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Fiscal Incentives Revisited

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The Philippines has a long experience in providing fiscal incentives to favored activities. Even before it institutionalized the investment incentive system in 1967 with the passing of the first Omnibus Investment Code (OIC), the government has been granting fiscal incentives to selected industries that it deemed, rightly or wrongly, to have large potential positive impact on the economy. There have been amendments to the Code 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 Executive Order 226). Throughout all these changes, the major strategy has been, at least until recently, to channel investments to sectors considered "desirable" in terms of key objectives. The latter invariably included employment generation and export promotion.

During the past few years, however, the strategy seems to have shifted more to "attracting" investments. And while the objectives of employment generation and export promotion are still there, they appear to be considered more as expected results (side effects) of attracting investments. At a glance, such a strategy appears to be less interventionist. However, there are serious implications not readily recognized that need to be examined. First is on the ideal role of fiscal incentives. And second is on government revenues.

The investment incentive system: a revisit

Basic principle: correcting for market failures

As a general rule, *the basic principle is that government should intervene only where the market fails*. The well-known examples are the cases of public goods like national defense, merit goods like education and health, equity objectives, incomplete markets (imperfect capital market) and externalities (activities of individuals with external impacts to society). And even in these cases of market failures, the government, because of its limited resources, should always evaluate (1) how it could intervene with the least cost and best results, and (2) if, given the cost, it should intervene at all.

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 said fiscal incentives. It is thus undoubtedly a form of (selective) government intervention. As such, the same underlying principle should apply. There should be some market failure

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that the government is trying to address. Indeed, there could be various market failures and distortions that prevent the optimal allocation of investment to occur, thereby preventing the industrial sector to assume its natural role as the leading sector in the development process. The investment incentive system therefore is ideally one measure to help the industrial sector realize its potential.

Its use as an industrial policy tool

There is indeed a role for fiscal incentives as an industrial policy tool, arising from the existence of market failures, e.g., those involving externalities and market distortions. In general, the effect of these externalities and market distortions is to make certain activities less financially profitable than they actually are from the point of view of society. There is therefore justification for granting fiscal incentives—to make socially profitable activities financially profitable as well.

Numerous arguments have been raised, however, regarding the manner of identifying such cases and the effectiveness of such a "selective" approach. This explains the practicality of focusing fiscal incentives on exports. The challenge is in choosing an activity regardless of export orientation but with large potential benefits to society. Hence, we are back to the difficulty of "picking winners." And while there is a lot of questions here, if done right, there are also potential gains.

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. Of course, this refers only to domestic investment and temporarily sets aside the question of attracting more foreign investment which will be discussed later.

As noted, the level of domestic savings and domestic investment is influenced by fiscal and monetary policy such as the overall tax rate, corporate income tax, and other general fiscal measures, not by the fiscal incentive system. The investment would therefore have happened as well even without said fiscal incentive, perhaps in another activity not encouraged by the fiscal incentive system or maybe even in the same activity. Thus, there are real fiscal costs involved in terms of forgone revenues. That is, whatever fiscal incentives are granted, the tax concessions (revenue forgone) are real "budgetary" costs to the government and should be justified by corresponding benefits. A rational government would therefore compare the benefits from granting these fiscal incentives vis-à-vis other government expenditures.

The role of fiscal incentives in attracting foreign investment

The above discussion disregards the question of attracting foreign investment with fiscal incentives. *Indeed, new foreign investment represents a net increase in available saving that would lead to higher output and growth*. Thus, 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.

Such view has of course been subject to question. Studies suggest that the fiscal incentive system is not a very important factor in a firm's decision to locate in a certain country. A good overall climate for investment, both domestic and foreign, and an expectation of stability and consistency in the economic policy regime can actually be of greater importance than tax exemptions and credits, particularly in attracting the kinds of investments that would be desirable and lasting (Aldaba 1996). Nonetheless, fiscal incentives remain to be a means of attracting foreign direct investments.

Fiscal incentives cost

Still, the bottom line is: *fiscal incentives are not costless. They are forgone revenues*. And 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.

The problem is that these costs are hidden costs, there being no outright payments involved. This makes fiscal costs difficult to estimate, especially considering that there are no robust data on investments—how much of these are registered with the Board of Investments (BOI) and how these investments are actually performing. Nonetheless, an attempt is made here to at least come up with some ballpark

figures to give us an idea (however rough) on what we are actually "spending" in the granting of these incentives, at least for income tax holiday (ITH).[1] In the process, some heroic assumptions would be made, hopefully with clear indications of the direction of the bias involved.[2]

Three sets of assumptions are made that yield three levels of estimates of forgone revenues, namely: (1) a high estimate of forgone revenues from ITH, (2) an intermediate estimate, and (3) a low estimate (not necessarily a lower bound). For all three estimates, there were three common assumptions.

One is that the return on investment (inclusive of tax) is 15 percent. This is based on the cut-off rate being used by the Investment Coordination Council in its evaluation of projects. While this may be too high, the estimates, however, are simply meant to be indicative and adjustments could easily be made by the reader to suit his own purpose. The higher the estimate is, the higher the forgone revenue implied is. One thing to keep in mind, however, is the question of why the government should reward unprofitable activities, unless there are clear externalities involved.

Two is that the realization rate of project proposals approved by the BOI is assumed to be 75 percent. And though again this may be too high, the BOI estimate showed that, in the case of incentives granting tax and duty free importation of capital, the actual availment was around 80 percent of that expected from project proposals. As such, the 75 percent rate is not unreasonable although adjustments could easily be made if this assumed rate is proven to be too high (or low). And *three* is that the average period of availment is five years.

In addition to the above common assumptions, there are also assumptions specific to the level of estimates. For the high estimate, the additional assumption is that investments would have been made anyway, even if in different activities. Thus, the forgone revenues are real costs since investment was only diverted from an activity that would have paid income tax to one that would not.

For the intermediate estimate, the assumption is that half of the foreign investment is lured by fiscal incentives, so that there would be no forgone revenues for these investments. And for the third set (low) of assumption, it is assumed that all foreign investments came in because of fiscal incentives, so that there are no forgone revenues for foreign investment. This is probably an extreme assumption (just as some would consider the assumption that all domestic investments would have been made anyway albeit in different activities). Again, these estimates are not meant to be absolute. Table 1 summarizes the estimated costs.

The estimates are disturbingly high—from a low of PhP10.6 billion to a high of PhP18.5 billion, considering that the collected revenues from corporate income tax for year 2000 amounted only to around PhP44.8 billion. It is difficult to judge if this really indicates how prevalent fiscal incentives are because of the absence of actual figures on investment. Nonetheless, this provides a clear indication that the forgone revenues are not minimal. And if these costs are not matched by corresponding benefits to society, then the implications are grave. Indeed, a worse case scenario is one where the Investment Priorities Plan (IPP) is promoting the wrong set of activities.

Based on actual availment of incentives, the BOI recorded around PhP4.2 billion from income tax holiday. Some insights could be gleaned from such a big gap between this actual availment figure from BOI and the estimates presented here. It could imply that the realization of investments for approved BOI projects is much lower than 75 percent (possibly only 30 percent), or the rate of return on investment for these BOI projects is much lower than 15 percent (pos-

Table 1. Estimates of forgone revenues per level of estimates (In million pesos)

Year	High	Intermediate	Low
2000	15,645.63	13,108.15	10,570.66
1999	18,536.92	15,407.42	12,277.93

[1] No attempt here is made to estimate revenues forgone from tax and duty free importation of capital as these incentives have expired. Moreover, the estimate on ITH alone already clearly indicates the magnitude of the cost of fiscal incentives.

[2] Hopefully, the errors involved in the simplification would also tend to cancel each other out.

sibly as low as only 6 percent), or most likely, some combination of both. In any case, if it were the former (low realization rate), then BOI should improve its follow-up and monitoring of approved cases and determine where the problems are. If it were the second (low return), then it raises more doubts on the benefits of the fiscal incentive system.

Lack of data about the actual firms' performance and significance had limited 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. This 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. The nature and product of the firm would also give an idea about whether the activity yields some externality (extra benefits to society, outside costs and benefits internal to the firm) that could provide a justification for its eligibility to receive fiscal incentives. For example, the fact that most of the investments made are domestic suggests that most likely, these are not additional investments encouraged by fiscal incentives.

Implications for reforms in the investment incentives system

Objective for reforms: transform the OIC to suit its ideal role

Three major points come out from this revisit. *One* is that fiscal incentives do have costs. *Two*, such costs must be compensated by net benefits to society. And *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 is not performing its role. Hence, the major objective for reforms should be to transform the BOI and the investment system into one that would fit its ideal role in industrial policy better—that of correcting for market failures and distortions, and performing real industrial promotion. Another objective is to set up a system that would minimize mistakes and losses from these mistakes. These considerations would not only help to maximize benefits from tax concessions but also ensure that the system would not, in effect, pose undue burden on our fiscal system.

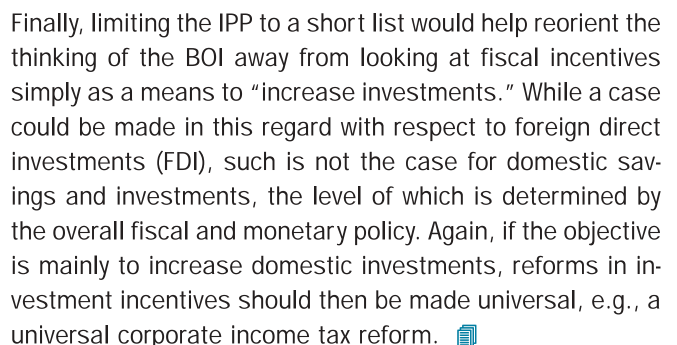
What needs to be done?

A necessary step towards this end is to limit the number of preferred areas in the IPP to, say, only 3-5 focused areas at a time because:

- 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 a dilution of industrial promotion.
- This is necessary to limit the probability of making mistakes (wrong choice of activities that are granted incentives). A short list will make the BOI more careful and judicious. It will also more likely help the BOI come up with sectors with extra and real benefits to society. In addition, should a mistake be made, the magnitude of losses will be limited.

Again, fiscal incentives have costs. And the wider the IPP areas are, the greater is the probability of making mistakes, thereby also increasing the possible welfare losses (from increased tax concessions coupled with lower benefits to society brought by these concessions).

The preferred list should necessarily pass a clear set of criteria. There should also be a provision that incentives will be available only for a definite and specified period of time. The definite time period is an extra precaution and should not be too long. It will also help ensure that the activities would become viable on their own and will result in a greater number of areas covered over time.



Finally, limiting the IPP to a short list would help reorient the thinking of the 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 in investment incentives should then be made universal, e.g., a universal corporate income tax reform.

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