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FISCAL INCENTIVES AND INVESTMENT IN THE PHILIPPINES

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Growing concerns about the country's fiscal problems have caused much talk about what can pull the country out of its economic troubles. The search for a strong and viable way out of the country's fiscal quagmire has become even more pressing as huge debt service payments have crowded out essential infrastructure and social expenditures – budgetary concerns that would undoubtedly seriously hurt the country's ability to compete in the global economy at present and in the not-so-distant future.

It is not a secret that better spending in infrastructure and education is inevitably the deus ex machina that will ultimately make the Philippines attractive to the Microsofts, Dells, or Nokias of the world. Unfortunately, these sectors are not getting their fair share of the budget pie. In fact, spending for roads, ports and other infrastructure, for education and other non-interest expenditures, have shown a marked decrease in recent years. (See table below)

Growing budget, shrinking public investments

Year	Tax Effort	Non-interest expenditures (as % of GDP)	Non-interest expenditures (% growth)
2001	13.50%	0.148	
2002	12.8%	0.152	2.7
2003	12.5%	0.14	-7.89
2004	12.4%	0.129	-7.86
2005	13.3%	0.113	-12.40

This may not come as a surprise, but watch the figures paint a stark picture. From a 2.70% growth

in 2002, non-interest expenditures plunged 7.89% by 2003 and plummeted even deeper by 12.4% in 2005. The toll that came from borrowings during the period, made necessary by the burgeoning budget deficit, unceasingly rose at the expense of crucial, productive public spending. These developments have made studies on revenue-raising measures, such as this one, quite urgent.

Congress has responded by filing of House Bill No. 3295, The Consolidated Investments and Incentives Code of the Philippines (i.e. the Fiscal Incentives Bill), which aims to simplify and rationalize the system of fiscal incentives offered by the government to investors. The bill, however, has generated some controversy as affected sectors have lobbied for the retention of their tax subsidies. The controversy has led to a need for a more thorough study of the effects of the bill.

This study analyzed the current system of fiscal incentives. It looked at the current system of income tax holidays, tax credits and import duty exemptions. It also looked at past laws and analyzed the proposed bill. It presents a comprehensive list of incentives that will be affected by the Fiscal Incentives Bill. It then used econometric analysis to recommend a better fiscal incentives system that would sustain investor interest while preserving some strength in the nation's Treasury. The study also answered specific issues raised by the Department of Finance regarding fiscal incentives.

The research and econometric analyses show what many policy makers, and economists have long suspected and feared. Incentives given out by the Board of Investments (BOI) are in large part redundant – many of the investments they sought to subsidize would have been undertaken anyway without the subsidies. For this reason, the benefits usually attributed to investment fiscal incentives, such as increased employment, increased wage payments, increased tax revenues from withholding tax generation, CANNOT be attributed to incentives. These benefits would have been generated anyway without the incentives. The incentives have failed to spur investments, they do not target the right set of investors, they contribute to uneven development, and they cost the government – which is already in dire straits – billions of pesos every year. The processes by which these incentives have been granted almost guarantee the failure of the existing system. The legal framework that regulates fiscal incentives was found to be unwieldy. Incentives granted by other investment promotion agencies (IPAs), such as the Philippine Economic Zone Authority, Subic Bay Metropolitan Authority (SBMA) and Clark Special Economic Zone (CSEZ) are shown to have little room for error. They have potentially substantial fiscal costs at even low levels of redundancy.

The needless provision of subsidies to firms that do not need them also has had profound economic, social and equity consequences. The poor, who depend on well-funded government services the most, are deprived of pathways out of poverty, the poorest regions in the country are deprived of funds for development, and the national government is forced to depend relatively more on ordinary workers to raise the necessary tax revenues, it is also forced to borrow more domestically and internationally.

Redundant incentives...

Based on data from different investment processing authorities (IPAs), a huge number of firms would have set up shop even without fiscal incentives and yet have benefited from these additional deal sweeteners.

Based on interviews with senior officials of the Board of Investments (BOI), around 95% of firms registered with it enjoy exemption from taxes and duties are redundant. Most investments that go through the screening process are redundant because they generate financial rates of return at levels that are already extremely attractive by domestic and even international standards. Thus, most investments would have been undertaken even without the incentives. In reality, therefore, investment promotions agencies can claim very little credit for generating additional investments and employment. The cost of redundancy is being reinforced because the main yardstick of an IPA's success is the peso value of investments registered. In reality, this yardstick should be really be the level of redundancy-adjusted investments.

Such viable businesses did not need an exemption from taxes and duties to survive and make money. They were already inherently viable sans incentives. Therefore, revenues foregone from these businesses constituted a real cost to the government.

By contrast, fiscal incentives given to investors whose businesses have great social and economic benefits but need fiscal incentives to be feasible do not cost the government anything, because revenues from these enterprises will not be there in the first place without the fiscal perks. These investments are not redundant. Non-redundant fiscal incentives truly generate investment, employment and other benefits for the country.
In addition to the expected profitability criteria, the economic literature suggests that in general,

exporting investments should be more sensitive to incentives than non-exporting investments. Here again, the BOI fails: a very large part of the value of its investment portfolio is domestic-market seeking.

Even among exporters, however, there is a hierarchy of redundancy. Resource-seeking investments – which depend on access to inputs indigenous to the Philippines, should not be very sensitive to incentives. Therefore, incentives provided to such industries should be thoroughly thought over.

...bleed government dry

Computations show that the government lost around P43.2 billion in 2004 in foregone revenues through the redundant BOI incentives alone, equivalent to about 1% of gross domestic product for that year. This figure is the sum of the cost of income tax holidays for BOI firms, which is P16.8 billion, and the cost of tax and duty exemptions on capital goods and raw materials imports and tax credits on raw materials for 2004, amounting to P26.4 billion.

Considering that the country's budget deficit is around 2% to 3% of GDP, this amount could have chopped off a huge chunk of the deficit and made significant ripple effects: it could have improved the country's credit rating, reduced the cost of borrowing from international financial markets, improved the domestic interest rates scenario and made the country more attractive to foreign investors.

In peso terms, the magnitude of losses from redundant fiscal incentives appears undoubtedly massive – but this is only a conservative estimate. Using an alternative computation, which reclassifies the incentives by intended market and nationality rather than by criteria, the figure climbs steeply to P51.8 billion for the BOI in 2004 alone.

Among the investment promoting agencies, the Philippine Economic Zone Authority (PEZA) was found to have the lowest redundancy rate at 10%, followed by Subic Bay Metropolitan Authority (SBMA) at 17.5%, Clark Special Economic Zone (CSEZ) at 36% and BOI at 80%.

This translates to losses of P15.7 billion in foregone revenues from PEZA's non-income tax holidays in 2004, P826.7 million from SBMA, and P1.6 billion from CSEZ.

The estimates also suggest that the restoration of incentives for the importation of capital goods by BOI-registered firms (Executive Order 313, originally signed by the President in 2004) cost the government around P11.1 billion during that year.

Even adjusting these losses to take into account benefits from jobs created, withholding taxes on wages, and net exports show the cost far outweigh the benefits.

The tragedy is that fiscal incentives represent an open wound that makes the government bleed year after year and in roughly the same magnitude. They have, for a long time, deprived the country of valuable resources for the true drivers of regional and international investment demand and the source of real competitiveness in the country: literacy and infrastructure.

Failure to spur investments

The paper also showed that in the case of BOI, many of the approved investments have not translated into real ones. Given the lag between investment approval and actual purchases of big machines, equipment and other capital outlays by a serious investor, official figures show that high investment approvals reported by the BOI had not resulted in real gross capital formation.

(The study had to use data on gross fixed capital formation from the National Statistical Coordination Board as proxy for actual investments made by BOI-registered companies, because at the moment, BOI cannot supply the data. It is posited that the level of investments approved by investment promotion agencies should be a good predictor of real gross capital formation in future years.)

The numbers suggest that either BOI-registered firms did not carry out their investments, or that incentives were used for motives totally unrelated to investment, or that other factors (besides incentives) were the main drivers of investment.

The figures may also mean that the annual Investment Priorities Plan and the BOI itself had not been able to target, screen and monitor the country's fiscal benefit package effectively. Consider this: the BOI heads a team every year to handpick sectors where the Philippines has a comparative advantage and give them tax and duty exemptions through the IPP.

But if these sectors are already enjoying comparative advantage status, do they really need tax and duty exemptions?

The redundancy of most incentives is also apparent when one examines the way companies make investment decisions. Officials from investment promotion agencies, as well as investors, admitted during interviews that assessing the impact of fiscal incentives on cash flow and income is usually the last step in companies' decision-making process. In the words of one investor, *one does not make an investment on the basis of incentives.* Incentives are usually just icing on the cake. For the most part, investment decisions have already been made by the time incentives come into play. So, incentives play little role in the investment decision.

What instead were discovered to be more potent in spurring investment? A vibrant economy, a well-educated workforce, good infrastructure, political stability, market size, wage cost and even consistency of legal and regulatory frameworks for businesses. In simple language: tax incentives are important only when investors are weighing the merits of similar countries, but incentives will never make up for deficiencies in the more fundamental determinants of investment (which can all be improved through greater funding and more efficient expenditures).

An excellent recent example of redundancy without need for statistical proof is Smart Telecommunications Inc.'s decision to invest in 3G technology. After announcements of its 3G investments, it belatedly asked the BOI for tax incentives after rival Globe Telecommunications obtained them. It is crystal clear that Smart needed no incentives to push through with its plans. But Globe didn't need them either in the first place, they had no choice but to match Smart, investment for investment.

Failure to target the right set of investors

All of these suggest that unless BOI's incentive-giving powers grind to a halt, government will continue to bleed profusely from needlessly foregone revenues every year.

On the other hand, incentives granted by the PEZA are relatively more effective and have a lower redundancy rate because they target exporters. Despite this, a net benefit analysis reveals that even the PEZA has very little room for redundancy – the PEZA net benefits are very sensitive to the redundancy rate. This underscores the need for tight investment screening, monitoring and controls at the PEZA.

BOI, PEZA, SBMA, and CSEZ incentives will only be potent if they are given to export-oriented firms. PEZA firms need to sell 50% - 70% of their products in export markets while BOI firms cater primarily to domestic markets. The ability of firms to sell exempted products outside these zones should be tightly monitored. The greater the leakage, the greater the cost to government.

Among PEZA incentives, the most effective are those given to private developers in PEZA ecozones *outside* Metro Manila, who have proven to be more effective in choosing the best locations, in building good investment support facilities and utilities at a fraction of the cost, and attracting foreign partners.

Prior to the passage of the PEZA Law in 1995, only four ecozones were developed and operated by the government. Despite the poor quality of these ecozones, demand for them grew as the country's strength in skilled labor, low labor cost and infrastructure were, at the time, more pronounced. But the government had no resources to put up more ecozones. Enter private developers who exhibited superior abilities as stated above. By transferring risks away from the government and into the private sector, ecozones in Region 4 have been a clear PEZA success.

Lopsided development

Replicating this success beyond Region 4 has, however, not been as easy. This is a reflection of the profound economic inadequacies in other regions. Inadequacies which other facets of the current system of incentives provision have tended to magnify.

Despite the generous perks government dangles to make investors bring their businesses to less developed areas, companies continue to cluster around areas that already had good infrastructure and skilled labor. Clustering goes a long way towards proving that investments are spurred more effectively by good infrastructure like access to seaports and airports, and skilled labor, than a whole slew of fiscal incentives be they income tax holiday, tax credits or the like. In other words, the reason for the clustering is that there are no funds to finance development, infrastructure, literacy and modernization in other regions. Redundant

incentives are playing a major role in depriving these regions of funds for development.

Cross-country studies show that the Philippines has not been doing well relative to its perceived competitors for investment in the region. Based on the World Competitiveness Yearbook, the Philippines has continued to lag behind its peers from 2000 to 2005. In terms of overall competitiveness, there is a clear and consistent separation between the Indonesia and the Philippines, and the group composed of Thailand, India, China, Malaysia, Hong Kong, Taiwan, and Singapore. India, in particular, has joined the group in the last two years. The 2005 WCY gave the Philippines lowest marks in human capital development, which refers, once again, to health and education.

Overall Country Competitiveness Rankings (World Competitiveness Yearbook)
(page 24 in the study)

Country	2001	2002	2003	2004	2005
Hong Kong	4	13	10	6	2
Singapore	3	8	4	2	3
Taiwan	16	20	17	12	11
Thailand	34	31	30	29	27
Malaysia	28	24	21	16	28
Taiwan	26	28	29	24	31
India	42	41	50	34	39
Philippines	39	40	49	52	49
Indonesia	46	47	57	58	59

Considering the insignificant role played by incentives in the location decisions made by investors, and given the current wide competitiveness gap between us and our neighbors. It is clear we will be excluded from the choice set of many investors, and no amount of incentive generosity will make up for deficiencies in investment drivers such as literacy and infrastructure (which our competitors have in greater abundance because of healthier fiscal positions). It is therefore time to be less myopic and think more long-term.

A deeper analysis of the data suggests that in general, redundant investments are those that are very large and concentrated in urbanized areas. Thus, while the burden of redundant incentives is shared by the general population, the beneficiaries of needless subsidies have tended to cluster in well-developed areas. True fiscal incentives reform, therefore, should lead to greater equity in the tax system and more equitable public financing of development in the long-run.

Unwieldy legal framework

As of this writing, there are nine laws that govern the country's system for fiscal incentives. There is a need to consolidate these into one law that recognizes the need to eliminate redundancy and improve monitoring of these incentives.

Details of Several Investment Laws

Law	Summary
Omnibus Investment Code of 1987 (Executive Order No. 226)	Provides the rules by which foreign investments may avail of incentives.
Foreign Investment Act of 1991 (Republic Act No. 7042) as amended by R.A. 8179	Governs the entry of foreign investments without incentives decreasing the minimum paid-in equity from $500,000 to $200,000.
Bases Conversion and Development Act of 1992 (R.A. 7227)	Provides for incentives to enterprises within the Subic Bay Freeport Zone.
The Special Economic Zone Act of 1995 (R.A. 7916)	Provides for incentives to enterprises within Special Economic Zones.
Export Development Act of 1994 (R.A. 7844)	Provides for incentives to exporting firms
Investors Lease Act (R.A. 7652)	Allows qualifying foreign investors to lease private lands for an initial period of up to 50 years renewable for up to 25 additional years
R.A. 7721	Eased the restrictions on the entry and operations of foreign banks
Amendment of the Build-Operate-Transfer Law (R.A. 7718, 1994)	Allows variations of scheme, eases restrictions on government financing and the setting of tolls and charges, and increases the opportunity for wholly foreign-owned corporations to undertake a project.
R.A. 7888	Allows the President of the Philippines to suspend the nationality requirements under the Omnibus Investments Code in the case of equity investments by multilateral financial institutions such as the International Finance Corporation and the Asian Development Bank

The ideal battle plan (A shopping list of recommendations)

For incentives, or any tax system for that matter, to be effective, they need to address three critical

factors. One, incentives should be effective in raising revenue. Two, they should be efficient in helping households and businesses plan their spending, and three, they should help distribute wealth fairly. Sadly, the study shows that the current system has failed on all counts.

From a foreign direct investment policy perspective, therefore, the Philippines' choices are whether to enhance the level of fiscal incentives to attract investments, to keep them at current levels, or reduce their scope. Given the growing disparities between the Philippines and its rivals for foreign capital, factors other than incentives are clearly the ones that will lead to greater competitiveness.

If the government is to solve this problem, it will have to make several painful decisions.

- Immediate reforms should include, among others, a decision to, at the very least, stop giving incentives through the BOI. This is not bound to be fun, given the Philippine business' resistance to removal of current investment perks.

  However, this painful decision can free up resources that can be spent for important social and economic projects. These funds can even be used more effectively by the Department of Trade and Industry itself in its investment promotion function.

- Grant incentives only to exporters, who will need tax and duty benefits to compete in foreign markets on the basis of cost. The economic benefits from exporting firms will far outweigh the cost of fiscal incentives.

- Streamline other incentives

- Enforce stricter screening and monitoring in other investment promotion agencies to prevent leakages

- Consolidate all incentives into a single law that recognizes the harm that comes from redundant incentives. Support current laws being proposed that are moving in this direction.

The overarching goal

Across classes, it is mostly investors that have benefited from the needless provision of fiscal incentives while the poor and middle-class taxpayers bear the onus of taxation.

In practice, the rationalization of fiscal incentives will by no means turn the Philippines into an Asian tiger overnight. But it will undoubtedly distribute gains to everyone in the long run: it will spread growth more evenly across the country, enhance the Philippines' competitiveness as an investment destination, and give non-exporting firms the wealthier market that they seek and need.

Truly, the rationalization of fiscal incentives ought to lighten the load for all.

Answers to issues raised by the Department of Finance

1. What should be the major objectives of the rationalization of incentives bill?
   a. *To reach the right group of investors. To improve overall equity in the tax system.*
   b. *To raise revenues properly and more equitably.*
   c. *To remove redundant incentives and raise revenues. To include some definition of redundancy into the resulting law.*
   d. *To have all incentives embodied in a single law which should simplify the framework for granting incentives*
   e. *To enforce stricter screening and monitoring of applicants and beneficiaries of incentives.*

2. Which investments should be

granted fiscal incentives? Should tax credits be included?

a. *Give incentives to exporting firms. Classifying investments by underlying motivation will also help in screening out redundant investments.*
b. *Provide incentives to those with high economic and social rates of return but low viability.*
c. *Maintain incentives to private ecozone developers, but be mindful that their capacity to attract investments is constrained by fundamental limitations like poor infrastructure and poor literacy rates.*

3. What are the criteria/ requirements/conditions for new investments? For expansion projects?

Limit special incentives to projects with high economic rates of return and a relatively low financial rate of return to screen out projects where incentives would be superfluous. Incentives should be limited to exporters.

4. Should incentives be based on location or on activity for BOI and ecozones?

a. *Incentives should be based on underlying investment motivation.*
b. *Criteria for registering investments should be simple, and easily verifiable both ex ante and ex post. The historical concentration of investments in the NCR, and regions 3, 4 and 7 is solid proof of the failure of a policy of incentives based on location.*

5. Should the grant of incentives be based on performance? If so, are there any exceptions? What, if any?

Monitoring results of registered investments on a regular basis could be costly, but necessary. At the very least, there should be strong incentives for firms to truly carry out their investment commitments.

6. Should incentives be time-bound or permanent?

Provided incentives are given only to exporting investors, there should be no problems in making them permanent.

7. Should BOI and ecozone incentives be equalized? Should incentives to ecozone locators be the same or different from those to non-ecozone locators? If yes or no, why?

a. *BOI and ecozone incentives should NOT be equalized, because BOI-registered firms are mostly non-exporting while*

PEZA investors are mostly exporting firms.

b. *IPAs need to ensure that ecozone locators are at least export-oriented.*

8. Or should a premium be given to zone locators?

   Provided they remain primarily exporters, their current premia should be retained but not increased.

9. Should the Philippines make its tax incentives at par with Asian neighbors?

   The current proposal by Dr. Felipe Medalla in a companion study is to eliminate the income tax holiday, and to instead offer generous net operating loss carryover provisions to beneficiaries, since NOLCO benefits cannot be claimed without first proof of actual investment.

10. Or should other factors be considered apart from regional competitiveness?

    Other factors, like infrastructure quality and quantity, functional literacy, and high real per capita GDP, appear to be even more important determinants of investments.

11. How can government operationalize a tax expenditure budget?

    This study estimates a tax expenditure budget per investment promotion agency.

12. As proposed in HB 3295, the BOI is both a policy-making body and an IPA. Is this an ideal structure?

    Based on initial results, the BOI's incentive-providing capacity should be severely limited, if not eliminated altogether. Revenues from the rationalization of fiscal incentives could go to improving efforts at investment promotion by PEZA and other IPAs.

13. At present, there is a proliferation of special laws granting incentives for investment in a number of industries – jewelry, agriculture/ fisheries, steel, etc. should their status be maintained, or should they be repealed and the incentives be placed under the ambit of the proposed omnibus investments law?

    The first best solution would be to consolidate all fiscal incentives provisions into one bill, to simplify the system and reduce redundancy.

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