State of the Fiscal Incentive Affairs

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ABSTRACT

Given this window of opportunity to re-think our fiscal position in lieu of the upcoming ASEAN Economic Integration, we need to assess our competitiveness in attracting investments. One way to attract investments is through granting fiscal incentives, but it will be on the expense of the government as foregone revenues. However, it is believed that the foregone revenues are being countered by employment and capital formation. But are these incentives really bringing significant contributions to the economy? This paper provides evidence showing that some incentives are redundant to the point that investments can still be attracted even without the incentives. Also, the study shows empirically that there is no direct link between employment generation and income tax holidays, which signals that we should review our fiscal incentives regime in order for us to be competitive in attracting investments and at the same time widen our tax base that could generate revenues for the government thus making our economy functional and fiscally sustainable.

Keywords: fiscal incentives, taxation, investments, fiscal sustainability

Introduction

In a world that is driven by globalization, more and more countries realize the importance of direct investments. For those developing countries that have a low capital, direct investments are important because they fuel the economy through infrastructure, employment, and additional capital for the domestic economy. In the era of economic integration, trade and investment liberalization have changed the landscape where enterprises operate. Given this new environment of heightened competition among regions, the name of the game is now making their economy conducive for business operations and ensuring gains coming from investing. But what mainly attracts direct investments? For an enterprise that is maximizing gains, it will likely invest if the benefits will outweigh the costs of investing. Studies also indicate that benefits in the form of investment incentives play a significant factor in the location decision of investors. The United Nations Conference on Trade and Development (UNCTAD) define investment incentives as “any measurable advantage accorded to specific enterprises or categories of enterprises by or at the direction of the government.” Medalla (2002) explains that
the investment incentive system is one way for the government to intervene when there is market failure since it attempts to influence the direction of investments through the granting of fiscal incentives. Morisset and Pirnia (2002) also showed that when political and economic stability, infrastructure, and transport costs are equal, tax rates and incentives influence the location decision of enterprises within regional economic groupings. Forsyth (1972) pointed out though “… incentives may often not play a key role in influencing the decision to undertake a particular foreign investment; however, once other factors have provoked the decisions to set up production facilities in a broad area, then the more precise location decision may be strongly affected by such factors.”

According to the Department of Finance (DOF), the Philippine government has foregone revenues of about Php 145 Billion due to reduced income tax rates, duty exemptions, and income tax holidays granted to investments. This accounts for 1.5% of our Gross Domestic Product (GDP). However, the numbers do not match. Table 1 shows that the Philippines received the least Foreign Direct Inflows in the recent years. Furthermore, poverty incidence is at 24.9%, unemployment is at 6.9%, and underemployment is at 19.5%. The numbers reflect that the social costs of tax incentives that the government bears outweigh the alleged benefits those enterprises promises to generate. That foregone revenue could simply be additional government budget that could be allocated to improving social security programs, providing basic services like education and health, and improving government services, yet we give them to enterprises that promise to bring investment projects in our country.

In his first State of the Nation Address, the President cites that rationalizing fiscal incentives is a priority measure and that it would be carried out before the end of his term. We note here that the clamor is noble but past administrations also attempted to rationalize fiscal incentives but it did not succeed due to strong lobbying of interest groups. Why is there a need to rationalize fiscal incentives? Medalla (2006) explains that tax incentives can be “redundant in the sense that the investor would still have invested in the country of no tax incentives have been granted.” Also as Diokno (2014) describe it, fiscal incentives are the “pork barrel on the tax side.” In order to accumulate political capital during elections, legislations use their power to grant fiscal incentives to industries so that they can get support from them. Moreover, rationalizing fiscal incentives will help the government plug the loopholes of government losses by setting a simplified system of granting incentives.

**Objectives of the Study**

Several studies from the International Monetary Fund (IMF) establish that the current fiscal incentives regime of the Philippines is “very generous” and “unnecessarily complex.” With all the numbers coming from the Department of Finance and insights coming from the International Monetary Fund, we want to provide a picture of the current fiscal incentive regime of the Philippines. This paper investigates the relationship between the fiscal incentives given and the jobs generated arising from the investment. Literature suggests that one of the
benefits from granting investment incentives is the amount of jobs that it will create. However, it is not the case here in the Philippines. In recent years, the Philippine economy has been tagged as a “jobless growth” economy—a growing economy with a high unemployment and underemployment rate. We want to see if rationalizing fiscal incentives can help in generating jobs, which could help the present administration’s advocacy of promoting inclusive growth. We will also investigate if we are really generous when it comes to granting fiscal incentives compared to our ASEAN neighbors. We know that in 2015, the ASEAN Economic Community (AEC) will come to life. We need to assess whether we can gain the benefits from this regional integration by being the investment hub in the region. And lastly, there are current pending legislation in rationalizing fiscal incentives. This paper will attempt to see whether these legislations can address the need for simplifying the granting of fiscal incentives. In the end, these objectives will help the government aim the essence of rationalizing fiscal incentives, which is to minimize government revenue loss and target investments that would really benefit the economy.

Framework

Legal Framework

There are a number of laws that establishes the various fiscal and non-fiscal incentives. However, only 2 laws serve as the foundation for all incentives: (1) Executive Order Number 226, commonly known as the Omnibus Investments Code of the Philippines, and (2) Special Economic Zones Act of 1995.

Omnibus Investments Code of 1987

Enacted in February 27, 1987, it is one of the major laws that govern fiscal incentives in the Philippines. Its primary objective is to encourage private foreign and domestic investments in desirable areas of activities in order to accelerate the development of the national economy. It also aims to develop industries and discourage monopolies by establishing and promoting a competitive investment environment. This investment package is the government’s way of enhancing the investment climate by a strong and attractive Investment Code that is needed for us to attain economic recovery and development.

This Omnibus Investments Code consolidates the basic laws on investments, which harmonizes their provisions of setting the guidelines for domestic and foreign investors. The law features provision of incentives according to preferred area, pioneer or non-pioneer, export production, and also rehabilitation or expansion of existing operations. Incentives granted to registered enterprises may include income tax holidays, tax credits on raw materials, supplies and semi-manufactured products, additional deduction from taxable income for labor expense,
additional exemption from wharfage dues and export tax, duty, impost and fess, hiring of foreign laborers, simplifies customs procedures, and other tax incentives.

To encourage investments through desirable areas of activity, it provides incentives for the following:

(a) Enterprises registered with the Bureau of Investments (BOI)
(b) Enterprises locating in less developed areas;
(c) Multinational companies establishing their regional or area headquarters or regional operating headquarters in the Philippines;
(d) Multinational companies establishing their regional warehouses in the Philippines for purposes of supplying spare parts or manufactured components and raw materials to the Asia-Pacific Region and other foreign markets;
(e) Enterprises locating in export processing zones

As Table 2 shows the general incentive provisions of the Omnibus Investment Code, its guidelines for the design of incentives for investments specify that fiscal incentives be treated as a subsidy for the market imperfections and a reward for contributing to economic development.

Special Economic Zone Act of 1995

This Act provides the framework for transforming and monitoring of certain designated areas called special economic zones or ecozones. An ecozone is a selected area with highly developed enterprises or which have the potential to be developed into agro-industrial, industrial, tourist/recreational, commercial, banking, investment and financial centers. Enterprises establishing their operations within the ecozones are granted incentives and privileges (National Tax Research Center, 2010).

This Act also establishes the Philippine Economic Zone Authority or PEZA. It is clearly the government’s way of making a better classification between local and foreign investors, an assertion of the importance of gaining access to foreign markets as opposed to being confined into domestic ones while using local endowments. It also pushed towards a geographical dispersion of industries, which have an effective linkage to local resource markets (Morales-Alikpala, 2010).

The incentive provision of the Special Economic Zone Act of 1995 is as follows:

“SECTION 23. Fiscal Incentives. - Business establishments operating within the ECOZONES shall be entitled to the fiscal incentives as provided for under Presidential Decree No. 66, the law creating the Export Processing Zone Authority, or those provided under Book VI of Executive Order No. 226, otherwise known as the Omnibus Investment Code of 1987.

Furthermore, tax credits for exporters using local materials as inputs shall enjoy the

SECTION 24. Exemption from Taxes under the National Internal Revenue Code. - Any provision of existing laws, rules and regulations to the contrary notwithstanding, no taxes, local and national, shall be imposed on business establishments operating within the ECOZONE. In lieu of paying taxes, five percent (5%) of the gross income earned by all businesses and enterprises within the ECOZONE shall be remitted to the national government. “

Those enterprises under ecozones are entitled to similar incentives granted as provided for under Presidential Decree Number 66 or those provided under Book VI of the Omnibus Incentive Code. A summary of these incentives are listed below:

(1) Exemption from the payment of all national and local taxes, except the real property tax on land owned by developers. In lieu thereof, they shall pay a tax equivalent to five percent (5%) of their gross income;
(2) Exemption from taxes and duties on imported equipment, raw materials and supplies directly needed for its operations;
(3) Other incentives under the Omnibus Incentive Code or those provided under Presidential Decree Number 66;
(4) Additional deduction for training expense;
(5) Incentives under the Built-Operate-Transfer (BOT) law;
(6) Simplified Import-Export procedures;
(7) Employment of foreign nationals; and
(8) Special Non-Immigrant Visa with Multiple Entry Privileges for the following non-resident Foreign Nationals in a PEZA-registered Economic Zone Enterprise: Investor/s, officers, and employees in supervisory, technical or advisory position, and their spouses and unmarried children under twenty-one years of age (National Tax Research Center, 2010)

Aside from the establishment of ecozones and providing incentive guidelines for enterprises inside the ecozone, several economic zones were also created under different laws. Table 3 will show all of the ecozones and their respective laws that created them.

Conceptual Framework

In this section, we aim to provide a sense of why fiscal incentives are good and bad for the economy. Medalla’s paper on fiscal incentives provided a good rundown of arguments that are for and against fiscal incentives. Also Fletcher lists down the advantages and disadvantages of the different fiscal incentives. This would give us an idea on why the Department of Finance and the Department of Trade and Industry clash in terms of granting fiscal incentives.

In his paper, Medalla (2006) argued that in order to achieve the political and socio-economic objectives of government policies, there would be unwanted and unintended effects that that will distort the market and make it imperfect. In order to offset these distortions and imperfections, fiscal incentives are needed. Take the case of capital and plants that are owned
by multinational corporations. With other countries that have a similar economic costs and structure with the Philippines, fiscal incentives would be the “clincher” in determining the location where the multinational companies will place their plants. Providing these incentives can be views as signals to investors about the country’s very open and welcoming attitude towards investment. However, he argued that given the same economic costs and structure with other countries, the Philippines has a larger public debt and providing incentives would curtail spending on education and infrastructure compared to other ASEAN countries. Also fiscal incentives (specifically on tax incentives) complicate the tax system and narrow our tax base, which is already small. Furthermore, tax incentives can open the door for bigger revenue losses from activities that have no bearing with the noble intention of granting the incentives. Finally, he argued that theoretically, fiscal incentives are used as a tool for industrial policy, however can the government “pick winners” given that it is hard to determine global technological change? He says that for countries with a weak state and bureaucracy, implementing an interventionist policy of picking winners will be hard (Medalla, 2006).

Fletcher (2002) defines fiscal incentives as the preferential treatment usually in the form of tax breaks, given to qualified investment projects. He then argued that some incentives are also useful in encouraging the dispersions of investments to less developed areas and/or more economically desirable industries or sectors leading to economic diversification. Table 4 will show the advantages and disadvantages of the different types of fiscal incentives

**Presentation of Data and Results**

In getting a clear picture of the fiscal incentives regime here in the Philippines, we aim to present the costs and benefits of these fiscal incentives to the country. While the Income Tax Holidays (ITH) are considered as costs, benefits are comprised of the estimated investments made per registered project, taxes paid during the ITH period, employment generated and maintained through the investments made, and foreign country revenues from the sales of exporting enterprises. We have covered the period of 2004-2008, classified by sector. Monetary amounts in this presentation are all in Philippine Pesos.

Table 5 indicates the aggregated costs and benefits data of industries availing income tax holidays. It also shows that the Income Tax Holidays as a percentage of GDP range from 0.15 to 0.33 percent. The next set of tables presents the costs and benefits data per industry sector. Table 6 shows that registered projects under agricultural products and allied services sector and information technology services sector have the biggest share of total over the years. Table 7 shows the estimated cost of projects upon registration with the Bureau of Investment of firms availing the Income Tax Holiday. Due to their high capital-intense projects, power generating and BOT projects dominate the share of total estimated investment on any given year. Table 8 on the other hand, indicates the taxes paid per sector, which is composed of taxes, and licenses
paid by firms and the withholding taxes firms paid by their employees. During that period, power-generating plants paid the biggest share of total taxes at 30 to 47 percent. Note however that in 2008, mass housing had the biggest share at 28 percent followed by oil deregulation projects at 16.3 percent. As Table 9 illustrates, among the employment generated per sector, information technology service projects have the biggest share of employment generated, amounting to 30 to 38 in a year. With a share of 11 to 18 percent of the total in a year, agricultural products and allied services projects are the next highest. In looking at the foreign country revenues from the sales of exporting enterprises by sector, Table 10 shows that electronics equipment has the biggest share in export sales, ranging from 21 to 42 percent, followed by information technology services and then by agricultural products and allied services. Lastly, Table 11 covers the costs of the fiscal incentives through the income tax holidays availed. It can be shown that power generating plant projects has the biggest share of income tax holidays availed among all industry sectors.

Aside from looking at the data per sector, we attempted to see empirically if the availed income tax holiday correlates with employment generated. The use of a Panel Data Regression analysis was used because we want to know whether the relationship of Income Tax Holidays and its benefits are significant across the 22 different sectors within five years. The empirical evidence\(^1\) shows that employment generated does not affect income tax holiday availed by enterprises. The result may suggest the income tax holidays are not effective fiscal incentives. As Medalla (2006) suggested, income tax holidays cannot make the unprofitable activities profitable and could mean that hiring more people into the enterprise might increase their losses thus employing only a small number of employees.

In preparation of the ASEAN Economic Community in 2015, we attempt to compare the incentive regimes implemented by other ASEAN member states. Together with our goal of making our fiscal incentives regime efficient and simple, we also want to make it appealing and competitive against our ASEAN neighbors. Come 2015, the ASEAN Economic Community promises a wide spectrum of opportunities that our country can potentially gain. From a free flow of capital, goods, and investment, the promise of direct investments coming into this regional economic bloc can be astounding. However, the Philippines must pave its way to attract those investments but now it is not the case. The Philippines has still the highest corporate income tax rate pegged at 30 percent while other ASEAN member states have already lowered it down in order for them to attract investments. Table 12 shows the different corporate tax rates among ASEAN member states. The next table, Table 13, shows all the different incentive regimes of the ASEAN member states and it shows that the Philippines need to catch up because we are already behind other ASEAN member states. They stepped up their efforts to enhance and develop initiatives that will attract investments. Through the use of tax, subsidies, regulation of regulatory requirements and even concessions, they have already paved

\(^1\) As seen in the Appendix
the way for the investments to come into their country and the Philippines should do the same.

Over all, our current fiscal incentives regime needs attention. It is not doing its job of promoting employment and attracting investments. They are just being enjoyed by several enterprises that cater to the domestic market and would still invest even without the incentives, thus making the incentive redundant. One reason why these redundant incentives are there is because of strong lobbying of several interest groups that would promise campaign funds and political support to politicians. As Professor Benjamin Diokno said, fiscal incentives are the “pork barrel on the tax side.” These foregone revenues could really go to programs that benefit the poor of improvement of public infrastructures and government services where many would be affected but instead, these go to the pockets of a few people.

Recommendation

In ensuring fiscal responsibility and stability of our economy, government should start to look for ways to cover the loopholes of our tax system, whose revenues are the lifeblood of the government. With the focus of this paper on the fiscal incentives, it is necessary to revisit and rationalize our fiscal incentives regime. The goal of rationalizing fiscal incentives is to streamline the process in which fiscal incentives will be granted. This will limit the powers of the interest groups to lobby excessive incentives in exchange of political support. This will also involve sunset clause provisions that puts an expiration date on all incentives provided by the government. Lastly, the rationalization of fiscal incentives will ensure that the goal of providing these incentives will be fulfilled. Earlier we said that previous administrations have attempted to rationalize fiscal incentives but have failed to do so. And now with the President’s mandate to the Congress to make this initiative a priority bill, the present Congress still has almost one and a half year to make this initiative into reality. Currently there are 5 different bills passed in Congress about rationalization of fiscal incentives, all of which have their different ways of implementing the measure but all agree that the fiscal incentives regime must be simpler and more effective. On the executive side, conflicting mandates of the Department of Finance and Department of Trade and Industry makes the rationalization of fiscal incentives more difficult to implement. It is a conflict between generating more revenues as fiscal managers versus the implementing agency that accommodates investments and facilitates trade. However, a breakthrough has been made where both departments crafted the proposal on rationalization of fiscal incentives. This proposal has been agreed upon by the two department heads and could be the basis for the passage of the rationalization of fiscal incentives before this administration ends. The proposal shows a much simpler system on granting fiscal incentives and introduction of a Strategic Investment Plan that will ensure that the enterprises granted by the incentive will really deliver verifiable results. The next table, table 14 will show how the proposed bill will place compared to some ASEAN member states. The proposed bill may not be as giving as the other member states but it will be competitive in terms of administration and simplicity of availing the fiscal incentive.
Finally, the call for rationalization of fiscal incentives is very much needed. As more interest groups push for their own personal gain and as the elections are slowly approaching along with the ASEAN Economic Integration in 2015, acting now can secure the future of our economy’s fiscal position and reap the economic gains of those potential investments coming into the region.

References


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