Philippine Membership in the RCEP will hurt MSMEs and the informal sector

On 2 June, 2022, the Philippine Senate deferred ratifying the Regional Comprehensive Economic Partnership, a free trade agreement covering ASEAN states and some partners. Senators opposing the agreement voiced concerns over ill effects on Philippine agriculture and manufacturing. Financial managers, executives, and supporting senators point to the sunk costs in studying the agreement, and in negotiating its terms. Before discussing it further, we must see what the RCEP offers.

1 Summarizing the RCEP

The Regional Comprehensive Economic Partnership (RCEP) plans to remove 90% of tariffs on imports between between ASEAN states and five partners: Australia, China, Japan, New Zealand, and South Korea. These removals shall happen on a schedule once ratified by signatories. The RCEP also provides against non-tariff barriers to trade, except for what the World Trade Organization guarantees.

Specifically, the RCEP provides for *originating goods* to be tariff-free. The agreement lists three types:

- goods wholly obtained or produced in a Party;
- goods produced in a Party exclusively from originating materials from one or more of the Parties; or
- produced in a Party using non-originating materials, provided the good satisfies the applicable requirements set out in Annex 3A (Product-Specific Rules).

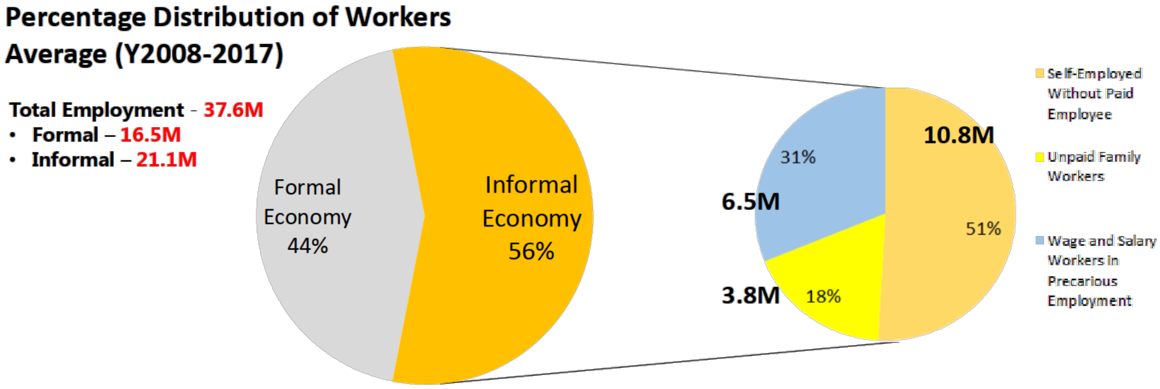
Critics of the move to defer ratification point out that not only have large costs gone into studying and negotiating the agreement, but the Philippines will miss out on benefits from the agreement:

- membership in the RCEP trading bloc, being the world's largest, gives incentives for foreign investors to move to the Philippines, and for already existing foreign investors to remain instead of relocating to RCEP-ratifying ones.
- foreign competition becomes possible against locally dominant firms, monopolies, and cartels.
- micro, small, and medium businesses will have access to foreign markets and reduced costs of doing business.
- cheaper raw materials and intermediate goods become available for exporters and local industries.
- the agreement incentivizes the government to subsidize economic sectors that will potentially lose out in the RCEP.

However, the RCEP and free trade in general have hidden risks and dangers most people don't know about. We shall discuss Geoeconomic implications that the RCEP has for the Philippines.

2 Geoeconomics and the Philippine Context

Traditional Political Economy sets foreign economic policy on what we call a country's *comparative advantage*. To illustrate, suppose that in Portugal, it takes 90 minutes on average to make one kilogram of cloth, and 80 minutes to press an equivalent volume of wine, while in England, it takes 100 and 120 minutes on average to produce the same respective amounts. While Portugal has an *absolute advantage* in producing both, it has a comparative advantage in producing wine, since it takes fewer minutes. Similarly, England has no absolute advantage in production, but it has a comparative advantage in producing cloth. As free trade advocates suggest, free trade between both states allows citizens to consume both goods for cheaper.



Source: International Labor Organization

The Philippines has a high labor pool, while Singapore has a high capital pool. Thus, labor is cheaper in the Philippines, while capital is cheaper in Singapore. For the Philippines, its comparative advantage is in labor intensive sectors, such that investing here nets the Philippines more benefits. For Singapore, it can afford to invest in capital intensive sectors.

However, policymaking relying on comparative advantage assumes the following:

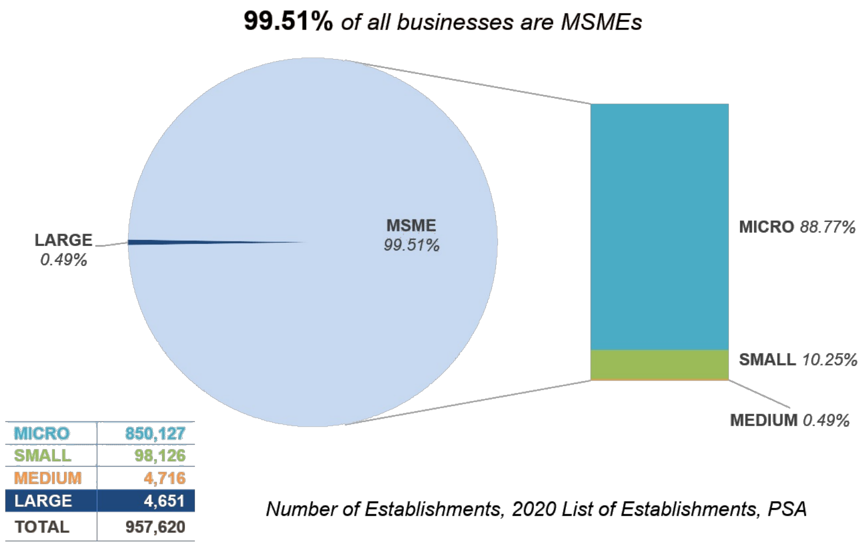
- constant production costs and profits: the cost of producing goods, and the profit from selling goods remains the same over time. In reality, improved technologies, shifting preferences, war and natural disasters, and other factors can cause changes here.
- constant returns to scale: if labor in the Philippines is increased by 5 units, then the output also increases by 5 units. However, production in reality sometimes sees decreasing or increasing returns to scale: increasing labor by 5 units in the Philippines may yield (for example) 3 or 7 units of output, respectively.
- homogeneous states: both England and Portugal are assumed to have the same kinds of workers and factories in each and every town, city, and county. Similarly, the Philippines is assumed to have the same quality of laborers per region, while Singapore is assumed to have homogeneous companies and capitalists. However, as Federalists know, heterogeneity often prevails.

To illustrate how using comparative advantage fails, let us return to the example of Portugal and England. If Portugal's policymakers abandon clothmaking, and focus on wine making, then they also abandon clothmaking's indirect effects: urbanization, social development, industrial growth, and mechanization. The policymakers also abandon derivative industries: dye-making, fashion design, and machine manufacturing. On the other hand, wine production has little else to offer beyond wines. Wines are also a luxury good, and the demand for wines can drop in hard times. Finally, wines rely on a perishable good (grapes), and the supply of grapes can fall in bad weather. Lopsided focus on wine production is fragile to black swan events.

England is also naturally more wealthy than Portugal. If Portugal focuses on wine making, then English leverage can subvert Portuguese interests, and give England the advantage in diplomatic relations. Portugal has no choice but to accept England's demands in exchange for free trade and access to more goods. On the other hand, a native Portuguese clothmaking industry sacrifices short economic benefit term for long term strategic gains.

Returning to the question of the Philippines, we see that local industries see a wide gap between labor and capital intensive ones. The government gives priority to subsidizing the latter to enhance "global competitiveness", while the former beg for scraps from lawmakers and the Cabinet. Lest we forget that more than an entire third of the Philippine economy relies on the informal sector. Quoting PSA Assistant National Statistician Vivian Illarina, "The informal sectors in agriculture, hunting, fishery and forestry contributed P1.35 trillion of GDP in 2016; industry, P1.4 trillion; and services, P2.28 trillion."

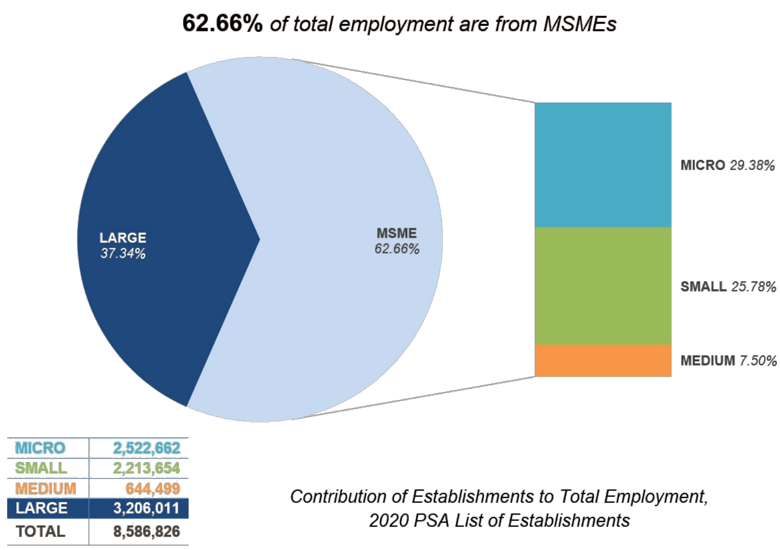
The government also has no incentive to aid this sector: they pay little taxes, they are not marketable for a global audience, and they don't follow government ideology about Managerialism, among other concerns.



Source: Department of Trade and Industry

Because of the government's mismanagement, local industries not relying on government favoritism stand to lose out in RCEP membership. It is absurd to expect the local sari-sari store and karenderia cook to be able to compete against foreign firms who grew and developed in more favorable environments. If RCEP membership comes to pass, the only ones who will benefit here will be the government's cronies in business, the ruling class of bureaucrats and managers, and their dynastic and oligarchic representatives. The informal sector will never be able to take advantage of RCEP membership, for the infrastructure to let that happen just doesn't exist yet. Just imagine the barbecue vendor exporting his wares to Singapore, or the Danao gunsmith packing his guns for Japan. The Philippines has too many institutional and structural issues to even consider engaging in free trade, and RCEP membership may see big business dominate even more.

Thus we come to this geoeconomic consideration: if the informal sector and MSMEs lose out in RCEP membership, foreign control of Philippine interests becomes too real a possibility. Foreign wares and goods can fill this vacuum, and only have to compete with government-backed enterprises. This outcome poses not just economic, financial, or business effects, but also political and diplomatic. Foreign leverage will force the Philippines to play nice with other countries' wants and needs. Our strong labor pool will become a de facto foreign labor pool if a crisis comes. The Philippines' strategic aims must be to preserve policy independence from foreign actors, and free trade in its current state will see this goal fall apart.



While making up less than 1% of businesses, Large Enterprises (the most successful corporations) have disproportionate shares in employment

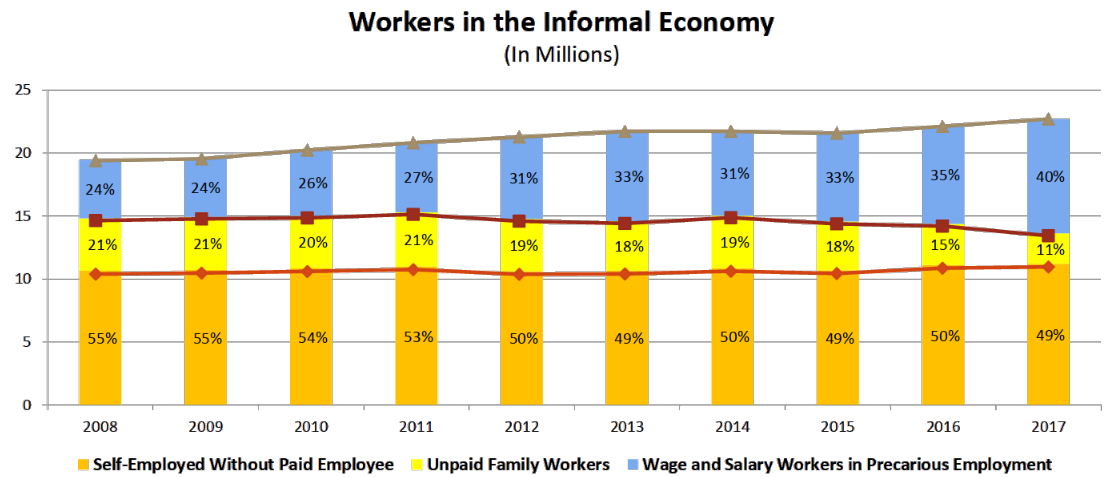
3 The foreign investment question

We must now note that the question of free trade is different from that of allowing 100% foreign ownership in enterprise. The latter has an element of control: policymakers can make sure no unsavory foreigners can enter and do business, can limit what industries foreigners can do business in, and can keep surveillance on foreigners who may pose national security risks. I myself still have reservations on this move from national security concerns. However, this move is already miles better in improving the local absolute state of industry than just throwing the country into free trade.

Senator Aquilino Pimentel raises the point that free trade will step up competition, while Dan Steinbock calls it a move to fight monopolies and cartels. As noted, however, foreign investment is a better first step. One must also see now that RCEP membership without reforms in foreign investment in fact hurt foreign investment more, for the complete loss of tariffs between signatories give incentives for local investors to move somewhere else less restrictive to foreign investment. Even before allowing foreign investment, a much better way of improving local industry exists through lifting bureaucratic and governmental controls on industry.

4 The Absolute State of Local Industry

The government implicitly favors some businesses over others. This is a given, since the government has a monopoly on force, and can dictate who gets scraps and who doesn't. Allowing free trade, however, will remove even the facade that the government cares for its constituents, for only the government's favored businesses and cartels have certainty for coming out alive.



Bureaucratic red tape encourages entry into the informal economy, with over half of informal sector workers being self-employed without employees

An easy first step to fix mismanagement is simply to stop giving advantages to some competitors in all markets. We're not just talking about cronyism, government contracts, or subcontracted monopolies in utilities and transport operations. The following need improvement or plain removal to ensure fair business:

- Limited liability for corporations. A businessman's job is to take on risk in his investments. Incidentally, this is also why it is just that most profits go the businessman, while employees only get salaries: to pay the businessman for taking on risk. Limited liability, however, removes enough risk from the equation that businessmen can afford to make shortsighted and irresponsible decisions. Corporations have inbuilt advantages in their market performance against other businesses simply by existing. Thus while a third of the economy rests on many micro, small, and medium businesses, the rest of the economy relies on fewer winners in the market. Incidentally, corporations' better performance also lets them be an oligopsony in the labor market: corporations can dictate wages and salaries more than employees can. With limited liability gone, we may even see wages rise naturally without the need for a minimum wage law.

- Subsidies: government subsidies to business are a necessary evil with how strong business cronyism is. However, removing limited liability necessarily means that subsidies also need to go away. Subsidies to businesses erode competitiveness the same way limited liability does, for they gives businesses free reign to be irresponsible, and they encourage entrepreneurs to seek capital from a risk-free source. However, subsidies are arguably worse than limited liability for this license comes from taxpayers themselves. To give an example, Republic Act 11337 provides startups with
  - subsidies in business registration,
  - use of office space and equipment, and
  - grants in research and development.

  These startups (defined in law as new businesses practicing innovative models) can play with taxes without having to answer taxpayers for failed ventures.
- Bureaucratic procedures: trifles like incessant licensing and registration fees, occupancy permits, elevator permits, sanitary permits, and the like give nothing but headache to businessmen, and unearned revenue to the local government. All these are covered by fraud prosecution and third party inspectors and standards organizations, such that the government's job of fixing asymmetric information (consumers not having information about goods and services) can also be left to the market. Local business, and local quality of life in general will see much better outcomes.

Finally, to debunk a much used talking point, free trade only helps dynasties and oligarchs instead of hurting them. The former can stay in power by coordinating with foreign interests in their own lands. The latter will survive and benefit from the informal sector and micro and small enterprises collapsing.

With how local Philippine industry is right now, RCEP membership will only hurt more than it will help. Removing business oligopolies and cartels rests more on the government getting past favoritism and kickbacks than on free trade. While allowing foreign investors is a great move, and a better move than allowing free trade, the best first step is reforms in local industry.