

Fiscal Incentives Revisited*

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ABSTRACT

This short paper attempts to clarify some of the issues and provide suggestions for reforms in the fiscal incentive system. In particular, the paper focuses on the Investment Incentive System embodied in the Omnibus Investment Code. The paper attempts to provide some estimate of revenues forgone, specifically from income tax holiday under different assumptions. The paper urges that the government should be aware of these costs, be very choosy in granting incentives, and should make sure that social benefits from preferred activities compensate for the costs. Toward this end, the paper proposes a two-tiered approach for reforms—generic and special incentives.

INTRODUCTION

The Philippines has a long history of providing investment incentives to selected activities. The earliest version, dating as far back as 1946, granted exemption from all internal revenue taxes (including income taxes) for a period of four years to “new and necessary” industries. In the 1950s, incentives in the form of liberal importation of raw materials and intermediate inputs were added. In the 1960s, identified “basic” industries were offered exemption from duties on imported equipment. The system of investment incentives was formally institutionalized in 1967 with the enactment of the Investment Incentives Act.

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There have been amendments to the Investment Incentives Act since then, starting with the 1970 Export Incentives Act, Batas Pambansa 391 (BP 391) in 1983, and culminating with the 1987 Omnibus Investment Code (under the Executive Order, EO 226). The changes reflected the shift in the focus of objectives: from reconstruction after the war (as reflected in the preference for new, necessary and basic industries) to export promotion and employment generation starting in the 1970s. Thus, at least until recently, the major strategy has been to channel investments to sectors considered "desirable," specifically those that have significant impact on exports and employment.

During the more recent years, the focus seems to have shifted again somewhat: from attracting investments in selected sectors to simply "attracting" investments. Not that there is no list of priority investment (IPP) areas, but that the investment incentive system is now seen more as a tool to "increase" investments. The objectives of employment generation and export promotion are still there, but these appear to be considered more as expected side effects of attracting investments. There is, of course, nothing wrong with the objective of increasing the level of investments. The problem is it is so difficult to determine if indeed the resulting registered investments are the result of the granting of attractive fiscal incentives. Moreover, while at a glance such a strategy appears to be less interventionist, at closer scrutiny, it is not clear if the wide range of activities (more so if there is no clear and specific IPP, so that anything can be eligible for incentives) to choose from gives added benefits.

Indeed, more possibly, this simply leads to higher chances of committing mistakes and unnecessarily increasing the implied costs in terms of forgone revenues from the fiscal incentive. Thus, there are serious implications not readily recognized which need to be examined. The first concerns the ideal role of fiscal incentives. The second, which to some is more important, pertains to government revenues.

Such a need to revisit the rationale for fiscal incentives has also become more apparent since conflicting objectives have become more pronounced: a critical need for more revenues and thus a call to limit fiscal incentives on the one hand, and a need for more generous incentives to compete for foreign direct investments on the other. This short paper is an attempt to clarify some of the issues and provide some useful suggestions for reforms toward rationalizing the fiscal incentive system.

The initial step in rationalizing fiscal incentives is to recognize the different purposes they serve. Fiscal incentives are used by various government agencies to promote their particular objectives. This has been the main reason for the mounting increases in fiscal incentives law. (Fiscal incentives are “easy” measures to pass because costs are hidden and benefits are highlighted. Hence, the tendency to pass more laws granting fiscal incentives for various reasons.) To have a better handle of the discussion, the paper focuses on fiscal incentives for industrial policy. Hence, fiscal incentives for other objectives, such as health, environment and agriculture are best dealt with (and analyzed) separately, preferably under the purview of the agencies to which they belong. Furthermore, the paper centers on the investment incentive system embodied in the omnibus investment code. The ecozones (under PEZA) and Freeport regimes (Clark and Subic), which are clearly part of industrial policy, are also excluded in the analysis as these are considered to be measures to make up for inadequate infrastructure (and to allow firms to take advantage of existing agglomeration economies), which fiscal incentives cannot adequately address.¹ The same analysis could be used and similar implications derived in these cases.

The paper will first discuss the economic rationale for the investment incentive system. This is followed by an analysis of the

¹ They also cater mainly to exports and/or foreign investments. As such, there seems to be greater justification for their existence (e.g., agglomeration economies, foreign investments and exports promotion) and more reason to presume that benefits accrue (especially if granted a reasonable occupancy rate of the zones), and consequently less reason to focus the analysis on.

types of fiscal incentives granted. Then the paper attempts to provide some estimates of revenues forgone, specifically from income tax holiday, with corresponding insights. Finally, the paper draws some key implications for reforms of the investment incentive system.

ECONOMIC RATIONALE FOR INVESTMENT INCENTIVES

As a general rule, *government intervenes where the market fails*. The investment incentive system attempts to influence where investments should go through the granting of fiscal incentives and the listing of priority areas eligible for these incentives. It is thus undoubtedly a form of (selective) government intervention. As such, the same underlying principle applies. There should be some market failure that it is trying to address. Indeed, there could be various market failures and distortions that prevent the optimal allocation of investment to occur (and as such prevent the industrial sector to assume its natural role as the leading sector in the development process). Government intervention is then needed to correct these market failures and distortions. Ideally, this is the role the investment incentives system should play.

Basic Principle: Correcting for Market Failures

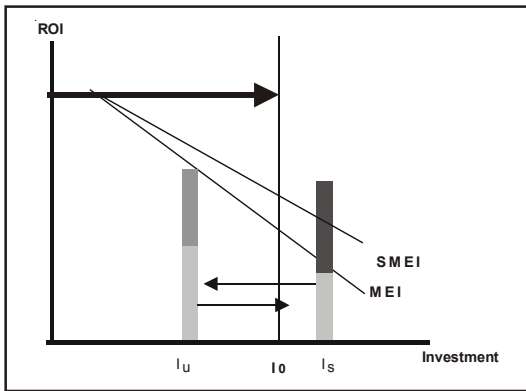
Not everyone, however, appreciates this role of fiscal incentives (see relevant IMF and World Bank studies). The argument seems to be that such a “selective intervention” is bound to create more costs (and failures) than benefits. This is an empirical question, which highlights further the need to review and rationalize the investment incentive system. Furthermore, there is a growing perception that these fiscal incentives are there more for government to correct its own policy-induced distortions, which make investing here very costly and cumbersome. To some extent, these concerns are very real and therefore suggestions have been made to simply do away with circuitous remedies, remove the selective fiscal incentive system and make it universal in application. However,

a big question is, how much more effective this approach is, especially given the uncertainty over the revenue implications of serious fiscal difficulties.

The Investment Incentive System as an Industrial Policy Tool

Notwithstanding these questions, what is important to realize is that there is a role for fiscal incentives, if applied judiciously. The theoretical analysis is illustrated in Figures 1 and 2.

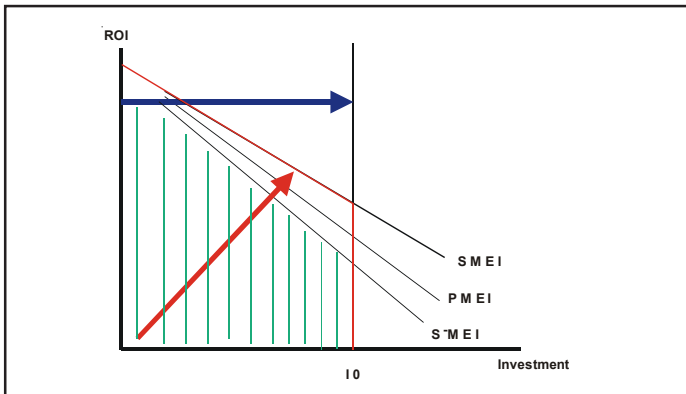
Figure 1. Marginal efficiency of investment (MEI)



Again, this role arises from the existence of market failures, e.g., those involving externalities and market distortions. Correcting these market failures would yield a different ranking of returns to investments from the point of view of society (vs. private ranking) and a higher marginal efficiency of investment (MEI) curve. Consider, for example, two investment opportunities, I_s and I_u . The dark shaded area in I_s indicates the external benefits of the activity, which private financial analysis ignores, while the dark shaded area in I_u indicates government subsidies (in whatever form they are granted to the firm), which private financial analysis considers. Hence, correcting market failures (the ideal role of the invest-

ment incentive system) for the marginal efficiency of investment to correctly reflect benefits and costs to society (as opposed to private individuals) implies some rearrangement of investment opportunities in the figure above. Specifically, in the figure, this means transferring investment opportunity I_s ahead (to the left) and investment opportunity I_u further away to the right. This yields a higher MEI curve from the point of view of society, the "social" marginal efficiency of investments (SMEI). (See Figure 1.) If the investment incentive system is able to correct market distortions such that the SMEI curve is also what is faced by the firm (that is, it also becomes the private marginal efficiency of investments), then given the level of available investible funds, I_o , the total returns to investments, the area under the curve SMEI is higher than what would have been without the investment incentive system, curve PMEI. (See Figure 2.)

Figure 2. Marginal efficiency of investment with investment incentives



Enough has been said and written on what these cases of externalities, market failures and distortions are. To summarize, in the case of market failures and distortions, the primary sources are found in:

- a) the trade distortions brought about by differential tariffs and other import controls;
- b) minimum wage legislation; and
- c) imperfect capital market.

The first two directly affect the prices of tradable goods and labor, respectively. Their market distortion is clear. The protectionist trade policy has inherent bias against exports, and has been a strong justification for export incentives. The first best policy has been to implement trade reforms to reduce the bias against exports and indeed a lot has been done in this area. The wage legislation, on the other hand, distorts the labor market, raising the cost of labor, inconsistent with full employment. It continues to be problematic, given the political nature of the issue.

The third deals more with the fact that access to capital is imperfect. Indeed, in certain cases, there may not be a market at all for certain types of loans and borrowers. This market distortion is one of the main justifications for build-operate-transfer projects, aside from the externalities they provide. This leads to the second major market failure, which could justify the use of fiscal incentives: externalities.

Externalities are benefits brought about by the activity of the firm, which it cannot charge, and costs incurred by the activity, which it does not pay for. The former is positive externality and the latter, negative. A foremost example of the latter is pollution, which the government is unable to check. As justification for fiscal incentives, what is relevant is the existence of positive externalities. Here are a few illustrative examples:

- a) Exporting activities are generally also found to have positive externality related to its positive correlation with overall productivity. This arises from the fact that the export sector needs always to be aware of and catch up with the best practice.
- b) In the externalities arising from interdependent investment decisions, certain investments may be socially prof-

itable as a whole, but individually, firms may not be as financially profitable and would not invest without critical mass of investment in the others.

The Metropolitan Railway Transport (MRT) project is a more specific example. The reduced traffic congestion and lessened air pollution on EDSA constitute externalities that the firm could not internally benefit from but are nonetheless real benefits to society.

While it is clear that such cases of market failures and distortions that would justify the role of investment incentives, valid arguments have been raised, mainly with respect to how to identify such cases, and the effectiveness of such a “selective” approach. Indeed, if the government is bound to commit more errors than make wise decisions, then perhaps it is better for it to veer away from such an approach, or totally abandon the use of fiscal incentives altogether as implied above. Such a case is illustrated in Figure 1, by SMEI, where the intervention of the investment incentives system makes wrongly rewards undeserving activities, thereby dampening instead of enhancing the investment opportunities from PMEI to SME.

There are potential losses from an erroneous investment incentives system. But done right, potential gains can also be huge. Imagine if there were extra benefits from an activity that would otherwise have not been encouraged without fiscal incentives (external benefits to society not internal to the firm and would thus not be considered in its investment decision). Imagine, too, if these external benefits led to growth elsewhere. In sum, imagine if the investment incentive system could be an effective industrial policy tool!

Objective: Not to Induce More Investment *Per Se*

The potential benefits of the fiscal incentive system arise from directing investment to “desirable” sectors. There is no presumption that benefits accrue because fiscal incentives would encourage more investments. Indeed, *the objective of granting fiscal incentives is not to induce more investment per se*. Increasing the level of savings

(and thus the level of investment) is primarily the task of the overall fiscal and monetary policy. This is, of course, only with regard to domestic investment and temporarily sets aside the question of attracting more foreign investment, which will be discussed later.

This is probably where a lot of confusion is coming from. The Board of Investments (BOI) appears to view most, if not all, investments registered as “additional” investments and, hence, does not think that there are foregone revenues involved in the granting of fiscal incentives. Thus BOI’s extremely low estimates of costs of incentives for every peso of investment and its predisposition to compete for DFIs using fiscal incentives. On the other hand, this is perhaps why the IMF and WB studies do not see the need for such fiscal incentives, which they consider costly and increasingly complex with the enactment of various incentive schemes, without necessarily leading to increased investments.

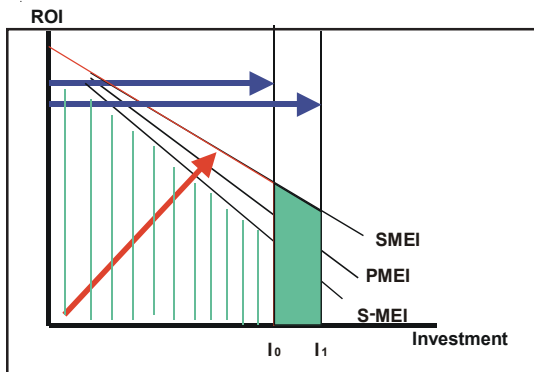
Again, *the objective is not to induce more investment per se*. This is especially true where domestic investment is concerned. The level of domestic savings and domestic investment is influenced by fiscal and monetary policy (overall tax rate, corporate income tax and other general fiscal measures, interest rate, etc.). If ever, the impact of fiscal incentives on the level of investment is bound to be marginal. What this implies is that whatever fiscal incentives are granted, the tax concessions (i.e., revenue forgone) are real “budgetary” costs to the government and should be justified by corresponding benefits. Indeed, a rational government would compare benefits from granting these fiscal incentives with other government expenditures. These concerns, however, are brushed aside by a misconception that fiscal incentives are costless since the investment would not have happened without them. However, as earlier pointed out, the level of domestic saving and investment is determined by overall fiscal and monetary policy, not the fiscal incentive system. As such, the investment would have been made, perhaps in another activity not encouraged by the fiscal incentive system (or maybe in the same activity, even without the fiscal incentive), so that there are real fiscal costs in terms of forgone revenues.

It cannot be overemphasized that if the paramount concern is to increase the level of investment, then it should be done via the overall fiscal and monetary policy (e.g., lower corporate income tax, interest rate, net operating loss carry over (NOLCO), etc., which are universally applicable). Still another set of concerns is how much additional savings and investments are encouraged and how much net losses in fiscal revenues are incurred. (Losses in fiscal revenues from implementing this universal tax incentive might even be more than offset by gains from increased output and employment that could arise from increased investment.) *Another strategy, of course, is to increase the level of investments by attracting direct foreign investments.*

The Role of Fiscal Incentives for Foreign Investment

The analysis above disregards the question of attracting foreign investment through fiscal incentives. *Indeed, new foreign investment represents a net increase in available savings which would lead to higher output and growth.* Policy pronouncements regarding the need for fiscal incentives to be competitive with other countries are not entirely surprising. The expectation is that competitive fiscal incentives could be used to raise total investment by attracting foreign investors (Figure 3, from I_0 to I_1). If such is the case, the benefits are clear (see the shaded area), as illustrated in the figure.

Figure 3. MEI with additional foreign direct investments



Yet the effectiveness of attracting foreign investments through fiscal incentives has been questioned. Studies suggest that the fiscal incentive system is not a very important factor in a firm's decision to locate in a certain country. (See, for example, Aldaba (1996) in *Catching up with Asia's Tigers*.)

Nonetheless, there are other advantages that could be derived from foreign direct investments that could be considered, aside from "additional savings." One pertains to those arising from its direct linkage with the world market. This means greater market access in both output and input, and learning from its expertise in dealing with these markets. Another advantage could be technology transfer. How important these advantages might be depends, of course, on the nature of the investment and, possibly, on conditions imposed by the host government.

The question is, do these advantages of foreign investment suggest that a premium should be attached to foreign investment, which could take the form of more generous fiscal incentives? There are a number of reasons, however, why this might not be feasible nor desirable. One of these is that offering more attractive incentives to foreigners than to Filipinos would be politically unacceptable. What would this imply if the nature and level of incentives chosen leaves the Philippines short of attracting the optimum flow?

It is important to remember that there are other ways to compete for foreign capital. A good overall climate for investment, both domestic and foreign, and an expectation of stability and consistency in the economic policy regime can be more important than tax exemptions and credits, particularly in attracting the kinds of investments that would be desirable and lasting. Studies show (Aldaba 1996) that a healthy overall economic activity is a more important determinant of direct foreign investments.

FORMS OF FISCAL INCENTIVES GRANTED

The income tax holiday (ITH) and the tax-free importation of capital equipment are the key incentives in the present Omnibus

Investment Code. (See Box 1 for a more complete list of incentives provided under EO 226.) These are uniform for exporters and nonexporters alike. The elimination of the openly pro-export incentives (present in the previous code) was said to have been done to avoid questions related to the GATT-WTO provision on prohibited export subsidy. The ITH is also claimed to be easier to administer, aside from being more attractive to investors.

Box 1. Incentives granted by the Board of Investments under EO 226

Income Tax Holiday (ITH)

- New projects with pioneer status for six (6) years
- New projects with a non-pioneer status for four (4) years
- Expansion projects for three (3) years
- New or expansion projects in less developed areas for six (6) years
- Modernization projects for three (3) years

Exemption from Taxes and Duties on Imported Spare Parts

Exemption from Wharfage dues and Export Tax, Duty, Import and Fees

Tax Exemption on Breeding Stocks and Genetic Materials

Tax Credits

- Tax credit on tax/duty portion of domestic breeding stocks and genetic material
- Tax credit on raw materials and supplies

Additional Deductions from Taxable Income

- Additional deduction for labor expense
- Additional deduction for necessary and major infrastructure works]

Non-fiscal Incentives

- Employment of foreign nationals
- Simplification of customs procedures
- Importation of consigned equipment for a period of 10 years
- The privilege to operate a bonded manufacturing/trading warehouse

These forms of incentives, on the other hand, are less neutral with respect to the choice between labor-intensive and capital-intensive industries and techniques of production. Duty-free importation of capital (especially where there is a premium on foreign exchange, i.e., society values foreign exchange more than its official rate) artificially cheapens capital. Also, the income tax holiday reduces the user cost of capital and encourages substitution of capital for labor.

Other possible types of fiscal incentives could be granted instead of the income tax holiday (ITH). For example, the fiscal incentive granted under BP 391 is in the form of tax credit equivalent to 10 percent of local content for exports and a tax credit equivalent to a percentage of value-added for domestic producers (10 percent for pioneer and 5 percent for nonpioneer). Such preference for exports and local content, however, could no longer apply to the GATT-WTO. The tax credit based on value-added, however, is still an option. It is factor-neutral, in contrast with the ITH. The question is the ease and cost of administration (and possibly its attractiveness to investors). Another type of fiscal incentive being considered is a tax credit equivalent to the personal income tax withheld. (These tax credits are all to be credited against corporate income tax due.) This last incentive is obviously biased for labor, which, given the premium placed by the government on employment, is not undesirable. However, a question could also be raised regarding its attractiveness. It is also unclear as to how easy or costly it is to administer.

Whatever the type of incentive used, fiscal incentives are real costs. The next section attempts to deal with this issue.

ESTIMATING THE COST OF FISCAL INCENTIVES

The bottom line is: *fiscal incentives are not costless. They are forgone revenues.* If we accept the fact that a lot of these investments would have been invested anyway (maybe to a different set of activities in the absence of fiscal incentives), then these costs are very real.

Fiscal Incentives Are Real Costs

The problem is that these costs are hidden, there being no outright payments involved. This makes it difficult to estimate, especially considering that there are no robust data on investments in terms of how much of these are registered with the BOI and how these investments are actually performing. Nonetheless an attempt is made here to at least come up with ballpark figures to give us some idea (however rough) about what we are actually “spending” by granting such incentives, at least for the ITH.² In the process, some bold assumptions would be made, possibly with clear indications of the direction of bias involved. (Perhaps also the errors involved in the simplification would cancel each other out.)

Four sets of assumptions are made which would yield: (1) a high estimate of forgone revenues from ITH, (2) an intermediate estimate, (3) a low estimate (not necessarily a lower bound) of forgone revenues, and (4) an estimate using the second set of assumptions but excluding exports. An effort is made in the last estimate (4) to segregate exports, where justification for fiscal incentives is least ambiguous.

A common assumption in all four sets of estimates is that the return on investment (inclusive of tax) is 12 percent. This is based on the cut-off rate being used by the Investment Coordination Council in its evaluation of projects. This may still be too high, but the estimates are simply meant to be indicative and adjustments could be easily made by the reader to suit his own purpose. The higher the estimate, the higher the forgone revenue implied. (One must keep in mind, however, why the government should reward unprofitable activities, unless there are clear externalities involved.) Another key assumption is the realization rate of project proposals approved by the BOI. This is assumed to be 75 percent. This seems like a reasonable first cut although, again, it may be too high. BOI

² No attempt here is made to estimate revenues forgone from tax- and duty-free importation of capital, which have expired. Also, the estimate on ITH alone clearly indicates the magnitude of the cost of fiscal incentives.

estimates, however, showed that, in the case of incentives granting tax- and duty-free importation of capital, the actual availment was around 80 percent of expected from project proposal. This means that the rate is not unreasonable. Again, however, adjustments could easily be made if the assumed rate is too high (or low). Finally, the average period of availment is assumed to be five years.

For the high estimate, FR_T^U , the additional assumption is that investments would have been made anyway (albeit in different activities), so that the forgone revenues are real costs since it only diverted investment from an activity which would have otherwise paid income tax to one which would not. (Of course, the amount of income would vary, but aggregation would possibly cancel errors out.) This yields the following formula.

$$FR_T^U = (.75) \sum_0^4 (I_{T-t}) (.12) (.32)$$

I refers to investment
 .32 is the tax rate

For the intermediate estimate, FR_T^E , the assumption is that half of foreign investments are lured by fiscal incentives, so that there would be no forgone revenues for these investments. Again, adjustments could be made by the reader according to what is considered a more reasonable figure. The domestic investments are assumed to be set by the overall fiscal and monetary policy and would have been made regardless of fiscal incentives. This yields the following formula.

$$FR_{T00}^E = .75 \sum_0^4 I_{T-t}^L (.12) (.32) + \sum_0^4 (.50) I_{T-t}^F (.12) (.32)$$

For the third set of estimates, FR_T^L , the assumption is that all foreign investments came in because of fiscal incentives, so that there are no forgone revenues for foreign investments. This is probably

an extreme assumption (just as some would consider the assumption that all domestic investments would have been made anyway, albeit in possibly different activities). Again, these estimates are not meant to be absolute. This yields the following formula.

$$FR_T^L = .75 \sum_0^4 I_{T-t}^L (.12) (.32)$$

I^L refers to domestic investments

The fourth set of estimates, FR_T^X , is just an attempt to segregate exports, where the justification for fiscal incentive is clearer. For this purpose, the intermediate assumption is used. The formula is given by the following.

$$FR_T^X = .75 \sum_0^4 I_{T-t}^{LD} (.12) (.32) + \sum_0^4 (.50) I_{T-t}^{FD} (.12) (.32)$$

The basic data needed for estimation are equity investments of BOI-approved projects. The results are summarized in Table 1 (see Annex A for the data set).

The estimates are disturbingly high, from a low of P7.2 billion to a high of P12.5 billion, considering that the collected revenue from corporate income tax for year 2000 was only around P44.8 billion. It is difficult to judge if these estimates really indicate how prevalent fiscal incentives are because of the absence of actual figures on investment. Nonetheless, they provide a clear indication that the

Table 1. Estimates of forgone revenues under the four assumptions

Estimated Forgone Revenues in million pesos				
	FR_T^U	FR_T^L	FR_T^E	FR_T^X
2001	11,086.94	7,212.61	9,149.78	8,634.30
2000	12,461.40	8,401.96	10,431.68	9,902.39

forgone revenues are not minimal. If these costs are not matched by corresponding benefits to society, then implications are grave. Indeed, a worst-case scenario is where the wrong set of activities is promoted by the IPP.

Another observation that needs to be highlighted is the implied subsidy given to exports. This is the difference between FR_T^E and FR_T^X . The implied subsidy to exports covered by BOI fiscal incentives is only around P500 million. This translates to less than 0.1 percent of the value of exports that could be attributable to BOI export incentives.

Based on actual availment of incentives, BOI recorded around P4.2 billion from income tax holiday (source: DOF Report). The estimates based on above exercise and corresponding assumptions are much higher—around two to three times as much. While the estimates are based on assumptions and should be considered more as simulation results, they nonetheless offer insights about the costs of fiscal incentives. In particular, some insights could be gleaned from such a big gap between the availment figure from BOI and the estimates presented here. The gap could imply any of the following: that the realization of investments for approved BOI projects is much lower than 75 percent (possibly only 50 percent); the rate of return on investment for these BOI projects is much lower than 12 percent (possibly as low as 6 percent); or, most likely, a combination of both. In any case, if it were the first, then BOI should try to improve its followup of the approved cases and determine where the problems are. If it were the second, then it raises more doubts on the benefits of the fiscal incentive system. There should be clear externalities from the investments granted investments, which make the activity more socially profitable than what the low financial returns imply.

Lack of data about the actual firms' performance and significance limit our findings to this broad interpretation of results. Estimating the revenue forgone is just one side of the equation. The next step is to find out if this cost is worth the benefits, which is

even more difficult to estimate. We can only infer some insights from looking at the type and nature of firms registered with the BOI. For more insights, Table 2 lists the top 20 BOI-approved registered firms in terms of project costs. If these firms are commercially viable, then the magnitude of income tax due should increase with project cost. Hence, the amount of fiscal incentives (e.g., ITH) should vary directly with project cost. Indeed, one could perform the same exercise above (e.g., assume a rate of return and the share of equity investment in project cost) to provide an estimate of fiscal incentives the firm potentially receives. This, however, is not done in this paper because of the higher likelihood of error since, for a particular firm, the details matter for specific firms. This is in contrast with the gross estimate of forgone revenue above, where the aggregation helps (i.e., by canceling out possible individual errors). The nature and product of the firm would also indicate whether the activity yields some externalities (e.g., extra benefits to society, outside costs and benefits internal to the firm), which could provide a justification for its eligibility to receive fiscal incentives. For example, the fact that most are domestic investments suggests that they are not additional investments encouraged by fiscal incentives.

IMPLICATIONS FOR REFORMS OF THE INVESTMENT INCENTIVES SYSTEM

Three major points may be deduced from the discussion. One, fiscal incentives are real costs. Two, these must be compensated by net benefits to society. Three, errors could mean huge losses (from the forgone revenue and the net losses from the activity itself). Such potential losses would occur if the OIC was not performing its role: correcting market failure. Hence the major objective of reforms should be to transform BOI and the investment system into one that would fit better its ideal role in industrial policy – correcting market failures and distortions and performing real industrial promotion. Another objective is to set up a system that would minimize mistakes and the resulting losses. These considerations would not

Table 2. BOI-approved projects: Top 20 firms, by project cost (2000)

Firm	Product	Project Cost In P'000	Ownership %Filipino
Central Negros Power Corp.	Power-generating plant	4447478	100.0
Bayan Telecommunications, Inc.	Local exchange telephone	3500000	100.0
Aces Philippines Cellular	Global mobile personal	3166300	100.0
Star Infrastructure	Southern Tagalog arterial	2217000	100.0
The Purefoods-Hormel C	Processed meat	1312756	60.0
Maritime E-Training, Inc.	IT -enabled support & knowledge	1083291	100.0
Southern Energy Mobile, Inc.	Power transmission	1070004	100.0
Bacnotan Industrial Park	Industrial park	1046038	100.0
Sca Hygiene Products Corp.	Adult diaper products	954035	59.3
North Wind Power Development	Power generating plant	911622	100.0
Goldland Philippines	Resort	719201	100.0
Nagtahan Terminals, Inc.	Downstream oil industry	668435	100.0
Philtranco Service Enterprises	Passenger bus service	602855	100.0
Total Information Management	Information technology	516000	99.7
Waste Recovery Company Inc.	Waste oil recycling	516000	50.0
Fluor Daniel Inc.	Engineering design	490117	100.0
Ami (Philippines), Inc.	Electronics	472500	100.0
Pilipinas Kao, Inc.	Fatty alcohol	448000	100.0
Cebu Mitsumi, Inc.	Integrated circuit module	437794	100.0
Universal Star Petroleum	Storage and sourcing of petro	401800	100.0

only help to maximize benefits from tax concessions but also, in effect, ensure that the system would not pose undue burden to our fiscal system. Finally, reforms should be based on three basic principles:

- a) economic soundness
- b) ease/cost of administration
- c) transparency.

A crucial step toward fleshing out these considerations is to limit the number of preferred areas in the IPP using a clear set of criteria. This is for two major reasons:

- a) By nature, the investment incentive system is selective. Without IPP, or with numerous areas in the IPP, the implied industrial policy has no clear focus and will result in dilution of industrial promotion.

- b) This step is necessary to limit the probability of making mistakes (wrong choice of activities granted incentives). A short list will make BOI more judicious and enable it to focus on sectors with extra and real benefits to society. In addition, should a mistake be made, losses will be minimized.

Fiscal incentives are real costs and the wider the IPP areas, the greater the probability of making mistakes and the higher the possible welfare losses (from increased tax concessions coupled with lower benefits to society as a result of those concessions). This is perhaps the more serious drawback of having no IPP (or having an indiscriminate IPP). This situation becomes more alarming the more generous the incentives are.

A supplement to the short list is the introduction of a notional indicative budget for fiscal incentives. This is short of preparing a tax expenditure budget that would have to undergo the usual budgetary procedure, which becomes less necessary with a short list of IPP areas. Besides, such a procedure (and would only clutter the process and make the system even more difficult to administer). However, the proposed budget could still be a very bold and radical change that may be difficult to implement. Hence, the "notional" budget could simply be a system of "fiscal incentives accounting," which the BOI should report at least to the Department of Budget Management (DBM) and the Department of Finance (DOF). Then it may well evolve into a more typical budgeting system, albeit still "notional" (involving a predetermined "notion" of how much fiscal incentives will be granted for the year at the start of the period.) Nonetheless, even just a system of fiscal incentives accounting would already promote transparency and will make the evaluation of the fiscal incentives system easier.

The proposed step should also include a provision that incentives will be available only for a specified period of time. (This is different from the time period specified for when an activity is still included in a list of preferred activities, or more specifically the num-

ber of years the approved investment could avail itself of incentives.) The definite time period is an extra precaution. It should not be too long (preferably should not go beyond what other countries give). Moreover, the definite time period will help ensure that the activities become viable on their own. It would also result in a greater number of areas covered over time.

Finally, this necessary step limiting the IPP to a short list would help reorient the thinking of BOI away from looking at fiscal incentives simply as a means to “increase investments.” While a case could be made in this regard with respect to foreign direct investments (FDI), such is not the case for domestic savings and investments (the level of which is determined by the overall fiscal and monetary policy). Again, if the objective is mainly to increase domestic investments, reforms pertaining to investment incentives should be made universal (e.g., a universal corporate income tax reform).

In view of the fact that the BOI does not want an IPP, it has a number of suggestions on the form of fiscal incentives to be granted. As emphasized earlier, it is crucial that there be a short list of IPP (not merely an IPP), supplemented by a system of fiscal incentives accounting. The form of incentives is secondary. Hence, this is what the reform of the investment incentive system should first aim for – a short list of IPP. The challenge is how to do this while addressing BOI’s concerns.

Proposal: A Two-tiered Approach

To stay within the basic principles and at the same time address the concerns of BOI, a compromise proposal is a two-tiered approach to the investment incentive system. Such a two-tiered approach incorporates the BOI’s position to do away with the IPP at the generic level but at the same time addresses the need to be very selective at the second level. This approach is described as follows:

First tier: Generic incentives

- a) no IPP, only BOI processing based on comparative advantage;
- b) fiscal incentives:
 - 1) Incentive for anti-pollution devices (T/D free import)
 - 2) Double deduction for R&D
 - 3) Tax allowance for LDA locators
 - 4) NOLCO: four years in MM, six years outside (length negotiable)
 - 5) For exports, access to inputs (including capital equipment) at world prices
 - ❑ Schemes already existing (e.g., tax and duty drawback system, bonded manufacturing warehouse)
 - ❑ Seek ways to improve availment.
 - ❑ This is not subject to GATT, since all it offers is access to inputs at world prices. Many other countries are practicing this.

Second tier: Special incentives

- a) Very selective IPP with stricter rules of selection
 - 1) A short list of at most five sectors at four-digit PSIC level, or its equivalent, shall be selected for special incentives.
 - 2) In the case of foreign investments falling outside the short list, direct foreign investments greater than, say, \$20 million, shall be considered for incentives.
- b) Fiscal incentives, in addition to generic incentives, composed of:
 - 1) BOI proposal: ITH with creditable employment taxes or NOLCO (longer than generic incentives above); thereafter, reduced income tax (six years within Metro Manila, eight years outside Metro Manila); or DOF proposal: tax credit equivalent to 10 percent of value-earned (or value-added)
 - 2) BOI proposal: tax and duty exemption on imported capital equipment

- 3) The short list of IPP shall be prepared by an interagency committee (Committee) chaired by BOI and composed of NEDA, DTI, DOST, private sector representatives and other invited agencies. The final list of IPP shall be approved by the Board (whose composition is extended to include DOF and NEDA).

Other provisions of the legislation were as follows:

- a) It should require presentation of a fiscal incentives accounting
- b) It should require a review of the IPP areas every two (or three) years and prepare a new short list of IPP areas
- c) It subsumes existing fiscal incentive schemes that are clearly for industrial policy leave other social objectives in the hands of the appropriate government agency (DENR for environment, DOH for health, etc).

If BOI (and eventually, Congress) will agree to a two-tiered approach and a system of fiscal incentives accounting, the form of fiscal incentive then becomes a secondary concern and concessions could be made there. This would constitute a big step in reforming the investment incentive system, the results of which could greatly benefit the country.

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Annex A. BOI equity investments, new and expansion projects by source and by market (in million pesos)

Year	By Source			Local Equity	Foreign Equity
	Total	Local	Foreign	DomOth	DomOth
1985	1,569.71	699.99	869.72	297.23	24.94
1986	1,354.22	1,012.43	341.80	450.43	64.77
1988	14,313.86	6,655.05	7,658.81	2,647.08	3,292.65
1990	40,109.96	21,961.38	18,148.59	16,201.93	9,582.63
1991	33,005.33	18,960.81	14,044.52	15,485.07	11,808.76
1992	15,957.63	10,360.14	5,597.49	7,953.18	3,604.66
1993	25,902.41	13,716.44	12,185.98	10,407.83	7,363.63
1994	157,338.19	96,050.89	61,287.30	78,857.05	48,213.59
1995	98,626.75	59,134.65	39,492.10	53,904.14	36,296.69
1996	110,613.77	86,081.08	24,532.69	82,596.73	20,784.81
1997	183,564.22	129,731.52	53,832.69	127,080.75	48,865.31
1998	80,906.92	44,475.09	36,431.83	43,757.77	33,748.25
1999	41,202.87	21,631.16	19,571.71	20,215.89	16,216.28
2000 r	16,399.74	9,816.01	6,583.73	8,494.57	3,760.05
2001	62,889.52	44,784.14	18,105.38	41,364.63	15,187.24

Source: Table 12, Selected Statistics on BOI-Approved Projects Under E.O. 226, by Type of Project and by Sector, Board of Investments.

Annex A (continued)
Equity investments in projects approved by BOI under E.O. 226, new and expansion projects, by sector
(in million pesos)

Year	By Source			Local Equity			Foreign Equity			Others	Others
	Total	Local	Foreign	Domestic	DomOth	Export	Domestic	DomOth	Export		
1985	1,569.71	699.99	869.72	297.23	297.23	402.77	24.94	24.94	844.78	-	-
1986	1,354.22	1,012.43	341.80	450.43	450.43	562.00	64.77	64.77	277.02	-	-
1988	14,313.86	6,655.05	7,658.81	2,647.08	2,647.08	4,007.97	3,292.65	3,292.65	4,366.16	-	-
1990	40,109.96	21,961.38	18,148.59	7,036.82	16,201.93	5,759.45	9,165.11	2,697.97	9,582.63	8,565.96	6,884.66
1991	33,005.33	18,960.81	14,044.52	10,904.46	15,485.07	3,475.74	4,580.61	7,375.05	11,808.76	2,235.76	4,433.71
1992	15,957.63	10,360.14	5,597.49	4,822.60	7,953.18	2,406.96	3,130.58	1,521.20	3,604.66	1,992.83	2,083.45
1993	25,902.41	13,716.44	12,185.98	5,431.34	10,407.83	3,308.60	4,976.49	2,910.80	7,363.63	4,822.35	4,452.83
1994	157,338.19	96,050.89	61,287.30	37,429.58	78,857.05	17,193.85	41,427.47	20,209.24	48,213.59	13,073.70	28,004.35
1995	98,626.75	59,134.65	39,492.10	18,418.07	53,904.14	5,230.51	35,486.08	30,682.30	36,296.69	3,195.41	5,614.38
1996	110,613.77	86,081.08	24,532.69	8,549.99	82,596.73	3,484.35	74,046.74	3,850.94	20,784.81	3,747.88	16,933.87
1997	183,564.22	129,731.52	53,832.69	17,384.45	127,080.75	2,650.78	109,696.30	3,624.15	48,865.31	4,967.38	45,241.16
1998	80,906.92	44,475.09	36,431.83	13,783.33	43,757.77	717.33	29,974.44	14,405.56	33,748.25	2,683.58	19,342.69
1999	41,202.87	21,631.16	19,571.71	5,047.10	20,215.89	1,415.27	15,168.79	13,004.93	16,216.28	3,355.43	3,211.35
2000 r	16,399.74	9,816.01	6,583.73	8,493.78	8,494.57	1321.443	0.79	3759.572	3,760.05	2823.682	0.478
2001	62,889.52	44,784.14	18,105.38	40,801.73	41,364.63	3,419.51	562.90	15,147.18	15,187.24	2,918.14	40.06

Note: Others (considered as domestic in foregone revenue computation):

Energy-related projects include power generating projects; Tourism-oriented projects include accommodation facilities (hotels/resorts), transport facilities (buses, coasters, cars) and other tourism-oriented projects; Public utilities include transport services like shipping, mass transport operation, cargo; Infrastructure service facilities include infrastructure for industrial estates, telecoms and other infrastructure projects; IT projects include softwares and hardware services, and website development.