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## FDI Investment Incentive System and FDI Inflows: The Philippine Experience

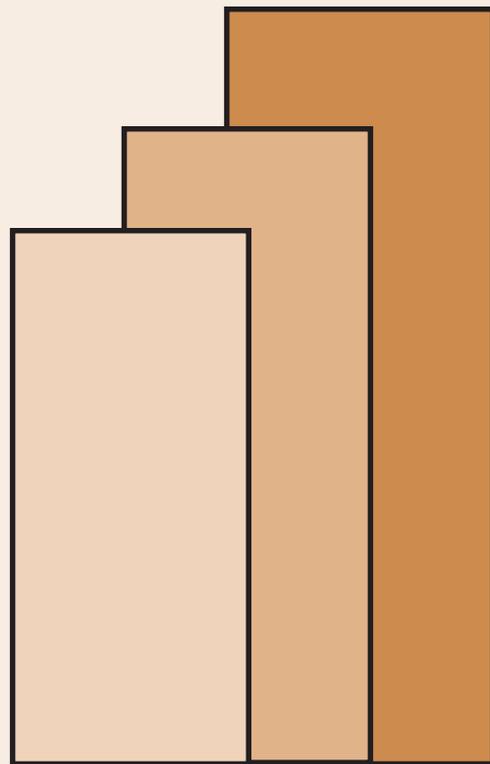
*Rafaelita M. Aldaba*

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For comments, suggestions or further inquiries please contact:

**The Research Information Staff**, Philippine Institute for Development Studies  
5th Floor, NEDA sa Makati Building, 106 Amorsolo Street, Legaspi Village, Makati City, Philippines  
Tel Nos: (63-2) 8942584 and 8935705; Fax No: (63-2) 8939589; E-mail: [publications@pids.gov.ph](mailto:publications@pids.gov.ph)  
Or visit our website at <http://www.pids.gov.ph>

## **Abstract**

This paper examines the country's investment incentive program for foreign investors and its success in attracting substantial FDI inflows. The analysis compares the FDI incentive system and FDI performance of the Philippines with other Asian countries. Since it is difficult to untangle the effect of tax incentives from other factors, the analysis also takes into account other factors such as level of competitiveness, costs of doing business and availability of infrastructure. Our experience tends to suggest that in the absence of fundamental factors such as economic conditions and political climate, tax incentives alone are not enough to generate a substantial effect on investment decisions of investors nor can they compensate for the deficiencies in the investment environment.

Keywords: foreign direct investment, corporate taxation, investment incentives

# **FDI Investment Incentive System and FDI Inflows: The Philippine Experience<sup>1</sup>**

**Rafaelita M. Aldaba**

## **I. Introduction**

In the last two decades, developing countries like the Philippines liberalized their policies to attract foreign direct investment (FDI) inflows. Countries viewed FDI as a potential source of employment and exports along with spillover benefits from the knowledge and technology that FDI inflows bring. Thus, governments have competed in offering various investment incentives to influence the investors' location decisions. These investment incentives include fiscal measures such as reduced tax rates on profits, tax holidays, import duty exemptions and accounting rules allowing accelerated depreciation and loss carry forwards for tax purposes.

There are currently two viewpoints on the importance of investment incentives on the location of FDI. The early literature on the determinants of FDI viewed investment incentives as a relatively minor determinant. Most econometric studies showed that investors are influenced in their decisions by strong economic fundamentals of the host economies. The most important determinants consisted of market and political factors like market size and level of real income, worker skill levels, availability of infrastructure and other resources that facilitate efficient specialization of production, trade policies, and political and macroeconomic stability (Blomström and Kokko, 2003).

With increasing globalization and the liberalization of trade and capital flows, the view on the limited effect of incentives on FDI has changed. More recently, econometric studies suggest that incentives have become more significant determinants of FDI flows. Recent studies indicate that FDI is lower in regions with higher corporate taxes. Based on econometric studies, the elasticity of FDI with respect to after-tax rate of return was found to be approximately unity. (Hanson, 2001). Hines (1996) found that US inward FDI flows originating from tax exemption countries were significantly more sensitive to US statutory corporate tax rates than FDI originating from tax credit countries. Using bilateral FDI flows between eleven OECD countries from 1984-2000, Bénassy-Quéré et al found that FDI flows respond asymmetrically to tax rate differentials between countries and that credit and exemption rules have an important effect.

However, among developing countries, the empirical evidence seems to indicate that tax incentives have little effect on FDI flows. In Brazil, extensive tax incentives resulted in significant revenue losses compared to the investment generated (Estache and Gaspar, 1995). Boadway, Chua, and Flatters (1995) found that tax holidays in Malaysia were of little value for the target firms. Halvorsen (1995) found that rates of return in supported projects in Thailand were so high that they would have taken place even without incentives. Wells et al (2001) found that tax incentives in Indonesia have done little to spur incentives.

This paper looks at the experience of the Philippines in attracting FDI inflows focusing on fiscal incentives. Has the country's investment incentive program for foreign

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investors been successful in attracting substantial FDI inflows? The analysis will compare the performance of the Philippines with other Asian countries. It is difficult to untangle the effect of tax incentives from other factors, in the paper, the analysis will take into account not only corporate taxation but other important factors such as level of competitiveness, costs of doing business and availability of infrastructure.

The paper is divided into eight sections. After the introduction, a brief overview of the tax policy reforms in the Philippines is presented. Section three discusses the current structure of taxation in the country. Section four reviews the Philippine FDI policy while section five presents the various tax and other fiscal incentive packages that the country offers. Section six presents the FDI performance, trends, distribution by sector, and its sources. Section seven compares the FDI performance of the Philippines vis-à-vis its Asian neighbors along with indicators of major FDI determinants. The final section summarizes the main findings and policy implications of the paper.

## **II. Tax Policy Reforms in the Philippines: mid-1980s to the present**

In the last two decades, the Philippines has witnessed two major episodes of tax policy reforms, first in 1986 and another in 1997. The 1986 Tax Reform Package (TxRP) was designed to promote a fair, efficient, and simple tax system. Prior to 1986, the income tax system had two tax schedules for (i) compensation and income (salaries and wages) category under a gross income scheme of nine steps from one percent to 35 %; and (ii) business and professional income on a net basis of five steps from five percent to 60%. A complicated sales tax structure existed consisting of sales/turnover tax along with a host of other indirect taxes such as compensating tax, miller's tax, contractor's tax, broker's tax, and film lessor and distributor's tax. Excise taxes were imposed on petroleum products, alcoholic beverages, cigars and cigarettes, fireworks, cinematographic films, automobiles, and other products classified as non-essential goods.

The 1986 TxRP unified the dual tax schedules applicable to individual income by adopting the lower zero to 35% tax schedule for both compensation and profit incomes. It also increased personal and additional exemptions to adjust for inflation and eliminated the taxation of those earning below the poverty threshold. To improve the fairness of the individual income tax system, the TxRP allowed the separate treatment of the incomes of spouses. Moreover, it increased the final withholding tax rate on interest income (from 17.5%) and royalties (from 15%) to a uniform rate of 20%. The final withholding tax previously imposed on dividends was phased out.

With respect to corporate income tax, the TxRP unified the earlier dual rate of 25% and 35% levied on corporate income to 35%. In the area of indirect taxes, it introduced a value added tax (VAT) rate of 10% to replace sales tax and other taxes. It also converted the unit rates formerly used for excise taxes to ad valorem rates. With regard to international trade taxes, the TxRP abolished export taxes and allowed further reduction in tariff rates.

There is broad consensus that the 1986 TxRP had a significant positive impact on the Philippine tax system. This is indicated by improvements in the tax effort, measured by the ratio of total tax revenue to gross national product (GNP), which rose sharply from an average of 11.3% of GNP during the period 1975-1985 to 16.2% in 1986. The share of taxes on income and profits expanded substantially from an average of 25.2% in 1975-1985 to 37.1% in 1996. This represented a positive development from the viewpoint of equity. Meanwhile, the share of excise taxes and import duties to total tax revenue dropped markedly from an average of 18% in 1975-1985 to 13.2%; and from 25.7% in 1975-1985 to 18.6%, respectively. (Manasan, 2002a). In terms of the overall responsiveness of the tax system to

changes in economic activity, Diokno (2005) found that, on the average, this indicator increased from 0.9% during the period 1980-1985 to 1.5% in 1986-1991.

After 1987, the government legislated more tax policy changes; although it should be noted that some of these were not consistent with the earlier reforms implemented under the TxRP. For instance, the Simplified Net Income Taxation Scheme (SNITS), passed in 1992, reverted the individual income tax system to the scheduler approach. This imposed different rate schedules to income from different sources, thus allowing non-uniform effective tax rates to be applied to waged, non-waged, and mixed income earners. During the years 1992-1998, the Philippine Congress legislated ten new tax measures that affected revenues positively and 28 tax measures that negatively affected revenues as they eroded the tax base by granting tax incentives and higher personal and additional exemptions. (Ibid)

To remove incentive distortions and boost taxation, the government embarked on another round of structural reform through the Comprehensive Tax Reform Program (CTRP). In February 1994, Administrative Order 112 created a Presidential Task Force on Tax and Tariff Reforms. The Task Force was chaired by the Secretary of Finance with members from the government, private sector, and the academe. It crafted a package of recommendations which formed the CTRP that intended to widen the tax base, simplify the tax structure to minimize tax evasion, and make the tax system more elastic and easier to administer.

The CTRP was presented before Congress in February 1996. While it was conceived to be legislated as a comprehensive measure, its actual legislation was carried out in a piecemeal fashion spanning over nearly two years of discussion and debate. As described by the Department of Finance (2003), “reforming the tax system is controversial in nature. Vested political and economic groups are expected to lobby hard in protecting their interests. Powerful lobbying can result in the insertion of provisions that allow exemptions and uneven tax treatment for certain groups, services, and taxpayers.”

The major components of the CTRP were enacted into various laws beginning in June 1996 with the passing of Republic Act (RA) 8184. This allowed the restructuring of the excise tax on petroleum products (from ad valorem to specific) together with tariff restructuring. In November 1996, RA 8240 was legislated to shift the excise tax on fermented liquor, distilled spirits and cigarettes from the ad valorem scheme (taxes are computed based on factory price) back to the specific tax system (taxes are based on volume of product sold).

RA 8241 amended RA 7716 or the Expanded VAT (EVAT) Law, which was approved in May 1994 to widen the VAT tax base and improve its administration. However, RA 8241 or the improved VAT Law introduced additional items that are exempted from EVAT which had the effect of narrowing the tax base.

- restored the VAT exempt status of cooperatives
- expanded the coverage of the term “simple processes” by including broiling and roasting
- expanded the coverage of the term “original state” by including molasses
- expanded the list of items that are exempted under the EVAT to include importation of meat; sale or importation of coal and natural gas in whatever form or state; educational services rendered by private educational institutions duly accredited by the Commission on Higher Education; printing, publication, importation or sale of books, newspapers, magazines, reviews or bulletins; operators of taxicabs, rent-a-car companies; operators of tourist buses; small radio and television broadcasting franchise grantees; sale of properties used for low-cost and socialized housing; and the lease of residential units with a monthly rental not exceeding 8,000 pesos per month.

The final component, RA 8424 or the Tax Reform Act of 1997, was legislated in December 1997. RA 8424 restructured individual and corporate income tax through the following major provisions:

- phased reduction in the corporate income tax rate from 35% in 1997 to 32% from 2000 onwards
- levy of a two percent minimum corporate income tax rate
- adoption of the net operating loss carry forward (NOLCO)
- accelerated depreciation using double declining balance or sum-of-the-years digits
- introduction of a tax on fringe benefits
- re-imposition of the final withholding tax on dividends although inter-corporate dividends remain exempt
- levy of a final withholding tax of 7.5% on interest earned by residents on foreign currency deposits
- increase in the level of personal exemptions for the individual income tax
- gradual reduction of the top marginal tax rate for the individual income tax from 35% in 1997 to 32% in 2000 onwards.

There is general sentiment among tax experts in the country that the CTRP version of Congress has departed significantly from its original objectives of providing a simple and transparent tax system. Manasan (2002b, 2004) indicated that the various bills adopted by Congress deleted key proposed features of the original tax reform package. Hence, its overall impact on the revenue performance of the tax system has been negative. Total tax revenue effort declined continuously from 16.98% of GDP in 1997 to 12.54% in 2002 with a slight improvement (12.7%) in 2003. Manasan pointed out that the adoption of specific rates for excise taxes, while meant to address evasion, reduced the buoyancy of the tax system because the indexation provision that was part of the original proposal was not approved by Congress. Moreover, the rationalization of fiscal incentives, which was an integral part of the proposal when it was first conceived, was not passed in Congress. While the revenue losses from the increase in personal exemptions were readily felt, the expected increase in revenues from the provisions on corporate income tax were not realized at the same time due to delays in the issuance of the implementing regulations of the said provisions.

Diokno (2005) also attributed the progressively declining tax effort and non-responsiveness of the tax system to changes in economic activity to the 1997 CTRP. He emphasized that the CTRP may be considered a major failure due to three factors: (i) non-legislation of the rationalization of fiscal incentives; (ii) delays in the implementation of some provisions that could have broaden the tax base; and (iii) inclusion of measures that are bereft of any rational justification such as the VAT on banks and financial intermediaries.

Very recently, a new VAT Law under Republic Act 9337 has been implemented as a major part of the government's efforts to address the country's serious fiscal problems. Under RA 9337, effective November 1, 2005, a 10% VAT has been imposed on oil and electricity coupled with an increase in the corporate income tax rate from 32% to 35% until 2008 to be reduced to 30% by January 2009. The VAT was also raised to 12% in February 2006.

### **III. Current Philippine Tax Structure**

The National Internal Revenue Code contains the laws governing taxation in the Philippines. This code underwent substantial revision with passage of the Tax Reform Act of 1997 and which took effect on January 1, 1998. The Bureau of Internal Revenue, which is under the Department of Finance, administers taxation. Its main functions consist of

assessment, collection, processing, and taxpayer assistance. The BIR is headed by a Commissioner who has exclusive and original jurisdiction to interpret the provisions of the code and other tax laws. The commissioner also has the powers to decide disputed assessments, grant refunds of taxes, fees and other charges and penalties, modify payment of any internal revenue tax and abate or cancel a tax liability. Taxpayers can appeal decisions by the Commissioner directly to the Court of Tax Appeals.

## **A. Philippine Income Tax System**

The primary types of taxation are: corporate income tax, individual income tax, value added tax, excise tax, customs duties, and local taxes.

### **1. Corporate Income Tax**

#### Regular Corporate Income Tax

The regular corporate income tax rate, which applies to both domestic and resident foreign corporations<sup>2</sup>, was 32% of taxable income until October 31, 2005. Effective November 1, 2005, this has been raised to 35%. This is expected to be reduced to 30% by 2009. For domestic corporations, the tax base is net world-wide income while for resident foreign corporations, the tax base is net Philippine-source income.

#### Minimum Corporate Income Tax (MCIT)

Beginning on the fourth taxable year from the time a corporation commences its business operations, an MCIT of 2% of the gross income<sup>3</sup> as of the end of the taxable year shall be imposed, if the MCIT is greater than the regular corporate income tax. If the regular income tax is higher than the MCIT, the corporation does not pay the MCIT. Any excess of the MCIT over the normal tax shall be carried forward and credited against the normal income tax for the three immediately succeeding taxable years. Corporations that are subject to special corporate tax system do not fall within the coverage of the MCIT.

#### Capital Gains

For domestic and resident foreign corporations, capital gains are generally subject to the regular corporate income tax rate of 32%. However, net capital gains from the sale or exchange of shares of stock that are not listed and traded in the local stock exchange are subject to a capital gains tax or 5% on net capital gains not exceeding P 100,000 and 10% on the excess. If the shares sold are listed and traded through the stock exchange, the tax shall be 1/2 of 1% of the gross selling price. The capital gains tax is 6% of the gross selling price or fair market value, whichever is higher, on sale or exchange of land or buildings not actually used in business and treated as capital asset.

#### Fringe Benefits

Tax Fringe benefits granted to supervisory and managerial employees are subject to a tax of 32% of the grossed-up monetary value of the fringe benefit. The grossed-up monetary value

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<sup>2</sup> A domestic corporation is a corporation organized under Philippine laws. A foreign corporation is considered a resident of the Philippines if it is engaged in trade or business in the Philippines (example, through a branch).

<sup>3</sup> Gross income refers to gross sales less returns, discounts and cost of goods sold. Passive income, which has been subject to a final tax at source does not form part of gross income for purposes of the MCIT. Cost of goods sold includes all business expenses directly incurred to produce the merchandise to bring them to their present location and use.

of the fringe benefit is determined by dividing the actual monetary value of the fringe benefit by 68%. Fringe benefits given by offshore banking units (OBUs), regional or area headquarters, regional operating headquarters of multinational companies, petroleum contractors and subcontractors are taxed at 15% of the grossed-up monetary value of the fringe benefit, which is determined by dividing the actual monetary value of the fringe benefit by 85%. The fringe benefits tax is payable by the employer. However, fringe benefits which are required by the nature of, or which are necessary to, the trade, business, or profession of the employer or which are for the convenience of the employer are not taxable.

#### Branch Profits

Any profit remitted by a branch (except those activities registered with the Philippine Economic Zone Authority or PEZA) to its head office is subject to a tax of 15%. The tax is based on the total profits applied or earmarked for remittance without any deduction for the tax component thereof.

#### Improperly Accumulated Earnings

A tax of 10% is imposed on the improperly accumulated earnings of a corporation, except in the case of publicly held corporations, banks and other non-bank financial intermediaries and insurance companies. This provision is aimed at corporations that accumulate income beyond the reasonable needs of their business, rather than distributing that income through dividends that are subject to tax. Unless proven otherwise, these are considered as improperly accumulated earnings for the purpose of avoidance of tax on shareholders.

#### Calculation of Taxable Income

The foreign income of a domestic corporation is taxable. Double taxation<sup>4</sup> is avoided through the tax credit of foreign taxes paid. The availability of tax credits is, however, subject to the per country and overall limitations. Alternatively, taxpayers may elect to claim the foreign tax as a deduction from taxable income.

In calculating taxable income, corporations are allowed to claim various itemized deductions from their gross income, including ordinary and necessary business expenses (see Box 1).

Business-related losses during the taxable year which have not been compensated for by insurance or other forms of indemnity are allowed to be taken as deductions.

No deduction is allowed for losses from transactions between certain related parties. The Commissioner of Internal Revenue has the power to allocate and adjust certain items of income and deduction among related taxpayers. Transfer prices between related parties are carefully examined to make sure that these are at arm's length and reasonable under the circumstances.

Subject to certain conditions, net operating loss in a taxable year is allowed to be carried over to the next three succeeding years following the year of loss.

Capital gains are gains arising from the sale or exchange of capital assets. Losses from the sale or exchange of capital assets are deductible but only to the extent of capital gains.

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<sup>4</sup> The Philippines has tax treaties with the following countries: Australia, Austria, Belgium, Brazil, Canada, China, Denmark, Finland, France, Germany, Hungary, Indonesia, India, Israel, Italy, Japan, Korea, Malaysia, the Netherlands, New Zealand, Norway, Pakistan, Romania, Russia, Singapore, Spain, Sweden, Switzerland, Thailand, United Kingdom, and the United States.

### Box 1: Tax Concepts

**Taxable income** means gross income less the deductions and/or personal and additional exemptions, if any, authorized for such types of income, by the Tax Code or other special laws.

**Gross income derived from business** is gross sales less sales returns, discounts and allowances and cost of goods sold. **Cost of goods sold** includes all business expenses directly incurred to produce the merchandise to bring them to their present location and use.

For a trading or merchandising concern, **cost of goods sold** includes the invoice cost of the goods sold, plus import duties, freight in transporting the goods to the place where the goods are actually sold, including insurance while the goods are in transit.

For a manufacturing concern, **cost of goods manufactured and sold** includes all costs of production of finished goods, such as raw materials used, direct labor and manufacturing overhead, freight cost, insurance premiums and other costs incurred to bring the raw materials to the factory or warehouse.

**Gross income** means all income derived from whatever source. Gross income includes, but is not limited to the following:

- Compensation for services, in whatever form paid, including but not limited to fees, salaries, wages, commissions and similar item
- Gross income derived from the conduct of trade or business or the exercise of profession
- Gains derived from dealings in property
- Interest, Rents, Royalties, Dividends
- Annuities, Prizes and winnings, Pensions
- Partner's distributive share from the net income of the general professional partnerships

**Exclusions from gross income** include

- Life insurance
- Amount received by insured as return of premium
- Gifts, bequests and devises
- Compensation for injuries or sickness
- Income exempt under treaty
- Retirement benefits, pensions, gratuities, etc.
- Miscellaneous items
- Income derived by foreign government
- Income derived by the government or its political subdivision
- Prizes and awards in sport competition
- Prizes and awards which met the conditions set in the Tax Code
- 13th month pay and other benefits
- GSIS, SSS, Medicare and other contributions
- Gain from the sale of bonds, debentures or other certificate of indebtedness
- Gain from redemption of shares in mutual fund

**Allowable deductions from gross income:** Except for taxpayers earning compensation income arising from personal services rendered under an employer-employee relationships where the only deduction up to a maximum limit of P 2,400 per year per family is the premium payment on health and/or hospitalization insurance, a taxpayer may opt to avail any of the following allowable deductions from gross income:

(i) Optional Standard Deduction - an amount not exceeding 10% of the gross income; or

(ii) Itemized Deductions which include the following:

- |   |                        |
|---|------------------------|
| -Expenses   | -Interest              |
| -Taxes  | -Losses                |
| -Bad Debts  | -Depreciation          |
| -Depletion of Oil and Gas Wells and Mines         | -Research &Development |
| -Charitable Contributions and Other Contributions | -Pension Trusts        |

Source: Bureau of Internal Revenue

All corporations subject to income tax must file quarterly income tax returns on a cumulative basis for the preceding quarter/s upon which their income tax is paid. The quarterly return for the first three quarters must be filed and the tax thereon must be paid not later than 60 days

after the close of each quarter. A final adjustment return covering the total net taxable income must be filed on or before the fifteenth day of the fourth month following the close of the fiscal year.

### Transfer Pricing

The country's transfer pricing law was patterned after that of the United States Tax Code. The BIR Commissioner is empowered to adjust the prices used between related parties if they do not comply with the arm's length standard. The BIR has largely limited its scrutiny of transfer pricing issues to low-interest loans and service fees<sup>5</sup>. Inter company charges such as payments to foreign affiliates for management fees, research and development, and general and administrative expenses are deductible. However, if the amounts paid are not consistent with the arm's length principle, the BIR is authorised to make an adjustment for tax purposes.

## 2. Individual Income Tax

### Compensation Income

Income derived from an employer-employee relationship is subject to tax ranging from 5% to 32% (see table below). Taxable compensation income includes salaries, wages, bonuses, allowances, tax reimbursements, and most fringe benefits.

Taxable Income	Tax Rate
Not over P10,000	5%
Over P10,000 but not over P30,000	P500 + 10% of the excess over P10,000
Over P30,000 but not over P70,000	P2,500 + 15% of the excess over P30,000
Over P70,000 but not over P140,000	P8,500 + 20% of the excess over P70,000
Over P140,000 but not over P250,000	P22,500 + 25% of the excess over P140,000
Over P250,000 but not over P500,000	P50,000 + 30% of the excess over P250,000
Over P500,000	P125,000 + 32% of the excess over P500,000

Citizens employed by regional or area headquarters and regional operating headquarters of multinational companies offshore banking units, and petroleum service contractors who occupy the same position as aliens employed by these entities are subject to a final tax of 15% on their gross income.

### Business Income

Income (after allowable deductions) of citizens and resident aliens derived from trade, business or practice of profession is also subject to the graduated 5% to 32% income tax. The same rates apply to resident citizens and resident aliens whether engaged in trade or business, practising profession, or employed.

In lieu of the allowed itemized deductions, citizens and resident aliens engaged in trade or business or practising a profession may elect a standard deduction in an amount not exceeding 10% of their gross income.

### Personal and Additional Exemptions

Individual taxpayers are entitled to personal exemptions: P20,000 for single individuals; P25,000 for heads of families; and P32,000 each for married individuals. A married individual or head of a family is allowed an additional exemption of P8,000 for each

<sup>5</sup> Isla Lipana and Co/Price Waterhouse Coopers (2005).

dependent not exceeding four. Married individuals are required to compute their individual income tax returns separately. The additional exemption for each dependent shall be claimed only by the husband unless he waives the right in favour of his wife.

### Passive Income

Interest on any currency bank deposit and yield or other monetary benefit from deposit substitutes and from trust fund and similar arrangements is subject to a 20% final tax. Interest from depository bank under the expanded Foreign Currency Deposit (FCD), system is subject to a 7-1/2% final tax. Interest earned by an individual from long-term deposits or investments is exempt from tax. However, if the depositor or investor pre-terminates the deposit or investment before the fifth year, a final tax is imposed in accordance with the following schedule: (i) 4 years to less than 5 years: 5% ; (ii) 3 years to less than 4 years: 12% and (iii) less than 3 years: 20%. Royalties are generally taxed at 20%; 10%, if from books, literary works, and musical compositions. Prizes exceeding P10,000 and other winnings (except Philippine Charity Sweepstakes and Lotto winnings) are taxed at 20%.

A final tax of 10% is imposed on dividends received from domestic corporations.

Net capital gains from the sale of capital asset held by an individual are fully taxable if the capital asset was held for 12 months or less, and 50% taxable if it was held for more than 12 months.

Net capital gains from the sale of stocks in a domestic corporation are taxed at rates depending on whether the stocks are listed and traded in the stock exchange. If the stocks are unlisted or listed but not traded in the stock exchange, the tax is 5% for the first P100, 000 of net capital gains and 10% for the excess over P100, 000. If the stocks are listed and traded in the stock exchange, the presumed gain is taxed at 1/2 of 1% of the gross selling price of such shares.

Presumed capital gains from sale of real property held as a capital asset located in the Philippines are taxed at 6% of the gross selling price or the fair market value, whichever is higher. Gains from the sale of principal residence by natural persons may qualify for exemption from the 6% capital gains tax if the proceeds from such sale are fully utilized in acquiring or building a new principal residence within 18 calendar months from the date of sale.

### **3. Value Added Tax**

A 12%<sup>6</sup> VAT is imposed on the gross selling price or gross value in money of goods, services and properties sold, bartered or exchanged. Any excise tax on these goods also forms a part of the gross selling price. In the case of imported goods, VAT is based on the total value of the goods as determined by the Bureau of Customs plus customs duties, excise taxes and incidental charges. The VAT is 0% on certain transactions such as export sales of goods and sales of services to non residents paid for in foreign currency and accounted for in accordance with the rules and regulations of the BSP.

While the obligation to collect and remit rests with the seller, the cost of the tax may be passed on to the buyer, transferee or lessee of the goods, properties or services. A VAT registered entity may credit the VAT paid on purchases of other goods and services (input tax) against the tax on its current period sales of goods or services (output tax). Until October 31, 2005, if the amount of input tax is greater than the amount of output tax, the excess was

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<sup>6</sup> Prior to February 2006, the rate was 10%.

credited against the succeeding period output VAT. Effective November 1, 2005, the new VAT law has imposed a provision limiting the amount of input tax that may be credited against the output tax to 70% when the amount of input tax exceeds the amount of output tax.

#### 4. Excise Taxes

Excise taxes are imposed on certain goods (such as cigarettes, liquor, and motor vehicles) manufactured or produced in the Philippines for domestic sale or consumption or for any other disposition. Excise taxes are also imposed on certain imported goods, in addition to the VAT and customs duties.

#### 5. Customs Duties

Goods are subject to customs duties upon importation except as otherwise provided for under the Tariff and Customs Code or special laws.

#### 6. Local Taxes

Under the Local Government Code, local government units (LGUs) are authorized to tax all activities except those expressly prohibited by the Code or other laws income tax, customs duties, documentary stamp tax, and estate and gift taxes.

### B. Total Revenue Collections

Figure 1 presents the distribution of the 2003 revenue collections of the Bureau of Internal Revenue and Bureau of Customs. Value added taxes accounted for 25 percent of the total revenue collections. This is followed by corporate income taxes which registered a share of around 21 percent of the total and individual income taxes which accounted for 17 percent. Excise taxes represented a share of 13 percent while import duties accounted for about 8 percent.

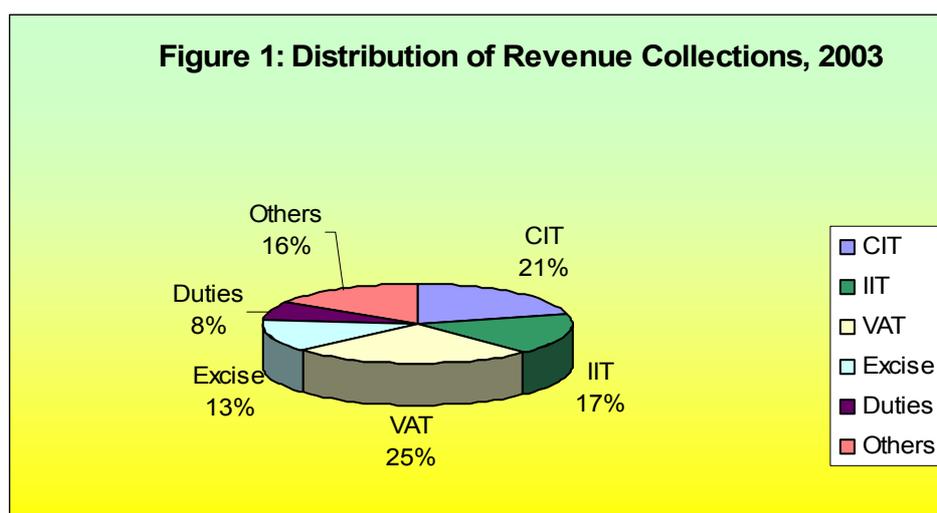


Table 1 shows the total revenue collections of the BIR and the BOC from 1996 to 2003. As percentages of gross domestic product, both internal revenue and customs collections have been steadily declining after 1996. In the case of internal revenue collections, an increase in 1997 was registered, but this continued to decline from 1998 to 2003. This indicates the deteriorating tax effort of the government. As a result, the country has been facing a chronic fiscal deficit. National government debt stood at Ph 3.355 trillion pesos in

2003, which accounted for around 78 percent of GDP. Public sector debt represented approximately 138 percent of GDP during the same year. Given this critical fiscal position of the public sector, the value added tax has been raised from 10 to 12 percent in February 2006. Moreover, VAT has also been imposed on oil and electricity along with increases in the corporate tax rates from 32 percent to 35 percent.

**Table 1: Total Revenue Collections (in million pesos)**

Year	BIR	% of GDP	BOC	% of GDP	Total
1996	260774	12.01	104566	4.81	365340
1997	314698	12.97	94800	3.91	409498
1998	337177	12.65	76005	2.85	413182
1999	341320	11.47	86497	2.91	427817
2000	360802	10.76	95006	2.83	455808
2001	388679	10.70	96232	2.65	484911
2002	394549	9.96	96251	2.43	490800
2003	426010	9.92	106092	2.47	532102

Sources: Bureau of Internal Revenue, Bureau of Customs, and National Income Accounts.

#### IV. Foreign Direct Investment Policy

Like most developing countries, the attitude of the Philippines toward foreign direct investment has changed considerably beginning in the 1980s. Recognizing the need to expand exports and the potential economic contribution of FDI through the transfer of knowledge and experience, the Philippines adopted more open and flexible policies toward FDI. Simultaneous with the market-oriented reforms consisting of trade liberalization, privatization, and economic deregulation that the country carried out between the 1980s and the 1990s, the country accelerated the FDI liberalization process through the legislation of RA 7042 or the Foreign Investment Act (FIA) in June 1991.

The FIA considerably liberalized the existing regulations by allowing foreign equity participation up to 100% in all areas not specified in the Foreign Investment Negative List (or FINL, which originally consisted of three component lists: A, B, and C)<sup>7</sup>. Prior to this, 100% eligibility for foreign investment was subject to the approval of the Board of Investments. The FIA was expected to provide transparency by disclosing in advance, through the FINL, the areas where foreign investment is allowed or restricted. It also reduced the bureaucratic discretion arising from the need to obtain prior government approval whenever foreign participation exceeded 40%.

Over time, the negative list has been reduced significantly. In March 1996, RA 7042 was amended through the passing of RA 8179 which further liberalized foreign investments allowing greater foreign participation in areas that were previously restricted. This abolished List C which limited foreign ownership in “adequately served” sectors. Currently, the FIA has two component lists (A and B) covering sectors where foreign investment is restricted below 100% are those falling under the Constitution or those with restrictions mandated under various laws.

<sup>7</sup> List A: consists of areas reserved for Filipino nationals by virtue of the Constitution or specific legislations like mass media, cooperatives or small-scale mining.  
List B: consists of areas reserved for Filipino nationals by virtue of defense, risk to health and moral, and protection of small and medium scale industries.  
List C: consists of areas in which there already exists an adequate number of establishments to serve the needs of the economy and further foreign investments are no longer necessary.

The mid-1990s witnessed the liberalization of the banking sector which allowed the entry of foreign banks. The 1994 Foreign Bank Liberalization allowed the establishment of ten new foreign banks in the Philippines. With the legislation of the General Banking Law (RA 8791) in 2000, a seven-year window has been provided during which foreign banks may own up to 100 percent of one locally-incorporated commercial or thrift bank (with no obligation to divest later).

In March 2000, the passing of the Retail Trade Liberalization Act (Republic Act 8762) allowed foreign investors to enter the retail business and own them 100% as long as they put up a minimum of US\$7.5 million equity. Singapore and Hong Kong have no minimum capital requirement while Thailand sets it at US\$250,000. A lower minimum capitalization threshold (\$250,000) is allowed to foreigners seeking full ownership of firms engaged in high-end or luxury products. R.A. 8762 also allowed foreign companies to engage in rice and corn trade.

To develop international financial center operations in the Philippines and facilitate the flow of international capital into the country, foreign banks have been allowed to establish offshore banking units (OBUs). OBUs are subject to virtually no exchange control on their offshore operations and are not subject to tax on income they source from outside the Philippines. Only income from foreign currency transactions with local banks, including branches of foreign banks that are authorised by the *Bangko Sentral ng Pilipinas* to transact business with OBUs and Philippine residents is subject to a final tax of 10%. Non-residents are exempt from income tax on income they derive from transactions with OBUs.

Incentives have also been offered to multinationals that establish regional headquarters (RHQ) or a regional operating headquarters (ROHQ) in the Philippines.<sup>8</sup> Both RHQs and ROHQs are entitled to the following incentives: exemption from all taxes, fees, or charges imposed by a local government unit except real property tax on land improvements and equipment; tax and duty free importation of training materials and equipment; and direct importation of new motor vehicles, subject to the payment of the corresponding taxes and duties.

While substantial progress has been made in liberalizing the country's FDI policy, certain significant barriers to FDI entry still remain. The sectors with foreign ownership restriction include mass media, land ownership where foreign ownership is limited to 40%, natural resources, firms that supply to government-owned corporations or agencies (40%), public utilities (40%), and Build-Operate-Transfer (BOT) projects (40%).

#### *List A*

Due to constitutional constraints, List A restricts foreign investment in the practice of licensed professions as well as in the following industries: mass media, small-scale mining, private security agencies, and the manufacture of firecrackers and pyrotechnic devices. Foreign ownership ceilings are imposed on enterprises engaged in, among others, financing, advertising, domestic air transport, public utilities, pawnshop operations, education, employee

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<sup>8</sup> An RHQ is a branch office that principally serves as a supervision, communications and coordination centre for the subsidiaries, branches or affiliates of a multinational company operating in the Asia-Pacific Region and other foreign markets. It is allowed to operate only as a cost centre, and may not participate in any manner in the management of any subsidiary or other branch office the multinational has in the Philippines, or to solicit or market any goods or services. An ROHQ is a branch office that is allowed to derive income in the Philippines by performing qualifying services to its affiliates, subsidiaries or branches in the Asia-Pacific Region (including the Philippines) and other foreign markets. The services it is able to render, however, are limited to general administration and planning, business planning and coordination, sourcing and procurement of raw materials and components, corporate finance advisory services, marketing control and sales promotion, training and personnel management, logistics services, research and development services and product development, technical support and maintenance, data processing and communication, and business development.

recruitment, public works construction and repair (except Build-Operate-Transfer and foreign-funded or assisted projects), and commercial deep sea fishing.

The exploration and development of natural resources must be undertaken under production sharing or similar arrangements with the government. For small-scale projects, a company should be at least 60 percent Filipino-owned to qualify. High-cost and high-risk activities such as oil exploration and large-scale mining are open to 100 percent foreign ownership. In 1998, private domestic construction was deleted from List A, lifting the 40 percent foreign ownership ceiling previously imposed on such entities.

Rural banking remains completely closed to foreigners. In securities underwriting, the limit on foreign ownership was raised from 40 percent to 60 percent in 1997. The limit for financing companies was also raised to 60 percent in 1998. The insurance industry was opened up to majority foreign ownership in 1994 with minimum capital requirements increasing along with the degree of foreign ownership.

In retail trade, foreign equity remains banned in retail companies capitalized at less than \$2.5 million.

#### *List B*

Under List B, foreign ownership in enterprises is generally restricted to 40 percent due to national security, defense, public health, and safety reasons. List B also protects domestic small- and medium-sized firms by restricting foreign ownership to no more than 40 percent in non-export firms capitalized at no less than US\$200,000.

#### *Land Ownership*

Land ownership is constitutionally restricted to Filipino citizens or to corporations with at least 60 percent Filipino ownership. The Philippine Constitution bans foreigners from owning land in the Philippines. Foreign companies investing in the Philippines may lease land for 50 years, renewable once for another 25 years, or a maximum 75 years.

#### *BOT*

The legal framework for build-operate-transfer (BOT) projects and similar private sector-led infrastructure arrangements is covered under RA 6957 (as amended by RA 7718). The BOT law limits foreign ownership to 40% in BOT projects. Note that many infrastructure projects like public utilities, franchises in railways/urban rail mass transit systems, electricity distribution, water distribution and telephone systems are in general natural monopolies.

#### *Omnibus Investments Code*

The Omnibus Investments Code mandates the incentives and guarantees to investments in the Philippines. Certain provisions of the incentives law impose more stringent conditions on foreign-owned enterprises which seek to qualify for BOI-administered incentives. In general, foreign-owned firms producing for the domestic market must engage in a "pioneer" activity<sup>9</sup> to qualify for incentives. "Non-pioneer" activities are generally opened

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<sup>9</sup> Pioneer projects are those which (i) engage in the manufacture, processing or production; and not merely in the assembly or packaging of goods, products, commodities or raw materials that have not been or are not being produced in the Philippines on a commercial scale; (ii) use a design, formula, scheme, method, process or system of production or transformation of any element, substance or raw materials into another raw material or finished goods which is new and untried in the Philippines; (iii) engage in the pursuit of agricultural, forestry, and mining activities considered as essential to the attainment of the national goal; and (iv) produce unconventional fuels or

up to foreign equity beyond 40 percent only if, after three years, domestic capital proves inadequate to meet the desired industry capacity.

For firms seeking BOI incentives linked to export performance, export requirements are higher for foreign-owned companies (at least 70 percent of production should be for export) than for domestic companies (50 percent of production for export).

Foreign-owned companies must divest to a maximum 40 percent foreign ownership within thirty years or such longer period as the BOI may allow. Foreign firms that export 100 percent of production are exempt from this divestment requirement.

## **V. Tax Incentives and Other Fiscal Measures to Attract FDI**

As the Philippines implemented trade reforms in the last two decades, the country also pursued changes in its overall investment and investment incentive policies. In 1987, a new Omnibus Investments Code was legislated which simplified and consolidated previous investment laws and added two measures: income tax holiday for enterprises engaged in preferred areas of investment and labor expense allowance for tax deduction purposes. Several other legislations containing investment incentive packages were legislated; the most important of which were RA 7227 known as the Bases Conversion and Development Act of 1992 and RA 7916 or the Special Economic Zone Act of 1995.

In general, the changes in investment incentive measures that the country adopted over time have improved the overall system of investment in the country (Maxwell Stamp, 2001). Austria (1998) also noted that these changes were a crucial factor in building up confidence in the economic prospects of the country. However, as the incentives to investments evolved, a more complex system of investment promotion programs and policies emerged.

The current system is characterized by different investment regimes administered by different bodies consisting of the Board of Investments (BOI), the Philippine Economic Zone Authority (PEZA), the Subic Bay Metropolitan Authority (SBMA), the Clark Development Corporation (CDC), and other bodies mandated by various laws to establish, maintain, and manage special economic or free port zones. Table 2 shows a comparison of the major incentives provided by the different investment incentive-giving bodies. BOI-registered enterprises are allowed income tax holiday up to eight years, tax and duty free importation of spare parts, and tax credit on raw materials. Under EO 226, the incentives of importing capital equipment duty and tax free and tax credit on purchase of domestic capital equipment expired in 1997. After the lapse of the income tax holiday, the regular corporate tax rate of 32% will apply to BOI enterprises. PEZA grants the most generous incentives including income tax holiday, basic income tax rate of 5% of gross income, and tax and duty free importation of capital equipment, spare parts, and raw material inputs. Except for the income tax holiday, Clark and Subic enterprises enjoy the same incentives available to PEZA enterprises.

Note, however, that the October 2004 and July 2005 rulings of the Supreme Court nullified the fiscal incentives at four special economic zones which included the Clark Special Economic Zone (CSEZ). In March 2006, Presidential Proclamation 1035 was signed declaring the CSEZ as a PEZA Special Economic Zone. Still, with the Supreme Court decision all locators are subject to back taxes and duties. The House of Representatives

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manufacture equipment which utilizes non conventional sources of energy. Non pioneer projects include those that are engaged in common activities in the Philippines and do not make use of new technology.

passed two bills seeking to regain the fiscal incentives and provide tax amnesty. Currently, the bills are in the Senate for deliberation.

**A. Board of Investments registered enterprises: 1987 Omnibus Investments Code**

Under the Omnibus Investments Code of 1987, foreign and domestic investors may avail of fiscal and non-fiscal incentives provided they invest in preferred areas of investment identified annually in the Investment Priorities Plan (IPP). If the areas of investment are not listed in the IPP, they may still be entitled to incentives, provided:

- at least 50% of production is for exports, for Filipino-owned enterprises; and
- at least 70% of production is for production, for majority foreign-owned enterprises (more than 40% of foreign equity).

**Table 2: FDI Incentives by Type of Investment Regime**

	Investment Regime	BOI OIC	PEZA	SBMA & CSEZ
Incentives	Income	4-8 years ITH	4-8 years ITH	No ITH
	Others	After ITH, payment of the regular corporate tax rate of 35% of taxable income	After ITH, exemption from national & local taxes, in lieu of this special rate of 5% tax on gross income	5% tax on gross income in lieu of all local & national taxes
	Importation of raw materials & supplies	Tax credit	Tax & duty exemption	Tax & duty exemption
	Purchase of breeding stocks & genetic materials	Tax exemption within 10 years from registration	Tax & duty exemption	Tax & duty exemption
	Imported capital equipment, spare parts, materials & supplies	Tax & duty exemption on spare parts (duty & tax free importation of capital equipment expired in 1997) <sup>10</sup>	Tax & duty exemption	Tax & duty exemption

In general, BOI registered enterprises are entitled to the following incentives:

**Tax Exemptions**

- a) **Income Tax Holiday (ITH)**
  - Six years for new projects granted pioneer status;
  - Six years for projects locating in Less Developed Areas (LDA), regardless of status (pioneer or non-pioneer) and regardless of type (new or expansion);
  - Four years for new projects granted non-pioneer status; and
  - Three years for expansion and modernization projects. (In general, ITH is limited only to incremental sales in revenue/volume.)
  - An additional year may be granted in each of the following cases:
    - i. The indigenous raw materials used in the manufacture of the registered product is at least fifty percent (50%) of the total cost of raw materials for the preceding years prior to the extension unless the BOI prescribes a higher percentage; or

<sup>10</sup> Executive Order 313 (2004) restored these incentives.

- ii. The ratio of total imported and domestic capital equipment to the number of workers for the project does not exceed US\$10,000 to one (1) worker; or
- iii. The net foreign exchange savings or earnings amount to at least US\$500,000 annually during the first three (3) years of operation.

In no case, however, shall a registered firm avail of ITH for a period exceeding eight years.

- b) Exemption from taxes and duties on imported spare parts; the duty & tax free importation of capital equipment which expired in 1997 was restored in May 2004 with the issuance of Executive Order 313.
- c) Exemption from wharfage dues and export tax, duty, impost and fees for a period of ten years from the date of registration.
- d) Tax exemption on breeding stocks and genetic materials within ten years from the date of registration or commercial operation.

#### Tax Credits

- a) Tax credit on the purchase of domestic breeding stocks and genetic materials within ten (10) years from the date of registration or commercial operation.
- b) Tax credit on raw materials and supplies

#### Additional Deductions from Taxable Income

- a) For the first five (5) years from date of registration, additional deduction for labor expense equivalent to fifty percent (50%) of the wages of additional skilled and unskilled workers in the direct labor force. This incentive shall be granted only if the enterprise meets a prescribed capital to labor ratio and shall not be availed of simultaneously with ITH. This additional deduction shall be doubled if the activity is located in a LDA.
- b) Additional deduction for necessary and major infrastructure works. This privilege, however, is not granted to mining and forestry-related projects as they would naturally be located in certain areas to be near their source of raw materials.

#### Non-fiscal Incentives

- a) A registered enterprise may be allowed to employ foreign nationals in supervisory, technical or advisory positions for five years from date of registration. The position of president, general manager and treasurer of foreign-owned registered enterprises or their equivalent shall, however, not be subject to the foregoing limitations.
- b) Simplification of customs procedures for the importation of equipment, spare parts, raw materials and supplies and exports of processed products.
- c) Importation of consigned equipment for a period of 10 years from date of registration, subject to posting of a re-export bond.
- d) The privilege to operate a bonded manufacturing/trading warehouse subject to Customs rules and regulations.

#### **B. Philippine Economic Zone Authority registered enterprises: Special Economic Zone Act of 1995**

The Philippines was one of the first countries in Asia to establish export processing zones (EPZs) to allow total automatic access to imports by firms located in the zones on the

condition that they will export their entire production. In 1969, Republic Act 5490 was legislated to pave the way for the first EPZ in Bataan. The issuance of Presidential Decree 66 in 1972 created the Export Processing Zone Authority (EPZA) to operate and manage all Philippine export zones. PD 66 required total production of firms to be geared entirely for exports, although, in certain instances and subject to the approval of EPZA, firms were allowed to sell 30 percent of their production in the domestic market. Foreign ownership up to 100 percent was permitted, but, only the industries being promoted were allowed to be set up.

In 1979, Executive Order No. 567 allowed the EPZA to designate a specific plant site of an industrial firm or a group of industrial firms as a special export processing zone which are entitled to the same incentives granted to the four government-owned regular zones located in Bataan, Baguio, Cavite, and Mactan. The limited success of these zones in the 1980s prompted the government to institute changes in its EPZ policies.

In 1995, RA 7916 was legislated to shift the focus away from government EPZs towards private industrial zones. Focus has also shifted from the traditional EPZ in which firms must be 100 % export-oriented and engaged in recognized manufacturing activities towards industrial parks which allow all industries regardless of market orientation and a separate, fenced-in EPZ for wholly export-oriented firms.

Republic Act 7916 replaced the EPZA and created the Philippine Economic Zone Authority (PEZA) to manage and operate government-owned zones and administer incentives to special economic zones (ecozones). RA 7916 also allowed greater private sector participation in zone development and management through the provision of incentives for private zone developers and operators. Zone developers are allowed to supply utilities to tenants by treating them as indirect exporters. Activities permitted within the economic zones have also been expanded.

Incentives to Ecozone export and free trade enterprises

- a) Corporate income tax exemption for four years to a maximum of eight years
- b) Exemption from duties and taxes on imported capital equipment, spare parts, materials and supplies
- c) After the lapse of income tax holiday, exemption from national and local taxes, in lieu thereof, special five percent tax rate on gross income<sup>11</sup>.
- d) Tax credit (equivalent to 25 % of duties) for import substitution of raw materials used in producing nontraditional exports
- e) Exemption from wharfage dues, export tax, impost or fee
- f) Additional deduction for training expenses
- g) Tax credit on domestic capital equipment (equivalent to 100% of taxes and duties)

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<sup>11</sup> Gross income refers to gross sales or gross revenues derived from business activity within the zone, net of sales discounts, sales returns and allowances and minus costs of sales or direct costs. The allowable deductions are direct salaries, wages or labor expenses, production supervision salaries, raw materials used in the manufacture of products, goods in process, finished goods, supplies and fuels used in production, depreciation of machinery and equipment, rent and utility charges, and financing charges.

- h) Tax and duty free importation of breeding stocks and genetic materials
- i) Tax credit on domestic breeding stock and genetic materials (equivalent to 100% of taxes and duties)
- j) Additional deduction for labor expense
- k) Unrestricted use of consigned equipment
- l) Employment of foreign nationals
- m) Permanent residence status for foreign investors and immediate members of the family
- n) Simplified import-export procedures

Incentives to ecozone domestic market enterprises

- a) Exemption from national and local taxes and in lieu thereof, payment of a special rate of five percent on gross income.
- b) Additional deduction for training expenses
- c) Incentives under the Build Operate and Transfer Law (BOT under RA 6957 as amended by RA 7718)

Incentives to ecozone developers/operators

- a) Exemption from national and local taxes and in lieu thereof, payment of a special rate of five percent on gross income
- b) Additional deduction for training expenses
- c) Incentives under the Build Operate and Transfer Law (BOT under RA 6957 as amended by RA 7718).

**C. Subic Bay Metropolitan Authority and Clark Development Corporation registered enterprises: 1992 Bases Conversion and Development Act**

RA 7227, or the Bases Conversion and Development Act of 1992, was enacted into law in March 1992 with the objective of accelerating the development of the former United States military bases into special economic zones. The Act created two administrative bodies, the Bases Conversion and Development Authority (BCDA) and the Subic Bay Metropolitan Authority (SBMA), tasked with adopting, preparing and implementing a comprehensive development program for the conversion of the Clark and Subic military reservations into special economic zones. The BCDA is mandated to oversee and implement the conversion and development of Clark and other military stations; while the SBMA is mandated to oversee the implementation of the development programs of the Subic Bay Naval Station and surrounding communities. In 1993, Executive Order No. 80 was issued establishing the Clark Development Corporation (CDC), as the implementing arm of the BCDA for the Clark Special Economic Zone. As earlier noted, the Supreme Court revoked these incentives in July 2005, stating that RA 7227 did not grant privileges to locators operating in Clark.

## Incentives

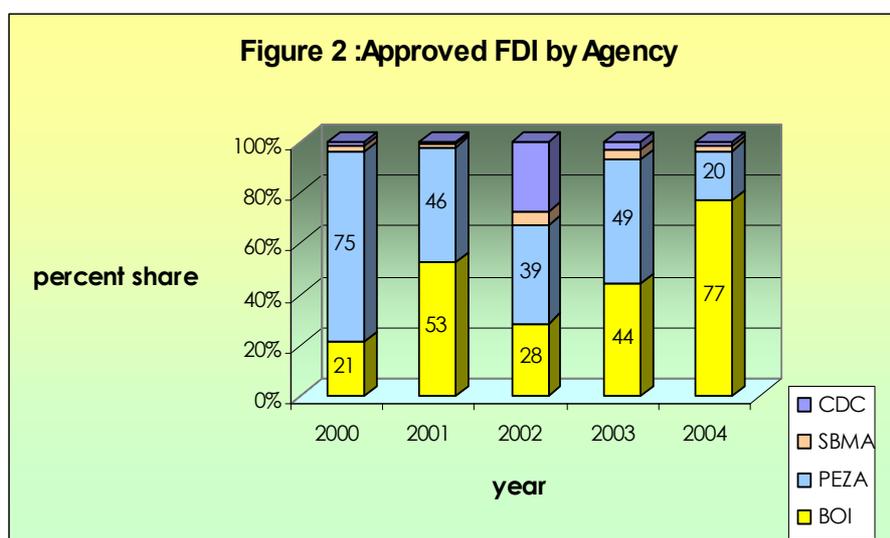
- a) A final tax of 5% on gross income earned shall be paid in lieu of all local and national taxes. (Gross income refers to gross sales derived from any business activity less cost of sales, cost of production or direct cost of services.)
- b) Tax and duty free importation of capital equipment, raw materials, supplies, spare parts and all other articles including finished goods.
- c) Permanent residency status for investors, their spouses, dependent children under 21 years of age, provided they have continuing investments of not less than US\$250,000.
- d) Employment of foreign nationals.

### D. FDI Approvals by Agency

Table 3 and Figure 2 present the distribution of approved FDI by agency, PEZA cornered the bulk of approved FDI with 75 percent of the total in 2000. It accounted for 39 percent of the total approvals in 2002 and 49 percent in 2003. In 2001, BOI was ahead with its share of 53 percent and in 2004 with its share of 77 percent. CDC received substantial FDI approvals in 2002 with its share of about 28 percent of the total.

**Table 3: Approved FDI (in million pesos)**

Year	2000	2001	2002	2003	2004
BOI	43611.5	102036.5	28352.1	28340.7	119542.8
PEZA	156697.8	88320	38741.1	31346	30430.8
SBMA	4663.8	1836.8	4902.2	2359.3	2729.7
CDC	2912.5	1568.9	27548.3	1748.6	2302
Total	207885.6	193762.2	99543.7	63794.6	155005.2



Source: Board of Investments

## VI. FDI Trends and Performance

In the 1980s, FDI inflows to the Philippines were very small and erratic owing largely to the economic and political instability that beset the country throughout the decade (see Table 4 and Figure 3). As a result, the Philippines missed out on the rapid growth of Japanese

FDI after the appreciation of the yen following the Plaza Accord of 1985. During the period 1983-1989, FDI inflows registered a negative average growth rate of -7.5%.

With the completion of the democratic transition process in the 1990s along with FDI liberalization, substantial improvements were felt as FDI inflows grew by 23.4% on the average from 1990 to 1999. With another political turmoil in the early 20s, average FDI inflows fell by 8.69% between 2000 and 2003. As percentage of gross domestic product (GDP), average FDI inflows increased from 0.54% of GDP in the eighties to 1.21% of GDP during the nineties. In the recent period, this reached an average of around 1.7% of GDP.

**Table 4: Trends in FDI 1980-2003**

Year	FDI Flow (million US \$)	Nominal GDP (million US \$)	FDI as % of GDP	Year	FDI Flow (million US \$)	Nominal GDP (million US \$)	FDI as % of GDP
1980	229.5	32452.3	0.71	1992	328.0	52977.4	0.62
1981	306.8	35645.1	0.86	1993	377.7	54367.9	0.69
1982	343.9	37140.2	0.93	1994	881.9	64084.9	1.38
1983	275.6	33211.3	0.83	1995	815.0	74121.1	1.10
1984	146.6	31407.9	0.47	1996	1281.0	82847.2	1.55
1985	246.9	30734.8	0.80	1997	1053.4	82343.4	1.28
1986	108.3	29867.9	0.36	1998	884.7	65171.5	1.36
1987	96.4	33195.4	0.29	1999	2106.7	76157.1	2.77
1988	64.0	37884.9	0.17	2000	1398.2	75898.8	1.84
1989	202.8	42574.6	0.48	2001	857.8	71205.4	1.20
1990	195.9	44310.7	0.44	2002	1431.4	76692.8	1.87
1991	415.3	45416.9	0.91	2003	1488.2	78626.8	1.89

Sources: Bangko Sentral ng Pilipinas and National Income Accounts.

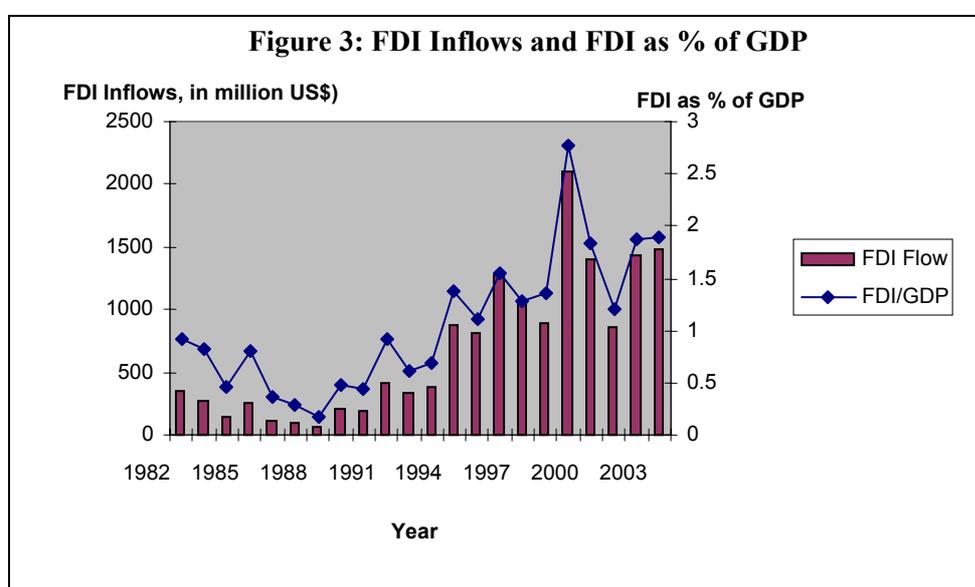


Table 5 presents the distribution of total cumulative flows across the major sectors from the eighties to the most recent period. Total cumulative flows to the Philippines increased from US\$ 2.03 billion to US\$ 8.34 billion between the 1980s (1980-1989) and the 1990s (1990-1999). From 2000 to 2003, a total of US\$ 5.16 billion was registered. FDI stock, measured by total cumulative flows, stood at US\$ 3 billion in 1989. This increased to US\$11 billion in 1990 and to US\$16.6 billion in 2003.

In the eighties, the bulk of FDI flows was concentrated in the highly protected manufacturing sector particularly in the manufacture of chemical and chemical products, food products, basic metal products, textiles and petroleum and coal. The average share of manufacturing went up from about 45% in the eighties to 50% in the nineties. Although with the reduction of protection in the manufacturing sector, its average share declined from 50% during the nineties to around 31% in the 20s. In the most recent period, FDI flows have been concentrated into the financial sector.

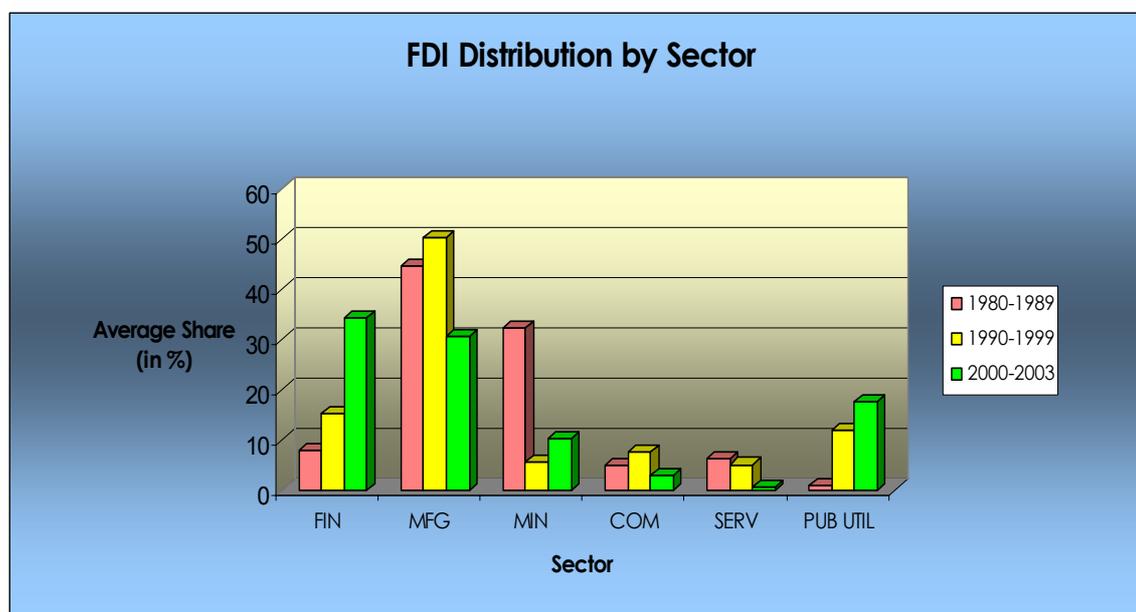
**Table 5: Distribution of Foreign Direct Investment by Sector (in percent)**

<b>Major Economic Sector</b>	<b>1980-1989</b>	<b>1990-1999</b>	<b>2000-2003</b>
<b>Total Cumulative Flows (in million US\$)</b>	<b>2027</b>	<b>8340</b>	<b>5164</b>
<b>Banks &amp; other Financial Institutions</b>	<b>8.11</b>	<b>15.45</b>	<b>34.19</b>
Banks	5.11	6.78	15.09
Other Financial Institutions	2.99	8.67	19.11
<b>Manufacturing</b>	<b>44.70</b>	<b>50.08</b>	<b>30.65</b>
Of which:			
Chemical & Chemical Products	13.36	5.72	3.55
Food	9.29	7.10	14.52
Basic Metal Products	5.71	2.27	1.85
Textiles	2.17	1.80	0.02
Transport Equipment	3.50	3.88	1.16
Petroleum & Coal	2.14	10.77	1.23
Rubber	-	0.60	0.01
Metal Products exc. Machinery	0.33	1.22	-
Paper & Paper Products	-	0.24	0.19
Machinery, Appliances, Supplies	-	12.23	3.99
Non-metallic Mineral Products	-	2.27	3.34
Others	-	1.34	0.49
<b>Mining</b>	<b>32.44</b>	<b>5.68</b>	<b>10.56</b>
Of which:			
Petroleum and Gas	28.15	1.66	10.54
Copper	0.51	0.00	-
Nickel	-	0.06	-
Geothermal	-	3.26	0.01
Others	-	0.41	
<b>Commerce</b>	<b>5.05</b>	<b>7.63</b>	<b>3.23</b>
Of which:			
Wholesale	2.86	3.86	2.03
Real Estate	1.23	3.42	1.20
<b>Services</b>	<b>6.39</b>	<b>5.29</b>	<b>0.91</b>
Of which:			
Business	2.36	1.13	0.63
Others	-	0.21	0.23
<b>Public Utility</b>	<b>1.13</b>	<b>11.94</b>	<b>17.82</b>
Of which:			
Communication	0.75	5.95	15.06
Water Transport	-	0.16	0.15
Land Transport	0.04	0.01	0.04
Electricity	-	5.39	1.54

Air Transport	-	0.20	
Others	-	0.05	1.03
<b>Agriculture, Fishery &amp; Forestry</b>	<b>1.66</b>	<b>0.36</b>	<b>0.01</b>
Of which:			
Livestock & Poultry	-	-	-
Fishery	-	0.13	-
Agriculture	2.01	0.23	
Others	-		
<b>Construction</b>	<b>0.52</b>	<b>3.00</b>	<b>2.44</b>
Of which:			
Transport Facilities	0.15		-
Infrastructure	0.66	0.70	0.10
Building	-	0.17	0.02
Gen. Engineering	-	1.10	2.31
Others	-	1.00	0.01

Source: Bangko Sentral ng Pilipinas

Within the manufacturing sector, FDI inflows shifted towards the production of machinery, appliances, and supplies as well as in petroleum and coal products. The large share of petroleum and coal in the nineties was due to the privatization of Petron, a government-owned and controlled company. The increase in machinery, appliances, and supplies can be attributed to the large inflows of FDI to the electronics sub-sector which has been the driver of export growth in the Philippines. In the most period, average FDI inflows appear to be strong in food manufacturing as its share more than doubled from 7% in the nineties to around 14.5% in the period 2000-03. While the average protection of the manufacturing sector has already declined, the food manufacturing sub-sector has remained highly protected relative to other manufacturing sub-sectors.



As indicated earlier, a lot of these changes in FDI flows and structure may be explained by the substantial FDI liberalization over the past decade. In the case of banks and other financial institutions sector, substantial increases in its share can be observed during the three periods under study. The share of the financial sector went up significantly from 8% in the eighties to 15% in the nineties. In the most recent period, its share further rose to about 34%. These increases in the share of FDI cumulative flows to the financial sector coincided

with the major banking reforms legislated since the mid-1990s. Prior to 1994, there were only four foreign banks in the country. These banks were heavily regulated; they could not engage in universal banking and trust operations and could not open new branches. Currently, there are a total of 19 foreign banks operating the Philippines.

Public utility also experienced substantial increases in its share which went up from 1% in the 1980s to 12% in the nineties and to around 18% in the period 2000-03. Within the sector, the communication sub-sector received the largest cumulative FDI flows increasing from less than one percent in the eighties to 6% in the nineties and to 15% in the most recent period under review.

In the past two decades, the share of mining fell drastically from 32% in the 1980s to around 6% in the nineties and in the most recent period, this went up to 11%. The share of agriculture, fishery, and forestry is very low and has declined in all three periods under study. Commerce, which includes wholesale and retail trade as well as private services saw increases in its share from 5% in the eighties to 7.6% in the nineties, though recently this dropped to around 3%.

**Table 6: FDI Inward Stock by Source**

Country	1989	1999	2003	Country	1989	1999	2003
U.S.A.	55.92	24.59	21.25	Panama	0.69	0.44	0.30
Japan	14.53	21.56	22.13	Austria	0.59	0.24	0.17
Hongkong	5.81	6.55	5.01	Singapore	0.49	3.14	6.04
Netherlands	4.82	11.53	11.57	Denmark	0.59	0.22	0.30
U.K.	3.45	4.16	5.16	Luxembourg	0.45	0.48	0.34
Switzerland	2.23	7.88	5.50	Malaysia	0.35	0.85	0.95
Australia	1.92	1.22	0.99	N Hebrides	0.27	0.07	0.05
Canada	1.58	0.52	0.61	Bermuda	0.28	2.38	1.66
France	1.37	0.87	2.95	South Korea	0.27	1.37	1.05
Nauru	0.33	0.12	0.08	Taiwan	0.64	1.61	1.41
Germany	1.01	2.09	3.96	V. Islands	0.00	3.01	3.22
Sweden	0.88	0.42	0.29	Others	1.53	4.68	4.99

Source: Bangko Sentral ng Pilipinas.

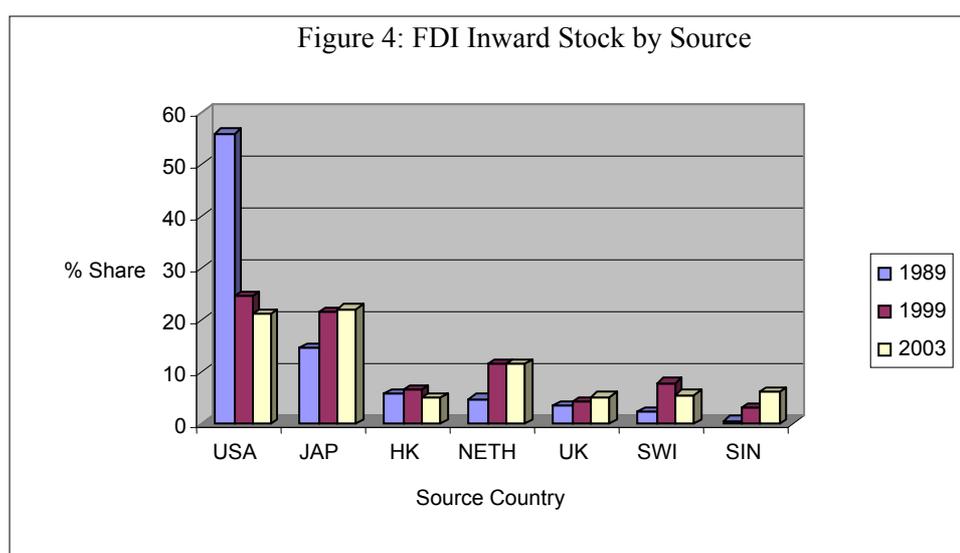


Table 6 and Figure 4 show that in the last two decades, changes were seen not only in the distribution of FDI by sector but also in the sources of FDI. Historically, the US was the Philippines' largest source of foreign investment. It is evident from the table that its dominance has been substantially diluted by the presence of Japan, Netherlands, Hong Kong, Singapore, UK, and Switzerland. Between 1989 and 1999, the cumulative share of the US fell drastically from around 56% to 25%, respectively. This dropped further to about 21% in 2003. The cumulative shares of Japan and Netherlands both increased from 15% to 22% and from 5% to 12%, respectively. Among developing countries, Singapore and Hong Kong have been the most important investors, followed by Taiwan, South Korea, and Malaysia.

## VII. Comparative Performance of the Philippines and Other Asian Countries

Table 7 presents FDI inflows data for the Philippines and other Asian countries: Vietnam, the People's Republic of China (PRC), Indonesia, Malaysia, Thailand, Taiwan, South Korea, and Singapore. It is evident from the data that the Philippines has performed poorly and has lagged behind the other countries. In terms of net FDI inflows, PRC is the largest recipient. Far second is Singapore, followed by South Korea and Thailand. The Philippines along with Vietnam and Indonesia were at the bottom of the list. Note that during the period 1981-1985, Vietnam's FDI inflows were almost negligible. By the next period, however, it was able to overtake the Philippines and during the period 1998-2001, its inflows were about the same as those of the Philippines. In terms of FDI per capita, Singapore tops the list followed by South Korea, Taiwan, Malaysia, and Thailand. The Philippines, Vietnam, and Indonesia received the lowest FDI inflows.

**Table 7: Net FDI Inflows in Selected Asian Countries**

Country	Net inflows (in current US\$ billion)			FDI per capita (US\$ per person)		
	1981-1985	1993-1997	1998-2001	1981-1985	1993-1997	1998-2001
Philippines	0.06	1.41	1.47	1.2	20.6	19.5
Indonesia	0.24	3.87	-2.73	1.5	19.9	-13.3
Vietnam	0.01	1.98	1.42	0.1	27.0	18.2
Malaysia	1.08	4.75	2.60	73.5	230.3	113.8
Taiwan	0.19	1.59	3.05	10.0	74.3	136.8
Thailand	0.28	2.29	5.18	5.6	39.0	85.8
SKorea	0.12	1.67	6.81	2.9	36.8	145.5
Singapore	1.35	8.28	8.05	508.5	2316.4	2011.8
PRC	0.85	36.31	41.29	0.8	30.1	32.8

Source: Foreign Investment Advisory Service, World Bank and International Finance Corporation (2005).

Studies of the determinants of FDI inflows have found that the most important factors on the ability of countries to attract FDI relate to the investment climate (particularly the FDI regime and the effectiveness of FDI promotion), the economic competitiveness of the country, and its growth prospects (FIAS, WB, and IFC, 2005). Box 2 summarizes three major determinants and factors consisting of economic conditions, host country policies, and strategies of multinational enterprises (MNE) that are associated with the extent and pattern of FDI in developing countries.

In assessing the determinants of FDI inflows to the Philippines, Aldaba (1995) found a strong positive correlation between FDI inflows and trade policy using effective protection rate as its indicator. Her results also revealed significant positive relationships between FDI and the stock of public investment (measure of infrastructure availability), real gross domestic product (market size indicator), and real effective exchange rate (competitiveness indicator with a real depreciation of the peso affecting FDI flows positively). As expected, the results

showed a significant negative relationship between FDI and political stability. No significant relationship between FDI and government investment incentive policies was found.

**Box 2: Host Country Determinants of FDI**

Economic conditions	• Markets	Size, income levels; urbanization; stability & growth prospects; access to regional markets; distribution & demand patterns
	• Resources	Natural resources; location
	• Competitiveness	Labor availability, cost, skills, trainability; managerial technical skills; access to inputs; physical infrastructure; supplier base; technology support
Host country policies	• Macro Policies	Management of crucial macro variables; ease of remittance; access to foreign exchange
	• Private Sector	Promotion of private ownership; clear & stable policies; easy entry/exit policies; efficient financial markets; other support
	• Trade & Industry	Trade strategy; regional integration & access to markets; ownership controls; competition policies; support for SMEs
	• FDI Policies	Ease of entry; ownership; incentives; access to inputs; transparent & stable policies
MNE strategies	• Risk Perception	Perception of country risk based on political factors, macro management, labor markets, policy stability
	• Location, sourcing, integration transfer	Company strategies on location, sourcing of products/inputs, integration of affiliates, strategic alliances, training, technology

Source: Lall, S. (1997), "Attracting Foreign Investment: New Trends, Sources, and Policies", Economic Paper 31, Commonwealth Secretariat.

**Table 8: Competitiveness Indicators for Selected Southeast Asian Countries**

Country	Growth Competitiveness Index		Macro Environment Index		Public Institution Index	
	2004	2006	2004	2006	2004	2006
Malaysia	29	26	27	31	43	18
Thailand	32	35	26	28	37	40
Philippines	66	71	60	62	85	88
Indonesia	72	50	64	57	76	52

Source: World Economic Forum, Global Competitiveness Report, 2003-2004 and 2006-2007.

Table 8 presents the ranking of the Philippines and other Southeast Asian countries (out of a total of 102 countries in 2004 and 125 countries in 2006) in terms of three sets of competitiveness indicators: growth competitiveness, macro environment, and public institutions indices. The growth competitiveness index covers measures of competitiveness such as institutions, infrastructure, macroeconomy, health & primary education, higher education & training, market efficiency, technological readiness, business sophistication, and innovation. The macro environment index is based on macroeconomic stability, country credit

risk, and wastage in government expenditures while the public institutions index is based on measures of the enforcement of contracts and law and degree of competition.

The table shows for all three indicators, the Philippines together with Indonesia performed substantially poorly than Malaysia and Thailand. However, while Indonesia's rankings have fallen between 2004 and 2006, those of the Philippines have increased.

A recent study by the Asian Development Bank-World Bank (2005) seems to confirm these findings. The ADB study indicated that macro instability in the Philippines remains a major concern for investors because of the country's serious fiscal problems. Moreover, the poor quality of key infrastructure services, a fragile and underdeveloped financial system, and a perception that contracting and regulatory uncertainty adds to the costs of doing business which also makes investors hesitant. The surveyed firms identified corruption and macroeconomic instability as the two biggest impediments to a good investment climate in the Philippines. Electricity supply, security and regulatory uncertainty also figured prominently.

**Table 9: Cost of Doing Business Indicators**

Country	Number of start-up procedures		Time to start a business (days)		Cost to register Business (% of per capita GNI)		Procedures to enforce a contract		Time to enforce a contract (days)		Employment laws index: range 0 (less rigid) to 100 (very rigid)	
	A	B	A	B	A	B	A	B	A	B	A	B
Philippines	11	11	59	48	24	18.7	28	25	164	600	60	39
PRChina	11	13	46	35	14	9.3	20	31	180	292	47	24
Malaysia	8	9	31	30	27	19.7	22	31	270	450	25	10
Hong Kong	5	5	11	11	2	3.3	17	16	180	211	27	0
Indonesia	11	12	168	97	15	86.7	-	34	225	570	57	44
S Korea	12	12	33	22	18	15.2	23	29	75	230	51	34
Singapore	7	6	8	6	1	0.8	23	29	50	120	20	0
Thailand	9	8	42	33	7	5.8	19	26	210	425	61	18
Vietnam	11	11	63	50	30	44.5	28	37	120	295	56	37

Note: A: 2003-2004 and B:2006-2007.

Source: World Bank, World Development Indicators, 2004 and 2006.

Table 9 shows a comparison of the business costs indicators for the Philippines and its East Asian neighbors. The World Bank's doing business indicators showed the same concerns on costs of doing business as well as complexity and uncertainty in contract enforcement. The data show that in 2004 the Philippines was perceived as providing a less certain environment compared with Indonesia, Thailand, China, and Malaysia. The table reveals that in general, except for the time to enforce a contract indicator, the Philippines performed significantly below the other East Asian countries especially in terms of corruption-related indicators. It had the worst indicators for number of days to enforce a contract and employment laws index.

However, the 2006 data reveal substantial improvements in the country's indicators such as time to start a business, cost to register business, procedures to enforce contracts, and employments laws index which all showed reductions. The same trend is observed among our neighbors. Except for number of procedures to enforce a contract, Thailand and Malaysia are still ahead of Philippine performance.

The ADB-World Bank (2005) survey on business costs in the Philippines showed differences in perceptions between foreign and domestic firms. In general, the findings reveal that macro instability and corruption are the most important constraints to business, followed by electricity and tax rates. Foreign firms, however, regard customs regulations, telecommunications, transportation, labor regulations, crime and labor skills as the most important constraints.

Tables 10 and 11 present infrastructure indicators measured by utility and real estate costs. Electricity and land acquisition costs in the Philippines are the highest in the region. The country is also among the highest in terms of internet and telecommunications costs as well as in facilities lease.

Table 12 compares the corporate income tax rates in the six countries. It is evident from the table that in terms of statutory corporate income tax rate, the Philippines has the highest rate. Given the availability of income tax holidays, the effective rates are reduced considerably.

**Table 10: Utility Costs**

Country	Electricity (US\$/KwH)	Water (US\$/cubic meter)	Sewer (US\$/cubic meter)	Telecom (US\$/minute to the US)	Internet (US\$/mo. T1 line equiv)
PRChina	0.08	0.21	0.18	0.25	5452
Indonesia	0.07	0.59	0.80	1.00	4863
Malaysia	0.07	0.51	0.66	0.24	4388
Philippines	0.10	0.21	0.19	0.30	5452
Thailand	0.06	0.31	0.17	0.56	4283
Vietnam	0.07	0.25	-	1.30	7497

Source: MIGA and World Bank, Benchmarking FDI Competitiveness in Asia, 2004.

**Table 11: Real Estate Costs**

Country	Land acquisition costs (US\$/square meter)	Building Construction Costs (US\$/square meter)	Facilities Lease (US\$/square meter gross/mo.)	Office Lease (US\$/square meter gross/mo)
PRChina	35	97	-	25
Indonesia	66	221	7	11
Malaysia	60	282	-	12
Philippines	61	1022	5	7
Thailand	52	329	2	5
Vietnam	-	-	3	12

Source: MIGA and World Bank, Benchmarking FDI Competitiveness in Asia, 2004.

**Table 12 : Corporate Income Tax Rates**

Country	PRChina	Indonesia	Malaysia	Philippines	Thailand	Vietnam
Corporate Income Tax Rate (in %)	30 national tax; 3% local tax	10% first Rp50M 15% next Rp50M 30% exceeding Rp100M	28	35 <sup>12</sup>	30	25

Source: The Economist Intelligence Unit (2004).

<sup>12</sup> Effective November 1, 2005, corporate tax rate has gone up from 32% to 35%.

**Table 13: Marginal Effective Tax Rate in Selected Asian Countries**

	Philippines	Thailand	Singapore	Malaysia
With interest deductibility	47	46	33	30
Adjusted for customs duty concessions	40	35	33	22
Adjusted for tax holidays	21	7	14	22
Adjusted for depreciation carried forward	21	7	-7	22

Source: Foreign Investment Advisory Service (1999)

**Table 14: Tax Incentives in Selected Southeast Asian Countries**

Tax Incentive	Philippines	Malaysia	Thailand	Indonesia	Vietnam
Tax holidays	3-8 years	5 years on 70-100% of statutory income & 10 years for companies of national strategic interest	3-8 years	3-8 years for new enterprises in 22 sectors	Up to 8 years
Reduced corporate income tax rates	for zone enterprises, exemption from national & local taxes & instead a special 5% tax rate on gross income	3% for offshore companies in Labuan & 10% for foreign fund management companies	50% reduction for 5 years for enterprises in investment promotion zones		25% foreign investors & 10, 15, & 20% for 10+ years when certain criteria are met
Import duty & VAT exemptions	Tax & duty free importation of capital equipment & raw materials for zone enterprises; tax credit on raw materials & supplies for BOI-registered firms	Exemptions & reduced import duty & VAT rates on inputs in certain sectors especially exporters	Exemptions & reduced import duty & VAT rates on inputs in certain sectors especially exporters	Exemptions & reduced import duty & VAT rates on inputs in certain sectors especially exporters	Exemptions & reduced import duty & VAT rates on inputs in certain sectors
Investment allowances & credits	Tax credits for purchases of domestic breeding stocks & genetic material as well as for incremental revenue	Investment allowance of 60-100% of qualifying capital expenditure	Allowance of 25% for investment in infrastructure	Reduction of taxable income by up to 30% of investment in priority sectors	If profits reinvested for 3 consecutive years, a portion or all of corporate income tax maybe refunded
Accelerated depreciation	Immediate expensing of major infrastructure investments by export enterprises in less developed areas	Accelerated depreciation of computer technology & environmental protection investments		Doubling of depreciation rates in favored zones & sectors	

Source: For Malaysia, Thailand, & Indonesia, Chalk (2001) and Price Waterhouse Coopers (2001) as cited in Fletcher (2002).

Table 13 presents the marginal effective tax rates in selected Asian countries. After adjusting for interest deductibility, the marginal effective tax rate for the Philippines is higher than Malaysia or Singapore and is almost the same as Thailand. After adjustments for

customs duty concessions, the effective rate for the Philippines drops to 40% but still the highest among the four Southeast Asian countries. After adjustments for income tax holidays, the Philippines' effective rate is reduced to only 21%, higher than Singapore and Thailand, but almost at par with Malaysia.

In terms of other tax incentives, Table 14 shows that the Philippines, Indonesia, Malaysia, and Thailand offer almost similar incentives such as tax holidays, reduced corporate income tax rates, investment allowances and credits, import duty and VAT exemptions; although there are some differences on the terms and conditions under which the incentives can be availed of.

Box 3 presents a case study of the recent experience of the Philippines in the automotive industry. Around the mid-1990s, the Philippines along with Thailand were shortlisted by General Motors as site for its assembly and parts manufacturing plant in Asia. The Philippines added certain features in its motor vehicle program to make it more attractive to GM. GM indicated that in terms of investment incentives, the two countries provided almost the same level. The case shows that more than incentives, the crucial factors were market size, logistics, infrastructure, free trade policy, perception of corruption, and activist labor unions. Clearly, Thailand has won the lion's share of investments as it emerged as the choice of Japanese, American and European car makers as their base to supply the whole of Asia.

### **VIII. Summary and Policy Implications**

The recent literature on FDI determinants has shown that due to increasing globalization and widespread liberalization, investment incentives have become significant factors in the location decisions of investors. Morriset and Pirnia (2002) indicated that the recent evidence on growing tax competition in regional groupings such as the European Union or at sub regional level within one country like the United States has shown that when factors such as political and economic stability, infrastructure, and transport costs are more or less equal between potential locations; then taxes may exert a significant impact. The experience of the Philippines, however, tends to suggest that for a country with relatively weak fundamentals; tax incentives, no matter how generous, will not be able to compensate for the deficiencies in the investment environment.

The Philippines has considerably liberalized its FDI policies in the last two decades. At the same time, it has implemented reforms in its investment policy and investment incentive measures. Over time, however, different investment incentive regimes evolved managed by different government bodies. In their effort to attract investors to locate in their areas, different incentive packages emerged with new ones trying to be more generous in terms of providing incentives. While the investment policy reforms and opening up of more sectors to foreign investors in the past decade resulted in improvements in FDI inflows to the country, on the overall, FDI inflows to the Philippines have been limited; hence the country's performance has lagged behind its neighbors in East and Southeast Asia.

To attract foreign investors to locate in the country, we tried to compete with other countries in providing tax incentives. However, these efforts resulted in a complicated investment incentive system. A complex investment incentive system combined with poor investment climate explain why the Philippines has performed badly in attracting FDI inflows relative to its neighbors. This tends to show that in the absence of fundamental factors such as economic conditions and political climate, tax incentives alone are not enough to generate a substantial effect on investment decisions of investors nor can they make up for the country's fundamental weaknesses.

**Box 3: On Why General Motors Favored Bangkok Over Manila**

The Association of Southeast Asian Nations (ASEAN) started preparing for the liberalization of the automotive industry in the early nineties. The biggest plan was for creation of the ASEAN Free Trade Area (AFTA) which would reduce tariffs on cars and parts to a uniform rate of five percent by June 2003. Western companies were excited with the prospects that this plan would bring. Many automotive companies saw the five percent tariff as low enough to allow the development of a pan-regional marketplace for cars and car parts.

In anticipation of AFTA, US automaker Ford decided to set up its factory in Thailand. Another major US major truck manufacturer, General Motors (GM), was next to bet on free trade. In 1995, GM announced that it was considering building a US\$1 billion assembly plant and parts manufacturing plant in Asia. In 1996, GM narrowed down its choice between either Bangkok or Manila as site for its Asian regional headquarters. Both Indonesia and Malaysia expressed their plans to pursue their own national cars, Timor and Proton, respectively. Thailand liberalized its car importation in 1991, while the Philippines removed all quantitative restrictions on auto imports in late 1995.

Around this time, the Philippines was producing an average of 11,447 vehicles per month while Thailand was producing 45,114 units. In terms of sales, Thailand sold 571,580 units in 1995 compared to 129,000 units in the Philippines during the same year. Thailand had a combined production capacity of 607,300 units while the Philippines had 230,000 units per year. Thailand had around 350 car parts manufacturers, the Philippines had about 170.

In February 1996, the Philippines passed a new law that liberalized the automotive industry. This legislation also prohibited car assemblers that intended to sell only to the domestic market from importing semi-knocked down (SKD-semi assembled cars without batteries and tires) units while their assembly facilities were being set up. Previously, car assemblers were allowed to import and use SKDs for six months which could be extended for another six months. To accommodate the entry of GM, an additional feature was added in the new law allowing new entrants to import SKD units to be sold in the domestic market, provided they would export at least 50 percent of their CBU production (70 percent in case of foreign companies). In an interview with a Board of Investments official, it was revealed that this was one of the requests made by GM.

In a survey of US automakers' ASEAN 4 (Thailand, Indonesia, Malaysia, Phils.) strategies of GM, Ford, and Chrysler (Big Three) conducted by the University of Michigan Transportation Research Institute (1999), the following advantages and disadvantages of Thailand and the Philippines were seen as crucial in the production investments of the Big Three in Asia:

	Advantages	Disadvantages
Phils	No major manufacturer Skilled, English-speaking workforce Supportive government Existing (completely knocked down) CKD automotive assembly	Logistics Real lack of qualified engineers & technical people Low education levels Reputation for activist unions Past corruption under Marcos Smallest vehicle market among ASEAN 4
Thail	Supportive government Free markets, allow imports Existing CKD automotive assembly Logistics Good labor relations Established infrastructure Large light truck market	Workforce quality Few English speakers Education system weakest among ASEAN 4 Real lack of qualified engineers & technical people

In July 1999, GM decided to establish its US\$500 million facility in Thailand's Rayong province.

There are costs associated with incentives and these hidden costs have a direct negative impact on fiscal revenues. Reside (2006) found that in 2004, eighty percent of BOI incentives were redundant, that is, these investments would have been carried out even without the incentives. In peso terms, this amounted to P43.2 billion in foregone revenues. For PEZA, the redundancy rate was the lowest at 10 percent, SBMA at 17.5 percent while Clark had 36 percent.

It is important to note that some of the existing fiscal incentives are necessary to reduce the economic distortions caused by the structure of protection. Incentive mechanisms allowing duty free importation of intermediate inputs for export oriented firms can address the existing anti-export bias created by relatively high tariffs on intermediate and capital goods. These mechanisms include duty drawback procedures (though their administration is costly and cumbersome) and export processing zones. On the other hand, fiscal incentives like income tax holidays do not address this need to reduce anti-export bias<sup>13</sup>.

Given the large costs associated with tax incentives, there have been moves to rationalize fiscal incentives; but so far, no legislation has been passed to address this issue. Lawmakers have acknowledged that the current system of incentives has been prone to corruption and other forms of abuse and has grown unmanageable due to the many implementing bodies governed under different laws. There is a pending bill at the Senate to harmonize and simplify investment incentives under one legislation<sup>14</sup> – Investments and Incentives Code of the Philippines to be adopted by the different investment promotion agencies in the country. The bill proposes to streamline the grant of incentives that are clear, simple, time-bound, performance based and at par with other countries in the region. The Investment Priorities Plan (IPP) will include industries with high comparative advantage, new product / service and export oriented products and will be valid for a period of three years. Similarly, there are four bills<sup>15</sup> filed in the House of Representatives to rationalize the country's investment incentives system by amending the existing Omnibus Investments Code of the Philippines (EO 226).

There is no doubt that these reforms are necessary to address the complexity of the country's incentive system and align it with international best practices. However, it is important to emphasize that simultaneous with this, efforts are needed to address fundamental factors such as the modernization of our infrastructure, raising the level of education and labor skills, upgrading existing technologies, increasing productivity and improvements in the overall business climate. All these together with our investment incentive program should form part of an integrated approach for attracting FDI (Blomström and Kokko, 2003). Improving the fundamentals for economic growth will not only attract FDI inflows but will also increase the chances for spill over benefits to accrue to the private sector. To realize this, it is important that local firms have the ability and motivation to invest in absorbing foreign technologies and skills.

The case of Ireland, which has for a long time been considered a preferred location for FDI, has shown that its success in attracting FDI and benefiting from such was largely due to the country's having the right fundamentals (Barry and O'Malley, 1999). It is also important to note that the various incentives that it provided to foreign investors have also been available to local companies. In Sweden, another successful country in attracting FDI, the country's industrial policy does not discriminate between foreign and local companies.

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<sup>13</sup> This was pointed out by Professor Felipe Medalla of the UP School of Economics.

<sup>14</sup> Senate Bill 1104 was introduced by Senator Franklin Drilon in the Thirteenth Congress of the Republic of the Philippines.

<sup>15</sup> House Bill (HB) 271 was filed by Speaker Jose de Venecia; HB 122 by Representative Joey Salceda; and HBs 1599 and 302 by Representative Jesli Lapus.

To attract export-oriented FDI, Ireland as well as Singapore pursued more integrated approaches by placing their FDI policies in the context of their national development strategies and focusing on productivity improvements, skills development, and technology upgrading (Blomström and Kokko, 2003).

It should be remembered that the new literature indicates that the response of multinational corporations to changes in tax incentives depends on their activities, motivations, market structure, and financing. In general, the new literature shows that (as summarized in Morisset and Pirnia):

- The impact of tax rates on investment decisions is higher on export-oriented companies than on those seeking the domestic market or location-specific advantages. Taxes are an important part of the cost structure of export-oriented firms because they operate in highly competitive markets with very slim margins (Wells, 1986).
- New firms prefer incentives that reduce their initial expenses (equipment and material exemption) while expanding firms prefer tax incentives that target profits (Rolfe et al, 1993).
- Small investors are more responsive to tax incentives than large investors (Coyne, 1994).

As the Philippines tries to reform its tax incentive system, care must be taken in discerning the implications of various suggested tax incentives and instruments to attract FDI flows. Our previous investment incentive experience has shown that given weak institutions in the country, this can easily become a source of corruption. During the late 1990s, the country's tax credit system was weakened by cases of tax credit fraud due to the proliferation of tampered, fake, and used tax credit certificates which were sold and re-used resulting in large costs to the government amounting to billions of pesos in revenue losses. Hence, there is a need to carefully weigh these incentive measures. As Morisset and Pirnia (2002) indicated, the impact of tax policy may significantly depend on the tax instruments used; for instance, a tax holiday and a general reduction in the statutory corporate tax rate may have the same impact on the effective tax rate but significantly different effects on FDI flows and on government's revenues.

Currently there are suggestions to replace income tax holidays with lower corporate tax rates. Hong Kong, for instance, is quite different from the rest of the Asian countries reviewed in the previous section as it offers few special incentives but instead, provides a low unified corporate income tax rate of 16%. This is almost half the typical standard rate in the region.

There are also proposals to shift from net income to gross income taxation. However, the business sector pointed out that this will put foreign investors at a disadvantage because they will not be able to claim a credit on their income tax that has been paid to the Philippine government. Moreover, the group argued that the proposed system will shift the debate on which expenses are considered parts of cost of goods sold. In the present system, this is not an issue because firms can deduct all business expenses regardless of whether they are included in cost of goods sold. By limiting the items to be deducted from direct costs, the business group warned that this will only create incentives for firms to find more creative ways to avoid taxes. Studies focusing on in-depth analysis of the impact of different tax instruments will be needed to come up with an optimal investment incentive policy for the Philippines. This is very crucial for us given the need to sustain earlier fiscal reforms and the need to attract substantial FDI flows.

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