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PERKY INTERVENTION

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PHILIPPINE INVESTMENT INCENTIVE SCHEME

PERKY INTERVENTION

Analyzing the investment incentive scheme: Is the Philippine Government giving too much and getting too little?

Every government strives to attain a healthy fiscal condition where debts and deficits are controlled, targeted taxes are collected, government revenues are efficiently and equitably distributed, and expected payoffs from subsidies are generated and returned to society.

In 2005, the Philippine government launched a series of fiscal reform programs with specific goals to deliver the country from its huge foreign debt and narrow down its ballooning budget deficit by 2010. It implemented the reformed value added tax (VAT), which raised the sales tax to 12% from 10% and the minimum corporate income tax rate to 35% from 32%. The government also increased taxes for tobacco and alcohol products, lifted tax exemptions on oil and petroleum products, and began privatizing state-owned power plants.

To further secure the country's fiscal position, the Bureau of Customs (BoC) and Bureau of Internal Revenue (BIR) boosted their revenue collection targets and tightened their tax collection processes. Currently, the Congress is deliberating on raising the common carriers tax for public utility vehicles, which has not been adjusted for years.

These reconstructions led to the modest improvement of the country's fiscal situation. Credit rating agencies, Moody's, Fitch, and Standard and Poor's, have all raised their outlook for the Philippines from "negative" in 2005 to "stable" in 2006 saying that the tax reforms, although yet to produce positive results, show the government's clear commitment to prudent fiscal management.

Investors' confidence was also boosted by these reforms. Since the new tax rate took effect in January 2006, the Philippine Stock Exchange has seen a 58% gain in the PSE Index, while net stock investment by foreign investors climbed to US$870.8 million in June 2007 from US$12.9 million in January 2004. Foreign direct investments increased significantly from US$688 million in 2004 to US$1,854 million in 2005, further growing in 2006 to US$2,345 billion. As a result, tax collection increased to 16.3% of the country's gross domestic product (GDP) in 2006, from a very low rate of 14.8% in 2003.

The country's fiscal resurgence encouraged the Congress to look for other loopholes in current systems and policies, reviving discussions to rationalize and simplify the country's investment incentives package, which have, for years, been plagued by redundancy and organizational inefficiency.

Investment incentive is a form of government subsidy offered to spur capital formation and business expansion. These are usually granted to spur investments in projects that result to social benefits such as employment generation, skills development of the local labor force, foreign technology transfer, increasing exports, tax generation, countryside development, and enhancement of the environment.

The Philippines, like other developing countries, offers very generous incentives packages, based on 146 tax incentive laws and covering almost all types of industries and activities. It offers various forms of concessions, both fiscal and non-fiscal, against its 35% statutory/nominal corporate income tax rate. (refer to Table 1). These perks are provided to registered export-manufacturers, exporters of IT-enabled services, establishments in special economic zones and IT parks, and firms located in the Least Developed Areas (LDAs).

TAX SHIELDS

The 1987 Omnibus Investments Code established the objectives and mechanisms for implementing national investment policies and specified the scope and nature of incentives to be offered. The Code also created the Board of Investments (BOI), the government agency responsible for promoting investments in the Philippines.

To provide the public with a guideline on availing incentives, the BOI prepares a list of preferred areas of activity every year called the Investment Priorities Plan (IPP). If a registered business enterprise is engaged in any of the 12 preferred sectors listed in the IPP, it is entitled to avail of incentives. These preferred sectors cover agribusiness; health care and wellness products and services; information and technology; electronics; motor vehicle products; energy; infrastructure; tourism; shipbuilding and shipping; machinery and equipment, raw materials and intermediate inputs; iron and steel production; and research and development.

On the other hand, if an enterprise does not qualify under the above criterion, it may still be granted incentives provided at least 50% of its annual production are

GIFT PACKS

Comparative Tax Incentives system

	Corporate Income Tax (CIT) Rate	Income Tax Holiday	Investment tax allowance	Carry over of losses	Accelerated depreciation	Research & Development	Import Duty concessions
Philippines	35%	✓ 4-6 years	✗ None	✓ 3-5 consecutive years	✓	✗ None	✓ For Export production
China	33%	✓	n/a 2 years review	✓ 5 years	✓ Subject to	n/a	✓ For Domestic production
Brunei	37.5	✓ 5-7 years	n/a	✓ Max. 6 years	✓ Rarely used	n/a	✓ For Domestic production
Malaysia	28%	✓	✓ 5 years	✓ 5 years	✓ Unlimited time industries	✓ For selected	✓ For Domestic and Export production
Vietnam	28%	✓ Max. 9 years	✗ None	✓ Max. 5 years	✓ On certain conditions	✗ None	✓ For Domestic and Export Production
Thailand	30%	✓ 3-8 years	✗ None	✓ 5 years	✓	✓	✓ For Domestic and Export Production
Indonesia	10-26%	✗ Tax reduction for 6 years	✓ 30% taxable income reduction for 5 years	✓ 5 years	✓	✗ None	✓ For Domestic and Export production

Source: Congressional Planning and Budget Department

EXTRA BOOST REQUIRED
30 Least Developed Areas in the Philippines

Region	Province
CAR	Abra Apayao Ifugao Kalinga Mt. Province
II	Quirino Nueva Vizcaya
IV	Aurora Marinduque Occidental Mindoro Palawan
V	Masbate Camarines Norte
VI	Guimaras Antique
VII	Siquijor
VIII	Biliran Eastern Samar Southern Leyte
IX	Zamboanga del Norte Zamboanga Sibugay
X	Lanao del Norte Misamis Occidental
XII	Saranggani Sultan Kudarat
CARAGA	Agusan del Sur Surigao del Norte Surigao del Sur
ARMM	Basilan Maguindanao Sulu Tawi-Tawi

Source: 2007 Investment Priorities Plan

for exports. Enterprises with foreign participation exceeding 40% may avail of incentives if at least 70% of its annual production is for exports and if the business activity is classified in the pioneer status in the IPP.

Pioneer enterprises are registered enterprises engaged in the following activities: the manufacture, processing, or production of goods that have not been produced in the Philippines; in agricultural, forestry, and mining activities; and the production of non-conventional fuels or manufactures equipment that utilizes non-conventional sources of energy in its operations.

The most popular kind of fiscal incentives is the income tax holiday (ITH). In the Philippines, this is granted to pioneer firms and to firms located in LDAs, exempting them from paying the corporate income tax for six years, while non-pioneer firms are granted four years of tax shield. All registered firms under the IPP are also exempted from paying taxes and duties on imported spare parts, wharfage dues, export tax, impost and fees, and breeding stocks and genetic materials. In addition to these, a registered firm enjoys several tax credits and may employ foreign nationals for five years.

Other investment promotion agencies (IPAs), such as the economic zones, also grant income tax holidays and other incentives for businesses. In the Philippines, there are 5 tourism economic zones, 58 manufacturing/industrial estates, and 69 I.T. parks and centers, including the independently managed Subic Bay Metropolitan Authority (SBMA) and the Clark Special Economic Zone (CSEZ). The zones grant incentives to establishments exporting at least 70% of their annual production and are supervised by the Philippine Economic Zone Authority (PEZA).

However, a large number of tax- and duty-exempt companies are considered recipients of redundant incentives, which makes the granted perks as actual loss of revenues to the government.[1]

FIGURES OF GENEROSITY

Total Tax & Duty Exemptions Granted, 2000-2005

Year	Amount
Year 2000 =	P147.55 billion
Year 2001 =	P151.61 billion
Year 2002 =	P144.03 billion
Year 2003 =	P299.93 billion
Year 2004 =	P282.80 billion
Year 2005 =	P229.4 billion

Sources: Department of Finance

"REDUNDANCY" DEFINED

In 2006, the United States Agency for International Development and the World Bank Group separately conducted in-depth studies on the Philippine investment incentives regime. The studies validated previous claims that the generous incentives offered are highly redundant and unnecessary. This implies that the majority of fiscal incentives granted are being given to investment projects that would have been implemented even without the fiscal perks, particularly the income tax holiday.

In a meeting with business group leaders, one of the authors of the said studies explained how to spot cases of redundancy or unnecessary tax expenditures. It begins with the premise that in considering places to invest in, investors are guided less by incentives and more by fundamental stimuli, such as the availability of required inputs, skilled human capital, and the size and purchasing power of the domestic consumer market. Other critical factors considered are political and macroeconomic stability, rule of law, quality of governance, and good infrastructure.

Redundancy is said to often occur when income tax holidays are given to domestic market-seeking and resource-seeking industries. Domestic market-seeking investments are those that find it ideal and profitable to invest here because of the attractive consumer market, while resource-seeking investments are those that are primarily interested in the presence of "crucially-needed inputs" in the market.

These industries are motivated by certain fundamental determinants and are expected to reap high profits at the time of registration. Determining this would simply require the IPAs to look at the investments' ex ante rate of returns. If it is high to very high by international and domestic standards (for the BOI, it is greater than or equal to 15% rates of return for 90%-95% of registered projects), then most likely the incentives given are redundant and are considered as real government expenditure.

The World Bank study highlights the role of exporting companies and efficiency-seeking investments in creating the desired social spillovers, such as employment generation. They are also said to be most sensitive to incentives as these directly impact the competitiveness of their industries in the world market.

A comparison of estimated redundancy rates among incentives administrators was made in the World Bank study using the ratio of the value of market-seeking domestic investments to total investments. It estimates that the redundancy rate for BOI investments typically exceeds 90%, while it is 10% for PEZA investments, 17% for SBMA, and 36% for CSEZ.

FOREGONE REVENUES

Redundancy may also occur if subsidized projects, originally expected to produce spillovers or positive social effects, fail to deliver expected social returns. Of course, *ex-poste* results can only be determined after a period of time following the granting of tax holidays.

In a 2004 study, the Department of Finance (DOF) estimated that for every P1.00 grant in income tax holiday, the average government revenue is only P0.13.[2] Out of the 16 industry sectors, only 4 produced a positive cost-benefit performance, namely Clothing and Accessories (2.98), Information and Technology Ser-

vices (1.5), Transport and Equipment (1.2), and Wood-based Products and Services (1.23).

The BOI, on the other hand, reported higher monetary benefits from the granting of incentives. The Board claims that for every P1.00 of income tax holiday granted, there is a corresponding P1.01 tax collected by the government.[3]

Similar to redundancy, foregone revenue resulting to the absence of actual returns are often caused by indiscretion and ad hoc decision-making on the part of the bureaucracy in granting incentives and in the 'foot-loose' nature of the IPP, as emphasized in the World Bank study.

ORGANIZATIONAL DILEMMA

While discussions are centered on the loopholes in the current incentives regime, much of the problem also lies in the lack of coordination between the DOF, BOI, IPAs, Department of Trade and Industry (DTI), and all the other agencies concerned. These agencies' operations and reports are inharmonious with each other, and their processes of granting incentives vary. Moreover, the existing incentive system saddled on more than 120 separate incentives laws and policies promoting various objectives and activities. These laws need to be streamlined and unified into a single law to remove confusion among investors, as well as to eliminate reported cases of "double registering" by businesses.

THE MOTHER BILL

In July 2006, former Senator Ralph Recto filed Senate Bill 2411 on the Rationalization and Harmonization of Fiscal Incentives, popularly known as the Recto Bill. It argued for the need to rationalize the fiscal incentives package given the numerous cases of redundancy in the current practice of granting incentives.

HARDLY RETURNED

DOF Estimated Government Revenue per Php of ITH (1995-2004)

Sector	No. of Firms	ITH	ITH per Firm	Est. Gov't Revenue Per Php of ITH
Agricultural Products and Allied Services	25	399,278,466	15,971,139	0.72
Chemical Based Consumer Products	8	467,483,504	58,435,438	0.09
Chemical, Textiles and Leather	10	539,647,611	53,964,761	0.13
Clothing and Fashion Accessories	26	106,089,754	4,080,375	2.98
Construction Materials	4	310,475,869	77,618,967	0.18
Electronics and Telecommunications Equip.	15	1,262,415,911	84,161,061	0.29
Engineering Products	18	200,851,168	11,158,398	0.67
Information Technology Services	47	1,159,687,019	24,674,192	1.5
Infrastructure and Utilities	47	37,807,363,788	804,411,995	0.04
Mining and Mineral Processing	6	139,726,012	23,287,669	0.57
Processed Foods and Beverages	27	479,582,411	17,762,312	0.67
Tourism and Industrial Estates	7	69,915,459	9,987,923	0.26
Toys, Sporting Goods, Gifts and Housewares	23	291,508,630	12,674,288	0.58
Trading and Other Services	25	304,736,483	12,189,549	0.52
Transport and Equipment	10	126,750,485	12,675,049	1.2
Wood-based products and services	26	83,504,235	3,211,701	1.23
Total	**324**	**43,749,016,804**	**Average**	**0.13**

Source: Department of Finance

NETTING ONE CENT

BOI's Comparison of Incentive Availments vs. Tax Collected (1995-2005)

Sector	Incentives Availed	Taxes Paid	Taxes Collected Per Php of Incentives
Agricultural Products and Allied Services	1,093,673,152.22	1,526,494,318.41	1.40
Chemical Based Consumer Products	745,088,536.88	430,548,532.91	0.58
Chemical, Textiles and Leather	4,936,746,490.83	3,674,496,918.72	0.74
Clothing and Fashion Accessories	290,240,466.23	67,175,315,868.34	231.45
Construction Materials	4,371,948,396.48	3,439,036,478.61	0.79
Electronics and Telecommunications Equip.	13,086,663,777.35	9,618,244,482.10	0.73
Engineering Products	517,786,809.12	706,516,066.64	1.36
Information Technology Services	3,921,079,655.29	2,681,617,519.22	0.68
Infrastructure and Utilities	93,181,047,688.95	30,593,716,749.99	0.33
Mining and Mineral Processing	1,143,937,410.36	2,070,376,248.01	1.81
Processed Foods and Beverages	2,147,016,582.93	1,526,494,318.41	1.40
Tourism and Industrial Estates	179,792,442.10	761,592,757.64	4.24
Toys, Sporting Goods, Gifts and Housewares	431,005,701.89	1,167,348,228.86	2.71
Trading and Other Services	702,122,264.61	1,864,108,091.23	2.65
Transport and Equipment	1,998,019,347.89	2,461,902,463.88	1.23
Wood-based products and services	767,631,821.51	1,235,736,903.95	1.61
Total	**129,513,800,544.64**	**131,171,810,003.72**	**1.01**

Source: Board of Investments

To eliminate redundancy, the Recto Bill sought to refocus the benefits of tax incentives mainly for exporters. As for registered domestic enterprises, the bill proposed to provide tax incentives to those locating in the 30 poorest provinces, and whose investments are at least P500 million and/or generating at least 200 jobs.

SB 2411 also sought to abolish the income tax holiday and replace it with a mix of the following perks: reduced corporate income tax of 15%, accelerated depreciation, net operating loss carryover, and duty exemptions on imported capital equipment, and raw materials and source documents. It introduced the concept of a special trust liability account, to be placed under the Bureau of the Treasury, to support a tax refund mechanism to replace the automatic VAT exemption for exporters.

Under this bill, the BOI and the PEZA were to be merged to create a single body called the Philippine Investment Promotions Administration (PIPA). Meanwhile, all IPAs would be mandated to submit their annual tax expenditures to PIPA and to the DOF for monitoring and review purposes.

The Congressional Planning and Budget Department (CPBD) supports this Bill saying that the changes it proposes, like the establishment of only one administering body, would make the incentive system more effective without compromising what is due to the government. The Bill, however, never reached the third reading in the 13th Congress. But despite its ill fate, the Recto Bill stirred the interest of the business sector and concerned government agencies. New bills on rationalizing fiscal incentives have been filed by lawmakers. At

present, there are four House Bill versions and one Senate Bill version filed and pending in the 14th Congress.

ON THE FLIP SIDE

The World Bank conducted a global study and found little correlation between the generosity of incentives and the growth of investment. While this may be so, the present state of the Philippines' investment climate should be considered. The country's competitiveness is now perceived to be way behind its neighbors, particularly in the areas of infrastructure development, transportation, the educational system, and the ease and cost of doing business.

In the 2006-2007 Global Competitiveness Report, an annual ranking of countries based on perceived investment location attractiveness, the Philippines ranked 71st, way below countries considered of similar jurisdictions such as Thailand and Indonesia which ranked 35th and 50th, respectively.[4]

Given this glaring fact, groups supporting the retention of the current incentives argue that although generous incentives are not the primary consideration in investing in a country, these are the Philippines' major come-on for investors. They discourage changing the investment rules, as this will demonstrate a culture of policy inconsistencies and lack of institutional continuity in the country.

For these same reasons, the DTI and the BOI, while recognizing the need to rationalize the current incentives, are against the recommendation of junking the income tax holiday and scrapping the IPP, predicting that such moves would surely dull what little competitive edge the country has.

WORLD BANK RECOMMENDATION

To rectify the loopholes identified in the said study, the World Bank suggests a variety of measures to adopt. The following are the proposed areas in rationalizing investment incentives:

1. Focus on exporters: Due to the nature of exporting companies as efficiency-seeking firms, the study suggests limiting the scope of future incentives to exporters and to adopt a phased transition away from tax holidays for eligible enterprises.

2. Focus on performance-based incentives: The government should work towards offering a limited menu/combination of available incentives, particularly performance-based perks (tax credits, investment allowance, training allowance, accelerated depreciation, and extended loss carry forward). Experts advise against tax holidays since it rewards the formation of new companies instead of targeting the increase of productive assets, infusion of better technology, labor training, and the like.

3. Adopt a phased transition: The paper also proposes to retain the three-year tax holiday for expansion projects eligible under the new criteria for a window of two years. It advises the use of a sunset clause, or setting a future date for the automatic repeal of an entire or sections of a piece of legislation as a means of transparently limiting the duration of incentives and capping the budgetary cost.

4. Organizational and Administrative Realignment: The best way to eliminate discrimination between PEZA zone exporters and BOI non-zone exporters is to refund all exporters their input VAT through the establishment of a trust liability account, as proposed in the Recto Bill. Such a move would discontinue the use of tax credit certificate. However, it is important for the BIR to develop the necessary capabilities to administer this system, such as strictly recording and monitoring data on actual outcomes, specifically actual investments, actual figures for exports and imports, and actual employment generation.

Similarly, to improve the overall administration and promotion of fiscal incentives, the DOF suggests the realign-

ment of BOI and PEZA functions. The BOI shall focus on investment generation and policy advocacy, while PEZA shall supervise zones and administer incentives.

GENEROUS IN GIFTS AND FLAWS

It can be argued that the Philippines needs to be generous in giving incentives to compensate for the lack of important fundamentals that make a good investment site. Income tax holidays, tax credits, and tax allowance, among others, seem necessary to attract the investors to pump prime the economy. But in the case of the Philippines, the generous perks availed by firms have not produced the expected positive results to society, thereby causing the government to forego billions of pesos yearly.

Clearly, rationalizing and simplifying the current fiscal incentives is a necessary move if fiscal stabilization is to be achieved. The question begs what incentives should we retain, revise, add, or scrap?

Several proposed concepts and legislative Bills have been presented to the stakeholders and have been discussed in Congress. Lawmakers now face the tough challenge of drawing up a simplified incentives scheme that will ensure the efficient provision and management of investment perks without sacrificing the country's attractiveness to investors. It must also eliminate tax distortions and abuse, increase transparency and accountability of tax administrators, and improve the government's revenue generation capacity. But more importantly, the new set of incentives must benefit the targeted investors, especially those that will generate great returns to the country.

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FOOTNOTES

[1] In a study conducted by Renato Reside, Jr, "Towards Rational Fiscal Incentives," he stated that many tax- and duty-exempt firms were found to have high rates of return before receiving incentives, and that many companies has low sensitivity to fiscal incentives.

[2] Figures from the Department of Finance were cited in the study conducted by the Congressional Planning and Budget Department in 2005. The estimated revenue per Php of ITH is computed by dividing the Est. Revenues within ITH Period with ITH.

[3] Figures are presented by the BOI during the MBC National Issues Committee Meeting, 13 September 2007. The Total Taxes Paid is composed of Other Taxes and Licenses and the Estimated Taxes after ITH.

[4] The Global Competitiveness Index captures the competitiveness of a country's institutions, infrastructure, macroeconomy, health and primary education, higher education and training, goods market efficiency, labor market efficiency, financial market sophistication, technological readiness, market size, business sophistication, and innovation.