Philippine fiscal Incentives: A Note on Design, Administration, and Context

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Introduction

The need to tighten the fiscal belt seems to be upon us once again. This year's fiscal deficit, initially targeted to be 3.2 percent (PhP250 billion or US$5.2 billion) of gross domestic product (GDP), will most probably surpass the 4 percent mark, a threshold the breaching of which has been linked to financial crises in the past. Fortunately, a number of factors discount the possibility of such a crisis. Particularly, the country's gross international reserves are at record levels, largely due to remittances from overseas Filipino workers, and have in turn enabled it to reduce external indebtedness.

This is not to say however that all is well. The main culprit behind the country's failing public finances is revenue collection (table 1). Particularly, the Bureau of Internal Revenue's (BIR) dismal collection performance dragged tax effort for the period of January 2009 to September 2009 down to 13.4 percent from an average of 14.1 percent over the previous three years (table 2).

The domestic economy has been on the brink of contraction, a result of the global slowdown that has pushed major economic players into simultaneous recession. The Philippines has avoided technical recession only because of government spending as embodied in this year's Economic Resiliency Plan (ERP), a PhP330-billion fiscal package geared towards stimulating the economy through a mix of government spending, tax cuts, and public-private partnership projects mostly in infrastructure. The virtues and failings of the ERP's design are beyond the scope of this paper, and the more important actual outcomes from the fiscal package have yet to be identified. It suffices to say however that given the awkward position that the domestic economy is in, and that 2010 is an election year, there is not much room to maneuver within government spending. As such, the need to collect revenues and raise funds in order to finance economic and social objectives in the coming year is of even greater importance today.

But that is not to say that the need to straighten government's finances is in response to an acute phenomenon that threatens only short-term goals. The national government's finances have been in chronic disarray, mainly due to a chronic inability to raise substantial tax revenues. With considerable difficulty on the revenue front and pressing commitments on the expenditure side, the prioritization of long-term economic and social objectives and the allocation of resources to finance such objectives have long suffered.

Among the countless recommendations for improved revenue collection[1] is the rationalization of fiscal incentives for investments. Not unlike many other economies, the Philippines grants effective subsidies to investors who meet certain eligibility criteria, usually pertaining to performance and location. These effective subsidies usually take the form of tax holidays and duty-free importation of raw materials and capital goods, and also include additional deductions for labor costs.

This paper aims to review the economic rationale behind investment incentives, particularly in the Philippine context, and formulate recommendations for future policy decisions that will hopefully enrich the discourse on the desirability of investment incentives. The following section focuses on the economic rationale for investment incentives. Afterwards, the structure of Philippine fiscal incentives is discussed. Two papers assessing Philippine fiscal incentives, Medalla (2006) and Reside (2006; 2007), are reviewed in detail. The conclusions contained in those papers regarding the overall efficacy of Philippine fiscal incentives are generally supported by this author. However, in an effort to enrich the ongoing discourse regarding rationalization of fiscal incentives, a review of strategic industrial promotion strategies employing such fiscal incentives is presented. The main idea of this paper is that while fiscal incentives, in their current design, administration, and context, may have proven to be of little value when it comes to encouraging investments, the notion of providing effective subsidies to worthy investors should not altogether be abandoned. Such fiscal incentives, if designed wisely, may in fact have an important role to play in the context of a broader framework of strategic industrial promotion. The concept of hierarchical investment preferences is discussed in brief, and how an effort to map out such preferences may prove to be a fruitful endeavor for future policy design. Finally, policy recommendations are set forth and future directions for research are suggested.

Fiscal Incentives and FDI: A Review

In 2001, a now-infamous bidding war for Canon Inc.'s proposed regional production facility took place between the Philippines and Vietnam. Because of a more aggressive fiscal incentive package, Vietnam won the bidding war, edging out the Philippines with an

[1] These include tax policy reform recommendations, such as the indexation of excise taxes, and improvements in tax administration.

additional two-year tax holiday.[2] By the following year, Canon Vietnam Co. Ltd. was established and had specialized in the production of bubble jet printers. By 2004, Canon Vietnam Co. Ltd. was producing 25 percent of Canon's total global production of bubble jet printers, was the largest exporter in Vietnam's capital Hanoi (representing 53 percent of the capital's foreign sector exports for that year), and posted earnings of more than US$200 million. Today, its 225,000-square-meter facility in the Thang Long Industrial Park in Hanoi is one of Canon's 16 manufacturing sites in East Asia outside Japan, none of which are located in the Philippines. The Philippines' consolation prize is that it became home to one of Canon's three research & development (R&D) facilities in Asia, specializing in the development of electronic application equipment and software.

The foregoing serves to demonstrate that the ultra-competitive contest for foreign direct investments (FDI) is a difficult game to play—a nation could very well be damned if they do and damned if they do not. The Philippines is one of a good number of countries that offer investment incentives in order to attract footloose investments. On the one hand, developing countries like the Philippines need to be able to mobilize as much public resources as possible in order to finance economic and social objectives such as health care and education. This means that tax holidays and other similar incentives come at a very high price for developing countries. On the other hand, as demonstrated by the Canon experience, there are indeed instances when aggressive fiscal incentives can tip the balance in favor of other, arguably similar economies.

Investment promotion strategies refer to the broad set of incentives that many countries now offer to attract investment, including specialist contacts and assistance, often through the investment promotion agency (IPA), streamlined bureaucracy, accelerated legal and administrative procedures (often also for customs procedures), tax rebates, planning permission and location incentives. Fiscal incentives are a popular package within countries' broader strategy.

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[2] Under the Philippines' Omnibus Investments Code of 1987 (OIC), "pioneer" firms can be granted a tax holiday up to a maximum of eight years. The OIC defines "pioneer" firms as follows.

ART. 17. Pioneer enterprise shall mean a registered enterprise (1) engaged in the manufacture, processing or production, and not merely in the assembly or packaging of goods, products, commodities or raw materials that have not been or are not being produced in the Philippines on a commercial scale of (2) which uses a design, formula, scheme, method, process or system of production or transformation of any element, substance or raw materials into another raw material or finished goods which is new and untried in the Philippines or (3) engaged in the pursuit of agricultural, forestry and mining activities and/or services including the industrial aspects of food processing whenever appropriate, pre-determined by the Board, in consultation with the appropriate Department, to be feasible and highly essential to the attainment of the national goal in relation to a declared specific national food and agricultural program for self sufficiency and other social benefits of the project or (4) which produces non-conventional fuels or manufactures equipment which utilize non-conventional sources of energy or uses or converts to coal or other non-conventional fuels or sources of energy in its production, manufacturing or processing operations

Behind this decided pursuit of FDI is the belief that investments, as a whole but particularly FDI, are the holy grail of sustainable growth and development. From the 1960s up to mid-1990s, the tigers of East Asia[3] posted phenomenally high rates of economic growth sustained throughout that period. Along with those growth rates, major improvements were achieved in health and education, and these served to produce higher per capita incomes and dramatic reductions in poverty incidence. At the heart of what has come to be known as the East Asian Miracle were record-high levels of investments, both foreign and domestic but mostly foreign, that enabled the region to integrate into the global economy. Taking advantage of relatively low labor costs and investor-friendly regimes, multinational corporations (MNCs) moved their production facilities to East Asia and transformed it into an international manufacturing haven. The region's exports surged as it started serving untapped foreign markets, and as job orders came in, production increased and new efficiencies were discovered. These in turn attracted even more foreign investments, and the virtuous cycle continued for many years.[4] Today, East Asia remains an attractive location for investors, and the East Asian Miracle continues to be a model of sustained economic growth and development that many developing countries still hope to emulate.

The most obvious potential benefit from successfully attracting investments is the capital that it provides. For many developing countries, capital is relatively scarce and the infusion of capital, especially from a foreign source, is more than welcome because it will require, among others, complementary labor, thus creating employment, another problematic area for many developing countries. More important than the obvious answer however is that FDI embodies technologies, knowledge, and know-how, to which developing countries would not have access otherwise. These new technologies and skills have the potential to spill over to domestic firms, spurring innovation and furthering technological advancement. Moreover, FDI has the potential to provide effective competition to domestic firms as they compete with MNCs not only for resources (e.g. labor, capital, raw materials) but also in the markets for final goods and services. Competitive outcomes therefore become closer to a developing country's reality. Finally, the formation of linkages with upstream and downstream industries will allow domestic firms to tap foreign markets and achieve productive efficiencies that would have otherwise been impossible had they been confined to their own domestic market.

The need and rationale for government intervention in attracting investments is that economies have much to benefit potentially from investments, especially FDI, and the total potential benefits are far greater that what is privately appropriable in the eyes of the MNC.

[3] Namely Hong Kong, South Korea, Thailand, Malaysia, Singapore, and, to some extent, Indonesia.

[4] The region was plunged into a crisis in 1997-98 that saw the region's exchange rates dropping, export volumes shrinking, and growth rates running negative. The general consensus now is that the crisis was due to the more volatile and less productive short-term capital flows and not FDI. Most of the economies recovered a few years after the East Asian Crisis.

In other words, the incentives that governments offer to investments are direct transfers of welfare from the public sector to the investors as some form of payment for the perceived public benefits that MNCs bring. Quite simply, governments are trying to address a market failure.

Fiscal incentives are a vital component of many governments' investment promotion strategies. Fiscal incentives can be designed to offset unintended and undesirable effects of indispensable government policies. Duties on imported goods, for example, are a relatively easy way of raising revenue, especially for developing countries. They also serve to protect, to some degree, local industries from foreign competition by raising the domestic market price of imported goods. However, in the case of the Philippines, such duties and tariffs makes exporters less competitive because most Philippine exports are made using a significant percentage of imported inputs.[5] This side-effect of tariffs bears on both local and foreign investors who cater to export markets. As such, an exemption on import duties for preferred investors can help to offset (albeit partially) this unintended bias against exports.

Finally, there is evidence to suggest that fiscal incentives to investments can serve as good signals to investors as to which countries are "investor-friendly." It has been found that when other factors — such as infrastructure, transport costs, and political and economic stability, now collectively known as investment climate — are more or less equal between two or even more locations, the taxes in one location may have a significant effect on investors' choices. This is perhaps what best describes the outcome of the 2001 Canon Inc. example earlier cited.

Fiscal incentives to investments however are not without cost. The most obvious cost would be forgone revenue. But if fiscal incentives are properly designed and administered and are ultimately able to achieve the ends for which they were created, then those forgone revenues shall have been offset by the expanded tax base that those investments have created. The ideal is to forgo revenue today in order to encourage investments that will in turn spur employment, exports, upstream and downstream linkages, and economic growth, which all in all will provide government a wider array of economic activities that it can tax. However, if those fiscal incentives are ill-designed or improperly administered, then the country will find no future economic activity to offset the forgone revenue. For example, income tax holidays are the most common and easiest tax incentive to grant to investors. For a pre-specified period of time, investors in preferred industries shall be exempt from any national income tax obligations it may have. This affords the investor some allowance when it comes to start-up profitability requirements in the first few years of the firm's life, as well as the ability to plow back its earnings into even more investments later on. However, because

[5] This is why a drop in import volumes can be very worrisome for the Philippines. While such a decrease represents a short-term let-up of demand for foreign currency (something that was a frequent problem for the country in its pre-OFW era), it also represents a future drop in dollar earnings.

income tax holidays benefit business ventures that are already profitable, there is the question as to whether income tax holidays, to begin with, are really necessary.

The exemption of preferred investments from certain taxes also suffers from that same weakness that all selective policies do, and that is arbitrage. If one investor for example operates two businesses, one of which is within a preferred industry, then only very meticulous regulatory audit procedures (with accompanying severe punishments) can prevent the transfer of expenses from one firm to another in other to minimize the investor's payable tax. The same is true in the case of firms' imported inputs.

Finally and perhaps most fundamentally, there is question as to whether fiscal incentives are even appropriate in the particular context of the Philippines. There are generally two strands in this line of thinking. The first strand is a question of policy choice. It argues that the Philippines needs to prioritize investment climate issues over the provision of fiscal incentives. The standard location decision-making model of the firm is a two-stage game where in the first stage, the firm "short-lists" desirable locations for its investment. The desirability of one location is a factor of numerous elements relating to investment climate. In the second stage of the game, the firm then evaluates its shortlisted locations based on its fiscal incentive package. Critics of the Philippines' fiscal incentives package assert that there is much more to be gained in focusing on the first stage of the game, rather than trying to win the game via an attractive investment incentive package.[6] Viewed from this perspective, it makes sense that even though incentives abound in the Philippines, the country has never enjoyed the high levels of investments (both domestic and FDI) that its neighboring countries have. The second strand in this argument is a question of administration. Because investment incentives are by nature selective, it opens government agencies and authorities to lobbying and corruption. Unless there is a credible and consistent system to penalize offenders, the fiscal incentives can end up robbing government of valuable tax revenue while enriching private pockets.[7]

Given the arguments both in support of and against fiscal incentives, the important question to ask is whether the cost of fiscal incentives, given their strengths and weaknesses, are outweighed not just by the <u>potential</u> benefits of successfully attracting investments but by the <u>actual</u> benefits that economies reap. Do fiscal incentives finance themselves? A universal answer to a question that is so severely dependent on individual economic contexts would most certainly be off-the-mark and downright careless. To be more precise, in its current design, administration, and context, are the Philippine fiscal incentives cost-effective?

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[6] Of course there is also a very ideological slant to this line of reasoning because addressing investment climate issues is always generic (it benefits all investors), while investment incentives are by nature selective.

[7] This line of argument however can be made for almost every kind of law or regulation in a corruption-ridden setting. A comment on this perspective will be made in later parts of the paper.

Fiscal incentives in the Philippines

There are numerous are numerous laws that detail the various incentives, both fiscal and non-fiscal, that can be enjoyed by investors in the Philippines. The foundation for all of these incentives however can be found in two key laws: the Omnibus Investments Code (OIC) of 1987, also known as Executive Order 226, and the Special Economic Zones Act of 1995. The main features of these two laws are briefly discussed below.

A. Omnibus Investment Code of 1987 (Executive Order 226, as amended)

The OIC's main objective is to encourage private foreign and domestic investments in various sectors of the economy in order to accelerate the development of the national economy. The Declaration of Investment Policies states (emphasis added):

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> "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* and in pursuance of a *planned economically feasible and practical dispersal of industries* and the *promotion of small and medium scale industries,* under conditions which will *encourage competition and discourage monopolies,* the following are declared policies of the State:
>
> 1. The State shall encourage *private Filipino and foreign investments* … which shall:
>
> - provide significant employment opportunities relative to the amount of the capital being invested;
> - increase productivity of the land, minerals, forestry, aquatic and other resources of the country, and improve utilization of the products thereof [and] improve technical skills of the people employed in the enterprise;
> - provide a foundation for the future development of the economy;
> - meet the tests of international competitiveness;
> - accelerate development of less developed regions of the country; and
> - result in increased volume and value of exports for the economy. (bullets added by author)
>
> …

> 3. The State shall extend to projects which will significantly contribute to the attainment of these objectives, *fiscal incentives without which said projects may not be established in the locales, number and/or pace required for optimum national economic development.* Fiscal incentive systems shall be devised to
>
> - compensate for market imperfections,
> - reward performance contributing to economic development,
> - be cost-efficient and
> - be simple to administer."

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The highlighted portions of the quoted text bear repeating. The social values that motivated the enactment of the OIC were economic nationalism, geographic dispersion of industries, the importance of small and medium enterprises (SMEs), and competition. Moreover, in its guidelines for the design of incentives for investments, the OIC specifies that fiscal incentives be on offer as compensation for market imperfections that have previously been discussed and as a reward for performance contributing to economic development. Finally, these incentives shall be available to both foreign and domestic investors.

The general incentive provisions of the OIC (and subsequent amendments thereto) can be found in table 3.

In terms of economic philosophy, the OIC is very much *laissez faire*-oriented, at least on paper. To quote (emphasis added):

> "ART. 28. Criteria in Investment Priority Determination. - No economic activity shall be included in the Investment Priorities Plan unless it is shown to be economically, technically and financially sound after thorough investigation and analysis by the Board.
>
> The determination of preferred areas of investment to be listed in the Investment Priorities Plan shall be based on *long-run comparative advantage,* taking into account the value of social objectives and employing economic criteria along with market, technical; and financial analyses."

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The idea that investments must be encouraged but only when it is in line with a country's comparative advantage, from where ever that advantage may emanate, was a widely-held view in the 1980s. Comparative advantage is a largely static concept that refers to the ability of one economy (usually contained in a nation-state), endowed with resources and technology, to produce some Good A at relatively lower opportunity cost than other economies. Conversely, other economies would be able to produce other goods at lower opportunity cost and as such, inter-economy trade would prove to be beneficial to all economies concerned. It is a static concept because in standard economic theory, comparative advantages are given, and it is in an economy's best interest to simply accept it and "go with the flow," so to speak. This perspective was very popular in the 1980s, especially as the failures of past import-substitution industrialization (ISI) schemes became very evident in many developing countries during that decade. The Philippines was not spared from the failings of ISI, and the OIC's provisions regarding comparative advantage reflect the almost knee-jerk resolve to rely solely on the free market.

Finally, it must be noted that the OIC was also widely held as the triumph of local industry lobby groups. Domestic capital that had been well-entrenched in their respective industries lobbied long and hard so that they would be treated no less than their international counterparts. In the end, the resulting OIC does not distinguish between foreign and domestic capital, thus clouding the economic rationale for providing incentives to investments.

B. Special Economic Zone Act of 1995

The Special Economic Zone Act of 1995 established the Philippine Economic Zone Authority (PEZA) and thus became more commonly known as the PEZA law. It was a clear effort at making a better distinction between local investors and foreign investors, an assertion of the importance of gaining access to foreign markets as opposed to being confined to domestic ones while using local endowments, and a stronger push towards geographical dispersion of industries with effective linkages to local resource markets. To quote the PEZA law (emphasis added):

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> SECTION 2. Declaration of Policy. - It is the declared policy of the government to translate into practical realities the following State policies and mandates in the 1987 Constitution, namely:
>
> a)"The State recognizes the indispensable role of the private sector, encourages private enterprise, and provides incentives to needed investments." (Sec. 20, Atr. II)

> b)"The State shall *promote the preferential use of Filipino labor, domestic materials and locally produced goods*, and *adopt measures that help make them competitive*." (Sec. 12, Art. XII)
>
> In pursuance of these policies, the government shall *actively encourage, promote, induce and accelerate a sound and balanced industrial, economic and social development of the country* in order to (bullets added)
>
> - provide jobs to the people especially those in the rural areas,
> - increase their productivity and their individual and family income, and
> - thereby improve the level and quality of their living condition
>
> through the establishment, among others, of special economic zones in suitable and strategic locations in the country and through measures that shall effectively attract legitimate and productive foreign investments.

The incentive provisions of the PEZA law are as follows:

> 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 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.

Like the earlier OIC, the PEZA law is reflective of the prevailing economic philosophy at the time of its crafting. In the 1990s, the East Asian Tigers were the epitome of sound growth and development policies. As will be discussed in greater detail later on, the East Asian model represents a more strategic and more dynamic concept of “comparative” advantage which has come to be known as competitive advantage. What East Asia proves is that relative advantages in production can be created, nurtured, and built up through a strategic industrial promotion strategy. This is radically different from the static concept of comparative advantage and its prescriptions of ultimate reliance on the free market.

Review of Literature on Fiscal Incentives Structure

There have been efforts to consolidate and rationalize the various investment incentive schemes in the Philippines. The efforts have largely been in reaction to 1) the fiscal crunch in which the country perennially finds itself, and 2) the emergence of a number of studies that have concluded that fiscal incentives to investments, in their current design and application in the Philippines, have been ineffectual at attracting foreign investments and very costly in terms of forgone revenues. Of the numerous studies that have been conducted, two papers that present the most rigorous and comprehensive analyses of Philippine fiscal incentives shall be discussed here. Both papers were completed in 2006 as part of the Economic Policy Reform and Advocacy (EPRA) project of the Ateneo Center for Economic Research and Development (ACERD).

C. "On the Rationalization of Fiscal Incentives" by Felipe Medalla (2006)

Medalla (2006) classifies registered investments (*I*), or those that are granted income tax holidays, into three categories:

- R = investments that are granted "redundant" incentives, or those investments that would have been made anyway even if there were no investment incentives,

- A = investments that would have gone to alternative domestic projects that investors would have preferred in the absence of the income tax holiday, i.e. incentives divert investment away from tax-paying sectors into non-tax-paying ones. This represents a *change in the composition* of the investment pool, rather than an *increase in the size* of the pool, and

- N = new and additional investments that were drawn in by the income tax holiday.

Designating t as the effective income tax rate, i as the taxable income per peso of investments, I_{min} as those investments subject to tax (i.e. if government sets some performance target above which the investor can avail of the income tax holiday), Medalla (2006) presents the revenue loss of income tax holidays as

$$\text{ITH Revenue Loss} = ti(R - I_{min}) + t_a i_a A$$

In the case of the Philippines, $I_{min} = 0$ as the government did not set any performance targets in any of the preferred industries. The equation then for the Philippines can be simplified as

$$\text{ITH Revenue Loss} = tiR + t_a i_a A$$

Note that government forgoes no revenue in the case of N investments. The forgone revenue stems from two avenues – via redundant incentives R and via the change in the composition of the investment pool. Medalla (2006) notes that the second avenue is a reasonable trade-off that government can make if investments in preferred areas indeed generate more positive externalities than those in non-preferred sectors. Assuming uniform tax rates and rates of return to investments, the equation can be simplified further to

$$ti(R + A)$$

which, using Medalla (2006)'s earlier classification of investments $I = R + A + N$, can then be expressed as

$$ti(R + A) = ti(I - N).$$

This equation then tells us that the revenue loss is high if redundancy is high and if incentives only change the composition of the investment pool rather than increase its size. While coming up with an estimation for revenue losses is tenuous and difficult[8], Medalla (2006) points out that estimation of social losses can be even more problematic. The translation of revenue loss into social cost requires a framework that will estimate how much one peso of forgone income costs government. A more inefficient tax and legal system corresponds to a higher marginal cost of public funds. In other words, for every peso of forgone income from a relatively easy-to-collect source (i.e. firm income), government will have to spend more than one peso to recover that same peso from private hands, thus inflicting a social net cost to society. Medalla (2006) qualifies however that

> "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 income tax holidays 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."

[8] Among the many issues involved, the most significant hurdle is the availability of data.

Meanwhile, on the benefits side, the incentives that do achieve its objectives are able to attract new investments that would have not materialized had there been no incentives --- those investments denoted by *N*. These new investments generate externalities that Medalla (2006) denotes as e, assumed to be percentage of total investment A. Moreover, investments that have been diverted into the preferred sectors from non-preferred sectors also generate positive externalities. Because these same investments would have generated externalities as well had they gone to non-preferred sectors, denoted by e_A, the net externality generated by A is

$$(e - e_A)A$$

Thus, the total benefit of income tax holidays is then

$$eN + (e - e_A)A = e(N + A) - e_A A$$

As such, the social benefit of income tax holidays depends on it efficacy in attracting new investments and on the incremental externality generated by attracting investments from non-preferred sectors into preferred ones.[9]

Finally, Medalla (2006) formalizes the benefit-cost ratio of income tax holidays.

$$\text{Benefit Cost Ratio} = \frac{e(N + A) - e_A A}{ti(R + A)} = \frac{e(N + A) - e_A A}{ti(I - N)}$$

With the additional assumption that A investments generate the same externalities which ever sector they choose, i.e. $(e - e_A) = 0$, then we have

$$\text{Benefit Cost Ratio} = \frac{e(N)}{ti(I - N)}$$

The benefit cost ratio of income tax holidays is directly proportionate to the positive externalities that investments generate and to the ratio $\frac{N}{I-N}$.

Medalla (2006) argues that in the case of income tax holidays, the benefit cost ratio is unlikely to be large. Income tax holidays cannot make unprofitable activities profitable. In fact, they only benefit activities that are already profitable. If those activities are profitable but only marginally so, then income tax holidays would be a very helpful incentive to offer. However, in the case of activities that are at least moderately profitable, then income tax holidays would most certainly be redundant because those investments would have been made anyway. In the case however that

[9] Note that $(e - e_A)A$ could very well be negative, particularly in the case where government chooses a "wrong" industry to support. This is the standard argument against strategic industrial policy – governments know no better than markets, thus markets should be left alone.

the Philippines has to compete with neighboring countries with similar cost structures and investment climate,[10] then income tax holidays could very well tip the balance favorably towards the Philippines. The problem though is that those competing countries may very well offer income tax holidays as well, and may actually be better able to afford it. However, Medalla (2006) concludes that this is the only case when income tax holidays are socially beneficial and therefore justifiable.

To summarize, Medalla (2006)'s analysis of the BOI's fiscal incentive scheme is found in table 4.

Medalla (2006)'s main policy prescription is to eliminate income tax holidays altogether, and to instead offer generous net operating loss carryover (NOLCO) provisions to beneficiaries of incentives. This would have the effect of strengthening inducements for actual investment, since NOLCO benefits cannot be claimed without first proof of actual investment. This will also enable IPAs such as the BOI and PEZA to monitor investors' compliance.

D. "Towards Rational fiscal Incentives: Good Investments or Wasted Gifts?" by Renato Reside (2006)

The Reside paper is by far the most comprehensive and exhaustive study conducted on the current structure of Philippine fiscal incentives. This paper has served as guide to many discussions on and debates about investment policy reforms in the Legislative Department.

Reside (2006) estimates the incentive redundancy rate in the Philippines using mainly three methods, with a fourth one to validate previous results. These are:

- Inferring redundancy through an examination of the correlation between the value of investment approvals and subsequent real gross capital formation. The test tries to determine whether investment commitments are subsequently carried out by registered firms.

- Inferring redundancy through an examination of the process by which investment promotion agencies screen and approve project proposals. This method examines screening and approval procedures at investment promotion agencies (IPAs) in order to determine whether leakages can occur.

- Developing a theory of investment motivation to determine investor sensitivity to fiscal incentives. This method estimates the redundancy rate by using criteria based on investment motives to isolate those investors thought to be most sensitive to fiscal incentives. and

[10] As in the two-stage game earlier discussed.

- Using regression analysis applied to the theory of investment location. This method attempts to statistically estimate the sensitivity of investment flows to incentives and is conducted in order to validate the results of the previous three methods.

1. Cross-region Correlation between Investment Approvals and Real Gross Capital formation

The cross-region correlation exercise reveals the following:

- There is medium to strong positive correlation between real gross fixed capital formation and current and lagged PEZA investment approvals in Region 4. There is weak correlation between real gross fixed capital formation and current and lagged PEZA investment approvals in Regions 3 and 7. There is no correlation between real gross fixed capital formation and current and lagged PEZA investment approvals in Region 1; and
- There is little or no correlation between real gross fixed capital formation and lagged BOI investment approvals in any region.

These results suggest that PEZA-registered investors have fulfilled their ex ante investment commitments to a greater extent than BOI-registered investors. The results in this section call into question the ability of the BOI to fulfill its mandate for dispersal and redistribution, goals all explicitly mentioned in the OIC. These results also point to widespread abuse of fiscal incentive privileges offered by the BOI, a significant amount of tax avoidance, and leakages. Reside (2006) concludes that this further reinforces the notion that the fiscal costs of fiscal incentives are high.

2. Evaluation of Investment Screening and Approvals Criteria

One of the criteria for investments approval is financial viability. IPAs typically evaluate project cash flows to ensure that investment activities are at least marginally profitable. Reside (2006)'s interviews with BOI officials however yield the interesting (though anecdotal) result that around 95% projects submitted for approval of the BOI generate a financial rate of return of 15% or greater prior to the application of incentives. It therefore follows that most projects would have been viable from an ex ante standpoint even without the provision of incentives. The current screening structure favors investments that are already financially viable without incentives. Approved investments enjoy incentives not in spite of demonstrated financial viability but rather because of it. The logical conclusion then is that redundancy of fiscal incentives is actually reinforced by the screening and approval procedure of investment promotion agencies.

3. Estimating Incentive-Sensitivity of Investments

Given that there seems to exist a very high tendency to provide incentives to investments that are already profitable to begin with, Reside (2006) then asks whether there is any sense, on economic grounds, in providing incentives to such investment activities. Reside (2006) asserts that there are three circumstances under which providing incentives to profitable activities can be justifiable. These are:

- if investors are sufficiently mobile to be able to extract even better terms from other jurisdictions;
- if the investors' primary motivation for investment is to compete in foreign export markets against exports from third countries. In this case, reducing unit costs of output production (perhaps adjusted for productivity of labor) will tend to be very important; and
- if the social benefits and spillovers from the investment far outweigh the costs of providing incentives.

Based on these three circumstances, Reside (2006) infers that providing incentives to investments geared towards the domestic market will be hard to justify. As such, the rate of redundancy shall be positively correlated to the proportion on non-exporting investments that are approved by investment promotion agencies. By its mandate, PEZA's approved investments are export-oriented and therefore, at least based on this method of estimation, PEZA's redundancy rate could be low. However, most of BOI's approved investments cater to the domestic market. This points to the possibility of a very high redundancy rate for BOI.

4. Reside (2006)'s Conclusions

The most important results of Reside (2006)'s extensive regression analyses are enumerated below.

- The provision of fiscal incentives is very costly and there is limited evidence of their efficacy in inducing investment across countries. Lagged regional BOI investments exhibited very low correlations with regional gross domestic capital formation, strongly suggesting that committed investments to the BOI did not materialize and casting serious doubt on BOI's ability to induce investment dispersal.

- In the BOI's case, the estimated fiscal cost of redundant incentives is very close to 1% of 2004 GDP - a reflection of the mostly domestic market (non-exporting) orientation of their registered investments.

- PEZA incentives have a much lower redundancy rate largely because they target exports. Reside (2006)'s estimates of PEZA's net benefit however are very sensitive to the redundancy rate. This highlights the need for tight investment screening, monitoring and controls at the PEZA.

- The power of incentives is of secondary importance relative to other, more potent inducers of investment. By and large, the primary factors inducing investment in the Philippines are 1) a vibrant regional domestic economy, 2) a well-educated work force, and 3) good regional infrastructure. Variables used as proxies for the generosity of Philippines fiscal incentives are generally statistically insignificant, or tend to reflect the three factors mentioned above.

- PEZA incentives have experienced limited success in attracting investments into locations beyond NCR and Regions 3, 4 and 7. This is a reflection of profound economic inadequacies in other regions. These are inadequacies which other facets of the current system of incentives provision have tended to magnify.

5. Policy Prescriptions

- Fine tune the targeting of investors. Reside (2006) suggests the use of underlying investment motivation, since classifying investments by such may shed light on the extent to which investors value fiscal incentives as an inducement for investment.

- Eliminate redundant incentives and (?) this way, to raise necessary revenues. Special incentives should be limited to projects with high economic rates of return and a relatively low financial rate of return.

- Consolidate all incentives into a single law in order to simplify the framework for granting incentives.

- Enforce stricter screening and monitoring of applicants for and beneficiaries of incentives.

- Monitoring *ex post* 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.

- The historical concentration of investments in NCR, and regions 3, 4 and 7 is solid proof of the failure of a policy of incentives based on location. Based on the results of this study, the most important locational domestic determinants of investment are: infrastructure quality and quantity.

- 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

E. A Waste of Resources

Both Medalla (2006) and Reside (2006), along with others who have conducted their own analyses, conclude that in its current design, administration, and context, Philippine fiscal incentives to investments have been ineffectual at achieving its primary goal of attracting investments that might not have been made had there been no fiscal incentive scheme in place and costly in terms of forgone revenue. Many of the incentives are redundant and have only been taken advantage of mostly by those who cater to the domestic market. Save for PEZA's success in a handful of regions, regional locator incentives have also failed to disperse investments across the country.

Policy Recommendations and Reform Proposals

Throughout the course of this paper, the phrase "Philippine fiscal incentives in its *current design*, *administration*, *and context*" has been repeated a number of times. The emphasis is important, and the qualification regarding the current design, administration, and context of Philippine fiscal incentives is deliberate.

F. Incentive Design

Several recommendations regarding fiscal incentive design have been proposed, and there are a good number that make sense. The more crucial ones are highlighted here.

The policy of granting income tax holidays should be carefully examined. From past experience, income tax holidays do factor into investors' decision-making. It is clear however that income tax holidays only serve to benefit investments that are already profitable in the first place, and investments with higher profitability serve to gain more from such absolute income tax holidays. More crucially, the income tax holiday will be inutile to a socially desirable but privately unprofitable investment. Moreover, corporate income taxes are a relatively easy way to raise public revenue. As such, income tax holidays are an expensive way to attract investments, particularly those that would have occurred even in the absence of such concessions (because they would have been profitable anyway). But income tax holidays do attract new investments and can serve the purpose for which they were designed. The complete elimination of income tax holidays could prove to be even more costly than in its current design because the country would miss out on those new investments. One possibility then is to impose a performance threshold for preferred investments. The income tax holiday can apply to a pre-specified rate of return, above which profits will be taxed. Medalla (2006) proposes a lower income tax rate concession to exporters, along with a longer net operating loss carry-over (NOLCO) provision, which he deems will be more cost-effective than the income tax holiday.[11] The NOLCO will also be much more attractive to socially-desirable-but-privately-unprofitable investment projects because the NOLCO can turn a project's profitability around. The proper administration of such concessions will be the burden of the tax authority, and many may object to this based on the belief that the Bureau of Internal Revenue (BIR) will be too compromised to carry out its mandate. Another objection might be that such a policy will be open to tax arbitrage and avoidance. These objections regarding administration will be discussed in the next section.

The elimination of incentives for non-exporting producers should also be seriously considered. Reside (2006) proposes that,

> "The provision of fiscal incentives to non-exporting investments, who will mostly be reliant on the Philippines market for sales, AND who will earn above average to very high returns will by and large be redundant. One proposed rule of thumb for redundancy: it is roughly equivalent to the proportion of registered non-exporting enterprises to total registered enterprises."

Duty-free importation of raw materials and capital goods for exporters, with the usual qualifications regarding local unavailability of suitable substitutes, should not be eliminated. This raises the effective rate of protection for exports and helps them become more competitive in export markets.

Finally, it is clear that investment incentives should be consolidated under a single law for ease of understanding and administration. The country's tax laws are begging

[11] Medalla (2006) says,

> "If the choice is between ITH (income tax holiday) 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. Morever, the ITH is unlikely to attract industries that are unprofitable in the short or medium run but are profitable in the long run."

for an update, and it is fortunate that a good number of bills have been filed in Congress precisely to address this problem. It is important to emphasize that a periodic review of incentives granted to investments should be a built-in provision in the new law, rather than just a knee-jerk reaction to some unintended consequence (which is what we have now). Each individual incentive granted may make sense at the time of it crafting, but over time, the cumulative effect of all the incentives offered might become too costly or counter-productive by giving investors an incentive to delay investments until they can obtain concessions. Authorities offering incentives to attract investment must periodically evaluate their relevance, appropriateness and economic benefits against their budgetary and other costs, including the long-term impact on resource allocation. A built-in review can allow for a more dynamic policy environment that will be responsive to new challenges in the economic landscape.

G. Administration of Fiscal Incentives

Although economic theory is replete with arguments justifying the employ of fiscal incentives and those against it, theory is silent when it comes to administration of such incentives. Furthermore, while many studies have focused on which incentives are most appropriate in the Philippine setting, only a few have discussed the issues regarding the institutions that govern and implement these incentives. Reside (2006) proposed the complete abolition of BOI's incentive-granting authority and stronger coordination between and among the various IPAs in the Philippines. The previous proposal requires a good amount of scrutiny, but it is clear from the outset that his latter proposal will prove beneficial.[12] There are also proposals to consolidate the tasks of approving investments and granting incentives under one umbrella agency in order to ensure that goals are consistent and mandates do not overlap.

It bears pointing out however that the granting of incentives is not and should not be the sole mandate of a well-designed IPA. In various publications of the United Nations Conference on Trade and Development (UNCTAD), four core IPA functions are highlighted: 1) investment climate promotion or investment image marketing, 2) investment project attraction, or the granting of investment incentives, 3) investment facilitation, and 4) aftercare. Emphasis on these four functions vary greatly across IPAs in other countries, but the key to successful investment promotion is an IPA's ability to recognize the investors' stage of decision-making and to tailor its campaign accordingly, since different promotional activities are more effective at different stages of the investment decision-making process. As potential investors first show signs of awareness and interest, building a positive reputation for the local investment climate must be the priority. Then, as the interest narrows down to specific ventures,

[12] Anecdotal evidence suggests that the relationship between the BOI and the PEZA is by and large competitive in nature, rather than cooperative and collaborative. Clearly, this cannot be good for investment promotion.

the IPA can focus on investment projects attraction in order to trigger the actual investment action. Once the investors have made a positive and definite decision, the IPA should facilitate both the entry requirements and the longer-term stay.[13]

The term "aftercare" deserves much emphasis. Until recently, many IPAs did not even bother to monitor investor compliance to investment promises made upon entry. This has made the evaluation of the efficacy of investment incentives very difficult. With only ex ante data on approved investments available, the task of establishing a causal relationship, even partially, between the investment incentives and actual investment decisions is rendered impossible. The notion of aftercare however emphasizes that IPAs should be tasked with, among others, ensuring that investment promises are delivered upon, and incentives such as income tax holidays should be made conditional on delivering on such promises. This means that IPAs should be tasked and authorized to monitor investors even after they have entered the country. But over and beyond simple monitoring, aftercare is defined as "comprising all potential services offered at the company level by Governments and their agencies, designed to facilitate both the successful start-up and the continuing development of a foreign affiliate in a host country or region with a view towards maximizing its contribution to the local economic development" (Young and Hood 1994). This encompasses both post-establishment facilitation services and development support activities aimed at promoting follow-on investments. Aftercare activities are becoming more and more important in the context of already-established FDIs who might be looking to reinvest their earnings, make new investments to increase capacities (sequential investments), and / or whose suppliers are looking to invest in a location in close proximity to their client (associated investments). The UNCTAD estimates that there are periods in which for certain regions, up to 70 percent of investment is linked to the existing investment base. This is especially true for developed countries, and it is possible that developing countries have only to realize the importance of aftercare in order to take advantage of this trend.

Specifically within the notion of aftercare is linkage promotion. Governments often adopt proactive policies to foster greater linkages, particularly by assisting local firms wishing to supply the foreign investor. These policies are especially helpful to harness the potential of local SMEs, who account for an overwhelming portion of the business population and face greater problems establishing linkages. Efforts to improve linkages can include linkage requirements, targeted approaches such as encouraging large investors to purchase from local suppliers or encouraging small local business to

[13] Obviously, IPAs will not be dealing with investors that are all at the same investment decision stage. The most successful IPAs are those which effectively utilize their resources to focus on the activity corresponding to the decision-making stage of the majority of their potential "customers."

cooperate in order to fill the demands of large investors via local small business supply chains, and other matchmaking services.

H. Context

While many authors have bemoaned the problems with the design of Philippine fiscal incentives, and a good number (although less than the previous group) have also pointed out the problems of administration, very few have emphasized the problem of context. Of course many have emphasized the importance of investment climate[14], or the multitude of factors that are primarily considered in an investor's decision-making process, and a number of critically important elements of the investment climate will be discussed below. These can be considered the broader economic context within which investment incentives operate. However, investment incentives should also be seen as operating within a broader policy context, particularly a broader industrial promotion strategy.

1. Economic Context: Investment Climate

It is clear, especially in the case of the Philippines, that offering financial and other incentives to attract foreign investors is not a substitute for pursuing policy measures that create a sound investment environment for domestic and foreign investors.

In a 2007 publication entitled "Philippines: Critical Development Constraints," the Asian Development Bank identified two critical constraints to growth in the country, one of which has important implications for the current discussion. Particularly, the ADB identified uncertainty in the private appropriability of returns to investments as one of the most crucial reasons why investments have remained so low in the country.[15] This uncertainty stems from two levels of risk, namely macroeconomic risk and microeconomic risk. Macroeconomic risk mostly refers to the high probability and frequency of economic crisis, often leading to capital flight, currency depreciation, and economic recessions, with all three forming a vicious cycle. Despite some improvement in the past decade, macroeconomic instability has remained a key investor concern. The Philippines' weak fiscal position has always been a critical constraint, and that it is due to weak revenue collection (as opposed to extravagant spending) is an even greater cause for concern. Government revenue to gross domestic product ratio has been the lowest in East and

[14] The World Bank says, "The investment climate reflects the many location-specific factors that shape the opportunities and incentives for firms to invest productively, create jobs, and expand. ... A good investment climate improves outcomes for society as a whole."

[15] Since the 1990s, Philippine investment rate has lagged behind its neighbors. In 2006, the share of gross domestic investment in GDP was at its lowest level since the East Asian Crisis of 1997.

Southeast Asia since 2001, and tax effort has had a problematic record in the past decade. This puts the country in an unenviable position. On one hand, current fiscal incentives have failed to attract large investments while imposing a costly burden on their revenue collection efforts. On the other hand, the failure in enhancing revenue collection has been one of the main reasons why investors are staying away. Indeed, this should fuel efforts to rationalize fiscal incentives.

On the micro level, poor governance is a credible threat to appropriability of private gains from investments and a critical constraint to investment and growth. Regression analysis shows that corruption, political instability and weak rule of law have had significant negative effects on investments and are particularly problematic areas for the Philippines. Cumbersome business procedures and over-regulation were also identified as critical constraints, along with contract enforcement and property rights.

The absence of sufficient and good quality infrastructure was also identified as a critical constraint to growth. The low levels of investment in and poor quality of infrastructure in the Philippines have increased the cost of doing business in the country and have adversely affected its perceived competitiveness. The increased cost of doing business and the inability to attract more foreign investments have constrained growth at both national and sub-national levels. Empirical testing shows a robust relationship between economic growth and infrastructure in the Philippines and that the causality from infrastructure to economic growth is highly significant. Within infrastructure, expensive and unreliable electric supply and inefficient transport networks are the two most critical constraints to growth.

2. Policy Context: Strategic Industrial Policy

The idea that we can completely abandon efforts at promoting investments by eliminating fiscal incentives altogether is naïve. That road will prove to be much more costly than the one we are on right now. However, while providing fiscal incentives is a necessary condition to attract investments, it is by no means sufficient to do so. More importantly, it is insufficient to allow society to reap the benefits of however little investments the country successfully attracts. Fiscal incentives need to be contextualized in a larger framework that promotes investments, employment, industry, structural change, learning, technological absorption, and all the other nice things we hope to get from FDI.

At the outset, it must be stated clearly and plainly that investment promotion is industrial policy. So is export promotion. Industrial policy has become the four-letter word in economic circles because of the failed import-substitution industrialization experience of many countries and because of the strong neoliberal sway in policy circles. However, as has been already stated, investment promotion is industrial policy. It is deemed to be more market-friendly and less reliant on government's prescience, but it is nonetheless industrial policy.

In a plea to "normalize" industrial policy, Rodrik (2007) said it best.[16]

> "Consider a set of policy interventions targeted on a loosely-defined set of market imperfections that are rarely observed directly, implemented by bureaucrats who have little capacity to identify where the imperfections are or how large they may be, and overseen by politicians who are prone to corruption and rent-seeking by powerful groups and lobbies. What would your policy recommendations be?
>
> You might be excused for thinking that I am referring to industrial policy and if you react by saying "these are all reasons why governments should stay away from industrial policy." But in fact what I have in mind are some of the traditional, long-standing areas of government intervention such as education, health, social insurance, and macroeconomic stabilization. All of these policy areas share the features described in the previous paragraph. Yet, curiously in light of the skepticism that attaches to industrial policy, almost no one questions whether they properly belong in the government's arsenal.
>
> …
>
> All these shortcomings notwithstanding, the debates in these policy areas are rarely ever about *whether* the government should be involved; they are about *how* the government should go about running its policies. It's not about *whether*, but about *how*."

There are generally two strains to objections to industrial policy. The first is the "Government is not omniscient." strain, and the second is the

[16] Rodrik's paper entitled "Normalizing Industrial Policy" is a must-read for anyone who deems himself an advocate of such.

"Government is corrupt." strain. Note that neither of these two strains argue against the economic merits of industrial policy – they are not based on economic principles or rationale. However, they are very powerful arguments against industrial policy and have served to silence many of its advocates.

The traditional informational and bureaucratic constraints on the conduct of industrial policy are not givens. They can be rendered less binding through appropriate institutional design. Three key design attributes that industrial policy must possess are embeddedness, carrots-and-sticks, and accountability.

Clearly, governments are not omniscient. In fact, real governments probably know even less than what economic theory ascribes to them.[17] As such, the bandwidth of interaction between governments and the private sector needs to be broader and the information about what could be a lucrative industry in the future should come from the private sector. Sound industrial policy therefore should have a mechanism for eliciting information from the private sector, particularly about constraints that markets face. The experience of the East Asian Tigers is replete with examples of such embeddedness. While their governments were indeed autonomous, they were always embedded in private sector networks. This is what has come to be known in political science and sociology circles as an "embedded autonomy." The right model of industrial policy should therefore be a strategic collaboration and coordination between private sector and government.

A good model of industrial policy should serve to provide consistent and serious incentives on one hand and consequences on the other. The carrots-and-sticks principle should go further than simply making government agents behave. Tax incentives and subsidies should be made conditional on performance of the investor, and the consequences of non-delivery should be severe. One of the reasons why Philippine fiscal incentives are so costly is that no one knows for sure if the promised investments were actually made. Yet investors enjoy the income tax holidays and duty-free imports of raw materials and capital goods. That non-compliance goes unpunished renders the tax concessions inutile as incentives, and transforms them simply into freebies. Making incentives conditional on performance ensures that investors make an effort to deliver on their promises, but also serves to weed away those investments that are simply inefficient or perhaps unsuitable for the country's particular context. Moreover, very specific performance indicators should be

[17] The standard model of regulation depicts government as maximizing a known social welfare function while taking private firms' objective functions as constraints. In reality, governments probably do not even know this much.

set with periodic evaluations scheduled ex ante. This makes evaluation fairly straightforward and easy to audit as well.[18] Clearly, a well-designed industrial promotion strategy will yield winners as well as losers. A zero casualty rate would point to a tentative industrial promotion strategy that either failed to push performance to its optimum or failed to attract marginally profitable (in the short run) but socially desirable investments. The key is not that governments should know which ones will win and which will lose, but rather government should have the ability to recognize those that are thriving (and help them thrive even more) and those that are failing (and phase out support for them).

Indeed, because embeddedness requires a closer than arms-length relationship between the private sector and government, public decision-makers are rendered susceptible to compromise and rent-seeking. It suffices to say that corruption should not go unpunished. There is no other solution to the problem of corruption apart from making government officials accountable. Mercy, reconciliation, and forgiveness have no place in the public arena of policy-making and enforcement. That being said, the mandate to carry out industrial policy should be designated to a specific agency, with its own performance targets and vested with the power to achieve those targets. The agency's lines of accountability should be made crystal clear, not only within the agency and in relation to other government agencies but more importantly to the general public. Transparency will be key as well. Again, these proposals are not ground-breaking policy innovations but rather generally accepted principles of sound public administration.

With regard to its design, what should a strategic industrial promotion strategy do?

<u>Anticipate Human Resource Needs</u>: Studies have found that the earnings of professional workers in emerging industries (such as financial intermediation, information technology, call centers, and real estate) in the Philippines are 300%-400% times those of the unskilled workers in those industries. This premium suggests that there is scarcity in human capital in emerging industries. This wage premium goes down to 200%-250% in more established industries. This points to a possible medium-run skills mismatch problem for the country and a need for a skills enhancement program.

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[18] Rodrik (2007) even suggests pre-specifying x number of jobs and so much exports after a number of years as performance indicators.

Correct Market Failures: The strongest theoretical motivation for financial subsidies to inward FDI is the potential spillovers of foreign technology and skills to local industry. This however is not an automatic consequence of foreign investment. The potential spillover benefits are realized only if local firms have the ability and motivation to invest in absorbing foreign technologies and skills. To motivate subsidization of foreign investment, it is therefore necessary to support learning and investment in local firms as well. This would also dovetail with investing in human resources, through investments in education, training and public health, which can all improve the capacity of a country to absorb foreign technology.

Promote and Create Linkages: Mandating linkages between foreign affiliates and local enterprises (e.g. local content, local equity or joint venture requirements) or technology transfer obligations are increasingly falling under the purview of World Trade Organization obligations. However, there is still much elbow room to promote linkages between large FDI and local industries, particularly SMEs. Linkage promotion services can be especially effective in matchmaking between foreign investors and domestic suppliers. The most common form is information exchange networks.

Provide Targeted Assistance to SMEs: In many cases, SMEs may be unfamiliar with the quality or technical standards required by foreign firms and thus have difficulty entering supply chain agreements with them. Training can be a valuable way to encourage linkages. Encouraging larger companies to share their material and service-sector purchasing requirements with smaller local firms can also help. In some cases, local suppliers may be individually too small to provide the needed volumes on a regular, secure basis, but efforts to create production cooperatives can assist SMEs in fulfilling the needs of larger firms. Especially in tourism and other service industries, training and facilitation can assist larger companies in sourcing supplies and labor from local communities, which can also assist in preventing labor or community disputes.

Conclusion: Doing the Right Thing, Doing the Thing Right

Corruption and administrative abuse have long stumped economists who advocate a more active government presence within the economy, and have served as ammunition for those who insist on limited governments and profess unwavering faith in free markets. However, to shy away from using a potentially important tool for development simply because that tool is open to abuse is to be shortsighted at best, irresponsible at worst. Corruption is a fact of Philippine policy life, and the only way to rid the country of it is not to abandon all policies and regulation that are susceptible to it[19], but rather to punish offenders and to do so consistently and severely.

The fact is that we are only still learning best practice lessons from around the world, and there is much room for innovation in policy design and administration. The Philippines needs to commit itself to a more a strategic and proactive approach to investment promotion. Fiscal incentives to investments are costly and have a significant failure rate. However, without the proper context of improving the investment climate and a broader framework for industrial promotion, fiscal incentives have less hope to achieve what they were designed to do and will be a bigger financial burden to the country.

[19] Is there any sort of regulation impervious to greed and abuse? This argument is raised in every discussion of any new regulatory instrument proposed in Philippine policy circles. We abandon regulation because we do not have the capacity to administer it properly, but the capacity to administer proper regulation is never built up because existing policies do not justify the need to do so. It then becomes a vicious cycle of regulatory atrophy. When markets run amuck or development goals do not materialize, we blame corruption.

TABLE 1: National Government Fiscal Position

	2001	2002	2003	2004	2005	2006	2007	2008	2009*
Revenues, PhP Billion									
January-December	567.5	578.4	639.7	706.7	816.2	979.6	1,136.6	1,202.9	1,239.2
January-September	511.6	517.2	368.3	404.2	598.8	715.9	812.3	879.9	839.8
Percent Growth [1]	10.2%	1.9%	10.6%	10.5%	15.5%	20.0%	16.0%	5.8%	-4.6%
% of GDP	15.6%	14.6%	14.8%	14.5%	15.0%	16.2%	17.1%	16.2%	14.7%
Revenues by Collection Agency									
BIR, PhP Billion									
January-December	388.7	402.7	427.4	470.4	542.7	652.7	713.6	778.6	798.5
January-September	85.1	92.8	243.9	269.4	398.4	480.8	521.9	587.9	557.0
Percent Growth	7.7%	3.6%	6.1%	10.1%	15.4%	20.3%	9.3%	12.6%	-5.2%
% of GDP	10.7%	10.2%	9.9%	9.7%	10.0%	10.8%	10.7%	10.5%	9.5%
BOC									
January-December	100.1	99.3	117.2	127.3	154.6	198.2	209.4	260.7	273.3
January-September	91.4	88.5	72.3	71.5	106.9	145.8	153.0	193.2	165.4
Percent Growth	5.4%	-3.2%	18.0%	8.6%	21.4%	28.2%	5.7%	26.3%	14.4%
% of GDP	2.8%	2.5%	2.7%	2.6%	2.8%	3.3%	3.2%	3.5%	2.9%
Other Offices									
January-December	78.7	76.3	95.2	109.1	118.9	128.7	213.6	163.6	167.4
January-September	335.2	335.9	52.1	63.1	93.5	89.3	137.4	98.8	117.4
Tax Effort (% of GDP)									
January-December	13.6%	12.8%	12.8%	12.4%	12.9%	14.3%	14.0%	14.1%	14.0%
Expenditures, PhP billion									
January-December	713.5	789.1	839.6	893.8	962.9	1044.4	1,149.0	1,271.0	1489.2
January-September	288.4	339.8	463.7	503.6	707.2	766.3	852.3	933.3	1,077.4
Percent Growth	9.9%	10.6%	6.4%	6.5%	7.7%	8.5%	10.0%	10.6%	15.4%
% of GDP	19.6%	19.9%	19.5%	18.3%	17.7%	17.3%	17.3%	17.1%	18.8%
Non-interest Expenditures									
PhP billion	538.7	603.3	613.2	632.9	663.1	734.3	864.6	1,006.5	1,253.9
% of GDP	14.8%	15.2%	14.2%	13.0%	12.2%	12.2%	13.0%	13.6%	16.1%
Overall Surplus/Deficit, PhP billion									
January-December	-146.0	-210.7	-199.9	-187.1	-146.8	-64.8	-12.4	-68.1	-250.0
January-September	223.3	177.4	-95.4	-99.4	-108.5	-50.4	-40.0	-53.4	-237.6
Overall Surplus/Deficit, % of GDP									
January-December	-4.0%	-5.3%	-4.6%	-3.8%	-2.7%	-1.1%	-0.2%	-0.9%	-3.2%
January-September	14.8%	10.7%	-3.8%	-2.5%	-3.2%	-1.3%	-1.0%	-1.1%	-4.1%

Source: Department of Finance, Manila http://www.dof.gov.ph October 31, 2009

* Computed with Q4 projection

[1] Percent growth from 2001 - 2007 pertains to year-on-year changes; pertains to Q1-Q3 for 2008 and 2009

TABLE 2: National Gov't Revenue & Tax Effort

2001 - 2009 (Q1 - Q3)

Year	Revenue Effort	Tax Effort	BIR Tax Effort	BOC* Tax Effort
2001	15.60%	13.60%	10.70%	2.80%
2002	14.60%	12.80%	10.20%	2.50%
2003	14.80%	12.80%	9.90%	2.70%
2004	14.50%	12.40%	9.70%	2.60%
2005	15.00%	13.00%	10.00%	2.80%
2006	16.20%	14.30%	10.80%	3.30%
2007	17.10%	14.00%	10.70%	3.20%
2008	16.20%	14.10%	10.50%	3.50%
2009 Q1	13.50%	11.50%	8.90%	2.50%
2009 Q2	16.70%	15.40%	11.90%	3.30%
2009 Q3	15.70%	13.10%	9.70%	3.20%
2009 Q1-Q3	15.40%	13.40%	10.20%	3.00%

Source: Department of Finance; http://www.dof.gov.ph

Table 3: Omnibus Investments Code of 1987

FISCAL INCENTIVES			
Incentive	**Specific Terms**	**Period**	**Eligibility Requirements / Qualifying clauses**
Income tax holidays / Income tax exemptions	Full exemption	6 years	• Newly registered, pioneer enterprise (as defined under Art. 17 of OIC). • Enterprise located in a less-developed area, as identified by the Board of Investments (BOI) in coordination with the National Economic and Development Authority (NEDA).[20] • Meets the prescribed ratio of capital equipment to number of workers set by BOI. • Utilization of indigenous raw materials at rates set by BOI. • Net foreign exchange savings or earnings amount to at least US$500,000 annually during the first three (3) years of operation. • Maximum of 8 years
	Full exemption	4 years	• Newly registered, non-pioneer enterprise • Meets the prescribed ratio of capital equipment to number of workers set by BOI. • Utilization of indigenous raw materials at rates set by BOI. • Net foreign exchange savings or earnings amount to at least US$500,000 annually during the first three (3) years of operation.
	Partial exemption	3 years	• Registered and expanding firms. • Enterprise located in a less-developed area. • Exemption is proportionate to expansion • No additional deductions from incremental labor costs due to expansion.
Taxable income deductions for labor expenses	Partial deduction – 50% of the incremental wages expense due to expansion.	5 years	• Registered and expanding firms • Project must meet the prescribed ratio of capital equipment to number of workers set by the Board • Additional deduction shall be doubled if the activity is located in less developed areas as defined in Art. 40.

[20] This is a locator incentive.

Table 3: Omnibus Investments Code of 1987 (cont.)

FISCAL INCENTIVES			
Incentive	**Specific Terms**	**Period**	**Eligibility Requirements / Qualifying clauses**
Duty Exemptions	Full exemption - importation of machinery, equipment, and spare parts	5 years	• New and expanding registered enterprises. • Enterprise located in a less-developed area. • No domestic producer of comparable equipment. • Equipment is for the sole use of the registered enterprise. • Prior BOI approval.
	Full exemption - importation of breeding stocks and genetic materials	10 years	• New and expanding registered enterprises. • Enterprise located in a less-developed area. • Such breeding stocks and genetic materials are not locally available and/or obtainable locally • Reasonably needed in the registered activity. • Prior BOI approval.
Tax credit	Full credit – acquisition of machinery, equipment, and spare parts	5 years	• New and expanding registered enterprise • Enterprise located in a less-developed area. • Equipment is for the sole use of the registered enterprise. • Equipment would have qualified for tax and duty-free importation • Prior BOI approval.
	Full credit - purchase of breeding stocks and genetic materials	10 years	• New and expanding registered enterprise • Enterprise located in a less-developed area. • Equipment is for the sole use of the registered enterprise. • Equipment would have qualified for tax and duty-free importation • Prior BOI approval.
	Full credit – supplies, raw materials and semi-manufactured products		• New and expanding registered enterprise • Enterprise located in a less-developed area. • Used in the manufacture, processing or production of export products

Table 3: Omnibus Investments Code of 1987 (cont.)

FISCAL INCENTIVES			
Incentive	**Specific Terms**	**Period**	**Eligibility Requirements / Qualifying clauses**
Exemption from Wharfage Dues and any Export Tax, Duty, Impost and Fee			• Registered export-oriented enterprises. • Enterprise located in a less-developed area.
Taxable income deduction	Full deduction of cost of necessary and major infrastructure works	Up to 10 years	• Registered enterprises. • Located in an area designated as necessary for the proper dispersal of industry, or in an area deficient in infrastructure, public utilities, and other facilities. • Prior BOI approval. • Title to all such infrastructure works shall be transferred to the Philippine Government. • Any amount not deducted for a particular year may be carried over for deduction for subsequent years not exceeding ten (10) years from commercial operation
Exemption from Contractor's Tax			• Registered enterprise. • Enterprise located in a less-developed area.
NON-FISCAL INCENTIVES			
Incentive	**Specific Terms**	**Period**	**Eligibility Requirements / Qualifying clauses**
Simplified customs procedures			• Registered enterprise. • Enterprise located in a less-developed area.
Employment of Foreign Nationals		5 years	• Registered enterprise. • Enterprise located in a less-developed area. • Registered enterprise is required to train Filipinos as understudies of foreign nationals in administrative, supervisory and technical skills.
Access to Bonded Manufacturing / Trading Warehouse			• Registered export-oriented enterprises. • Enterprise located in a less-developed area.

System			

Table 4: Medalla's Evaluation of Various Fiscal Incentives

	Domestic Market-Oriented	Export Market-Oriented
Income tax holiday	• Likely to be redundant. • If given to Filipinos, the ITH either fails to attract new investments or simply redirects investments away from domestic industries that are not covered by the ITH (but does not increase total investments in the country).	• Redundant if the cost of producing in the Philippines is much lower than in other countries. • May be justifiable if cost of producing in the Philippine is not much lower than in other countries that give the incentive.
Zero taxes and duties on spare parts and raw materials	• Redundant if firm can compete with imports (which pay duties). • Incentive raises the effective tariff protection • Can induce new investments only if domestic producer is marginally competitive.	• Justifiable. • Taxes and duties on raw materials may make cost efficient exporters globally uncompetitive.
Zero taxes and duties on capital goods	• Redundant if firm can compete with imports (which pay duties). • Incentive raises the effective tariff protection • Can induce new investments only if domestic producer is marginally competitive.	• Justifiable. • Taxes and duties on capital goods reduce rate of the return to capital and may make an otherwise competitive industry globally uncompetitive.

From Medalla (2006).

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