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A call for strategic government–industry coordination The autobus is leaving...Can the Philippines catch it?

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Jn its effort to develop the automotive industry, the Philippine government has adopted local content requirement and protectionist policies for almost thirty years. However, these policies have resulted in very limited localization as the automotive assemblers encountered difficulties in achieving the local content requirements set by the government.

In the 1990s, the assembly sector was opened up to accommodate new players. At the same time, previous restrictions on the number of models that could be assembled were removed. The industry was also liberalized to allow the importation of all types of motor vehicles. In July 2003, the government completely abandoned its local content program.

Tariff on completely built unit (CBU) imports was reduced from 100 percent prior to the 1980s to 70 percent in 1981 and to 50 percent in 1982. This was further reduced to 40 percent in 1993 and then to 30 percent in 2000. With the country's commitment to the ASEAN Free Trade Area–Common Effective Preferential Tariff (AFTA-CEPT) scheme, tariffs were reduced to five percent in 2005 and are scheduled to be completely eliminated by 2010.

Volume, particularly in view of the current weak domestic demand, has been a major internal problem among local assemblers in

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terms of reducing costs and improving their competitiveness. Compounding this is the absence of a strong supplier base in the country. Thus, the firms have remained highly dependent on imported components and parts which continue to add up to their rising costs of production.

The automotive industry is a highly competitive and technology-intensive industry. It requires large economies of scale and a high degree of specialization in parts and components manufacturing. The global operations of the automotive industry are highly complex and frequently integrated within the strategies of multinational organizations. With the industry's globalization thrust, automotive parts and component manufacturing has located in many countries while automotive assembly has concentrated mainly in countries that have large domestic markets and that serve as platforms for regional exports. In terms of demand for the automotive industry's products, consumers want a large variety of models at competitive prices.

This *Policy Notes* is therefore a call for immediate government action in crafting temporary

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adjustment measures in preparation for the zero tariff environment under the AFTA by 2010. Equally important is the need to formulate, in coordination with the industry, a comprehensive program and a coherent set of policies to help the industry adjust efficiently and benefit from the globalization process.

Economic structure and performance of the industry

Assembly firms

The Philippine automotive industry originally consisted of 14 car assemblers with a combined annual capacity of 221,450 units and 21 commercial vehicle assemblers with a total capacity of 145,950 units. In 2002, the Chamber of Automotive Manufacturers of the Philippines (CAMPI) reported that the assembly sector generated a total investment of around P40 billion and total employment of 15,000 workers.

Currently, only five of the 14 registered car assemblers are still engaged in auto manufacturing. Some, like the Asian Carmakers and Scandinavian, have shifted their operations to importing and distribution. The industry is dominated by five Japanese firms, namely, Toyota, Honda, Mitsubishi, Isuzu, and Nissan, and one American manufacturer, i.e., Ford. The share of the industry leader, Toyota, has been consistently increasing from 28.9 percent in 2002 to 38 percent in 2007.

In 2007, the Philippine automotive industry sold a total of 117,903 vehicles, the highest

sales registered after the 1997 Asian financial crisis (Table 1). This, however, is still below the peak sales of 162,095 units reached in 1996. While our ASEAN neighbors started to recover in the early 2000s, the Philippines has continued to lag behind. As Figure 1 shows, the Philippines has the smallest sales volume, with Vietnam catching up as its sales increased tremendously from 47,000 units in 2006 to 92,000 in 2007 (representing a remarkable increase of 97 percent).

In the last four years, domestic assembly operations have been declining. As Table 1 shows, the number of domestically assembled vehicles sold dropped from 85,388 units in 2003 to 61,128 units in 2007.

Given this shrinking scale of domestic production, the completely knocked down (CKD) operations have become very costly. With the reduction of tariffs to five percent under the AFTA-CEPT, imports of domestic firms as a proportion of total industry sales have increased substantially from 8 percent in 2003 to 48 percent of total sales in 2007.

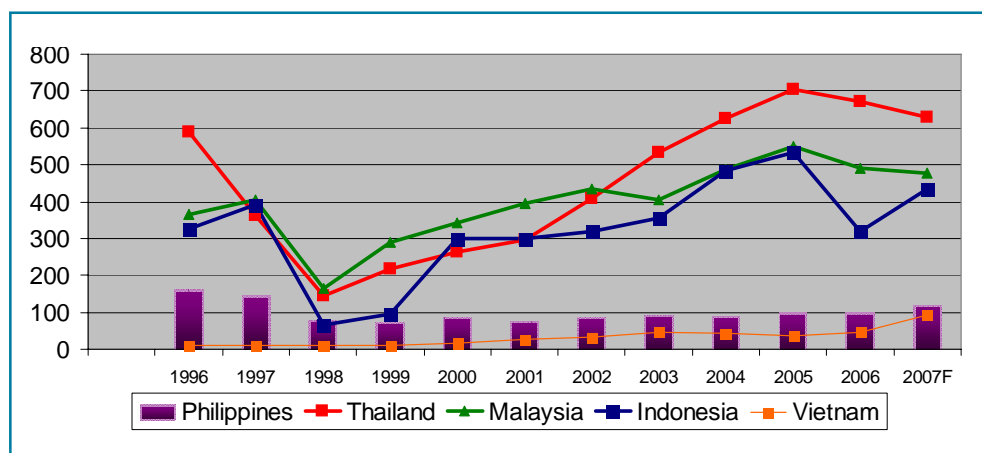
Based on the manufacturing data from the National Statistics Office (NSO), the automotive industry's average share in total manufac-

Table 1. Philippine automotive sales, production, and imports

Year	Sales	Production/CKD Sales	New CBU Imports	CBU Imports as % of Total Sales	CKD Sales as % of Total Sales
1992	60,360	58,899	941	2	98
1993	83,811	82,202	1,461	2	98
1994	103,471	99,346	1,609	2	96
1995	128,162	127,016	4,125	4	99
1996	162,095	137,365	1,146	1	85
1997	144,435	120,488	24,730	15	83
1998	80,231	67,903	23,947	15	85
1999	74,414	64,635	9,779	13	87
2000	74,000	70,851	3,149	4	96
2001	76,670	65,202	11,468	15	85
2002	85,587	74,734	10,853	13	87
2003	92,336	85,388	6,948	8	92
2004	88,068	58,822	29,246	33	67
2005	97,063	58,566	38,497	40	60
2006	99,541	56,050	43,491	44	56
2007	117,903	61,128	56,775	48	52

Source: Production data from 1991 to 1996 are from the Board of Investments. Data from 2000 to 2003 are from T. Kubo (2004), Asia: climbing to the world's largest auto industry and market, *Asian Automotive Business Review* 15 No. 4. Meanwhile, 2002 to 2003 figures were adjusted to exclude exports data. Data from 1997 to 1999 refer to sales of domestically assembled vehicles. Sales from 1990 onwards are from CAMPI and 2004–2007 sales breakdown are from TMP.

Figure 1. ASEAN industry sales, 1996–2007 (in units)



Source: Ford Philippines (2007), Developments in the automotive industry: Philippines and ASEAN.

turing value added reached 3.2 percent during the period 1976–1980. This, however, started to fall in the succeeding periods. In 2001 and 2002, the sector accounted for only one

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percent of total manufacturing value added. In terms of employment contribution, the number of workers in the sector was reduced from 12,126 workers in 1999 to 9,698 in 2003. This represented less than one percent of total manufacturing employment.

The industry's export of passenger cars increased from 12,367 units in 2003 to 14,417 in 2005 but dropped to 6,730 units in 2006. These are mostly passenger car exports (with spark ignition combustion engine exceeding 1500 cc but not more than 3000 cc) to Thailand and Indonesia and mainly Ford's exports under the ASEAN Industrial Cooperation Scheme.

Auto parts and components

The parts and components segment of the automotive industry is composed of 256 companies producing around 330 different parts and components made of metals, plastic, rubber, and composite materials. Of the 256 automotive parts manufacturers, 124 are considered first-tier manufacturers who are directly supplying the needs of domestic automotive assemblers. The remaining 132 are mostly small and medium enterprises (SMEs)

serving as second- and third-tier subcontractors who supply the needs of the first-tier manufacturers. By the end of 1999, total investments in the sector amounted to about P27 billion. This increased to P28 billion in 2001. Total employment, meanwhile, was 45,000 workers in 1999 but declined to 33,000 in 2002.

The bulk of the industry is composed of small firms with capitalization ranging from P0.5 to P5 million. Most of these firms operate as "mom and pop" style suppliers with varying capabilities and some real quality problems. These firms failed to develop as they have insufficient capital and technology that are necessary to improve their products. The large firms with capitalization of more than P100 million account for only about seven percent of the industry. They comprise the major players of the industry and are the same companies manufacturing parts for original equipment manufacturer (OEM) car assemblers and engaged in exporting activities.

Competitiveness and weak domestic linkages

Despite the imposition of high levels of tariff and nontariff barriers on imported CBUs for more than two decades, the local automotive industry has failed to develop as an efficient industry capable of competing internationally. At best, the local content program had only a limited impact on the growth and development of the parts and components industry. Very little parts and components are sourced locally, with the domestic parts sector ac-

counting for only 10 to 15 percent of the total number of parts and components needed by local assemblers.

The nonavailability of the necessary parts and components domestically and the high dependence of the industry on imported parts have continued to add up to the assemblers' rising costs of production. The industry's high cost structure has tended to price vehicles assembled in the country out of world markets. With weak competitiveness, the linkage of small and medium parts makers with multinational corporations has also failed to develop.

Auto parts are one of the country's top three exports. These, however, are highly concentrated to a few products like wiring harnesses and transmissions which are highly import dependent. Auto parts exports are made by large multinational corporations (MNCs) like Toyota Auto Parts. Backward linkages are limited and as such, the value added of these export activities has remained low.

Subcontracting arrangements are seen as possible mechanisms to help improve the competitiveness of SMEs and the ability to create and upgrade backward linkages. The number of subcontractors in the industry, however, fell from 71 enterprises in 1994 to only 22 enterprises in 2003. Total subcontracted work as a percentage of the industry's value of output sold also declined from 0.61 percent to 0.53 percent between 1994 and 2003.

Smuggling problem

The small size of the Philippines' domestic market is the major factor that explains the industry's lack of competitiveness. This has, however, been exacerbated by the unfair competition from the entry of smuggled second-hand vehicles in the Subic Bay Freeport and other special economic zone ports.

Under Republic Act 8506, the importation of second-hand cars has remained prohibited. Except for imports by returning residents and members of the diplomatic corps, used cars cannot be imported. This prohibition has been circumvented though through free port zones which have been used as staging points to allow the duty-free entry of used vehicles in the country.

Given the relatively cheap second-hand imported vehicles, industry sales of domestic assemblers have been negatively affected. In December 2002, the government legislated Executive Order (EO) 156 to prohibit the importation of all types of used motor vehicles and parts and components at any point of entry, including those in free port zones, with the exception of those that may be allowed under certain conditions. However, for several years, EO 156 could not be enforced because of a temporary restraining order issued by the Olongapo City Regional Trial Court and a subsequent decision by the Court of Appeals in February 2005 that declared EO 156 to be unconstitutional and illegal. This was however overruled by the Supreme Court with its final decision to

prohibit the importation of second-hand vehicles.

Table 2 compares data on imports of used vehicles from the Land Transportation Office (LTO) with those from the NSO compilations. NSO imports data are based on the import entries of used vehicles while the LTO data refer to newly registered used imported passenger cars, SUVs/UVs, trucks, and buses.

A substantial discrepancy is found between the NSO and LTO figures. Note that the NSO cumulative total of 130,740 used vehicles represented only about one-fifth of the LTO new registration data for used vehicles amounting to 561,039. On the average, the difference between the two data sets is around 71,700 vehicles between 1998 and 2003. This large data gap between the two data sets could indicate a rough estimate of the volume of smuggled vehicles.

The shrinking domestically assembled CBU sales due to the unabated entry of smuggled second-hand vehicles that are priced 30 to 50 percent lower and the weak supplier base

have been preventing foreign automakers from seriously considering the Philippines for a more important role in their global production networks (GPNs). While Ford made the Philippines its regional hub for passenger cars in the early 2000s, its Thai plant—the Auto Alliance—is expanding for the assembly and export of 100,000 units of passenger cars.

Philippines and Thailand: a comparison

With the rising globalization and economic integration trends, a new form of industrial organization known as the global production network (GPN) has emerged in the industry. Toyota's Innovative Multipurpose Vehicle (IMV) Project is one such example. Under the IMV Project, Toyota upgraded and expanded plants in Thailand, Indonesia, Argentina, and South Africa and turned them into assembly and export bases for a line of IMVs. In 2005, Japan's first R&D center in an emerging market, the Toyota Technical Center Asia Pacific Thailand Co. Ltd, was opened in Thailand.

The 1990s witnessed the emergence of Thailand as the regional hub not only of Toyota but of the world's other large automakers such as Mitsubishi, Honda, Auto Alliance (Ford and Mazda), General Motors (GM), and Isuzu. As the export platform of these companies, Thailand's production increased markedly from 589,126

Table 2. Used vehicle imports: NSO trade data vs. LTO registration data

	1998	1999	2000	2001	2002	2003	Total	Average
LTO newly registered imported used vehicles	81,034	78,369	88,057	97,024	113,327	103,228	561,039	93,507
NSO imports of used vehicles	4,480	5,112	46,384	22,071	20,967	31,726	130,740	21,790
Difference	76,554	73,257	41,673	74,953	92,360	71,502	430,299	71,717

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units in 1996 to 1,176,840 in 2006. A total of 539,206 units were exported while 682,693 units represented domestic sales in 2006.

As of 2002, Thailand had 1,800 locally based suppliers, with 700 classified as first-tier suppliers and the remainder as second-tier suppliers. This domestic supplier base provides engines, engine components, body parts, brake systems, steering systems, suspensions, transmissions, and electronics. With a strong supplier base, Thai-based automakers source almost 90 percent of their parts domestically.

Aside from its stable macroeconomic environment, good infrastructure, relatively large domestic market, and the presence of an extensive network of components manufacturers, Thailand's success in integrating with the GPNs of foreign auto companies has been the product of its long years of policy reform. From a highly protected industry orientation, Thailand was able to successfully shift its trade and industrial policy to an export-oriented one in the early 1990s.

After thirty years of protection, the 1990s witnessed the opening up of the Thai automotive market. Tariff rates on both CKD kits and CBU vehicles were reduced by more than 50 percent. With the reduction in tariff on both CKD and CBU, the gap between domestic and foreign automotive prices was narrowed down. In 1992, the government again reduced the tariff rates. Poapongsakorn and Wangdee (2004) observed that the tariff reduction

Table 3. Tariffs and excise taxes in the Thai CBUs

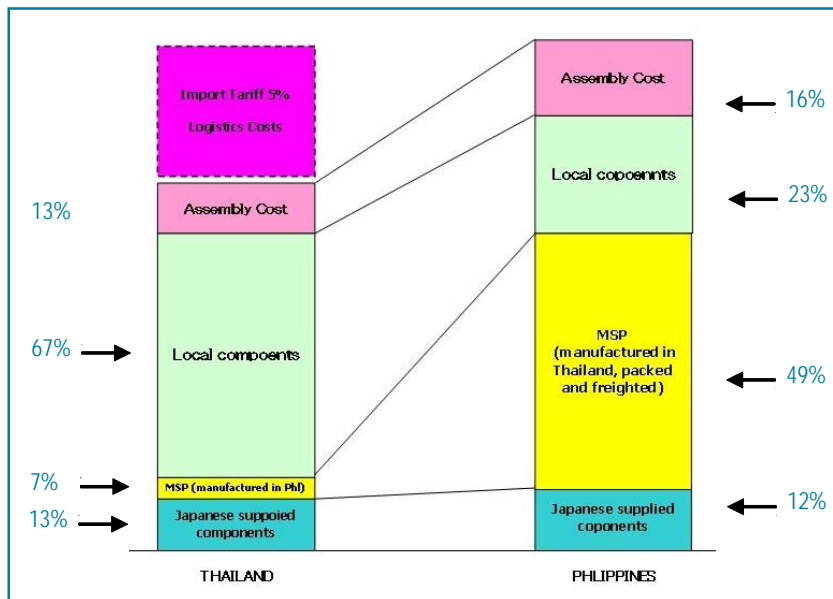
CBU Type	Before 1992	1992	1999	2000–present
Passenger cars over 2400 cc				
Tariff rate	300	68.5	80	80
Excise tax	44-55	41.8	43-50	41-48
Passenger cars under 2400 cc				
Tariff rate	180	42	80	80
Excise tax	44-55	35.75	41.25	38.5
Pickup truck				
Tariff rate	120	60	60	80
Excise tax	9.9	na	5.5	3.3

Source: Ministry of Finance as cited in Kohpaiboon (2006)

lowered domestic automotive prices and combined with economic expansion, auto sales rose during the period 1991–1996, reaching a peak level of 589,126 units.

Thailand's tariff structure has provided higher rates of effective protection than the Philippines. In 1997, Thai assemblers had an effective protection rate of 497 percent while auto parts had 112 percent. In contrast, the Philippines' assemblers enjoyed 97 percent effective protection while auto parts received only 10 percent. Thailand was able to manage its trade policy reform strategically particularly in the promotion and development of one-ton pickups. This has transformed the Thai automotive industry into a regional hub of many foreign automakers and the world's largest production base for one-ton pickups, which is considered as Thailand's niche market. As Table 3 shows, pickup trucks had always received the lowest excise tax and tariff rates for vehicles in the last three decades, thereupon tremendously reducing their prices (Kohpaiboon 2006).

Figure 2. Comparative cost study between Thailand and the Philippines



comprising 16 percent of total cost and Thailand's, only about 13 percent.

As illustrated in Figure 2, vehicles assembled in the Philippines tend to be more costly than those assembled in Thailand. With a smaller scale of operations and with only 23 percent local content, production costs for the Philippines run about 1.4 times higher than those in Thailand where local content accounted for a much higher rate at 67 percent of total production cost. The ratio declines to 1.2 if the vehicle is imported as a completely built unit to the Philippines due to the inclusion of a 5 percent import tariff and logistics costs.

Figure 2 compares the cost of manufacturing a particular vehicle model in the Philippines and Thailand and illustrates a considerable difference in the cost of production between the two countries. The cost differences and inefficiency of the vehicle assembly industry in the Philippines may be explained by the firms' *low-volume production* and the *absence of a strong supplier base*, as previously noted. Imported raw materials consist of multi-supplied parts (MSP) manufactured in Thailand and supplied components from Japan. These account for about 61 percent of the total production cost in the Philippines while in Thailand, these comprise only 20 percent. Due to the Philippines' small level of operations, its assembly costs are higher than those in Thailand, with the Philippines' costs

Globalization and the need for industry adjustment measures

Strong political will to effectively enforce EO 156 is foremost needed to address the smuggling issue. Aside from stopping smuggling, the government also has to play an important role in strengthening the industry. Government coordination with the private sector, workers, academe, and other concerned groups is important to move the industry forward. Support from all sectors is needed to formulate a more coherent set of policies and comprehensive strategy and program that will enhance industry competitiveness and encourage the industry to specialize and expand in market segments where it is closest to being internationally competitive. To benefit from the economic integration process, a lot

depends on the response of global automotive companies and domestic firms.

While the country's current limited domestic market prevents assemblers from reaping the benefits of mass production, the removal of tariff and nontariff barriers through the AFTA is an important step in creating a market that is of sufficient size to allow economies of scale in production and provide incentives for investment.

To enable firms to cope with a zero tariff environment by 2010, though, the government needs to design temporary industry adjustment measures and incentives to expand the market for both assembled vehicles and parts and to improve the firms' performance and competitiveness. The measures should enable the industry to face competition arising from zero tariffs from AFTA by 2010 as well as to facilitate its integration into the regional/global production networks of foreign automakers. There are seven car assemblers manufacturing eighteen models at a total of around 60,000 units. The average production per model is around 3,300 units which is very small. As one top auto executive noted, it would be difficult to compete in a zero tariff environment with this scale of production unless certain adjustment measures and incentives are formulated.

The development of parts and components and the manufacture of vehicles for both the domestic and export markets seem to be the

best way to integrate the industry into the global automotive industry and to link domestic auto parts companies, especially the SMEs, with regional production networks.

Incentives should be provided only to potentially viable domestic manufacturing firms that are deemed capable of adjusting. The incentives should be based on manufacturing volume and conditioned on a firm's scale of operations. They should only be for a limited time to ensure that only the most efficient firms will be given temporary support. The incentives should also be conditioned on performance indicators such as the firms' ability to increase their productivity whose gains will eventually be passed on to consumers in terms of lower prices that could further stimulate demand. Monitoring and regular evaluation should be carried out to ensure that the objectives are being attained and programs effectively implemented.

The government needs to design a complete package of technical, financial, marketing, and human resource development for the auto parts sector consisting mainly of SMEs. It likewise has to set up programs to strengthen and link local parts and components with MNCs. Support to SMEs should not be through increased tariff protection but through the provision of access to capital and technology which are at the root of their underdevelopment. Given the parts suppliers' limited technology and R&D capability, finding technologically fit foreign partners will be a critical move. The active participation of the

industry association will be needed in this endeavor.

Cluster development is also one way to develop internal and external linkages. Clusters are important in improving firm competitiveness and broadening the local supply base. At present, the industry is implementing the “ECOP-Big Enterprise, Small Enterprise” (EBESE) Program, with Toyota Motor Philippines Corporation taking the lead in strengthening the capacities of its suppliers. Increased involvement and commitment from other industry members, along with an allocation of sufficient government funds for the program to make it more sustainable, is thus necessary.

Conclusions

Active government support for market expansion is crucial as firms adjust toward a zero tariff environment. Strong political will is needed to curb smuggling. Without resolving the smuggling issue and formulating an adjustment program to help the industry during the transition process, the possibility is high that existing assemblers might shift to

CBU trading. This poses potential dangers of further eroding the country’s manufacturing base.

The government has an important role to play in formulating, implementing, monitoring, and coordinating a coherent set of strategic policies to help domestic firms adjust to the changing international and regional economic environment. One important lesson from our trade policy reform in the 1990s is that unilateral trade liberalization alone is not sufficient to improve industry competitiveness. Policy coordination at all levels and an adjustment strategy to help firms cope with the new policy environment are necessary. Comprehensive measures are vital in strengthening the domestic automotive assembly and parts industry and in enabling them to take advantage of the opportunities arising from globalization, in general, and the AFTA, in particular. Since the zero tariff environment under the AFTA-CEPT is barely two years away, implementing these adjustment measures at the earliest time possible is extremely important. This may be the industry’s last chance, but there is hope that with the correct strategy and its effective implementation, the Philippines can still make it. 📄

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