THE NEED (OR NOT) FOR FISCAL INCENTIVES

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After the passage of RA 10351 or the Sin Tax Reform 2012, the bill on the rationalization of fiscal incentives for investments to further shore up government collections has been certified a priority measure by the Aquino administration. This bill aims to rationalize fiscal incentives across industries to improve transparency, further bolster revenues, and level the playing field.

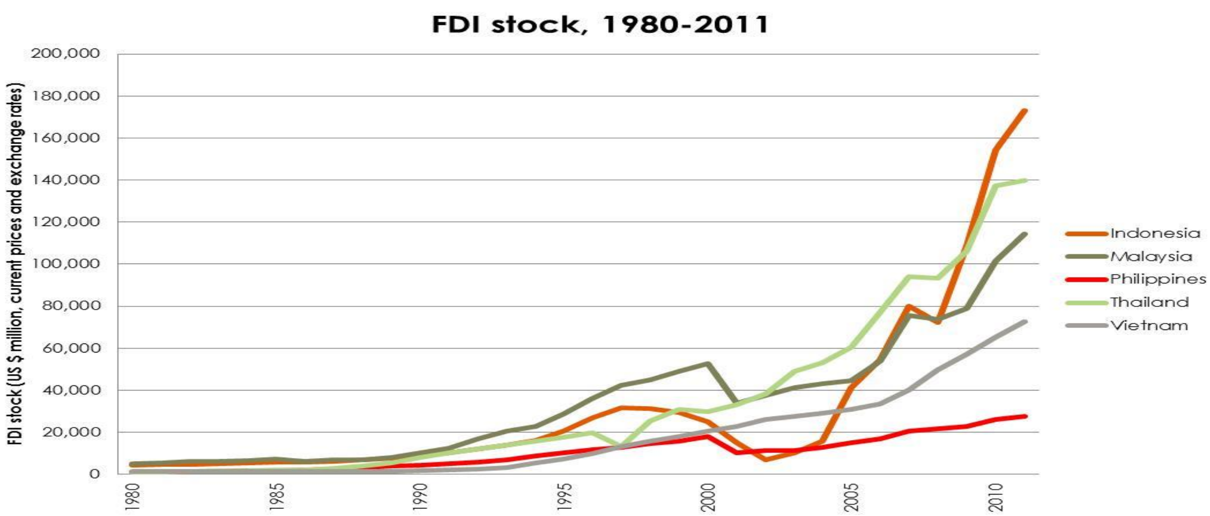
Fiscal Incentives and their Rationale

Investment incentives, as defined by UNCTAD (2000), refer to "any measurable advantage accorded to specific enterprises or categories of enterprises by or at the direction of the government". The government uses three main categories of investment incentives as follows: financial incentives such as outright grants and loans at concessionary rates, fiscal incentives such as tax holidays and reduced tax rates, and other incentives such as subsidized infrastructure or services, market preferences and regulatory concessions (UNCTAD, 2004)

Fiscal incentives are but one of the instruments in countries' development and investment promotion strategies. Fletcher (2002) defines fiscal incentive as the preferential treatment, usually in the form of tax breaks, given to qualified investment projects. Supporters of fiscal incentives argue that providing fiscal incentives is crucial in promoting *incremental* investment, creating *new* jobs and resulting in other social and economic benefits (Fletcher, 2002). Some experts have also argued that countries need fiscal incentives in order for them to be competitive vis-à-vis their neighbors. In this case, incentives become more of a signaling device, that is to say, incentives signal to the rest of the world that a location has a good business environment that is open to investment. This argument might particularly be significant in the case of footloose enterprises which are not tied to a specific location and which can easily relocate across international borders. Because investment projects in certain industries can be located anywhere globally, there exist competition among countries in terms investment incentives they offer. The foregoing justification for fiscal incentives, however, is basically applicable only to Foreign Direct Investments (FDI) because the impact of fiscal incentives in the case of domestic investments will just be to shift investment that would have been undertaken anyway toward preferred areas/sectors away from non-preferred areas/sectors.

However, some analysts have also argued that incentives are desirable because of the positive spillovers that results from an investment, which includes the diffusion of new knowledge and technology to the rest of the economy, as well as the upgrading of the skills of the country's workforce (UNCTAD: 2000). Others have likewise justified fiscal incentives on their usefulness in encouraging the dispersion of investments to less developed areas and/ or more economically desirable industries or sectors. In other words, incentives may be used as a tool to encourage dispersion of industries and enhance countryside development, attract high-technology industries that could diffuse technology to the rest of the country, and enhance economic diversification (Fletcher, 2002).

Inter-country evidences, however, only show modest impact of fiscal incentives on investments. There are cases where fiscal incentives do not usually mean an attractive business climate. Chalk (2001) for example, cites the Philippines and Indonesia as examples of countries which offer the most generous fiscal incentives and yet, they do not perform better in terms of overall competitiveness than countries which have relatively narrow and more targeted fiscal incentives regimes. It has been argued that the effectiveness of fiscal incentives in increasing investment will only take place if projects which are sensitive to taxes are given more favorable tax treatment (Tuomi, 2012). Because of the difficulty in correctly selecting tax-sensitive projects (Tuomi, 2012), providing wide-ranging fiscal incentives would only mean sacrificing revenues on the side of the government while not necessarily attracting additional investments (Chalk:2001). This is illustrated in Figure 1 which shows the low FDI stock of the Philippines relative to its neighboring countries since the 1980s.



In addition to the meager effects of incentives on the country's FDI, a significant portion of the fiscal incentives provided by the BOI appears to be redundant, i.e. incentives are granted to investors who would have invested anyway even without the incentive. In 2004, revenues foregone as a result of the redundant fiscal incentives provided by BOI alone amount to 43.18 Billion pesos or around 1% of GDP during that year (Reside, 2006).

While fiscal incentives serve as a promotional tool for investment, other determinants of the attractiveness of a country to investments cannot be compensated for by just the granting of incentives. For one, the overall investment climate, which includes the presence of infrastructure, cheap labor, consistent and predictable policy and regulatory environment, is deemed to be more important than the provisions of fiscal incentives. In addition to this, fiscal incentives may not always be the best instrument to address externalities and market failures. To the extent that fiscal incentives have been successful in influencing the allocation of domestic investments towards favored areas/sectors, overall economic inefficiencies may result if government is not able to identify winners. If the objective is geographic dispersal of industry, provision of adequate and good quality infrastructure might be more important. Other factors that are crucial in attracting foreign investments include the current trade policy regime, openness to international markets, investment policy regime, and institutional and governance set-up (Wijesinha: 2013).

Type of fiscal incentives and their merits

Fiscal incentives can be broadly categorized into: (1) tax holidays (no taxes for a period of time), (2) investment allowances and tax credits, (3) reduced Corporate Income Tax (CIT) rates, (4) accelerated depreciation, (5) exemptions from indirect taxes, and (6) export processing zones. Table 1 summarizes the primary pros and cons of each type of tax incentive.

Fletcher argues most strongly against tax holidays because despite the ease in administration, tax holidays are more "intransparent, create multiple distortion, and are very susceptible to abuse and tax avoidance strategies" (Fletcher, 2002) First, holiday taxes are generally not well-targeted. To wit, ITHs attract the short-term, highly profitable, footloose industries (Klemm: 2009), which do not match investment priorities of the government and which should not be the target of fiscal incentives, to begin with. This results in redundancies and high revenue losses on the side of the government. Second, tax holidays provide opportunity for tax avoidance. Since ITHs are usually time-bound, enterprises may opt to enter economic relationships with a tax exempted enterprise after the expiration of the tax holiday, and through transfer pricing, could shift profits to the partner enterprise (zee et. al., 2002). Third, the enterprise may seek extensions through rent-seeking to remain competitive with other enterprises (Klemm, 2009) or through redesignation of an investment as a new one (Zee et. al., 2002). Fourth, because enterprises under tax holiday may not be required to file tax returns, revenue costs of such incentive are often untransparent (Klemm, 2009). Fifth, tax treatments like tax holidays which target export activities might be inconsistent with the trade rules of the WTO (Botman et. al., 2008).

Investment allowance and tax credits, on the other hand, are advantageous because of the ease in implementation, and transparency (Klemm, 2009). However, investment allowance will result in distortion on the choice of capital. Specifically, an enterprise would opt for short-lived capital because replacement of capital would then be eligible for allowance and credit (Klemm, 2009). Also, although it might boost physical investment, which is advantageous, it might also cause a shift in investment away from financial and human capital investment (Klemm, 2009).

Reduced tax rates differ from tax holiday because there is no complete elimination of tax liability (Holland and Vann, 1998). However, Klemm (2009) argues that if the reduction of tax rates will be time bound, it would just be like the tax holiday in which, it will attract short-lived enterprises which would leave after the duration of the incentive. In addition to this, rules must be defined in identifying the sectors that would be eligible to the reduced tax rates.

Finally, accelerated depreciation, according to Fletcher, can be considered to be "relatively transparent, less susceptible to abuse, and result in fewer distortions" (Fletcher, 2002). Because total deductions are not changed, the time value of money becomes the benefit the enterprise receives from this incentive (Klemm, 2009).

Table 1. Pros and Cons for the Government of Different Types of Tax Incentives	
Advantages	Disadvantages
1. Lower CIT rate	
• Simple to administer. • Revenue costs are more transparent.	• Largest benefits go to high-return firms that are likely to have invested even without incentive. • Invites tax avoidance through high-tax enterprises shifting profits to low-tax ones via transfer pricing (intracountry and international). • Acts as windfall to existing investments. • Unlike specific benefits, may not be tax spared by home country tax authorities.
2. Tax holidays	
• Simple to administer. • Allows taxpayers to avoid contact with tax administration (which may be important if it is complex or corrupt). • Same as lower CIT rates, except might be tax spared.	• Attracts short-run projects. • Invites tax avoidance through the indefinite extension of holidays via creative redesignation of existing investment as new investment. • Creates competitive distortions between old and new firms. • Revenue costs are not transparent unless tax filing is required, in which case administrative benefits are foregone.
3. Investment allowances and tax credits	
• Can be targeted to certain types of investment with highest positive spillovers. • Revenue costs are more transparent.	• Distorts choice of capital assets in favor of short-lived ones, since a further allowance is available each time an asset is replaced. • Qualified enterprises may attempt to abuse the system by selling and purchasing the same assets to claim multiple allowances. • Greater administrative burden. • Discriminates against investments with delayed returns if loss carry-forward provisions are inadequate.
4. Accelerated Depreciation	
• All of the benefits of investment allowances and credits. • Does not generally discriminate against long-lived assets. • Moves the CIT closer to a consumption-based tax, reducing the distortion against investment typically produced by the regular CIT.	• Some administrative burden. • Discriminates against investments with delayed returns if loss carry-forward provisions are inadequate.
5. Exemptions from Indirect Taxes (VAT, import tariffs, etc.)	
• Allows taxpayers to avoid contact with tax administration (which may be important if it is complex or corrupt).	• VAT exemptions may be of little benefit—under regular VAT, tax on inputs is already creditable; outputs may still get taxed at later stage. • Prone to abuse—easy to divert exempt purchases to unintended recipients.
6. Export Processing Zones	
• Allows taxpayers to avoid contact with tax administration (which may be important if it is complex or corrupt).	• Distorts locational decisions. • Typically results in substantial leakage of untaxed goods into domestic market, eroding the tax base.

Sources: Fletcher (2002), "Tax Incentives in Cambodia, Lao PDR, and Vietnam", Paper prepared for the IMF Conference on Foreign Direct Investment: Opportunities and Challenges for Cambodia, Lao P.D.R., and Vietnam, Hanoi, Vietnam, August 16-17.

Current fiscal incentives in the Philippines and the Need for Reform

There are currently more than 140 laws granting fiscal incentives in the Philippines. (STSRO:2010), which include the Omnibus Investment Code in 1987 which simplified previous investment laws and added other incentive measures, the Bases Conversion and Development

Act of 1992 and Special Economic Zone Act of 1995 (Aldaba, 2007). Under the current incentive system, different bodies, namely the BOI, PEZA, SMBA, CDC, and other bodies mandated to manage special economic or free port zones administer different investment regimes (Aldaba, 2007). Table 2 provides a comparison of the major incentives provided by a number of major bodies.

Table 2. FDI incentives by type of investment regime

	Investment Regime	BOI OIC	PEZA	SBMA and 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 percent of taxable income	After ITH, exemption from national and local taxes, in lieu of this special rate of 5 percent tax on gross income	5 percent tax on gross income in lieu of all local and national taxes
	Importation of raw materials and supplies	Tax credit	Tax and duty exemption	Tax and duty exemption
	Purchase of breeding stocks and genetic materials	Tax exemption within 10 years from registration	Tax and duty exemption	Tax and duty exemption
	Imported capital equipment, spare parts, materials, and supplies	Tax and duty exemption on spare parts (duty and tax free importation of capital equipment expired in 1997)*	Tax and duty exemption	Tax and duty exemption

* Executive Order 313 (2004) restored these incentives.

SOURCE: Aldaba, 2007

Status of Reform Efforts

The passage of the fiscal incentive bill has taken time to realize. In the lower house, House Bill (HB 4935) or the Investments and Incentives Code, which was introduced in 1995 and re-filed every year thereafter, has only been approved on third reading in the House in the 14th Congress. On the other hand, two Senate bills presented in the 16th Congress are currently being eliberated, i.e. Senate Bill 987 introduced by Senator Ralph Recto and Senate Bill 35 introduced by Senator Cynthia Villar.

Senate Bill 987 (Recto Bill)

Senate Bill 987 (SB 987), sponsored by Senator Ralph Recto, proposes the consolidation of all Investment Promoting Agencies (IPAs) into one centralized agency. The Board of Investments

(BOI) and the Philippine Economic Zone Authority (PEZA) will be merged, renamed and reorganized as the Philippine Investment Promotion Administration (PIPA), which is attached to the Department of Trade and Industry (DTI). This bill seeks to abolish the Investments Priorities Plan (IPP), hence, under this bill, no preferred list will govern the types of investments to be given tax incentives.

Under this bill, export enterprises or domestic enterprises located in the 30 poorest provinces are qualified to register with PIPA to avail of the incentives. The bill provides the following sets of incentives:

I. For registered export enterprises:
   a. Reduced CIT of 15% or a 5% of gross income earned in lieu of all national and local taxes, except of value-added tax (VAT) and real property tax on land
   b. NOLCO for 10 years
   c. Accelerated depreciation
   d. Exemption from customs duties and taxes of the importation of capital equipment, raw materials, and source documents
   e. Exemption from wharfage dues
II. For registered domestic enterprises:
   a. Reduced tax rates. Imposition of preferential tax rate of 15% of taxable income
   b. NOLCO for 5 years
   c. Accelerated depreciation

Senate Bill 35 (Villar Bill)

Senate Bill 35, introduced by Senator Cynthia Villar, proposes that the Board of Investment (BOI) shall implement the provisions of the code. The BOI will be governed by its Board of Governors which is composed of representatives from key agencies and the private sector. The BOI upon the consultation with other representatives shall formulate the Investment Priorities Plan (IPP) that should be governed by the current MTPDP and PTPIP.

Two performance based-incentives are provided to qualified enterprises, i.e.(1) direct taxes incentives such as NOLCO, accelerated depreciation and double deduction of training expenses and research and development, and (2) indirect taxes incentives such as 0% VAT on sales, exemtion from customs duties and taxes on importation of capital equipment, raw materials and source documents and wharfage dues and export tax. Qualified enterprises which avail of the ITH, reduced CIT, or the 5% tax rate of GIE shall be precluded from availing the performance-based direct taxes incentives.

This bill provides varying incentives to export enterprises, domestic enterprises, strategic enterprises, enterprises located in ecozones and freeport zones, and domestic enterprises located in the identified thirty poorest provinces or less developed areas. This bill provides the fiscal incentives as follows:

I. Incentives to registered export enterprises
   a. ITH to 6 years
   b. Reduced CIT of 15%

Or 5% tax rate on Gross Income Earned (GIE) in lieu of all national and local taxes except real property tax

c. NOLCO for 5 years
d. Accelerated depreciation
e. Double deduction for training expenses and research and development
f. Exemption from customs duties and taxes for the importations of capital equipment, raw materials and source documents
g. 0% rate of VAT on the sale by a domestic enterprise to a registered export enterprise
h. Exemption from wharfage dues and export taxes
i. Access to bonded manufacturing warehouse
j. Other incentives for registered enterprises in ecozones and freeport zones

II. Incentives for registered domestic enterprises
a. ITH to 4 years
b. NOLCO for 5 years
c. Accelerated depreciation
d. Double deduction for training expenses and research and development
e. VAT and duty refund on importation of capital equipment and/or raw material
f. Preferential access to financing and acceptable form of collaterals
g. Assistance in the preparation of project study

III. Incentives for domestic "strategic" enterprises
a. ITH for 6 years
b. Reduced CIT of 15% for 8 years
c. NOLCO for 8 years
d. Accelerated depreciation
e. Double deduction for training expenses and research and development
f. VAT and duty refund on importation of capital equipment and/or raw material

IV. Incentives for Registered Domestic Enterprises in the Thirty Poorest Provinces or Less Developed Areas
a. ITH for 6 years
b. Reduced CIT of 15% for 12 years after the entitlement to ITH or NOLCO
c. NOLCO for 5 years
d. Accelerated depreciation
e. Double deduction for training expenses and research and development
f. VAT and duty refund on importation of capital equipment and/or raw material

Assessment of Senate Bill 987 (Recto Bill) and Senate Bill 25 (Villar Bill)

The creation of the PIPA, as proposed by Senator Recto, appears to be consistent with international best practice. Centralizing the promotion and administration of incentives into a single agency is desirable not only because it is cost effective (OECD, 2011), but also because it contributes to the quick delivery of results to investors (Genoff, 1998).

Both bills focus on investment promotion, which is a positive development. However, a credible signal on the government's direction as to the type of foreign investment the country desires to attract needs to be given to prospective investors. Such investment priorities should fit in the country's industrial strategy. At present, the Investment Priority Plan (IPP), which is issued annually, provides list of preferred investment activities that would qualify for incentives. This list, however, is almost all-encompassing which then falls short of being a priority list (Leyco, 2013). However, the outright abolition of the IPP, as proposed by the Recto Bill, does not support the need for a well-targeted provision of fiscal incentives. Rather, what is needed is greater selectivity in the list of activities in the IPP.

Both bills are going in the right direction in the sense of unifying the various fiscal incentive regimes. By adopting a uniform policy, redundancies and lost revenues for the government can be lessened. In addition to this, *the granting of the two bills of incentives to exporters (particularly the provision of tax and duty free importation of inputs) is important because of the need for these enterprises to have access to have inputs priced at international market prices like their competitors from other countries*. However, the Recto Bill is better in the sense that it can reduce the redundancy rate more by only providing incentives to a limited number of enterprises, hence avoiding the provision of incentives to enterprises who will still invest even without the incentives. Under the Recto bill, only the export enterprises and domestic enterprises in the 30 poorest cities are qualified for fiscal incentives, as compared to the Villar Bill, which extends the list to include domestic enterprises and domestic strategic enterprises. By limiting the granting of fiscal incentives to enterprises in the 30 poorest cities under the Recto Bill, they are able to better target the ones which are most sensitive to incentives, and promote dispersal of industries and growth to less-developed areas.

The Recto Bill seeks to eliminate ITH which is desirable because it would lessen the redundancies, thus generating more revenues for the government. The bill instead opts for reduced corporate income tax rates. The reduced CIT has some advantages over the ITH. However, there is a need to further calibrate reduced CIT rate in the context of tax and fiscal incentive regimes in other countries. Off hand, 15% appears to be on the high side relative to the other countries. In addition to this, the reduction of CIT rates has to be time bound. Although, some might argue that by setting time boundaries to the reduction of CIT rates, it might just be like the ITH which would attract footloose industries which would exit the market after the CIT rate reduction period specified.

Overall, both bills provide significant improvements to the current fiscal incentive regime in the country. By simplifying the provision and administration of fiscal incentives, government revenues can be boosted without compromising level of investments in the country.