

## A REVIEW OF FISCAL INCENTIVES FOR EXPORTS IN THE PHILIPPINES

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### I.0 INTRODUCTION

In recent years, there has been a renewed concern in the design and administration of export promotion policies. Worldwide, this interest has been stimulated by the success stories of the East Asian dragons; success that has been largely attributed to their export performance. At the same time, the works of Bhagwati (1978), Krueger (1978), Michaely (1977), and Balassa (1978), among others, documented with cross-country data the positive link between economic growth and exports. In the Philippines, a recurring balance of payments problem has highlighted the need to nurture exports. Furthermore, the import substituting strategy pursued in the 1950s and 1960s and the concomitant trade regime that has been carried over into the 1970s and early 1980s are perceived by many as exhibiting an overwhelming bias against exports (Power and Sicut 1971; Tan 1979; Medalla 1986).

In this context, export promotion becomes imperative not only because exports are by themselves desirable owing to the foreign exchange they bring and their favorable growth implications but also because of the need to counteract the antiexport bias of the prevailing trade regime and, thus, to create a more neutral incentive environment. In principle, export promotion implies the use of instruments that (1) compensate for the implicit penalties against exports in the macroeconomics milieu, and (2) provide incentives to the exporting activity over and above those which would prevail in a neutral strategy. However, it should be stressed that the emphasis of this paper will be on the identification of instruments that will neutralize the penalty on exports inherent in the present macroeconomics environment rather than on the provision of subsidies to exports per se.

The purpose of this paper is to review and analyze fiscal incentives for exports in the Philippines. Specifically, this study will focus on the assessment of the incentives provided under the aegis of the Board of Investments (BOI) and the Export Processing Zone

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Authority (EPZA) and the tax and duty exemption/drawback schemes administered by the Bureau of Customs (BOC) and the BOI.

The next section presents an analytical framework for the design of a rational incentive package for exports. The nontechnical reader may skip it but should take note that it derives the desirable characteristics of an export policy that will mitigate, if not eliminate, the bias against exports arising from the existing protection structure. The first-best solution consists of zero tariffs on imports and a realistic exchange rate policy. In a second-best scenario, in the period when the first-best solution is not yet forthcoming because of political and other considerations or in the interim period before a first solution is actually put in place, the appropriate set of policies include: (1) providing exporters access to intermediate and capital inputs at free trade prices; (2) ensuring that exporters are subject to a free trade exchange rate, or, alternatively, that they are compensated for the penalty to them that results from an overvalued exchange rate; and (3) possibly providing exporters with the same amount of net effective protection accorded to producers in the import substituting activity.

Section 3 describes and evaluates the existing fiscal incentives to exports against the backdrop outlined in the preceding section. Finally, the last section summarizes the findings of the study.

## 2.0 THEORETICAL FRAMEWORK

The rationale for the provision of export incentives is better understood by taking a closer look at the bias against the export activity relative to the import substituting activity (engendered by the prevailing protection structure). The bias against exports,  $B$ , may be defined as the proportional difference in the domestic value added in import substitution and the domestic value added in exporting (Balassa 1971). Alternatively,  $B$  may be viewed as the proportional difference in the level of effective protection accorded to the import substitution activity and the exporting activity. Thus,

$$B_j = \frac{v_{dj}^{is}}{v_{dj}^x} - 1 \quad (1)$$

or,

$$B_j = \frac{(1 + T_j^{is}) - \sum_i a_{ij} (1 + T_i)}{(1 + T_j^x) - \sum_i a_{ij} (1 + T_i)} - 1 \quad (2)$$

or

$$B_j = \frac{(1 + \text{EPR}_j^{\text{is}}) v_j^{\text{is}}}{(1 + \text{EPR}_j^{\text{x}}) v_j^{\text{x}}} - 1 \quad (3)$$

where  $v_{dj}$  is domestic value added in industry  $j$ ,

$v_j$  is free trade value added in industry  $j$ ,

$T_j$  is the implicit tariff rate on the output of industry  $j$ ,

$T_i$  is the implicit tariff rate on intermediate input  $i$ ,

$a_{ij}$  is the amount of intermediate input  $i$  used to produce one unit of output  $j$ ,

$\text{EPR}_j$  is the effective protection rate of industry  $j$ ,

$\text{is}$  refers to the import substituting activity, and

$\text{x}$  refers to the export activity.<sup>1</sup>

$B$  may be measured directly for aggregate (or sectoral) exportables and importables by taking into account prevailing tariffs and quantitative restrictions on imports as well as all subsidies actually granted to exports (including BOI/EPZA incentives and duty exemption/drawback on imported inputs into exports). The present paper, however, follows another track. It simply uses equation (2) as a starting block in the formulation of criteria against which the existing incentive system for exports may be assessed. Thus, for analytical purposes, equation (2) is initially viewed from the perspective of a situation where there are tariffs and nontariff measures on importables but where taxes and subsidies on exports are assumed to be zero. Next, the set of conditions that will reduce, if not eliminate, the bias against exports that results from the protection structure is derived. These conditions are then used as guideposts in the actual appraisal of the prevailing export incentive schemes in Section 3.

In a situation where there are no subsidies on exports and where the implicit tariff rates on importables are not all equal to zero,  $B$  is

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1. The implicit tariff is the ratio of domestic price to border price of any given community less one.

positive.<sup>2</sup> This measure represents the penalty on exports relative to import substitution that the protection structure perpetuates. This antiexport bias can be eliminated by reducing the expression in equation (2) to zero. The first-best and most direct way of achieving this is by the outright removal of tariffs and restrictions on all imports. Doing this reduces both the numerator and denominator of the first term in (2) to the free trade value added,  $v_j$ . It also implies that the effective protection rate,  $EPR$ , is zero for all  $j$ 's. Consequently,  $B$  becomes equal to zero. However, both economic (adjustment costs, timing/sequencing issues, etc.) and noneconomic (political, etc.) considerations may indicate that the first-best approach may not be feasible in the short run or even in the medium term. The second-best solution would then compensate for the bias against exports via a combination of a subsidy on output and an exemption/drawback on taxes on inputs used in the production for exports.

The appropriate combination of instruments in this second-best scenario suggests itself, if, from equation (2), we were to ask: what adjustments must be introduced in the denominator of the first term, i.e., the domestic value added in the exporting activity, to make it equal to the numerator of the first term, i.e., the domestic value added in the import substituting activity, so as to remove the bias against exports? And the answer is: simultaneously reduce all  $T$ 's in the exporting activity to zero and augment the resulting value added by an amount equal to  $(EPR^is) v_j$ . In other words, the bias against exports arising from the protection structure may be counteracted by (1) giving export producers access to inputs (intermediate and capital) at world market prices, (2) ensuring that exporters are subject to a free trade exchange rate, and (3) providing exporters with the same amount of net effective protection accorded to producers in the import substituting industry.

Setting all  $T_i$ 's on intermediate inputs to the export activity to zero would reduce equation (2) into:

$$B_j = \frac{(1 + T_j^{is}) - \sum_i a_i (1 + T_i)}{1 - \sum_i a_i} - 1 \quad (4)$$

2. Medalla (1990) estimated the average tariff on importables to be 30 percent and the implicit tariff on exportables to be negative 2 percent in the second half of the 1980s. The resulting EPRs are 75 percent for the former and -4 percent for the latter.

$$B_j = \frac{(1 + EPR_j^{is}) v_j^{is}}{v_j^{is}} - 1 \quad (5)$$

Thus, by making intermediate inputs used in export production tariff free, adjustment (1) puts exporters on an equal footing with their foreign competitors in terms of costs of inputs. It equates domestic value added in exports to its free trade value added and reduces the EPR in the export activity to zero. This adjustment may be broken down into the following: (1a) the elimination of nontariff restrictions on the importation of inputs to export production, (1b) tax and duty free importation of intermediate inputs and capital equipment used in export production, (1c) the giving to exporters of a rebate equal to the implicit tariff times the border price of locally-sourced importable inputs, and (1d) the granting to exporters of a rebate equal to the implicit tariff times the border price of the importable goods content of nontraded and domestically-procured intermediate inputs. Adjustments (1c) and (1d) are essential because tariff and nontariff measures drive a wedge between the border price and domestic price such that the domestic price of the importable input, regardless of whether it is actually imported or purchased locally, increases by an amount equal to the implicit tariff,  $\tau$ . These adjustments are necessary to avoid the discrimination against the use of domestically-produced, importable intermediate and capital inputs in export production that will arise if only adjustments (1a) and (1b) are put in place. They would, thus, encourage efficient backward linkages in the export activity. At the firm level, adjustment (1d) may be given to final exporters in the hope that its benefits will be passed on to the indirect exporters or that it may be made available directly to indirect exporters.

Equation (5) suggests that even after exporters have been given access to inputs at undistorted prices, some bias against them would still remain relative to their world competitors as well as relative to domestic producers of import substitutes. Specifically, the remaining penalty on exports is equal to the product of the effective protection rate in import substitution and the free trade value added in the export activity, i.e.,  $EPR_j^{is} \times v_j^*$ . Recall, however, that the effective protection rate may be expressed as:

$$(1 + NEPR_j) = \frac{(1 + EPR_j)}{(r^* / r)} \quad (6)$$

where  $NEPR$  is the net effective protection rate in industry  $j$ ,

$*r$  is the shadow exchange rate, i.e., the exchange rate that will obtain under a free trade regime, and

$r$  is the official exchange rate.

This implies that the remaining correction may be subdivided into two parts: (a) granting exporters an incentive whose benefit is equal to the proportional difference between the shadow exchange rate and the official exchange rate times the free trade value added in the exporting activity, i.e.,  $[(r^*/r) - 1] v_j^x$ , or what we call adjustment (2), and (b) giving exporters an incentive whose benefit is equal to the net effective protection rate of the import substituting activity, times the free trade value added in the export activity,  $v_j^x$ , i.e.,  $NEPR_j^{is}$ , or what we refer to as adjustment (3).

Thus, introducing adjustment (1) and adjustment (2) in equation (2) yields the following:

$$B_j = \frac{(1 + EPR_j^{is}) v_j^{is}}{v_j^x + v_j^x (r^*/r - 1)} - 1 \quad (7)$$

Substituting equation (6) in equation (7), we obtain:

$$B_j = \frac{(r^*/r) (1 + NEPR_j^{is}) v_j^{is}}{(r^*/r) v_j^x} - 1$$

or,

$$B_j = \frac{(1 + NEPR_j^{is}) v_j^{is}}{v_j^x} - 1 \quad (8)$$

Once it is recognized that the protection system makes it possible to maintain a balance of payments equilibrium at a lower exchange rate than that which will prevail under a free trade regime, it becomes apparent that making exporters truly competitive in the international market would not be enough to provide them with inputs at free trade prices. It is also necessary to compensate them for the undervaluation of the foreign currency that is engendered by the tariff system. This would require that the net effective protection rate of exports be made to equal zero by giving exporters

tariff free inputs and allowing them to enjoy a free trade exchange rate. In this manner, exporters are given a truly free trade status.

On the other hand, if exporters were to be given a compensating adjustment equivalent to the net effective protection received by producers of import substitutes on top of corrections (1) and (2), they would be placed on an equal footing not only with their foreign competitors but also with import substituting domestic producers.

It should be emphasized that, depending on the manner in which corrective measures are actually implemented, the bias against exports might be reduced on a firm level basis or on an aggregate or industry basis. Moreover, reducing  $B$  to zero on an aggregate basis is no guarantee that the bias against exports at the firm level would also be eliminated. In this case, what usually happens is that certain importers are overcompensated while others are undercompensated. What results then is a greater dispersion of the incentive structure at the firm level than originally intended.

Incentives that are granted on an across-the-board basis, as well as those that are designed to achieve specific objectives, tend to provide the appropriate adjustments at the level of the firm. On the other hand, indirect ways of counteracting the disincentives to export (e.g., granting of an accelerated depreciation allowance to compensate for the overvaluation of the domestic currency) are not only less cost effective but also likely to have undesirable side effects.

### 3.0 ANALYSIS OF FISCAL INCENTIVES TO EXPORTS

Given the perspective of Section 2, we are now ready to evaluate the existing package of incentives to exports. At present, the Philippines employs a number of schemes, all aimed at providing free trade status to exports in terms of their intermediate input use. These are discussed in detail in 3.1. BOI and EPZA also grant various other incentives to export producers; these are reviewed and analyzed in 3.2.

#### 3.1 *Access to Intermediate Inputs at World Market Prices*

##### 3.1.1 *Description*

To ensure that exporters are competitive with their foreign counterparts as far as input cost is concerned, the government administers tax and duty exemption as well as tax and duty drawback mechanisms. BOI-registered and EPZA-registered export producers are allowed tax and duty free importation of capital equipment. At the same time, exporters may avail themselves of tax and duty exemption on imported intermediate inputs via any one of the

following: (1) locating in an export processing zone (EPZ), (2) using bonded manufacturing warehouse (BMW) facilities, and (3) importing under Customs Administrative Order 3-78 (CAO 3-78). On the other hand, tax and duty drawback on imported intermediate inputs used in export production may be obtained under the following modes: (1) individual drawback scheme of the Bureau of Customs (BOC), and (2) fixed drawback scheme of the BOI.

EPZ enterprises are exempt from tariffs, taxes and other restrictions that might otherwise be imposed on their imports. In terms of value of exports, EPZ enterprises ranked second amongst firms that availed themselves of the various exemption/drawback systems (WB 1987). To import intermediate and capital inputs, EPZ enterprises are asked to follow a five-step process requiring only three documents (Table 1), while other exporters wishing to import under consignment need to submit a total of 23 documents (Table 2). Also, the non-CIF cost of imports of EPZ firms is low. The processing fee charged by EPZA on each shipment is no more than ₱200 (DTI, 1988).

Likewise, the bonded manufacturing warehouse system allows exporters to import inputs free of tax and duty. It also facilitates the release of imported raw materials from the BOC. There are at least fifteen documentary requirements for the establishment of a BMW. Foremost amongst these are: (1) BOI registration; (2) the firm's commitment to export at least 70 percent of its output; (3) annual FOB sales which should be at least equal to US\$1 million; (4) "formula of manufacture"<sup>3</sup>; and (5) copy of feasibility study of BMW operations. There are also specific requirements to be met regarding the physical condition of the BMW (Table 2). The operation of a BMW entails the payment of certain fees: (1) a fixed annual supervision fee of ₱45,000; (2) a performance bond of ₱200,000 to guarantee compliance with the laws and regulations affecting BMWs; and (3) a reexport bond equivalent to the amount of duties, taxes and other charges that would have been due otherwise. Finally, all imports of BMWs are required to be covered by a BOI certificate of nonavailability of local substitute.

While access to BMWs tends to be effectively limited to large firms producing primarily for the export market, small, medium and indirect exporters may import raw materials tax and duty free by making use of the facilities of common customs bonded warehouses (CCBWs) operated by the Philippine International Trading

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3. The "formula of manufacture" consists of physical input coefficients endorsed by the National Institute of Science and Technology (NIST) and differentiating between domestically-produced and imported inputs.



**Table 1**  
**DOCUMENTATION AND PROCEDURAL REQUIREMENTS**  
**FOR IMPORTS OF EPZ FIRMS**

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The following are the documentation and procedural requirements for the importation of goods for EPZA enterprises:

1. Application for an Import Permit (IP) shall be filed with the Enterprise Assistance (Import-Export) Division of the Enterprise Operations Department, EPZA, in Manila, or with the Enterprise Service Division in the zones. The application is made on EPZA Form No. 8101 (IP) accomplished in eight (8) copies, accompanied by the following:
    - a) Firm offer;
    - b) Proforma invoice; and
    - c) Sales contract.
  2. Upon approval, copies of the permit shall be distributed as follows:
    - a) Original and yellow copies to the importer;
    - b) Green copy to the BOC, Manila; and
    - c) Blue copy, one each to the EPZA Police and the Manila International Container Port (MICP).
  3. The examiner or the Enterprise Service Officer I (ESO I) will assess the amount of processing fee to be paid by the importer and issue a payment slip to the cashier.
  4. The importer pays the processing fee to the cashier of the Financial Department, and presents the official receipt (OR) to the Import-Export Division.
  5. The importer submits to the Import-Export Division of EPZA a photocopy of the L/C or other documents evidencing the mode of payment, together with the sales contract. Failure to submit the required documents within thirty (30) days from the approval of the permit shall be a ground for cancellation of the permit by EPZA, unless extended on reasonable grounds.
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Corporation (PITC), Philippine Exporters Foundation (Philexport), Mindanao Textile Corporation (Mintex), Philippine Integrated (Manufacturers) Exporters, Inc. (PIE), Red Flower Garments, Inc., and Royal Undergarments Corporation (RUC), and others. BMWs and CCBWs account for the biggest chunk of exports (in terms of export value) with access to duty free imports (WB 1987).

Entities that operate CCBWs essentially serve as import agents of small exports for a service fee that ranges from 1 to 4 percent of the CIF value of imports. The exporters are generally required to be

**Table 2**  
**DOCUMENTARY AND OTHER REQUIREMENTS FOR**  
**ESTABLISHMENT OF BMWs**

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*Without Subcontracting*

1. Instruments evidencing absolute ownership or lease contract covering the proposed warehouse;
2. Plant location showing means of access to the property;
3. Plant layout showing and describing the size and construction of the proposed warehouse, together with the intended use of each room, section or compartment, as well as the surrounding premises;
4. Flow chart showing the nature of the work of manufacture/processing;
5. Certified true copy of Registration Certificate with the SEC, together with the Articles of Incorporation and By-Laws of Co-Partnership, as the case may be;
6. Certified true copy of Registration Certificate with the BTRCP and BIR;
7. List of machinery and equipment;
8. Certified true copy of Certificate of Registration with the BOI;
9. BOI endorsement of the application (for garments, GTEB issues the license to operate a BMW);
10. Copy of Inspection Permit from the Electrical Department;
11. List of articles to be manufactured;
12. List of all raw materials to be imported;
13. Formula of manufacture, patterns or sketches of articles to be exported;
14. Building (mayor's) permit; and
15. Copy of project feasibility study of BMW operation.

*With Subcontracting*

1. Name of subcontractor;
2. Copy of contract with the subcontractor;
3. Certificate of accreditation of the subcontractor, if already accredited by BOC; if the subcontractor selected has not as yet been accredited, a letter of application of the subcontractor, together with other documents required for the application;
4. Flow chart showing the specific processing stage to be subcontracted; and
5. List of materials to be subcontracted.

Table 2 (continued)

*Physical Conditions*

1. Plant location — The proposed BMW shall be located in an accessible place to ensure easy inspection by customs officials.
2. Compartments for materials/articles
  - a) Every BMW shall have permanent compartments separated from the premises to be used exclusively for the storage and safekeeping of all imported materials, finished articles ready for export, and by products/wastages;
  - b) The compartment shall be properly secured to prevent any unauthorized person from having access thereto;
  - c) Such compartments shall each have two locks: the key of one lock shall be kept by the customs bonded warehouse officer at all times and the key to the other lock shall be kept by the operator;
  - d) The contents therein shall be properly arranged for the convenience of the authorized customs official making the required examination, inspection or inventory.
3. Office space for customs personnel. — Accessible and adequate office space shall be provided for the customs personnel to be assigned at the BMW.

*Fees*

1. Supervision fee equal to ₱45,000 per annum.
2. Performance bond in the amount of ₱200,000 to guarantee compliance with laws and regulations affecting BMWs.
3. Re-export bond equivalent to the amount of duties, taxes and other charges that would otherwise be due.

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Source: DTI (1988)

registered with either the BOI or NACIDA or to be accredited by the BOI, NACIDA, BOC, GTEB, etc. The documentary requirements for accreditation in a CCBW varies from 5 to 17 (Table 3). They also have to comply with the "formula of manufacture," the BOI certification of nonavailability of local substitute, and the posting of the reexport bond requirements.

CAO 3-78 exempts small- and medium-scale exporters from the payment of duties and taxes on raw materials imported on consignment basis. To be eligible for this privilege, exporters have to satisfy

**Table 3**  
**SAMPLE ACCREDITATION REQUIREMENTS FOR CCBW**

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**A. Philexport**

In order to be accredited with Philexport, the exporter must submit a duly accomplished application form together with:

1. Bank certification of export performance;
2. Copy of business papers;
3. Formula of manufacture;
4. General service agreement; and
5. Accreditation fee.

**B. Red Flower Garments**

1. Duly accomplished GTEB-BMW Form No. 11-A (to be notarized);
  2. Copy of Articles of Incorporation/Articles of Partnership;
  3. Copy of Mayor's Permit;
  4. Copy of Income Tax Return (ITR);
  5. Copy of Audited Financial Statements (AFS) of Interim Balance Sheet (if operating for less than a year);
  6. Sketch of location of plant and factory;
  7. Plant layout;
  8. List of authorized representatives (including brokers) and their position/s, specimen signature/s;
  9. Certificate of registration with BOI;
  10. Certificate of registration with BTRCP/SEC;
  11. List of machineries (brand, model, type, serial no.);
  12. Certificate of ownership of machineries;
  13. Contract of lease/title over plant premises;
  14. List of names of office personnel/workers;
  15. Latest payroll sheet;
  16. Purchase order/sales contract;
  17. List of materials to be imported;
  18. Company profile (to be notarized); and
  19. Certification if one of these requirements has not been prepared).
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the following: (1) their total assets must be between ₱500,000 and ₱5 million; and (2) they must not be registered with the BOI as an export producer, nor should they have access to drawback and warehousing schemes of the Tariff and Customs Code of the Philippines (TCCP) or to the incentives under the Embroidery Law or the EPZA charter. Firms wishing to avail themselves of benefits under CAO

3-78 have to submit some 20 documentary requirements in support of an application for duty exemption (Tables 4 and 5). In particular, the Certificate of Qualification requires the signature of the Commissioner of the Bureau of Customs himself. Like the BMW scheme, CAO3-78 calls for the submission of a formula of manufacture and the posting of a reexport bond that is one and a half times that required under the BMW scheme.

Direct and indirect exporters may obtain drawbacks of taxes and duties paid on intermediate inputs either from the BOC or the BOI. The requirements for drawback claims under the BOI scheme are presented in Table 6. As with the other schemes, compliance with the "formula of manufacture" requirement and the BOI certification of nonavailability of local substitutes is prescribed. Tax credit under this system is available from 7 to 30 days upon submission of the necessary documents. It should be pointed out that the law provides that, at most, 99 percent of the duties and taxes paid on imported materials may be refunded.

While the refunds under the individual drawback scheme of the BOC are based on actual usage of imported inputs, tax credits under the fixed drawback scheme administered by the BOI are based on predetermined rates. The requirements and procedures to be followed for firms to benefit from the fixed drawback system are relatively simple (see Table 7). However, while this scheme is available to both BOI and non-BOI registered export producers, the number of export items covered is rather limited (e.g., only 225 items in 1987) (WB, 1987).

Finally, under the value added tax (VAT) system that is currently in place, exports are zero-rated. This implies that a VAT-registered enterprise will not be taxed on its exported output but could claim a tax credit for value added tax paid on imported and locally-sourced raw materials used in export manufacture. The tax refund is due within 60 days from the date of filing of claim, which is 20 days following the end of each quarter.

### 3.1.2 *Assessment*

#### *Unrestricted Choice Between Local and Imported Inputs*

The framework outlined in Section 2 suggests that an important component of providing free trade status to exports is the absence of restrictions on imports of intermediate inputs to export production. This implies that exporters are given unrestricted choice between imported and locally-produced inputs. Contrary to this precept, all exporters except those located in an EPZ are required

**Table 4**  
**DOCUMENTARY REQUIREMENTS IN APPLICATION**  
**FOR DUTY EXEMPTION UNDER CAO 3-78**

**1. CB IMPORT AUTHORITY (IA)**

Requirements for issuance of IA:

- 1.1 Copy of the Certificate of Registration with the concerned government agency, such as the BOI, GTEB, PITC, or CB; in the absence thereof, a Certificate of Qualification from the BOC;
- 1.2 Copy of the processing agreement between consignee and foreign principal or supplier, or the confirmed purchase order or export L/C;
- 1.3 For regulated items, commodity clearance from the appropriate government agency;
- 1.4 Proforma Invoice; and
- 1.5 Mark-up Computation Report approved by the CB Export Department (this requirement can be waived for the first shipment).

Requirements for MCR

- 1.5.1 Copy of Processing Agreement of Confirmed Purchase Order (PO);
  - 1.5.2 Copy of Certificate of Registration as export producer with the BOI, CB, GTEB, EPZA or other government agencies (for new applications); or  
 Copy of Certificate of Qualification (if not registered with any government agency);
  - 1.5.3 If the product's quantity and/or fee/billing is based on the PO, Agreement or other documents — copy of source document; or  
 If the product's quantity and/or fee/billing is estimated — explanation on how the estimates were derived, i.e., assumptions used, basis of assumptions and supporting documents/computations, if any;
  - 1.5.4 If the quantity/cost of the consigned materials is based on the invoice or other documents — copy of source document; or  
 If the quantity/cost of consigned materials is estimated — explanation on how the estimates were derived, i.e., assumption used, basis of assumptions and supporting documents/computations, if any; and
  - 1.5.5 Formula of Manufacture submitted to the Bureau of Customs.
2. BOI certificate of nonavailability;
  3. Re-export bond equal to one-and-one-half times the ascertained duties, taxes and other charges;

Table 4 (continued)

**4. Certificate of Qualification (CQ)****4.1 Requirements for CQ**

- a) Authentic copy of importer's Certificate of Registration with the SEC, and the copy of the Articles of Incorporation or Articles of Co-Partnership, for corporations or partnerships; and Certificate of Registration with the BTRCP (formerly BDT) for sole proprietorships;
- b) Financial Statement certified by the BIR;
- c) Certified copy of a valid and subsisting contract between the importer and foreign supplier/buyer;
- d) Formula of Conversion certified by the Department of Science and Technology or any appropriate government agency;
- e) Plant's location map; and
- f) Sworn Statement stating the following:
  - i. That the materials are to be imported on consignment basis, and are solely intended for commercial export or sample purposes, based on the design/pattern prescribed by the supplier/foreign buyer.
  - ii. Procedures to be followed in the production of imported materials; and
  - iii. That the applicant does not have the financial capacity to make prior payment of the customs duties, taxes and other charges, or does not have the necessary resources to establish and operate a bonded manufacturing warehouse.

**4.2 Procedures for Securing Certificate of Qualification (CQ)**

- a) The importer files five (5) copies of the Letter of Application and the required documents with the Drawback Unit of the Bureau of Customs if he is within the jurisdiction of the Port of Manila and the NAIA Customs House. The documents are filed with the District Collector of Customs in case of other ports of entry.
- b) The Drawback Unit processes the application and supporting documents. If found in order, the application is transmitted to the Legal Unit for review.
- c) The Legal Unit reviews the application and recommends approval/disapproval of the CQ. The application is endorsed to the Commissioner of Customs for signature and approval.
- d) The Commissioner of Customs approves/signs the CQ.
- e) Upon approval, the Certificate of Qualification (CQ) is prepared and the applicant is required to signify acceptance of the terms and conditions of the award, as indicated at the back of the CQ. (The CQ shall be good for a period of six (6) months.)

**Table 5**  
**PROCEDURES FOR THE RELEASE OF IMPORTATION**  
**UNDER CAO 3-78**

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1. The importer submits to the Entry Processing Division the following:
    - a) Import Entry and its supporting documents; and
    - b) Copy of the CQ.
  2. The Entry Processing Division processes the entry and stamps the name "SMALL SCALE INDUSTRIES" and forwards the entry to the Special Assessment Unit, Bonded Warehouse Division, Port of Manila (POM), or International Airport (NAIA).
  3. The Special Assessment of Warehousing Unit:
    - a) Undertakes an examination and appraisal of the shipment pursuant to existing rules and regulations;
    - b) Verifies if the imported materials as declared in the entry documents are the ones specified in the CQ;
    - c) Adds the quantity of raw materials imported to date and checks if the quantity specified in the contract was not exceeded; and
    - d) Transmits entry to the Bonds Division.
  4. The Bonds Division, on the basis of the documents presented:
    - a) Checks if there are due and demandable bonds from previous importations;
    - b) Checks and approves ordinary re-export bonds; and
    - c) Transmits entry to the Cash Division, POM, or the Liquidation Unit, Collection Division, NAIA.
  5. The Cash Division or Liquidation Unit:
    - a) Receives entry and issues Permit to Deliver Imported Goods (POM) or Gatepass (NAIA);
    - b) Forwards the same to the Piers and Inspection Division, POM, or the Office of the Bonded Warehouse Supervisor, or the PAL Warehouse, NAIA; and
    - c) Returns the entry to the Special Assessment Unit, Bonded Warehouse Division, POM, or the Warehousing Unit, Assessment Division, NAIA.
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Source: DTI (1988).



to get a BOI certification of nonavailability of domestic substitute for imported raw materials. This condition is over and above the more general restrictions on imports pending complete import liberalization (Medalla 1990).

Another common feature of the various duty exemption/drawback schemes is the "formula of manufacture" requirement. WB (1987), on the other hand, notes that the determination of the formula of manufacture appears to be unsystematic and usually set on an ad hoc basis in the Philippines. This is in stark contrast to Rhee's (1984) assertion that the regular publication of up-to-date input-output coefficients for exports is an important element in effective import administration for exports in East Asian countries.

### *Exemption/Drawback of Taxes and Duties on Imports*

The capital equipment portion of adjustment (1b) and (1c) of the analytical framework is made available to EPZA- and BOI-regis-

**Table 6**  
**REQUIREMENTS FOR BOC DRAWBACK CLAIMS**

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1. Import documents;
  2. Export documents;
  3. Bank credit memo or similar document evidencing remittance of export proceeds;
  4. Abstract of record (Form No. 1);
  5. Certificate of nonavailability of competitive substitutes for the imported materials for regulated commodities under CB Circular 1029;
  6. Formula of manufacture or conversion issued by DOST or other related agencies;
  7. Certificate of exportation (Form No. 11), if required; and or
  8. Constructive exportation documents (for indirect exporters);
    - a) Purchase order;
    - b) Sales invoice;
    - c) Delivery receipt;
    - d) Certificate of sales and delivery confirmed by a Chief of the Bonded Warehouse Division (Drawback Form No. 1-A); and/or
    - e) Certificate of sales and delivery confirmed by EPZA (Drawback Form No. 1-B).
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**Table 7**  
**REQUIREMENTS AND PROCEDURES FOR FIXED DRAWBACK SCHEME**

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**Documentary Requirements**

1. Export invoice;
2. Bill of lading;
3. Bank credit memo; and
4. A statement under oath stating that:
  - a) Taxes and duties have been paid on the raw materials/supplies;
  - b) Said raw materials/supplies are not enjoying preferential rates; and
  - c) Said raw materials/supplies were purchased within one (1) year from date of actual exportation.

**Procedures for Availment of Standard Rebate**

1. Importer/claimant files application including the required documents with the Tax Rebate Center (TRC) through the Records Section of the BOI.
  2. If the documents are complete, applicant pays the application fees with the Cashier. Otherwise, documents are returned to the applicant for completion.
  3. Tax Credit Application (TCA) is forwarded to the industry group and evaluated by the Analyst.
  4. The Analyst prepares an Evaluation Report and issues a Tax Credit Certificate (TCC) amounting to the computed tax credit based on the standard rate.
  5. The deputized representative of the BOC and the BIR to the Center sign the TCC's in the following manner:
    - a) The representative of the Customs Commissioner signs the tax credits against tariff duties.
    - b) The representative of the Commissioner of Internal Revenue signs tax credits against the value-added tax.
  6. The TRC releases the TCC to the supplier/applicant within two (2) working days from the time the application is officially accepted.
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Source: DTI (1988).

tered exporters. On the other hand, the duty free importation of intermediate inputs to export production, the other half of adjustment (1b) and (1c), is met with varying degrees of effectiveness by the different exemption and drawback systems that are currently in place. This arises because the non-CIF cost of imports under these schemes is greater than zero as a result of the transactions cost associated with them. It should also be emphasized that in practice all of these schemes account for less than 50 percent of export values, with the majority of small exporters effectively excluded (WB, 1987).

Table 8 presents an estimate of the implicit tariff equivalent of the direct and transactions costs that are incurred by firms who are able to avail themselves of the different duty exemption/drawback schemes that are now in operation. The estimates are based on the fixed fees required by the various exemption/drawback schemes expressed as a proportion of average import values for participating exporters as gathered from interviews with a small number of exporters. From the point of view of the individual exporter, locating in an EPZ distorts the price of imported inputs least if one takes into account both direct and indirect (transactions) costs of importing materials. EPZ firms are charged fees that are almost nil when expressed as a proportion of the value of their imports. Furthermore, they are subject to the least number of documentary and procedural requirements insofar as their importation of intermediate inputs is concerned. This is, however, achieved at great costs to the government in terms of infrastructure and administrative expenses. Note that, even if no allowance were made for the capital costs of putting up the EPZs, the EPZA consistently remains in deficit from its inception. The cumulative net loss of the EPZA in the period 1985-89 amounted to ₱1.08 billion, it being in the red in four years out of this five-year period.

While BMWs free exporters from actually paying taxes and duties on imported inputs, the financial costs associated with this system in the form of supervision fees, overhead expense, and performance/reexport bonds premiums are by no means small when expressed in nominal terms. In addition to the supervision fee of ₱45,000 per annum, BMW operators have to shoulder the rental cost of the facility. These expense items appear to be too lumpy for small exporters and, thus, inhibit them from using this mechanism. However, when expressed relative to the value of the imports of the typical BMW, these fees do not appear to be as high because of the largeness of their operations. In fact, the evidence suggests that BMWs are the second most effective mechanism in providing tariff

**Table 8**  
**ESTIMATED IMPLICIT TARIFF EQUIVALENT OF TRANSACTIONS**  
**COSTS ASSOCIATED WITH VARIOUS IMPORT SCHEMES FOR**  
**EXPORT PROCEDURES (As a Percentage of Import Value)**

		a/
<b>Export Processing Zone</b>		
<b>Bonded Manufacturing Warehouse</b>		
— supervision fee		0.15
— rent		0.12
— performance bond		0.01
— re-export bond		0.83
— others		0.63
<b>Total</b>		<b>1.74</b>
<b>Customs Common Bonded Warehouse</b>		
	low	high
— service fee	1.00	4.00
— re-export bond	0.00	1.40
— others	1.00	1.00
<b>Total</b>	<b>2.00</b>	<b>6.40</b>
<b>CAO 3-78</b>		
	low	high
— re-export bond	1.69	1.69
— others	3.50	6.00
<b>Total</b>	<b>5.19</b>	<b>7.69</b>
<b>Drawback Scheme</b>		
	low	high
— interest cost	3.75	15.00
— 99% limit	0.38	0.38
— unofficial charges	1.88	0.00
— others	3.50	6.00
<b>Total</b>	<b>9.51</b>	<b>21.38</b>

a/  
 Negligible.

free inputs to export producers. Nevertheless, some improvements in the administration of BMWs need to be made. While the procedural requirements for importations under BMWs are simpler relative to other schemes, these are more stringent than those in other countries where exporters using BMWs are not required to submit a "formula of manufacture" and to post a reexport bond (Rhee 1984).

The operation of CCBWs is a commendable development since it minimizes the bias against small exporters inherent in the BMW system. Note that BMWs and CCBWs do not differ very much in terms of the implicit tariff embedded in the costs of their imports. Furthermore, some CCBWs have also introduced laudable innovations of their own. For instance, Philexport allows the issuance of a postdated check in lieu of the reexport bond. This has effectively permitted exporters to escape the payment of the reexport bond premium and suggests that, in the future, a promissory note might be able to take the place of the reexport and performance bond requirements of the other schemes.

The complicated administrative requirements and the implied high transactions cost of importing intermediate inputs for export production under CAO 3-78 result in an implicit tariff equivalent to 6 percent. While this figure is roughly one-half of that implied by the BOC drawback scheme, it is more than three times that under the BMW scheme. The culprit behind the unfavorable comparison of the exemption system under CAO 3-78 with the BMW system appears to be the more complex and time consuming import procedure under the former. Also, the higher reexport bond required under CAO 3-78 adds four-tenths of one percent to the implicit tariff equivalent of the various costs involved.

The duty drawback system under the BOC and the BOI, on the other hand, entails additional cost in terms of the interest cost on the working capital used to pay the duties and taxes on imported intermediate inputs before the tax credit claims are actually granted. The capital holding cost constitutes by far the bulk of the implicit tariff equivalent of the direct and indirect costs associated with the drawback mechanism. Exporters availing themselves of the duty drawback on intermediate inputs have to contend with the tedious import arrangements, as well as with the time consuming procedure attendant to the avilment of the drawback claims. In the case of the BOC scheme, all these costs amount to at least one-half of (and at most equal to) the average tariff rate on raw material inputs if there is no duty exemption/drawback. While the drawback under the BOI system is generally made available within a shorter period of time relative to that of the BOC, the implicit tariff on

imports subject to the BOI drawback is still roughly equal to that of the CAO 3-78 system and roughly equal to 6 percent or one-quarter of the average tariff rate on intermediate inputs in the absence of a duty exemption/drawback. Moreover, it should be pointed out that the product coverage of the fixed drawback system of the BOI is rather limited.

To sum up, there appears to be an obvious need to streamline the existing import arrangements for exporters. This is a major source of indirect cost of imports of intermediate inputs by exporters. With regard to the relative merits of the various exemption/drawback schemes, the advantages of the BMWs and CCBWs over other schemes cannot be underestimated. However, the former are better suited to firms that produce primarily for export. At the same time, the edge of exemption over the drawback scheme is obvious. Thus, one cannot escape the need for an efficient exemption system that will cover firms that produce both for the domestic and export markets as well as those that export marginally as these types of exports will become increasingly important in the medium term. There is also a need to simplify the administrative arrangements of the individual drawback as it represents a big proportion of the implicit tariff equivalent of the direct and indirect costs of imports subject to individual drawback. The use of a promissory note in lieu of the reexport and performance bonds should alleviate somewhat the increased costs suffered by exporters due to their inability to import duty free inputs. The coverage of the standard rebate should be broadened given the proven advantage of this system in reducing the implicit tariff on imports for use in export production.

#### *Rebate of Implicit Tariff on Domestically-Produced Tradeable Input*

The zero rating of exports under VAT partially addresses the requisites of adjustment (1c) of our analytical framework as it rebates the domestic indirect tax component of the implicit tariff for domestically-produced traded inputs. However, the holding cost of capital involved in the advance payment of VAT on raw materials is not taken into consideration. Moreover, the import duty portion of the implicit tariff on domestically-sourced importable inputs is not accounted for. It is interesting to note that the tax credit equal to 10 percent of the net local content that is given to exporters under the old Investment Code (BP 391) provided, among other compensating adjustments, part of the duty component of adjust-

ment (1c).<sup>4</sup> Therefore, it is unfortunate that this provision was dropped with the promulgation of the 1987 Investment Incentive Code.

### *Treatment of Indirect Exporters*

Finally, it should be pointed out that correction (1d) called for by our analytical framework is available only to indirect exporters registered with the BOI. In practice, the number of BOI-registered indirect exporters is very small. The inadequate mechanisms available aimed at giving indirect exporters access to inputs at free trade prices, as well as the failure to rebate the tariff that would have been paid on domestically-purchased importable intermediate inputs, have not only made our exporters less competitive than their foreign competitors but have also hampered the development of backward linkages from our exports. In this regard, the Philippines should explore for indirect exporters the South Korean domestic letter of credit. Although designed primarily to afford indirect exporters automatic access to export financing, the system can also be used as a convenient and automatic means of verifying transactions between exporters and indirect exporters, thus giving the government a mechanism for providing tariff-free inputs to indirect exporters (Rhee 1984).

## **3.2 *Export Incentives under BOI and EPZA***<sup>5</sup>

### **3.2.1 *Description***

Incentives to exports in the form of investment and other inducements have been in force in the Philippines since 1970 with the enactment of Republic Act 6135 or the Exports Incentives Act. Since then, it has been amended and codified three times over. However, the changes introduced under Batas Pambansa 391 (BP 391) in 1983 were truly radical and deserve some comment despite the fact

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4. Note that since the early 1980s only 30 tariff lines have been subject to duty of less than 10 percent. Moreover, the average tariff on intermediate inputs has since stood at 25 percent (Medalla 1986). Thus, the correction of the duties portion of (1c) even with the tax credit on net local content was incomplete. Finally, it should be pointed out that over and above rebating the part of the duties that would have been paid if the locally-produced inputs were imported, the tax credit for net local content provision effectively grants registered exporters a subsidy equal to 10 percent of their value added. This result becomes apparent once one decomposes net local content into its parts: local nonindigenous raw materials plus value added.

5. In addition to the special treatment of imported materials and equipment in EPZs that effectively establish a free trade regime for exports, EPZA grants the same incentives to exporters as those offered by the BOI.

that the law has since been superseded by Executive Order 226 (EO 226) or the Omnibus Investments Code of 1987 (OIC 1987).

A comparison of the incentives granted under BP 391 and EO 226 is presented in Table 9. EO 226 replaces the provisions on tax credit on net value earned and net local content with an income tax holiday. Duty free importation of capital equipment is made available to both exporting and nonexporting firms under EO 226 while this privilege was granted to exporting firms only under BP 391.<sup>6</sup>

EPZA-registered firms produce solely for the export market. On the other hand, BOI registration may be obtained if the proposed project is included in the Investment Priorities Plan or, if it is not so listed, at least 50 percent of its total production is for export.<sup>7</sup> The equity restrictions on foreign investors are waived if they propose to engage in a pioneer project or if they propose to export at least 70 percent of their total output.<sup>8</sup>

### 3.2.2 *Assessment*

Following the approach developed in Manasan (1986; 1988), the impact on the internal rate of return (IRR) of a hypothetical BOI-registered firm of the more important provisions of BP 391 and EO 226 is estimated. Under BP 391, the benefits to exporters, measured in terms of increments in their IRR, are three times as large as those granted to nonexporters (Table 10). On the other hand, EO 226 does not differentiate between exporters and nonexporters. Consequently, the inducements made available to exports are reduced by half while those provided to nonexporters are almost doubled as a result of the shift to the 1987 Investments Incentive Code (Tables 10 and 11).

From the vantage point of the analytical framework presented in Section 2, the income tax holiday provided to new and expanding EPZA/BOI-registered exporters under EO 226 and the tax credit on net value earned and net local content granted to existing and new exporters under BP 391 may be viewed as providing compensating adjustments to counteract the antiexport bias resulting from the overvaluation of the domestic currency arising from the prevailing trade regime, adjustment (2). It was pointed out earlier that, in

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6. BP 391 allowed pioneer nonexporting firms to defer all duties and taxes on capital equipment while nonpioneer, nonexporting firms were permitted to defer only 50 percent of these taxes for a period of five years.

7. The 50 percent export criterion was first introduced in 1983.

8. In general, foreign equity participation in any particular project cannot exceed 40 percent.



**Table 9**  
**COMPARISON OF INCENTIVES UNDER BP 391 AND EO 226**

Incentive	BP 391				EQ 226			
	Domestic producer		Export producer		Domestic producer		Export producer	
	Pioneer	Non-Pioneer	Pioneer	Non-Pioneer	Pioneer	Non-Pioneer	Pioneer	Non-Pioneer
1. Exemption from duties and taxes on imported capital equipment			100%	100%	100%	100%	100%	100%
2. Deferral of duties and taxes on imported capital equipment, to be repaid within 5 years	100%	50%	N/A	N/A	N/A	N/A	N/A	N/A
3. Tax credit on domestic capital equipment equivalent to duties and taxes on similar foreign equipment			100%	100%	100%	100%	100%	100%
4. Tax credit on domestic capital equipment to be repaid within 5 years	100%	100%	N/A	N/A	N/A	N/A	N/A	N/A

Table 9 (continued)

5. Tax credit on net value earned for five years	10%	5%	10%	5%	N/A	N/A	N/A	N/A
6. Tax credit on net local content for five years			10%	10%	N/A	N/A	N/A	N/A
7. Tax holiday	N/A	N/A	N/A	N/A	6-8 yrs. <sup>a/</sup>	4-7 yrs. <sup>a/</sup>	6-8 yrs. <sup>a/</sup>	4-7 yrs. <sup>a/</sup>
8. Net operating loss carry over	Yes	Yes	Yes	Yes	No	No	No	No
9. Deduction from taxable income of 50% of incremental labor expense for 5 years	No	No	No	No	Yes <sup>b/</sup>	Yes <sup>b/</sup>	Yes <sup>b/</sup>	Yes <sup>b/</sup>

<sup>a/</sup> These are applicable to new projects. Expanding firms are entitled to 3-year tax holiday. Existing firms are not entitled to the tax holiday at all.

<sup>b/</sup> Redundant for firms enjoying tax holiday.

**Table 10**  
**CHANGE IN THE INTERNAL RATE OF RETURN OF HYPOTHETICAL BOI**  
**REGISTERED FIRMS UNDER BP 391<sup>a</sup>**  
**(In percentage points)**

	Exporting				Non-Exporting			
	Non-Pioneer n=10    n=20		Pioneer n=10    n=20		Non-Pioneer n=10    n=20		Pioneer n=10    n=20	
1. Exemption/ deferral of duties on capital <sup>b</sup>	3.5	2.5	3.5	2.5	.5	.25	1.0	.5
2. Tax Credit on net value earned	2.25	.5	3.5	1.75	2.25	.5	3.5	1.75
3. Tax credit on net local content	9.0	4.75	9.0	4.75	—	—	—	—
4. Total	15.75	6.75	17.0	10.0	3.75	1.75	5.5	3.25

<sup>a</sup>/Change in IRR is computed relative to  $IRR_0 = 10\%$ .

<sup>b</sup>/Computed based on  $t_k = .2$  and VAT where  $t_k$  is tariff on capital equipment.

addition to effectively providing exporters with a rebate on the tariff that would have been paid had locally procured importable intermediate inputs been imported, the tax credit on net local content of exports also grants an adjustment equal to 10 percent of the value added in the export activity. This implies that, after correcting for the implicit tariff embedded in the domestic price of the domestically-purchased importable input, BP 391's provisions on tax credit on net local content and on net value earned give registered exporters, at the firm level, an adjustment whose benefit is equal to 15 percent and 20 percent of the value added of nonpioneer exporting firms and pioneer exporting firms, respectively. Recalling that the required correction under (2) calls for augmenting the value added in the export activity by an amount equal to the product of the value added and the proportional difference in the

**Table 11**  
**CHANGE IN THE INTERNAL RATE OF RETURN OF HYPOTHETICAL**  
**BOI REGISTERED FIRMS UNDER EO 226<sup>a</sup>**  
**(In percentage points)**

	Non-Pioneer		Pioneer	
	n=10	n=20	n=10	n=20
1. Tax holiday without extension	2.5	1.75	3.5	2.5
2. Tax holiday with maximum extension	3.75	2.75	4.0	3.0
3. Duty exemption on capital <sup>b</sup>	3.5	2.5	3.5	2.5
4. 1 + 3	7.25	4.9	8.25	5.75
5. 2 + 3	8.75	6.0	9.0	6.5

a/Change in IRR is computed relative to  $IRR_0 = 10\%$ .

b/Computed based on  $t_k = .2$  and VAT where  $t_k$  is tariff on capital equipment.

shadow and official exchange rates and noting that the estimated overvaluation of the exchange rate resulting from the protection system is in the vicinity of 25 percent (Medalla 1986), we can safely conclude that BP 391 incentives provide registered exporters with slightly less than the required adjustment to counteract the overvaluation of the domestic currency. Furthermore, this highlights Rhee's (1984) assertion that "a value-added based incentive is the ideal form of tax incentive for exports." This is so because value added-based incentives permit an appropriate amount of correction to be made at the firm level.

A comparison of line 2 in Table 10 and line 1 in Table 11 suggests that the tax credit for net value earned under BP 391 and the income tax holiday under EO 226 provide roughly equivalent benefits to new and expanding exporters. This implies that the income tax holiday provides new and expanding BOI/EPZA-regis-

tered exporters, on the aggregate, with a compensating adjustment that is approximately equal to 5-10 percent of their value added. However, it should be emphasized that under EO 226 exporters are not able to get the equivalent benefits arising from the value added portion of the tax credit on net local content that was available under BP 391. Moreover, because the income tax holiday is profit-based the correction arising therefrom tends to hold at the aggregate level but not at the firm level. Thus, some new and expanding BOI/EZPA-registered enterprises might actually receive more or less than the average benefit depending on the distribution of their income stream over time. Furthermore, existing exporters are not entitled to the income tax holiday under EO 226 although they are similarly penalized by the protection system. Finally, the absence of tax sparing arrangements between the Philippines and major capital exporting countries that tax their residents' income on a global basis nullifies the potential benefit to the foreign investors of the income tax holiday.

To sum up, the changes introduced in the investments incentive scheme under EO 226 have resulted in the increased inadequacy of BOI/EPZA incentives in providing export producers, at the aggregate level, with the equivalent compensating adjustment to counteract the antiexport bias arising from the overvaluation of the domestic currency because of the protection system. What is even more alarming is the failure of the system to provide the appropriate correction at the firm level, unlike BP 391.

A number of other issues that have a direct bearing on export promotion may be raised as regards the Investments Incentives Code. First, the "measured capacity" concept as a criterion in project selection was dispensed with under BP 391 but was reinstated under EO 226. This concept implies some limitation on competition: It loses substance not only when there is a potential for exports but also when imports are not prohibited. Thus, if the BOI uses it to regulate entry it will penalize exporters on two counts: potential exporters might not be allowed entry because of overcrowding; and, existing exporters will have to bear the higher input costs implied by limited output (arising from the use of the measured capacity concept) in the upstream industries.

Second, there has been some concern about the competitiveness of BOI incentives with those offered by other countries given the importance of foreign investments in filling the country's financing gap. Manasan (1988) assessed the investment incentives granted by the ASEAN countries and concluded that the tax regimes in the said countries are, to a large extent, equally attractive with or

without investment incentives. Since that comparison was based on EO 226 incentives, it may be inferred from the results of our earlier discussion of the merits of a profit-based incentive that BP 391 incentives are more generous than those of other ASEAN countries with respect to export producers. Also, the Philippines, unlike Malaysia and Singapore, does not provide exporters with incentives based on export promotion/overseas expansion expenditures. Thus, the adoption of EO 226 might have reduced the ability of the Philippines to attract footloose export industries relative to its neighbors in the region.

Finally, what appears to hinder the flow of foreign capital into the country is not so much the amount of incentives that are available but the restrictive regulatory environment for foreign investments that exists at present. The replacement of the Investment Priorities Plan with a short negative list of activities that would be closed to foreigners would be a step in the right direction. A review of the equity and divestment rules is also called for.

#### 4.0 CONCLUSION

When viewed against the backdrop of the total protection structure, the rationale for fiscal incentives to exports becomes apparent: to compensate for the bias against exports that arises from the prevailing trade regime. Obviously, the first-best solution to this problem is the outright revamp of the structure of protection whereby a uniform tariff structure is put in place while nontariff measures are eliminated and the exchange rate is allowed to seek its own level in a free market. However, in the event that the set of policies defined by this first-best solution is not yet in place, it is essential that a second-best policy package aimed at making our exporters competitive with their foreign counterparts be put in place. The second-best solution requires: (1) the provision of intermediate inputs and capital equipment to exporters at free trade prices, and (2) the provision of incentives designed to counteract the penalty on exports that results from the existing structure of protection at the firm level.

Access to intermediate inputs for exports at undistorted prices is greatly hampered by (1) the existing government requirement for exporters to get a certificate of nonavailability of domestic substitutes for imported raw materials from the BOI; (2) the transactions costs arising from the complicated import arrangements for exporters that are currently in place; (3) the absence of up-to-date and disaggregated input-output coefficients that should streamline and introduce

greater automaticity and transparency in the administration of the various exemption/drawback mechanisms; (4) the absence of an effective exemption/drawback system for small as well as marginal exporters; (5) the inadequacy of the existing mechanism to provide indirect exporters with access to intermediate and capital inputs at free trade prices; and (6) the failure to rebate the tariff that would have been paid had domestically-sourced importable inputs to exports been imported.

On the other hand, the government appears to have backtracked in respect to the provision of compensatory incentives to exports with the enactment of the 1987 Omnibus Investments Incentives Code. While the earlier legislation included a value added-based incentive as well as one formulated to correct for the tariff embodied in the domestic price of locally-manufactured importable inputs to exports, the new incentive scheme eliminated these measures and effectively reduced the benefits granted to exports. Furthermore, the income tax holiday under EO 226 has the undesirable characteristic of either overcompensating or undercompensating exporters at the firm level, making it an efficient user of government resources. The efficacy of using a value added-based incentive cannot be over-emphasized in this regard. It should be recognized that, at this point, it is not possible to simply revert back to the 1983 incentives scheme because of the Philippine accession to GATT. The new challenge lies in the design of innovative performance-based incentives that provide the necessary adjustments at the firm level and do not invite counter-vailing measures from the country's trading partners.

Finally, it should be emphasized that the pitfalls in designing compensatory policies for exports that provide the appropriate level of correction at the firm level reinforce the urgent need to move to the first-best solution.

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