



## **On the Rationalization of Fiscal Incentives**

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## On the Rationalization of Fiscal Incentives

By Felipe Medalla\*

### Introduction

Policymakers face the difficult task of deciphering whether tax incentives attract additional investments or confer economic rents to investors who do not need the incentives. If incentives are given to investors who would invest in the country anyway even if such incentives had not been granted, the incentives represent costly revenue losses. On the other hand, if the incentives attract investors who would have invested elsewhere if the Philippine government had not granted the fiscal incentives, there would be no revenue loss. Indeed, in the latter case, the incentives not only generate a lot of direct benefits (e.g., higher employment and faster development of skills and technology) but may in fact indirectly increase government revenue in the long run to the extent that the *additional* investments attracted by the incentives result in higher economic growth in the long run.

Proponents of tax incentives take the latter view. Those who take the former view, however, think that the social costs of the tax incentives may in some cases outweigh the alleged benefits that they generate. Critics of generous tax incentives not only see them as revenue losses, they also see them as ineffective instruments for increasing investments, which can in fact make the country less attractive to investors to the extent that they make the tax system more complex and more difficult to administer and to the extent that they force the government to raise tax rates on the non-exempt taxpayers, borrow more money (and worsen sovereign credit ratings) or reduce public spending on infrastructure and education.

It turns out that the Philippine experience with tax incentives is not unique compared to other developing countries. While some incentives may have been instrumental in making Philippine exports more competitive, it could very well be that much of the tax incentives that have been given to firms that serve the domestic market were redundant (i.e., the investments would have been made anyway even in the absence of incentives), or served only to divert investments away from activities that would have contributed more to government's tax effort (since they are not qualified to receive incentives) and could have generated as much benefits for the economy in terms of job creation, and technological change as the investments that are qualified to receive the tax incentives. Indeed much of the quotation below<sup>†</sup>, though based on an assessment of tax policies in a wide cross-section of developing countries, fits the Philippines quite well:

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<sup>†</sup> Tanzi, V. and H. Zee, "Tax Policy for Emerging Markets: Developing Countries," National Tax Journal, Vol. 53 no. 2 (June 2000) pp. 299-322.

“While granting tax incentives to promote investment is common in countries around the world, evidence suggests that their effectiveness in attracting incremental investments (above and beyond the level that would have taken place if no incentives were given) is often questionable and that their revenue costs could well be high.... Foreign investors--the primary target of most tax incentives in most developing countries---...normally base their decision to enter a country on a whole host of factors, among which the availability of tax incentives is only one and frequently far from being the most important one. The existence of natural resources, political and economic stability, transparency of the legal and regulatory systems, adequacy of supporting institutions (e.g., banking, transportation, and other infrastructure facilities), ease of profit repatriation, and economic and skilled workforce are usually far more decisive than tax considerations in determining suitable investment locations. If these factors are favorable, and the country’s tax system is in line with international norms, then tax incentives would at best play a role at the margin in influencing an investor’s decision. ....a conceptually legitimate purpose for granting them in developing countries is to rectify some forms of market failure most notably those involving externalities. An obvious example would be incentives target for promoting certain sectors such as high-technology industries the development of which is likely to confer significant positive externalities on the rest of the economy....Nevertheless, not all incentives are equally suited for achieving such objectives, however justifiable they may be; some are simply more cost effective than others on both policy and administrative grounds. Unfortunately, the most prevalent forms of incentives in developing countries tend also to be the least meritorious.”

Tax incentives can be “redundant” in the sense that the investor would still have invested in the country if no tax incentives have been granted. Moreover, even if they do succeed in changing the composition of investments (without necessarily changing total investment) it is not clear that the investments that are encouraged by the incentives are better for society than the alternative investments that that they have indirectly discouraged.

Furthermore, not all incentives are equally cost-effective. For instance, income tax holidays are probably the least cost-effective of all the tax incentives since they only serve to make investments that are already attractive even more attractive but cannot make unprofitable but socially desirable activities attractive to investors. On the other hand, exemption of capital goods and intermediate inputs from taxes and duties, if granted only to exporters, partially offset the unintended penalties on exports that cannot be avoided under a protectionist policy regime (via the effect of protectionism on the exchange rate and the cost of inputs). However, they can be abused (e.g., used for smuggling) and raise the effective rate of protection if granted to industries that sell their products in our home market at prices that are significantly higher than border prices because of protective tariffs and other non-tariff barriers.

The next sections look at BOI and PEZA incentives and propose a framework for analyzing them. The basic conclusion is that (a) income tax holidays are likely to be redundant incentives, (b) fiscal incentives that are given to firms that sell their products to the domestic market are either redundant or serve only to reallocate investments away

from economic activities that do not receive incentives to those that do, without affecting total investments in the country and (c) that exporters' inputs should not be taxed since exporters, unlikely inward looking firms, must sell their products at border or world prices.

### On Philippine Tax Incentives

Although there are many Philippine laws that grant one form of tax incentive or another, the most important ones (in terms of the value of tax incentives) are to be found in the Omnibus Investment Code (Executive Order No. 226) and the Special Economic Zone Act of 1995 (Republic Act No. 7916)

The Omnibus Investment code (OIC) explicitly states that fiscal incentives must be used to “*compensate for market imperfections*” and “*to reward performance contributing to economic development*”

Article 39 lists down the fiscal incentives that can be given to firms that are engaged in “*a preferred area of investment*”

- (a) Income Tax Holiday. – Six years for pioneer firms, four years for non-pioneer firms and three years for expanding firms (proportionate to the expansion)/
- (b) Additional Deduction for Labor Expense.
- (c) Tax and Duty Exemption on Imported Capital Equipment.
- (d) Tax Credit on Domestic Capital Equipment
- (e) Exemption from Contractor's Tax.
- (f) Exemption on Breeding Stocks and Genetic Materials.
- (g) Tax Credit on Domestic Breeding Stocks and Genetic Materials
- (h) Tax Credit for Taxes and Duties on Raw Materials used in the manufacture, processing or production of products exported directly or indirectly by the registered enterprise.
- (i) Exemption from Taxes and Duties on Imported Spare Parts. – For registered enterprises with a bonded manufacturing warehouse which export at least seventy percent (70%) of production.
- (j) Exemption from Wharfage Dues and any Export Tax, Duty, Impost and Fee.—for exports by a registered enterprise of non-traditional export products.

In contrast to the 1983 investment code which the OIC replaced, all of the above incentives are available to both export-oriented firms and firms that cater to domestic markets, except for taxes and duties on imported raw materials and spare parts. Because the incentives granted to firms that cater to domestic markets were expanded by the OIC, some analysts view the the OIC as a triumph of the lobby of protected industries, which probably wanted to be compensated for the negative effects on them of the government's trade liberalization program (i.e., reduction of tariffs and elimination of many non-tariff barriers).

“Thus, the income tax holiday and the tax-free importation of capital equipment rank as

the key incentives in the new Code. As already noted, these are uniform for exporters and non-exporters alike. This contrasts with the 1983 Code which explicitly aimed incentives at mitigating, if not overcoming, the bias against exports from the protection system. Thus the new Code, insofar as tax incentives are concerned, is virtually neutral between exporters and non-exporters. The duty-free importation of imported inputs serves as the only advantage of exporters which is available to all exporters, registered or not with the BOI.”\*

That the OIC is in fact meant to help protect domestic industries from foreign competition is explicitly stated in the Code:

“ART. 2. Declaration of Investment Policies. - To accelerate the sound development of the national economy *in consonance with the principles and objectives of economic nationalism*”.... (italics added).

Thus although the OIC explicitly stated that the goal of investment policies is to compensate for market imperfections and promote development by creating employment, increasing productivity, improving the technical skills of the people, accelerating the development of less developed regions in the country, increasing exports and providing a foundation for future development of the economy; it also said that this must be done in a manner that is consistent with economic nationalism; which in our context cannot be divorced from protectionism.

Given this context, it is not surprising that that much of the BOI tax incentives are redundant (Reside, 2006), since those who lobbied for incentives were really much less concerned with correcting market failure than with raising the rate of return to capital invested by domestic capitalists who were hurt by trade liberalization,

Unlike the BOI incentives, the PEZA incentives are much more aligned with the original objective of the 1983 code of removing the bias of the country’s tariffs and trade protection against exports:

SECTION 23. Fiscal Incentives. - Business establishments operating within the ECOZONES shall be entitled to the fiscal incentives as provided for under Presidential Decree No. 66, the law creating the Export Processing Zone Authority, or those provided under Book VI of Executive Order No. 226, otherwise known as the Omnibus Investment Code of 1987.

Furthermore, tax credits for exporters using local materials as inputs shall enjoy the same benefits provided for in the Export Development Act of 1994.

SECTION 24. Exemption from Taxes Under the National Internal Revenue Code. - Any provision of existing laws, rules and regulations to the contrary notwithstanding, no taxes, local and national, shall be imposed on business establishments operating within

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\* Austria, M.S. and E. M. Medalla (1996) “A Study on the Trade and Investment Policies of Developing Countries: The Case of the Philippines Discussion Paper series no. 96-03, Philippine Institute for Developing Studies.

the ECOZONE. In lieu of paying taxes, five percent (5%) of the gross income earned by all businesses and enterprises within the ECOZONE shall be remitted to the national government.

SECTION 25. Applicable National Taxes. - All income derived by persons and all service establishments in the ECOZONE shall be subject to taxes under the National Internal Revenue Code.

SECTION 26. Domestic Sales. - Goods manufactured by an ECOZONE enterprise shall be made available for immediate retail sales in the domestic market, subject to payment of corresponding taxes on the raw materials and other regulations that may be adopted by the Board of the PEZA.

### Arguments in Favor of Tax Incentives

Despite the obvious advantages of broad tax bases and low tax rates (in terms of revenue-raising capacity and of economic and administrative efficiency), there are theoretical arguments that can be put forward to support the use of tax incentives to offset the negative effects of market distortions and imperfections. In some cases, the market distortions are themselves unintended or unwanted effects of government policies that are meant to achieve political and socioeconomic objectives. Tariffs, for example, are meant to raise revenues and protect domestic industries. They, however, unwittingly make exporters less competitive by raising their input costs. Moreover, the cost penalty on exports goes beyond the cost of raw materials since they affect the exchange rate and labor costs as well. For instance, tariffs and quantitative restrictions on food imports that are meant to raise the income of farmers indirectly raise the cost of wage goods and as a result raise labor costs as well, thereby indirectly penalizing all industries. For industries that cater to domestic markets, the cost penalties on inputs may be wholly or partially offset by tariffs on competing imports. Exports, on the other hand, must compete in global markets and do not benefit from tariffs that protect domestic industries.

The same thing can be said about laws and regulations that raise labor cost more than labor productivity. They raise the welfare of people who can get jobs in the formal sector, but they may reduce employment and competitiveness of labor intensive industries. Or put in another way, such laws create a “wedge” between the demand curve for labor and its supply curve. As a result, tax incentives that result in higher employment may raise the economy’s over all efficiency.

While policy-induced market distortions can affect the country’s static comparative advantage, some market imperfections can reduce the country’s ability to improve its productivity and international competitiveness in the long run. To the extent, for example, that firms can learn from other firms’ best practices and benefit from other firms’ skills development programs (without having to pay for the benefits), it can be argued that company taxation should be designed to provide incentives for inward foreign direct investment (FDI) if the FDI that is attracted contributes to productivity

growth by introducing modern machinery, technology and organization and by providing access to global marketing networks and skills to a country with a weak managerial class and a poorly trained work force. Moreover, to the extent that the positive spillover effects of FDI can be increased by raising the ability of domestic firms to absorb the new skills and knowledge that are brought in by foreign-owned firms, giving the tax incentives to domestic firms that borrow foreign technology can also be seen as a way of correcting or offsetting market failures.

Finally, to the extent that capital and plants that are owned by multinational corporations (MNC's) are very mobile internationally, incentives can be viewed as signals to foreign investor about the country's very open and welcoming attitude towards foreign investment. Moreover, to the extent that other countries with similar economic and cost structure as the Philippines offer generous fiscal incentives, it could be that the fiscal incentives may turn out to be the "clincher" that could decide where the MNC's will locate their plants. In short, the Philippines has to offer fiscal incentives since other countries which compete with the Philippines also offer incentives that are even more generous than what the Philippines offers. The table below shows the number of countries offering different types of incentives.

#### Types of Incentives Used by Region

	Africa	Asia	Latin America & Caribbean	Central & Eastern Europe	Western Europe	Other Countries	Total
No. of Countries Number Giving:	<u>23</u>	<u>17</u>	<u>12</u>	<u>25</u>	<u>20</u>	<u>6</u>	<u>103</u>
Tax Holidays	16	13	8	19	7	4	67
Accelerated depreciation	12	8	6	6	10	5	47
Investment allowances	4	5	9	3	5		26
Import duty exemption	15	13	11	13	7	4	63
Duty Drawback	10	8	10	12	6	3	49

Source: UNCTAD, 1995, from Jacques Morisset and Neda Pirnia (2001) "How Tax Policy and Incentives Affect Foreign Direct Investment A Review" from Louis T Wells, Nancy J Allen, Jacques Morisset, Neda Pirnia (eds) *Using Tax Incentives to Compete for Foreign Investment: Are They Worth the Costs?* The International Finance Corporation and the World Bank, Washington DC, pp 69 – 106

## Arguments Against Tax Incentives

One argument against trying to give generous incentives that match those that are granted by our neighbors is that the Philippines has a much larger public debt and is spending much less on education and infrastructure compared to other ASEAN countries. For instance, potential investors in infrastructure BOT projects say that one of the main obstacles to private investments in infrastructure in the Philippines is the cost of funds is higher for identical projects in the Philippines (compared to say Thailand and Malaysia) due to the higher interest rates on Philippine sovereign debt (to which borrowing by private investors in the Philippines is benchmarked).

As will be discussed later, the claim that tax incentives have no adverse impact on revenue assumes that the investments that benefit from tax incentives would have gone to other countries in the absence of fiscal incentives. For this to happen, it must be the case that an investment in the Philippines is fundamentally viable but could earn a higher risk-adjusted rate of return in another location, *and* the profit differential is small enough that a tax break reverses the Philippines' locational disadvantage. But as argued earlier one of the reasons why the risk-adjusted rate of return in the Philippines is lower is precisely because of poor fiscal performance which can be precisely alleviated by being much more stingy in the use of tax incentives.

Another reason some forms of tax incentives like income tax holidays (ITH) may not be as effective as hoped for by its proponents is that the corporate tax rate in the Philippines is about the same as that of the U.S. which taxes income of its corporations from all countries. Since the U.S. is unlikely to sign a "tax sparing" treaty with the Philippines (which will treat taxes waived by the Philippines as though they have been actually paid for the purpose of computing the U.S. company's taxable income in the U.S.), a Philippine ITH actually increases the U.S. tax liability of U.S. companies that invest in the Philippines.\*

To make matters worse, ITH may create a lot of opportunities for illegal tax arbitrage. The ITH is not intended to be extended to the company's employees and officers or its affiliates. But what is to prevent transfer pricing to transfer profits between two companies that have common owners if one company is tax-exempt and the other one is not? Similarly, what is to prevent income-tax-exempt companies from replacing salaries by dividends through stock options (which are taxed at a lower rate than salaries for high-income employees)? Finally, which applies not to income taxes but to indirect taxes and customs duties as well, tax free imports may be smuggled into the domestic market without paying taxes. (This is explicitly prohibited by the PEZA law but newspaper accounts of reported violations is not uncommon)†

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\* Tax laws may actually allow deferral of payment of U.S. taxes on the Philippine income of American corporations if income in the Philippines is reinvested and not remitted as dividends. Still, the argument holds that at least a fraction of the ITH will benefit the U.S. treasury and not the U.S. company that invests in the Philippines.

† Every time there are two different tax rates on similar activities or financial instruments, there are great opportunities and returns for disguising the high tax activity or financial instrument as a low-tax one. A former BIR commissioner has been quoted by the papers as saying that there is possible leakage from the

The important point is that tax incentives complicate the tax system and stretch very thinly or even put under heavy temptation scarce human resources of departments of finance and tax collection bureaus (e.g., competent and honest revenue officers). Perhaps the best example of this was the so called tax-credit scam where fake tax credits of exporters were sold to oil companies (allegedly with the active connivance of an under-secretary of the Department of Finance, a department that is very rarely associated with corruption.).

Another problem is that even if the administration of taxes can be strengthened and investment promotion policies are on paper anchored on sound economic principles, the granting of tax incentives can be driven by powerful lobbies (e.g., protection of inefficient industries or high profit margins of influential import-competing industries under the banner of economic nationalism). Moreover, tax incentives can open the door to abuses that cause enormous revenue losses from activities that have nothing to do with the explicit and noble reasons for granting the incentives.

Moreover, while there is theoretical basis for using tax incentives as a tool for industrial policy (e.g., subsidizing investments that may not be profitable in the short run but are good for the economy in the long run because they generate a lot of externalities that are not captured financially by the “pioneer” investor), the practical question is whether government can “pick winners” given that the direction of global technological change is so hard to forecast and given that the exercise of picking winners may be driven more by present lobbies rather than by future needs. For instance, while a strong entrepreneurial role of government might have worked in Japan, Korea, Taiwan and Singapore (although this too is subject to debate), it is very questionable whether the same interventionist policies can work in countries like the Philippines which have a much weaker state and bureaucracy.

### *A Framework for Evaluating the Social Desirability of Granting Fiscal Incentives*

The next sections discuss brief framework for evaluating the costs and benefits of fiscal incentives such as income tax holidays. It starts with a framework for estimating revenue losses that result from the grant of incentives. At one extreme, one could argue that there is no revenue loss to the extent that all of the recipients of the incentives would have invested in some other country (e.g., which offers more generous fiscal incentives) the resources that they had invested here if they had not been granted the fiscal incentives. At another extreme, one can argue that the incentives are all infra-marginal and that all the incentives are redundant because the level of investments would not be affected by the incentives. The truth is most likely to be somewhere in between the two extremes. Where the mid-point is would depends on the type of the incentives. For instance, in the case of income tax holidays, a large proportion of the tax incentives is likely to be redundant. On the other hand, in the case of exporters that use a lot of imported inputs,

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tax-exemption of longer-term financial instruments to the extent that tradeable long-term financial instruments have are close substitutes for short-term financial instruments that are held to maturity.

even a low tax on imported inputs may make it very difficult for all but the most efficient firms to compete in global markets. The quotation below explains why ITH may not be a very effective tool for correcting for market failures:

“Of all the forms of tax incentives, tax holidays are the most popular among developing countries. While admittedly simple to administer, they have numerous shortcomings, which even though shared to some degree by other types of incentives are particularly pronounced: (1) by exempting profits irrespective of their amount, tax holidays tend to benefit an investor who expects high profits and would have made the investment even if there was no such incentives; (2) tax holidays provide a strong incentive for tax avoidance, as taxed enterprises can enter into economic relationships with exempt ones to shift their profits through transfer pricing; (3) the duration of the tax holiday, even if formally time-bound, is prone to abuse and extension by investors through creative redesignation of existing investment as new investment (e.g., closing down and restarting the same project under a different name but with the same ultimate ownership); (4) time-bound tax holidays tend to attract short-run projects, which are typically not so beneficial to the economy as longer-term ones. The latter may become profitable only toward the end of the holidays and therefore can make little use of such holidays even losses can be carried forward..... (5) the revenue cost to the budget is seldom transparent, unless enterprises enjoying the holiday are required to file tax returns, in which case this case, administrative resources must be devoted to activities that yield no revenue, and a frequently alleged benefit of tax holidays would be negated.”\*

As previously discussed, on the other hand, tax and duty exceptions of imported inputs and capital equipment of exporters are, strictly speaking, not incentives, but are instruments for offsetting disincentives on exports arising from protection of domestic industries from foreign competition. Moreover, it cannot be ruled out that the waiver of duties and taxes on imported inputs may spell the difference with regard to domestic exporters being able to compete or not in foreign markets. This applies as well to tax credits for domestically produced substitutes for these inputs and capital goods. But as already mentioned, the grant of tax credits to exporters which use domestically produced inputs and capital goods taxes complicate the tax system and create more avenues for cheating, especially if the tax credit certificates are negotiable or transferable to other companies. As a result, policy makers have to weigh the benefits from export promotion that the tax credits generate against the cost that such incentives impose on the tax system.

Finally, the net benefits from the incentives would depend on how much of the investments that are drawn by the incentives could have gone to other domestic investment projects which are not part of government's preferred areas of investment and the extent to which the investment areas that are not being promoted by government also generate externalities (which are not necessarily lower than the supposed externalities generated by the preferred investments).

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\* Tanzi and Zee, p.316

### *Revenue Loss from Income Tax Holidays (ITH)*

The following acronym (IRAN) hopefully provides a good mnemonic device for classifying investments that receive fiscal incentives such as tax holidays.

$$\mathbf{I} = \mathbf{R} + \mathbf{A} + \mathbf{N}$$

**I** = Investments that are granted ITH (or another tax incentive)

**R** = Investments granted **R**edundant incentives (would have come in even without the ITH)

**A** = Investments that would have gone to **A**lternative domestic projects that would have been preferred by the investor in the absence of the ITH

**N** = **N**ew and additional investments that were drawn in by the ITH

Using the above symbols, the revenue loss from the income tax holiday is  $\mathbf{t}_a(\mathbf{R} - \mathbf{I}_{\min}) + \mathbf{t}_a\mathbf{i}_a\mathbf{A}$  where

$\mathbf{I}_{\min}$  = Investments that are registered but are subject to tax (e.g., incentives are granted only for performance above government set targets)

$\mathbf{i}$  = Taxable income per peso of investment (with subscript if income varies across sectors)

$\mathbf{t}$  = *effective* income tax rate (with subscript if effective tax rates vary across sectors).

If  $\mathbf{I}_{\min}$  is high (e.g., equal to **R**) then the revenue loss would be limited to  $\mathbf{t}_a\mathbf{i}_a\mathbf{A}$ , the income tax payments that government would have received if the investments that were diverted by the incentives from other parts of the economy had not been diverted. This is clearly a revenue loss but is not an argument against giving the incentives if one accepts the premise (which will be examined later) that investments in some areas are *preferred* (and are therefore in the IPP) to others because they generate greater positive externalities. Revenue loss is reduced to the putative tax revenue from alternative domestic investments because redundancy is avoided by not giving incentives to investments that would have come in anyway even without the incentive.

The analysis is very similar to that of monopolistic markets with perfect price discrimination. The perfectly price discriminating monopolists cannot incur revenue loss by offering lower-priced packages to the new customers if existing customers cannot shift to the lower-priced package. The cost of incentives is reduced (but is not necessarily equal to the minimum)\* because incentives are granted only on the basis of *additional* performance of activities that generate positive externalities.

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\* Even if  $\mathbf{I}_{\min} = \mathbf{R}$ , to the extent that part of the new investments **N** would have come in at tax rates that are positive but are lower than  $\mathbf{t}$ , there would still revenue loss. The revenue loss  $\mathbf{t}_a\mathbf{i}_a\mathbf{A}$  is referred to as a

However, it is most likely a good idea to set  $I_{\min}$  at zero because positive and flexible levels would require *bargaining* between incentive granting authorities and investors. Bargaining would result in a complex, cumbersome, protracted (e.g., as shown by government's experience with unsolicited BOT projects) and non-transparent (possibly corrupt) process which will discourage investments, defeating the very purpose of granting the incentives. At any rate (as demonstrated by the recent grant of tax incentives to mobile phone companies), there is no basis for saying the incentive granting bodies try very hard to avoid giving incentives that are redundant.

Some countries like Korea and Singapore try to have the best of both worlds by having regular and special windows for granting incentives. The first window is open to everyone who meets the criteria for getting the incentives and is applicable to every dollar of investment that is put in. The second window is open only to large investors that meet the requirements of the government's industrial policy and technology plan. The incentives granted to special FDI are large (cash, subsidized loans and land) but are subject to negotiation. For obvious reasons, it is not a good idea for developing countries (and even Korea, according to many Korean economists) to have the second window.

If  $I_{\min}$  is zero, then the revenue loss is  $tiR + t_a i_a A$ ,\* tax incentives that are given to investments that do not need incentives and the taxes that the investor would have paid if he had invested in alternative projects that do not qualify for incentives.

Note that there are two types of revenue loss. The first  $tiR$  is referred as a redundant incentive. The second ( $t_a i_a A$ ), as already mentioned, results from the fact that the incentives divert investments away from taxpaying activities to non-taxpaying activities. The first is unavoidable if the discriminatory granting of incentives is too costly, both from the point view of the government and the point of view of the investors (for reasons discussed above). The second is a *reasonable* trade-off that government can make if it is indeed true that investment in *preferred* investment areas (e.g., the IPP) generate more positive externalities than ordinary investments.

Finally, if the investments that are not qualified of incentives have the same rate of return as the investments that receive the ITH and are subject to the same effective income tax rates that as those that are waived by the ITH (e.g., the investments do not go to the informal sector if the ITH is not available), then and the revenue loss from the ITH is  $ti(I - N)$  since  $ti(R + A) = ti(I - N)$ . In other words, the revenue loss is equal to all incentives granted minus the incentives that are granted to *new and additional* investments.

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*redundant* incentive. The revenue that could have been generated by taxing N at a lower but non-zero rate is referred to as a *partially redundant* incentive.

\* The revenue loss will be greater if the owners of firms that are granted ITH allow their firms to be used as tax shelters by firms and persons who are not entitled to the ITH. For instance, the fact that dividends are taxed lower than salaries, as is the case in our country, would not create incentives for firms to pay its managers dividends in lieu of salaries (through employee stock option plans) only if the corporate income tax rates are at least as high as individual income tax rates.

In summary, the revenue loss is high if the new (and additional, not just redirected) investments  $N$  that are attracted by the ITH is low and a huge chunk of investments that benefit from the ITH are either recipients of redundant incentives ( $R$ ) or investments that are diverted from non-exempt alternatives ( $A$ ) because of the tax incentives.

On the other hand, other things equal, revenue loss is lower if  $t_a$  is low. In this case, the revenue loss is low because scarce resources are transferred from lightly or barely taxed to untaxed activities. Moreover, if  $t_a$  is low because a lot of domestic investment is in the informal sector or in closed family corporations that have two books (one complete and accurate and the other for the tax collectors), the diversion may actually be good for tax collections in the long run after the ITH expires. This, however, is stronger argument not for granting ITH but for lowering taxes for all firms (which precisely is hard to do if the ITH is being abused and is characterized by redundancy).

Finally, even if one can be sure the  $N$  is close to zero, it would still be hard to estimate revenue loss unless one is willing to assume that the effective tax rate on the alternative investments that were not undertaken because of the tax incentives is equal to the effective tax rates that were waived because of the tax holiday (e.g., if it is known that  $t = t_a$ ) or one knows how much of the investment would have come in in exactly the same form and how much would have gone to non-preferred areas in the absence of incentives (e.g., the ratio of  $R$  to  $A$ ).

### The Social Cost of the Incentives

Even assuming that one can estimate revenue loss with some degree of confidence, one cannot conclude immediately that the *net* social cost of tax incentives is equal the lost revenue. One needs a framework for translating revenue loss to social cost. If taxes are non-distortive and costless and easy to collect, the net social cost of revenue loss from the ITH is zero (since the revenue loss from the incentive is recovered by government from other taxpayers at zero cost, the fiscal incentives merely transfer income from one private party to another). But if costless lump-sum taxes and transfers were possible, all taxes will be lump sum taxes and the income tax rate would be zero to begin with and there will be no need for the ITH.

In other words, the revenue loss from the incentives has low social cost only in economic models where cost of transferring money from tax payers to the treasury (in order that the treasury will be able to afford to give tax incentives to investors) is not significant. In the literature there are two types of efficiency losses that society incurs when government transfers money from some parties to others. The first has to do with the economic deadweight loss of taxation. For instance, the economy becomes less efficient as entrepreneurs and workers shift from market to non-market activities and leisure to avoid consumption and income taxes. The second has to do with collection, administration and compliance (or in some cases non-compliance) cost. A good example of non-compliance cost, is the amount of resources tax cheats have to use to "beat the system" (e.g., tax cheats who get caught will try minimize their losses by hiring

expensive lawyers). In general, the more inefficient the tax and legal system, the higher the marginal cost of public funds.

If the cost of collecting taxes is high, either because of deadweight losses or the high cost of tax administration and compliance or because the taxes cause deadweight losses, then a peso that is already in the treasury is worth much more than a peso that is still in private hands. Laffont and Tirole have cited literature that the cost of public funds is greater than 2 for countries like the Philippines. So the net cost to society of a peso of redundant incentives can actually exceed one. The people who benefit from the ITH get 1, but a peso of lost revenue on the part of government may cost more than 2, so the net loss to society (the value in shadow prices of the treasury's loss minus the ITH recipient's gain) is more than 1.

Moreover, if the recipient of the redundant fiscal incentive is a foreigner, the net loss to Philippine society from the redundant incentives is even greater. The net loss of society is the revenue loss valued at the shadow price of public funds minus zero (since the foreigner's gain is not a welfare gain from the point of view of our country's social accounting system, as shown by the fact that our country receives, not gives, foreign aid).<sup>\*</sup> Finally, one can extend this reverse foreign aid analysis to the case where the people who benefit from the redundant incentives are rich Filipinos while the people who have to pay higher taxes or who suffer from a reduction in social services are on average significantly poorer than the people who received the redundant incentives. There is a social loss from the transfer because a peso of taxes or cut back in services for the latter group is worth much more to society than a peso of redundant tax breaks for the former group (which is unlike the redundant tax breaks given foreigners is not of zero value to society but like the grant to foreigners is not worth as much as the loss of others.)

The government can of course postpone taxation by borrowing or avoid taxation by spending less. In the former case, it can be argued that the marginal cost of funds is lower to the extent that future generations are expected to be richer and future tax systems are expected to be more efficient. To the extent, however, that credit markets do not buy this line, spreads on Philippine sovereign debt will rise and the marginal cost of public funds may be rather high. If for instance, the spread rises by only 10 basis points, the interest expense of the Philippine government can rise by as much as four billion pesos per year (four trillion pesos times .001). On the other hand, if government pays for the tax incentives by reducing spending in education and infrastructure, the social cost can even be higher. (This is true as well for rich countries like the U.S. For instance, an American senator once remarked that the incentives that are meant to attract investors to secure the welfare of the future generations ironically result in the sacrifice of the welfare

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<sup>\*</sup> If the investor is from a country (e.g., the United States) that taxes foreign income of its residents, the investor actually benefits very little from the ITH since the increase in his taxable income in the United States (with some deferral to the extent that accounting rules allow it) is equal to the Philippine income taxes that have been waived. For this reason, the ITH given FDI from the US can be seen as a reverse foreign aid since a poorer government is effectively giving money to a richer government. For the foreign investor to benefit from our ITH, the other country must "spare" (e.g., counted waived taxes in the Philippines as paid for tax purposes). However, home-country tax sparing is usually applied only if there is a tax treaty between the investor's home and host countries.

of the future generations because the incentives came at the expense of spending in infrastructure and education, the very things that are needed to secure the welfare of the future generations.)

In summary, not all of incentives are redundant, so it would be a mistake to count all tax breaks that can be accounted for as social cost. But some of the incentives are redundant and there is good reason to treat at least a fraction of the estimated revenue loss from the ITH not as a pure transfer but a true social cost. The greater the public debt and the more inequitable and inefficient the tax system, the greater the social cost of the redundant incentives or incentives that simply reallocate investments away from the rest of the economy to BOI's preferred areas.

### The Social Benefits from the ITH

If  $e$  is the externality or spillover effect of the non-redundant investments that are attracted by the ITH, then the benefit from the ITH minus the externality that the diverted investment could have generate in its alternative use. Thus, the benefit from the ITH is  $e(\mathbf{A} + \mathbf{N}) - e_a\mathbf{A} = (e - e_a)\mathbf{A} + e\mathbf{N}$ . If alternative domestic investments generate zero positive externalities as the preferred investments, then the benefit is simply  $e(\mathbf{N} + \mathbf{A}) = e(\mathbf{I} - \mathbf{R})$ . On the other hand if the domestic investments that do not receive incentives generate as much positive externalities as those that do, then the social benefit from the ITH is simply  $e\mathbf{N}$ . In short, if it is not clear that the BOI preferred areas of investments are much more beneficial to the country as ordinary domestic investments, only the new (and additional) investments drawn in by the incentives generate additional positive externalities. But if this is the case, BOI investments that are financed by Filipinos generate no additional positive externalities for the country (unless one can argue that the Filipino investor would have invested his or her money abroad or would have spent his or her money on additional consumption if he or she had not been given the fiscal incentive) and incentives should be given only to foreign investors.

However, the converse (that all foreign investments are new) does not necessarily follow. It cannot be ruled out that some of the foreign investments could have come in any way even in the absence of incentives.

In summary, incentives generate positive spillover effects in two ways: (a) they attract *new* foreign investments which generate positive externalities and (b) they *redirect* domestic investments away from sectors or areas that generate relatively low spillover effects to areas in the Investment Priorities Plan, which presumably generate greater positive externalities than the run of the mill or garden variety domestic investments.

On the one hand, one can say that the Investment Priorities Plan is a well-thought out document and the investments that are listed there are precisely that ones that fit a long-term vision of the country's international competitiveness. On the other hand, one can point to the poor track record of the BOI (e.g., what were the externalities that were generated by the polyester fiber industry, one of its perennial preferred investment in the 1970's?) and Manasan's finding that BOI firms tend to be less export-oriented and less

labor-intensive than the rest of the manufacturing sector. At any rate, it is sad commentary that neither DTI nor BOI monitors or has attempted to quantify the so-called positive externalities that their preferred investments have generated.\*

### The Benefit-Cost Ratio

If one assumes that the marginal cost of public funds is around 2 and investments that do not receive the ITH generate the same externalities as preferred investments and are as likely to pay taxes as the average firm, then the benefit cost ratio is  $eN/ti(R+A) = eN/ti(I-N)$ . This is likely to be a small number unless  $e$ , the externalities per peso of investment is large. This is so since  $N/(I - N)$ , as will be discussed later, is likely to be small. One can argue that except for FDI in export-oriented firms, most investments that were granted the ITH either would have invested in a project that is exactly identical or is different but would also have been located in the Philippines even if there had been no ITH.

There is good reason to infer that an ITH cannot generate the expected social benefits by attracting *new and additional* projects that generate huge externalities. In the first place, if the projects that generate the huge externalities are profitable to begin with, the ITH would be redundant. This would be the case if the profitable project caters to the domestic market or sells its output abroad but is located in the Philippines because of cheaper raw materials or special types of labor (e.g., workers who are proficient in English) or cheaper raw materials or inputs.

In the case of the profitable industries that cater to domestic markets, the alternative is to service the Philippine market from an off-shore plant, which will be more costly if the Philippines is really a an efficient location for the plant because imported goods are subject to modest but not insignificant tariffs. On the other hand, if the domestic plant that serves the domestic market is not competitive in spite of the tariff protection that it receives, then an ITH cannot make it competitive. What could possibly make it competitive would be a waiver of taxes and duties on inputs and capital goods. In this case, the incentives are just ways of raising *effective tariff protection*---and the debate about fiscal incentives is just another reincarnation of the trade liberalization debate.

If the firms that are applying for incentives serve third-country markets, it is important to ask what attracts them to the Philippines in the first place. If they were attracted by cheaper or higher special skills or raw materials in the Philippines, it cannot be immediately concluded that all incentives are redundant. However, some types of incentives, may be more effective than the others; and the ITH is, compared to other

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\* If development of skills and systems is an indicator of externalities, foreign banks seem to generate the greatest externalities. For example, many presidents of domestic banks are CitiBank “alumni.” However, that similar anecdotes are unheard of with regard to BOI investments and that neither BOI nor DTI bothers to monitor or quantify the hoped for spillover effects are a strong indicator that the spillover effects are not really the main reason for granting the incentives.

forms of fiscal incentives, most likely to be redundant. This is so since an ITH will either not make difference in the investors' decisions if the investment is unprofitable or very profitable to begin with. An unprofitable investment will remain unprofitable even after it is granted an ITH. A very profitable investment, on the other hand, is likely to come in anyway even without the incentives. In short, an incentive can make a difference only if the project is only marginally profitable or an alternative location in another country is even more profitable (in which case the ITH can change the relative attractiveness of the Philippines, especially if neighboring countries have similar cost structures but offer more generous incentives).

In general, profitable and socially desirable projects will happen with or without government encouragement. (This, Adam Smith so eloquently argued when he said that it is not by the benevolence of the butcher and the baker that we get our meat and our bread.) By definition, ITH is likely to be a redundant incentive in this case. Since the entire rationale behind incentives is to make unprofitable but socially desirable projects profitable, the ITH is not a ideal instrument for correcting market failures. A direct subsidy can raise profitability from negative to positive, but a reduction of income tax liability, when there is no income in the first place is f[un]utile. (However, for obvious reasons, cash grants to selected investors are the most difficult to administer.)

<b>Project Description</b>	<b>Socially Desirable</b>	<b>Socially Undesirable</b>
<b>Very Profitable</b>	Tax incentives would be redundant	Should be taxed
<b>Marginally Profitable</b>	<i>ITH might help</i>	Should be taxed
<b>Money Losing</b>	ITH won't help, subsidies if well targeted will help	Benign neglect is best policy

In short, ITH works only if the investor is choosing between alternative investments which are only marginally different in terms of profitability but are very different in social desirability (as shown in *italics* in the above table). In this particular case, the ITH is the "clincher" which moves resources towards the project with high positive externalities from the project with lower externalities. Thus, the ITH could steer domestic investments away from projects that are modestly profitable but have low positive externalities to domestic investments that were hitherto only marginally profitable but generate a lot of externalities. To simplify, if it can be assumed that there are zero externalities ( $e_a = 0$ ) from the modestly profitable projects which are not in BOI's preferred areas and the total investment is  $A$  (to maintain the original notation), but there are large externalities from projects in the government's investment priorities plan (IPP) which are only marginally profitable, then an ITH can be the "clincher" that can convince the private investors to redirect their investment funds to government's preferred investment areas that were marginally less attractive without the incentives but offer sufficiently attracted after-tax rates of return when the ITH is factored in. Then the social benefit from the incentives is  $e(N+A)/ti(R+A)$  which can be large even if  $R$  is not small and  $N$  is small provided both  $A$  and  $e$  are large. In other words, investment incentives improve social welfare even if they do not attract new and additional

investments because they redirect investments away from low externality activities to high externality activities. (But as already discussed, there is no empirical basis for saying that  $e - e_a$  is high.)

Another important question is the whether it is likely that the ITH is a clincher. As already mentioned, the “clincher” scenario is rather unlikely one for domestic-market-seeking investments or investments that are drawn in by natural resources (e.g., mining) or by special skills of Filipino workers (call centers?). If the incentives are not the clincher, then they simply result in lower output prices or higher rates of return. In the case of firms that serve domestic markets, whether consumers or investors capture the rents from the ITH depends on the competitiveness of the market or, if the market is monopolistic, the way the monopoly power is regulated. (See Box for the case of the ITH given to Manila Water.)

If the firms that receive the incentives are in industries where there is competition (whether perfect, imperfect or oligopolistic), it matters whether all the firms receive investments. If only a some but not all firms or only the “early birds” (in the case where “excess measured capacity” is a basis for not granting the incentives to new firms, which is the current appeal of incumbent firms in the cement industry) are granted the incentives, the government may end up deciding the market shares of the different market players. This creates a rent-seeking environment; and worse, it could be that the market players chosen by the government are not necessarily the most efficient.

#### **ITH for Manila Water Case: The Case of the Redundant Incentive**

Manila Water Co. applied for and received both an income tax holiday and its extension with the delay of its commercial operation. Under the concession agreement, Manila Water’s investors will not benefit from the tax holiday since taxes are reimbursable expenditures (any cut in tax liabilities reduces reimbursable expenses and the savings must be passed on to consumers as lower tariffs). In sum, the tax holiday has no effect on Manila Water’s decision to invest. It did, however, reduce its borrowing requirements since the savings in taxes temporarily improved its cash flows (since the taxes are front ended while the tariff reductions will affect revenues through out the concession period). Eventually, the tax breaks will have to be passed on to consumers over the life of the project in the form of the lower tariffs so the initial improvement in cash flows due to the tax breaks will be offset in the future by lower cash flows. The ultimate beneficiaries from the tax breaks are the consumers who will eventually pay (very slightly) lower tariffs and the customers who got connected earlier than scheduled (since it would have take months if not years to close the financing that is need to finance the accelerated expansion of services). Fortunately for the consumers, water tariffs are regulated. So they benefited from Manila Water’s “redundant” incentives. Customers of most of the firms that received redundant BOI fiscal incentives may not be as lucky.

## The Case for Differential Treatment of Exports

Much of the previous discussion on the lost revenue from ITH (to the extent that it is a redundant incentive or only serves to redirect investment away from taxed areas to areas that are covered by ITH) applies as well to waiver of taxes and duties on imported inputs. The difference, however, is unlike the ITH, the waiver of taxes on inputs can make an unprofitable activity profitable. (This point is of course not new and is just an application of the concept of effective protection to tax incentives). Suppose for instance that border prices are equal to 1 for all goods. Suppose further that average duties on inputs and output are  $d_I$  and  $d_O$  and intermediate input per unit of output is  $a$ . Note that the completely imported unit of the good will sell at  $(1 + d_O)$  while the domestically produced good (which uses imported inputs) will  $a(1 + d_I) + (1 - a)c$ , where  $c$  ( $\leq 1$  if the industry is efficient) is the unit cost of the domestic value added. It can be seen that if tariffs on output and inputs are equal ( $d_I = d_O = d$ ), then the domestic producer can compete with imports provided  $c < 1 + d$ . In short, an efficient producer which receives the at least the same tariff protection as the tariffs on his inputs does not need any additional incentive. Of course, if  $c$  is much higher than 1, the firm can compete with imports only if  $d_I$  is much lower than  $d_O$  (i.e.,  $d_I$  is zero because of the waiver of taxes and duties on imported inputs)

And here lies the problem with waiving taxes and on capital goods used by firms that sell their products to domestic markets. If the firm sells to a protected market which has a tariff which is at least equal to the tariff on its inputs (which with very rare exceptions is the case in the Philippines, the waiver of duties and taxes on imported raw materials and capital goods is clearly a redundant incentive if the firm is efficient. Conversely, the only time that the waiver of taxes and duties on capital goods is not a redundant incentive is if the domestic producer is inefficient. But if the domestic firm is inefficient, the grant of incentives makes the economy more inefficient, which is acceptable only if the firm is expected to eventually (hopefully quickly) become efficient. In other words, the debate about giving the tax and duty waiver on capital goods imports of firms that sell their outputs to the domestic market is simply a rehash of the pros and cons of having an industrial policy. Those who favor the incentives invoke the infant industry argument. Those who are against, cite the poor track record of the government in “picking winners” and the long list of infant industries that have never been weaned from protection. At any rate, from the point of view of those who do not believe that the government is capable of competently executing an industrial policy, waivers of taxes and duties on capital goods of firms that cater to protected domestic markets either represents redundant incentives (tariff protection is sufficient for firms that are not extremely inefficient) or represents a misallocation of resources (the incentives reallocate resources away from globally competitive uses to uncompetitive uses).

Note, however, that by definition the protection given by the tariff system to exporters is zero. Thus, if the exporter must pay taxes on inputs, it can compete globally only if  $c < 1 - ad/(1-a) < 1$ . In short, even an efficient firm (i.e.,  $c < 1$ ) may not be able to compete abroad if it uses a lot of imported inputs even if the taxes and tariffs on its inputs are not very high. Suppose for example that an export industry is 10% more efficient than what

is necessary to compete globally but it uses eighty cents of inputs for every dollar of export and the inputs are subject to a low duty of three percent, then the efficient industry won't be able to compete unless duties on its inputs are waived (  $.8 \times 1.03 \text{ plus } .2 \text{ times } .9$  is greater than 1)

In this sense, the 1983 investment code hues closer than the present code (OIC) to sound economic principles to the extent the waiver on taxes and duties on capital goods and raw materials used to be limited to export-oriented industries unlike the OIC which also gives non-exporters tax and duty waivers on imported capital goods and raw materials..

### Analysis of BOI Incentives and Policy Recommendations

The following table summarizes the redundancy or non-redundancy of fiscal incentives (ITH and waiver of taxes and duties):

	<b>Firm Sells to Domestic Market</b>	<b>Firm is Export-Oriented</b>
<b>Income Tax Holiday (ITH)</b>	This incentive is very likely to be redundant. If given to Filipinos, the ITH either fails to attract new investments or simply redirect investments away from domestic industries that are not covered by the ITH (but do not increase total investments in the country).	This incentive is redundant if the cost of producing in the Philippines is much lower than in other countries. However, this incentive may be justifiable if cost of producing in the Philippine is not much lower than in other countries that give the incentive.
<b>Zero taxes and duties on spare parts and raw materials</b>	Incentive is redundant if firm can compete with imports (which pay duties). Incentive raises the effective tariff protection and can induce new investments only if domestic producer is marginally competitive.	This type of fiscal incentive is justifiable. Taxes and duties on raw materials may make cost efficient exporters globally uncompetitive.
<b>Zero taxes and duties on capital goods</b>	Incentive is redundant if firm can compete with imports (which pay duties). Incentive raises the effective tariff protection and can induce new investments only if domestic producer is marginally competitive.	This type of incentive is justifiable. Taxes and duties on capital goods reduce rate of the return to capital and may make an otherwise competitive industry globally uncompetitive.

On the other hand, the following table gives a breakdown of tax revenue foregone under the ITH granted by the BOI (as estimated by Reside):

**Breakdown of BOI Income Tax Holiday by Type of Recipient**

	<b>Domestic market-seekers</b>	<b>Exporters</b>	<b>Total</b>
<b>Filipinos</b>	8,602,467,191	933,210,674	9,535,677,865
<b>Non-Filipinos</b>	8,268,168,792	839,857,085	9,108,025,877
<b>Total</b>	16,870,635,984	1,773,067,760	18,643,703,744

The above table shows that 16.9 billion of the 18.6 billion pesos of ITH incentives given by the BOI went to firms that sell their products domestically. Moreover, more than half of the revenue loss from the ITH that benefited exporters accrued to Filipino exporters (who are unlikely to relocate abroad if the ITH had not been granted). It is therefore quite likely that 95% of the ITH given by the BOI are redundant (16.9 B to domestic-market-seekers plus 0.9B to Filipino exporters divided by the total 18.6B).

**BOI Grant of Incentives on Raw Material Imports**

	<b>Imported Raw materials incentives</b>		
	<b>Domestic market-seekers</b>	<b>Exporters</b>	<b>Total</b>
<b>Filipinos</b>	11,787,497,818	1,278,728,364	13,066,226,182.59
<b>Non-Filipinos</b>	11,329,426,715	1,150,810,964	12,480,237,679
<b>Total</b>	23,116,924,534	2,429,539,327	25,546,463,862

As shown in the table above, the redundancy ratio for waiver of taxes and duties on raw materials was only slightly lower. Around 90% of the incentive (23.1B out of 25.5 B) were given to firms that sell their products to the domestic market.

The waiver of duties and taxes on capital goods was much smaller (1.96 B). However, the redundancy ratio is also quite high since 90% of the incentive (1.77 B) was given to domestic-market-seekers.

	<b>Domestic Capital goods incentives</b>		
	<b>Domestic market-seekers</b>	<b>Exporters</b>	<b>Total</b>
<b>Filipinos</b>	904,197,273.04	98,088,900.38	1,002,286,173.42
<b>Non-Filipinos</b>	869,059,481.35	88,276,592.00	957,336,073.35
<b>Total</b>	1,773,256,754.39	186,365,492.38	1,959,622,246.77

In summary, 42.7 billion or 92.5% (incentives given to non-exporters plus the ITH given to Filipino exporters) of the BOI incentives were likely to be redundant or reallocative (changes the distribution of Filipino investments but not total investments).

Given the advantage of flatter, broader and simpler tax systems (e.g., lower tax rates with universal application of NOLCO and accelerated depreciation) and the amorphous nature of the supposed externalities generated by investments that are preferred by the BOI, the first best is to remove all incentives given to firms that receive tariff protection and make the PEZA incentives available to all exporters.

Incentives to non-exporters should be removed since the incentives are likely to be either redundant (if the firms are efficient, they are already getting a very good deal because of the tariff protection) or inconsistent with economic efficiency (that the incentives are not redundant is actually bad news since it means that the firms that are being given protection are inefficient).

The duty and tax incentives on raw materials and capital goods used by exporters should be retained. (The incentives are, strictly speaking, not really incentives but are partial removal of cost penalties on them arising from the country's protectionist trade policy).

The grant of ITH to exporters should be re-examined. If the ITH is either to be given to all exporters or not at all, however, (since case-by-case grant of the ITH would reduce transparency and would create too much room for discretion), it may be wiser to give it to all exporters and to let them choose between the 5% tax on gross income and the ITH. This is so since there are two types of errors. The first is giving a redundant incentive and the second is losing investment to a neighboring country that gives the ITH. It seems that the second error is potentially more costly than the first.

If the choice is between ITH for exporters and lower corporate income tax rates and extended NOLCO provisions for exporters, the latter is likely to be more cost effective. This is so since ITH for a limited period may in practice be for indefinite periods (since companies are likely to be renamed or "redesignated" in order to qualify for new extended holidays. Moreover, the ITH is unlikely to attract industries that are unprofitable in the short or medium run but are profitable in the long run.

Thus, effectively much of BOI incentives in their present form should be abolished while the PEZA incentives to exporters should be retained. Safeguards should also be put in place to prevent the use of and tax and duty free import privileges as avenues for smuggling and the expansion of incentives to areas not intended by congress.. Moreover, the OIC should also be amended to increase the accountability of the board or authority that grants the incentives. There should be an objective estimate of how much of the incentives are redundant and an attempt to monitor and measure periodically the alleged positive spillover effects of the investments that are made by firms that sell their products to domestic markets (if such are granted). Perhaps the best way to do this is to give NEDA and DOF more say in the incentive-granting board or authority and make them render periodic reports to congress that quantify and classify the incentives that have been granted (whether redundant or not, whether given to inward-looking or export-oriented firms).

## Conclusion

Recipients of investment incentives belong to either one of three types:

- (a) In the first type, incentives are given to investors who would invest in the country anyway even if such incentives had not been granted. In this case, the tax incentives are clearly very bad for society. The public debt is very high; our tax system is inefficient and inequitable; public spending on infrastructure and social services is very low; and the gap between rich and poor in our country is very high. Funds transferred from the state to investors (who are on average much richer than the average Filipino) impose a huge cost on society that is possibly worth more than double the economic rents that are created by the incentives. In this case, the incentives are *redundant* and very costly to society since a government that is heavily indebted and virtually unable to meet the people's needs for basic infrastructure and social services is paying the rich to do things that they would have done anyway even without the incentives
- (b) In the second case, the incentives make Filipino capitalists redirect investments *away* from the projects of their first choice (the projects they would have chosen if the government had not induced them to investment in its *preferred or priority areas*). In this case, how the incentives affect society depends on the how the activities that are in government's preferred areas compare with the activities that are not and the value of the public funds that are given up because of the incentives.
- (c) In the third case, the investments that are attracted by the incentives are totally new (and *add* to total investments that would have taken place without the incentives). In this case, the incentives impose no cost on the treasury and clearly generate a lot of benefits. At the very least, the incentives create new jobs and could even bring in new skills and technology. On the other hand, zero revenue is lost since the investments would have not taken place without the tax incentives.

In the case of the income tax holiday (ITH) granted to Filipino investors, regardless of whether the project is domestic or export-oriented, it is extremely unlikely that the investments that receive the ITH are additional investments (e.g., of the third type), unless one can argue that Filipinos would have invested in other countries if not for the ITH. Filipinos are more likely to invest in projects that are in the Philippines than in projects outside the Philippines (since they are less familiar with how things work in other countries).

Moreover, for projects that really matter from the point of view of granting the incentives (making socially desirable but privately unattractive projects attractive), the ITH does not work. Socially desirable but private unprofitable projects will remain so even after the ITH.

If the investors are Filipinos, the ITH is either redundant or (though less likely to be so) effective only in changing the composition of investments but not total investments. The latter occurs when the investment that is *strongly* preferred by the government is *marginally* inferior to the investors' preferred alternative investment project. (The ITH is the "clincher"). But, here the question is whether the areas listed in Investment Priorities Plan really generate more positive spillover effects for society than ordinary projects. The mere fact that DTI/BOI can't quantify (and does not seem even to attempt to measure or monitor) the so-call spillover effects of *registered* investments is an indicator that the benefits from the incentives are small relative to the cost of the incentives to the treasury.

In the case investments in projects that are meant to serve the domestic market (regardless of whether the investor if Filipino or foreign) the ITH does not work. Because of tariffs on imports, the investor must invest in the Philippines in the Philippines if it is efficient to produce the product on the Philippines. If, on the other hand, it is inefficient or more costly to produce the product in the Philippines, it will remain so even with an income tax holiday.

The only time that the ITH can be good for Philippine society is when it is given to to a foreign investor who is thinking of exporting from the Philippines (e.g., a multinational corporation) and is thinking of locating in another country with a similar cost structure and incentive package as the Philippines. In this case, the ITH is the clincher. Moreover, the treatment of taxes and duties on inputs can make or break the decision to investment in the Philippines in the case of export-oriented industries that use a lot of imported inputs, where even a low tax on inputs can severely handicap an otherwise competitive firm. There is good reason for giving this incentive to export-oriented firms. (That the industry has low value added is no reason for not supporting them. In the case of the semi-conductor industries, for example, 10 or 20 percent of a huge sum like 30 billion dollars is a lot of money).

Finally, waiver of taxes and duties on inputs of domestic-oriented firms only serve to raise the effective rate of protection since tariffs on competing imports are not insignificant. However, since the duties on raw materials and capital goods are not very high, it is unlikely that waiving them can make the difference regarding the survival of the recipient of the incentives. If the recipient of the incentive is globally competitive, the tariff on competing imports would be more than enough to encourage investments. With or without the tariff on inputs, the cost efficient domestic producer can offer a lower price than the importer who is subject to a higher tariff than the tariff on inputs. On the other hand, a high cost domestic producer is likely to remain a high cost producer relative to imports even if tariffs on inputs and capital goods are waived. Thus, the incentive, except for marginally competitive firms, is either redundant or irrelevant for firms that serve domestic markets.

The ITH account for more than 40% of the value of BOI incentives and only 5% of the revenue loss from the ITH accrued to non-Filipino exporters. In addition, more

than 90% of the incentives on given to imports of raw material and capital goods imports are enjoyed by firms that serve domestic markets. As a result, less than 10% of BOI incentives have been granted to investments that would not have come to the Philippines in the absence of the incentives.

In short, there is good reason to abolish the income tax holiday and retain the waiver of taxes and duties on the imported inputs, both capital goods and raw materials, of exporters.

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