her Master of Arts in Economics from UP Diliman. She was a research consultant at the United Nations Development Programme from 2004 to 2005, where she conducted an extensive review of related literature regarding the fiscal implications of trade-related policy reform. She is an Associate Professor in Economics at ADMU, and serves as an Economic and Performance Measurement Adviser for the Department of Foreign Affairs, Trade, and Development (Philippines Program) of the Government of Canada.



Ofreneo, Rene

Rene E. Ofreneo is Professor XII and former Dean of the UP School of Labor and Industrial Relations, and was one of the UP Centennial Professor awardees for 2009-2010. He served as an Undersecretary of the Department of Labor and Employment in 1997-98. A veteran of labor relations and industrial policy, he was on the board of the Hong Kong-based Asia Monitor Resource Center, was a research consultant of the Union Network International, and served as Executive Director of the Fair Trade Alliance, a unique industry-labor-CSO multi-sectoral coalition and social partnership initiative. He sits on the board of *The Journal of Industrial Relations* (Sydney) and the *Asia-Pacific Business Review* (London). Dr. Ofreneo is a founding Trustee of the Climate Change Congress of the Philippines.



Viterbo-Quimbo, Victoria

Victoria Viterbo-Quimbo got her first-hand experience in planning, development and institutions of the country from her two decades of service at the National Economic and Development Authority, where she also served as Development Information Director. She obtained her BA Economics from UP Diliman in 1981 and her MA Economics from the same university in 1991. She also took MA Economics at the Hitotsubashi University in Tokyo, Japan in 1993. She is a Senior Lecturer at the University of the Philippines Asian Center, teaching National and Local Perspectives in Philippine Development, and Project Evaluation.

Research Assistants



Arjay Mercado

Arjay Mercado is an MA Economics student at the UP School of Economics. He got his BS Business Economics degree, Cum Laude, from the same school. Arjay is the Chairperson of the UP Diliman University Student Council for AY 2014 – 2015.



Nadine Agustin

Nadine Agustin has a Bachelor's Degree in Economics from the University of Santo Tomas. She previously worked as an Economist at DENR-Forest Management Bureau. She was also a volunteer at the IMF Family Association and Habitat for Humanity in Washington D.C. She is currently pursuing her Masters in Economics degree at the UP School of Economics.

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ACTION FOR ECONOMIC REFORMS

Unit 1403 West Trade Center
132 West Avenue, Quezon City
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www.aer.ph | 63 2 4265626