TOWARDS RATIONAL FISCAL INCENTIVES

(Good investments or wasted gifts?)

Dr. Renato E. Reside, Jr.

University of the Philippines
School of Economics
July 16, 2006

PHILIPPINE ECONOMIC SOCIETY
44th Annual Meeting

BUSINESS AND GOVERNMENT WITHOUT A CONSCIENCE

(the tragic redundancy of fiscal incentives for investment in the Philippines)

Dr. Renato E. Reside, Jr.

University of the Philippines
School of Economics
July 16, 2006

PHILIPPINE ECONOMIC SOCIETY
44th Annual Meeting

What?

- Q: What are fiscal incentives for investors?

- Answer: 4 – 6 year income tax holidays (no need to pay taxes for 4 – 6 - 8 years), tax and duty exemptions on imports of capital equipment and raw materials, accelerated depreciation, investment tax credits and tax liability deductions, etc.

- **INCENTIVES = SUBSIDIES**

Who grants?

- Q: Who grants fiscal incentives/subsidies?

- Answer: Investment promotion agencies (IPAs) - Board of Investments (EO226), Philippine Economic Zone Authority (RA7916), Clark, Subic and other freeports and special economic zones – all under Department of Trade and Industry (DTI)

- + 40-45 other laws granting incentives to specific industries (Congress)

The losers…

- Q: What do DepEd, public hospitals and public health, infrastructure, regular wage and salary earners (whose taxes are withheld) and the poorest, least developed areas in the country have in common?

- **Answer: They are all unwitting victims of redundant fiscal incentives**

Redundant incentives

- **Investments that were given incentives or perks that would have been undertaken even without them = REDUNDANT**
- **Redundant investments = FISCAL COST = FOREGONE GOVERNMENT REVENUES = BURDEN ON SOCIETY AS A WHOLE BUT ESPECIALLY ON THE POOR**
- **= NEEDLESS PROVISION OF SUBSIDIES TO INVESTORS**

Fallacy of redundant incentives

- **The fallacy here is that many investments need to be subsidized in order for them to be undertaken.**
- **This study debunks this claim. The fact is, MANY investments DO NOT NEED TO BE SUBSIDIZED FOR THEM TO BE MADE!**
- **Main implication: the endless and needless provision of subsidies to investors is at great expense to the real losers in this process!**

Benefits of non-redundant investments

- But what are the benefits of fiscal incentives that are not redundant?
  - Capital formation and investment that would not have taken place without them
  - Associated social benefits – added employment, extra dollar earnings from exports, additional taxes generated.
  - NON-REDUNDANT INVESTMENTS ARE GOOD! But how are they distinguished from redundant ones?

This study asks…

- What are the criteria for determining redundant investments?
- How much is the fiscal cost of redundant investments?
- What are the social costs of redundant investments?

Redundancy Rate Defined

- The redundancy rate = (ratio of investments receiving incentives that would have been made even without them) ÷ (all registered investments)

Investment promotion fallacy: All incentives benefit the country

- **FALSE.** If an investment is redundant, its incentives CANNOT be said to have produced the benefits associated with them (since the investment would have been made even without the incentives, benefits of increased employment, withholding taxes, etc. would have come anyway)
- **If an investment is redundant, incentives benefiting them are a PURE COST to government – the subsidy is wasted since it didn't need to be given!**

Criteria for Redundancy

- **The literature has tried to define redundancy one way (above-average to very high returns on investment).**
- **Do IPA-registered investments have above average ex ante returns?**
- **If yes (as in the Philippines), then some (or all!) of the amount will be redundant.**

Criteria for Redundancy 1: High ex ante expected returns

- **For most IPA's, the ex ante rates of return for most approved projects are high to very high by international and even domestic standards (≥ 15% rates of return for 90%-95% of registered projects at BOI, for example)**

- **Earning very high returns are a necessary, but not sufficient condition for the incentives to be redundant. To further distinguish redundant from non-redundant investments, classify them further by underlying motivation**

Criteria for Redundancy 2: underlying motivation

- 1990's industrial economics literature used PRIMARY underlying investment motivation to classify sensitivity of investors to incentives

- What is the **MOST IMPORTANT MOTIVE** for an investor undertaking an investment?

- Basically, three:

The three primary motivations for investment are

- Primarily (domestic) market-seeking – motivated by size and strength of market; as well as potential use of market to access other regional and global markets

- Primarily resource-seeking – motivated by presence of crucially-needed inputs in market

- Primarily efficiency-seeking – motivated by cost of inputs adjusted for productivity

Examples of the three primary motives for investment are

- Primarily (domestic) market-seeking – Globe and Smart, property development
- Primarily resource-seeking – mining, call centers
- Primarily efficiency-seeking – electronics, semiconductors

Given primary motives for investment, sensitivity of investors to incentives are:

- For primarily (domestic) market-seeking – Low
- For primarily resource-seeking – Low
- For primarily efficiency-seeking – High

Sensitivity to incentives

- Thus, efficiency-seeking investors are sensitive to incentives since their primary motivation is to reduce unit costs adjusted by productivity

- Market- and resource-seeking investors are not as sensitive to incentives as the former

Sensitivity to incentives

- The main implication: only incentives provided to efficiency-seeking electronics and semiconductor firms have actually induced investments in the country.

- Incentives/subsidies given to investments with other primary motives were redundant, especially since they were already expected to be very profitable at the time of registration.

Criteria for Redundancy 3: exporter/non-exporter

- **The exporter/non-exporter classification also captures much of the previous arguments and is a neater and more observable method**

- **Exporters (non-market-seeking investors) – survey and cross-country empirical evidence supports the view that they will be sensitive to highly sensitive to the generosity of fiscal incentives.**

Sensitivity to incentives: exporters

- Incentives tend to help exporters be more price-competitive or help to attract (away from competing countries) FDI exporters seeking better terms

- The literature suggests that non-exporters (primarily domestic market-seeking investors) – will tend to have low sensitivity to fiscal incentives relative to other inducements (such as a strong, vibrant domestic market)

Sensitivity to incentives: non-exporters

- The provision of fiscal incentives to non-exporting investments, who are mostly reliant on the Philippines market for sales, AND who will earn above average to very high returns will by and large be redundant.

- Proposed rule of thumb for redundancy: determine the proportion of registered non-exporting enterprises registered with an IPA

Hierarchy of redundancy even among exporters

- But EVEN among exporting investments, there is a hierarchy of redundancy
- Least redundant – electronics and semiconductors
- Gray area – resource-seeking but exporting investments

Redundancy Questions

- So essentially, several questions must be answered to determine whether an investment is redundant:
- Question 1: Is it expected to earn above average to high returns over project life at the time of registration? Are the incentives redundant?
- Question 2: Is it an export-oriented investment?
- Question 3: Is it an efficiency-seeking investment? (if yes, then least redundant)

Other redundancy Questions

- Question 4: Is there a fiscal problem?
- Question 5: What is the effect of an indiscriminate tax exemption on the poor? On other non-tax-exempt firms?
- Question 6: What are the resource allocation and equity implications of redundant tax exemptions?

Other justifications for incentives

- Fiscal incentives are SUBSIDIES provided by government
- The economic justification for granting subsidies rests on the ability of the subsidized activity to generate social benefits way beyond the private returns to the firm
- Proxy for social benefits – exports, employment generation, taxes generated, enhancement of the environment
- Evidence for other spillovers very difficult to quantify

Efficacy of incentives

- Too much emphasis being given by IPAs to incentives as an inducer of investment

- **Investor surveys suggest that incentives are just "icing on the cake"; investment location decisions have already been justified on the basis of more fundamental determinants – number of competitors, expected size of market, access to infrastructure and access to skilled labor, etc.**

Efficacy of incentives

- In the vast majority of cases, registration with the relevant investment promotion agencies is made AFTER firms have already made firm commitments to investment

- Investment decisions seldom hinge on incentives! Thus, many times we just needlessly give subsidies to investors!

Efficacy of incentives

Tax Incentives and Foreign Direct Investment: A Global Survey

UNITED NATIONS

New York and Geneva, 2000

The role of incentives in promoting FDI has been the subject of many studies, but their relative advantages and disadvantages have never been clearly established. There have been some spectacular successes as well as notable failures in their role as facilitators of FDI. As a factor in attracting FDI, incentives are secondary to more fundamental determinants, such as market size, access to raw materials and availability of skilled labour. Investors generally tend to adopt a two-stage process when evaluating countries as investment locations. In the first stage, they screen countries based on their fundamental determinants. Only those countries that pass these criteria go on to the next stage of evaluation where tax rates, grants and other incentives may become important. Thus, it is generally recognized that investment incentives have only moderate importance in attracting FDI.'

FOREIGN DIRECT INVESTMENT SURVEY

A STUDY CONDUCTED BY THE MULTILATERAL INVESTMENT GUARANTEE AGENCY
WITH THE ASSISTANCE OF DELOITTE & TOUCHE LLP

2002
JANUARY

Survey of firms; results show percentage of firms citing a particular factor as important in investment decisions

table 2 **TOP 20 CRITICAL LOCATION FACTORS**, percent cited as "very influential"

Acce	77
Stabl	64
Ease	54
Relia	50
Abili	39
Abili	38
Level	36
Cost	33
Crime and safety	33
Ability to hire skilled laborers	32
National taxes	29
Cost of utilities	28
Roads	26
Access to raw materials	24
Availability and quality of university and technical training	24
Available land with all services in place	24
Local taxes	24
Access to suppliers	23
Labor relations and unionization	23
Air service	23

These are the fundamental determinants of investment and investment location decisions! Incentives are NOWHERE to be FOUND HERE!

INCENTIVES/SUBSIDIES ARE AMONG THE LEAST IMPORTANT CONCERNS OF FIRMS!

table 2.12 **LOCATION FACTORS: OTHER BUSINESS CONDITIONS,** by sector, in percent

	Manufacturing	Services
Stable Social & Political Environment	65	63
Ease of Doing Business	52	57
Availability of Grants & Incentives	18	9
National Taxes	30	28
Local Taxes	23	24
Access to Finance	16	20
Level of Corruption	24	28
Existence of a Bila		

Incentives are FOUND HERE! WAY BELOW the list of important factors affecting investment decisions!

INCENTIVES/SUBSIDIES ARE AMONG THE LEAST IMPORTANT CONCERNS OF FIRMS!

table 2.13 **LOCATION FACTORS: OTHER BUSINESS CONDITIONS,** by region of headquarters, i

	Asia/Pacific Rim	North America	Western Europe
Stable Social & Political Environment	53	68	64
Ease of Doing Business	45	62	54
Availability of Grants & Incentives	10	23	7
National Taxes	30	30	23
Local Taxes	28	25	18
Access to Finance	23	18	11
Level of Corruption	18	44	38
Existence of a Bilateral Investment Treaty	10	10	20

Efficacy of incentives

- Empirical evidence for the potency of incentives is also scant. At best, incentives matter only when investors are choosing among similar competing locations

- **But RP is already perceived by investors as (highly) uncompetitive relative to its perceived regional competitors, especially with respect to infrastructure and quality of labor**

RP now way below its perceived competitors; now more like Indonesia

Table 7: Overall country competitiveness rankings, World Competitiveness Yearbook

Country	2001	2002	2003	2004	2005
Hong Kong	4	13	10	6	2
Singapore	3	8	4	2	3
Taiwan	16	20	17	12	11
Thailand	34	31	30	29	27
Malaysia	28	24	21	16	28
China	26	28	29	24	31
India	42	41	50	34	39
Philippines	39	40	49	52	49
Indonesia	46	47	57	58	59

Source: World Competitiveness Yearbook, various issues

RP now way below its perceived competitors in many other areas

Table 8: Education: Ranking in 2005 IMD World Competitiveness Yearbook

Educational System (ability to meet the needs of a competitive economy)		**Pupil-teacher ratio (primary)**		**Pupil-teacher ratio (secondary)**	
Singapore	3	Malaysia	28	Malaysia	37
India	11	Taiwan	31	Taiwan	38
Hong Kong	15	Thailand	35	Indonesia	39
Taiwan	21	Hong Kong	43	Hong Kong	43
Malaysia	22	China	44	China	46
Thailand	35	Singapore	48	Singapore	47
Philippines	**37**	Indonesia	49	Thailand	50
China	53	**Philippines**	**56**	India	56
Indonesia	57	India	59	**Philippines**	**58**

Source: World Competitiveness Yearbook, various issues

RP now way below its perceived competitors in many other areas

Table 9: Infrastructure: Ranking in 2005 IMD World Competitiveness Yearbook

Road density		Efficiency of distribution system for goods and services		Infrastructure maintenance and development		Air transportation (quality encourages business development)		Water transportation (quality of harbors, canals, etc.)	
Singapore	2	Singapore	2	Singapore	1	Singapore	2	Hong Kong	1
Hong Kong	8	Hong Kong	3	Hong Kong	2	Hong Kong	3	Singapore	7
Taiwan	23	Taiwan	19	Taiwan	16	Malaysia	19	Taiwan	18
India	29	Malaysia	24	Malaysia	22	Taiwan	25	Malaysia	22
Philippines	**34**	Thailand	40	Thailand	29	Thailand	34	Thailand	32
China	38	India	47	China	42	India	40	China	47
Malaysia	41	China	53	India	49	**Philippines**	**47**	**Philippines**	**48**
Indonesia	44	**Philippines**	**56**	Indonesia	54	Indonesia	48	India	54
Thailand	49	Indonesia	59	**Philippines**	**58**	China	49	Indonesia	58

Source: World Competitiveness Yearbook, various issues

Over-dependence on incentives is MYOPIC!

- Given the state of RP's competitiveness, it is an **illusion** that more incentives can help us remain internationally competitive. It is the **MYOPIC** view. It is time for **LONG-TERM** considerations to prevail. We must enhance the quality of education, infrastructure and other government services for all.
- **More generous incentives CANNOT AND SHOULD NOT MAKE UP FOR INTERNATIONALLY INFERIOR INFRA AND EDUCATION!**

Fiscal cost of fiscal incentives

- **Assumptions when computing costs of fiscal incentives to redundant investments**
- **Average return on investment = 20%**
- **4 years income tax holiday**
- **10% VAT + duties (average of 2%) on imports of capital equipment, raw materials and use of domestic capital goods**

Fiscal cost of fiscal incentives

- **This study finds the RECURRING provision of redundant fiscal incentives is very costly (in 2004, my estimate is – 43.2B PhP - almost 1% of 2004 GDP, or half to a third of the budget deficit for BOI alone – at 90% redundancy rate).**

- **Note: BOI-registered service exporters like call centers were NOT considered redundant for purposes of fiscal cost computation.**

Net benefits of IPAs

- **IPA social benefits = wages generated + withholding taxes generated + peso value of net exports by registered firms**
- **IPA social cost = cost of redundant incentives provided by IPA**
- **IPA social benefit – social cost = net benefits**

Net benefits of IPAs

- **This study finds that the issue with respect to PEZA is the registration of investments in gray areas (exporting, but resource-seeking).**

- **SBMA and CSEZ are highly likely to have lower contributions to society – they registered relatively more market-seeking investments than PEZA**

Fiscal cost and cross country evidence on fiscal incentives

- This study finds the level of redundant fiscal incentives at the BOI is roughly at the same level as in other ASEAN countries (Thailand, Vietnam, Indonesia)

- **But we want to be more cost efficient than them since we are in a tighter fiscal bind. We cannot afford the same level of redundancy.**

Cross-region (within RP) evidence on the impotence of incentives

- **In addition to the weak cross-country evidence on the efficacy of incentives, this study provides empirical evidence that even within the country, incentives have very limited power to induce investment (real regional gross capital formation as defined by NSCB).**

Cross-region (within RP) evidence on the impotence of incentives

- **There is no statistical correlation between the pattern of investment registrations by the BOI in one period and real gross capital formation in subsequent periods**

- **This suggests that investments are not being undertaken to the extent committed**

- **In any case, the fiscal cost appears to be large**

Cross-region (within RP) evidence on the impotence of incentives

- **Year after year, the annual Investments Priorities Plan grants more generous fiscal incentives to businesses locating in areas considered to be less developed (LDAs) (longer tax holidays, regardless of status, among others).**

Cross-region (within RP) evidence on the impotence of incentives

- **But there is no evidence that a province's inclusion in this list has led to an increase in investments to these areas over time.**

- Investments have clustered in regions with stronger and richer economies, better infrastructure and greater levels of functional literacy – factors that, compared to incentives, are more fundamental inducers of investment.

Table 45: Average regional shares in total BOI investment project approvals

Region	NCR	1	2	3	4	5	6	7	8
Average, 1979-2003	28.19%	2.49%	0.41%	7.92%	25.11%	1.66%	3.91%	3.19%	4.07%
Average, 1987-2003	22.90%	3.41%	0.60%	10.30%	29.24%	1.03%	4.32%	3.93%	2.42%
Average, 1995-2003	14.40%	3.46%	1.04%	12.61%	26.47%	0.76%	5.23%	1.65%	0.40%
Average, 2000-2003	18.79%	3.70%	0.01%	12.42%	15.37%	0.33%	10.74%	0.98%	0.50%

Source: Board of Investments

Table 46: Average regional shares in total BOI investment project approvals

Region	9	10	11	12	CAR	ARMM	13	Several locations	Not Indicated
Average, 1979-2003	0.45%	4.74%	3.35%	1.16%	1.24%	0.24%	2.01%	9.82%	0.04%
Average, 1987-2003	0.54%	1.98%	2.43%	1.17%	0.38%	0.01%	0.87%	14.44%	0.06%
Average, 1995-2003	0.43%	2.44%	2.27%	0.91%	0.18%	0.00%	0.50%	27.16%	0.08%
Average, 2000-2003	0.38%	1.49%	4.40%	1.26%	0.15%	0.00%	0.37%	28.93%	0.18%

Source: Board of Investments

Table 48: Average regional shares in total PEZA approved investments

REGION	Total	NCR	1	2	3	4	5
average (1980-2004)	100.00%	2.59%	15.25%	0.00%	18.63%	44.72%	0.00%
average (1980-1995)	100.00%	0.01%	22.78%	0.00%	26.22%	26.26%	0.00%
average (1995-2004)	100.00%	6.49%	1.83%	0.00%	5.00%	79.01%	0.00%
average (2000-2004)	100.00%	**12.71%**	3.18%	0.00%	**3.95%**	**69.59%**	0.00%

Source: Philippine Economic Zone Authority

Table 49: Average regional shares in total PEZA approved investments

REGION	6	7	8	9	10	11	12
average (1980-2004)	0.00%	18.19%	0.08%	0.00%	0.35%	0.04%	0.15%
average (1980-1995)	0.00%	24.72%	0.00%	0.00%	0.00%	0.00%	0.00%
average (1995-2004)	0.00%	6.12%	0.19%	0.00%	0.87%	0.10%	0.39%
average (2000-2004)	0.00%	**7.67%**	0.38%	0.00%	1.75%	0.00%	0.77%

Source: Philippine Economic Zone Authority

Incentives are impotent!

- **Results in the study confirm that:**

  1) high real per capita GDP;
  2) better infrastructure; and
  3) greater levels of functional literacy

  are the ONLY fundamental inducers of investment across regions in the Philippines

- **Incentives are insignificant!**

Incentives are impotent!

- These RP regional results are very consistent with results of cross-country studies
- But high real per capita GDP, better infrastructure and greater levels of functional literacy are mostly found in regions that are already well-endowed, such as regions 3, 4A, 7 and NCR
- So, investments have historically clustered in these places.

Cross-region (within RP) effects of redundant incentives

- **The clustering of most investments in areas with already viable initial conditions for investment has meant that viable employment opportunities for skilled labor have also tended to cluster in these areas. This has only reinforced inequality across regions.**

Cross-region (within RP) effects of redundant incentives

- The clustering of efficiency-seeking investments in region 4A is because the region has access to adequate airport and seaport facilities, presumably, via good and uncongested roads (i.e., good infrastructure)

- **Thus, access to good infrastructure is the primary driver of regional locational decisions for PEZA investments.**

Cross-region (within RP) effects of redundant incentives

- **From a cross-country perspective, though, incentives provided to private ecozone developers may have reduced FDI risks for locating in the Philippines.**

- **Most private ecozone developers choose to locate in region 4A, which offers the least risk for them because it has good infrastructure**

Cross-region (within RP) effects of redundant incentives

- But BOI's approvals of redundant investments have reduced funds available for infrastructure throughout the country!

- **So the BOI has effectively hurt the efficiency-seeking investors registered with the PEZA! It has also limited PEZA's ability to attract more efficiency-seeking investors and disperse them regionally!**

Cross-region (within RP) effects of redundant incentives

- **The clustering of past investments in a select few regions has also ensured that the demand for future infrastructure and human-capital-enhancing public expenditures will also tend to cluster there at present and for the foreseeable future (see SLEX improvements, etc.)**

Cross-region (within RP) effects of redundant incentives

- Redundant incentives deprive the country of resources for crucial poverty- and inequality-reducing expenditures, such as, for example, in education (e.g., DepEd) and infrastructure (e.g. for roads and ports)

- **These expenditures benefit ALL regions, not just regions 3, 4A, 7 and NCR**

Effects of rationalizing incentives and allocating expenditure wisely

- **These expenditures also make ALL regions MORE COMPETITIVE for investments, not just regions 3, 4A, 7 and NCR**

- **Given the statistical results in the study, the WHOLE country will be better able to attract investments if investment promotion agencies internalize the fiscal AND SOCIAL implications of EXCESSIVE and INDISCRIMINATE subsidy provision**

Effects of rationalizing incentives and allocating expenditure wisely

- Even with perceived inefficiencies in the expenditure system, this study provides empirical evidence that higher national government spending on roads and education increases the length of roads per region and the level of functional literacy in each region.

- **So an extremely limiting budget constraint due to shortfalls in revenues hurts national and regional investment competitiveness!**

Almost all of Philippines' weakest criteria in 2005 World Competitiveness Report can be addressed through additional fiscal resources!

Table 11: Philippines' weakest criteria (2005 WCY)

Criteria	2005 Rank
Pupil-teacher ratio (secondary education)	58
Pupil-teacher ratio (primary education)	56
Secondary school enrollment	58
Total health expenditure – percent of GDP	60
Dependency ratio – population under 15 and over 64 years old	59
Interest payments – percent of current revenue	49
Fixed telephone lines – per 1000 inhabitants	59
Overall productivity (GDP per person employed)	56
Investment risk – Euromoney creditworthiness rating	57
Internet users	57
Total public expenditure on education – percent of GDP	59
Country credit rating	52
GDP per capita	57
Foreign investors' freedom to acquire control in domestic companies	59
Customs' authorities ability to facilitate efficient transit of goods	57
Risk of political instability	56
Degree to which relocation of production is a threat to the future of the economy	59
Degree to which government decisions are effectively implemented	58
Adequacy and efficiency of energy infrastructure	56
Degree to which the country's image discourages business development	53

Source: World Competitiveness Yearbook 2005

Cross-region (within RP) effects of incentives

- The combination of preserving the current system of providing needless, redundant and costly fiscal incentives and the resulting inadequacy of resources devoted to true regional investment drivers, such as education and infrastructure, has been inequality-preserving and inequality-reinforcing (both across regions and across income classes).

Cross-region (within RP) effects of incentives

- Excessive redundant incentives do not promote investments AND exacerbate inequality across classes and regions!

- **This is why regional dispersal of industries has never been achieved!**

- Belated efforts at industry dispersal are too late; the damage has been done

Inequality-preserving and reinforcing

- Redundant incentives are a pure subsidy provided to firms, but this is invisible; it is not part of GAA (the national budget)

- This study estimates that BOI alone may have an invisible budget close to half that of DepEd!

- The DTI's combined invisible budget for redundant investors is a very, very large component of the RP annual budget!

Other real effects of redundant incentives

- Other effects of costly and redundant fiscal incentives:
  - Adds to stock of foreign and national debt
  - Raises sovereign fiscal risk, undermining the country's overall competitiveness as investment destination; lowering our international credit ratings
  - Keeps domestic interest rates high
  - Keeps international cost of borrowing high

Other real effects of redundant incentives

- Other effects of costly and redundant fiscal incentives:
  - Deprives all other sectors of needed expenditure
  - Distorts resource allocation in the economy (deprives resources for investments with higher social benefits)
  - Encourages undesirable behavior among firms – tax avoidance, revenue and expenditure shifting, etc.

Other real effects of redundant incentives

- Other effects of costly and redundant fiscal incentives:
  - A host of adverse selection, moral hazard and free-rider problems
  - The mere existence of incentives already gives rise to so many agency problems and exploitable opportunities for undesirable behavior and rent-seeking by firms

Lack of transparency and accountability

- Provision of fiscal incentives MUST be seen as a USE of public funds. Therefore, there must be a great deal of TRANSPARENCY and ACCOUNTABILITY in the system

- **We need information on WHO were given incentives and WHAT TYPE. The level of tax expenditures must also be computed, as well as estimates of fiscal cost of redundancy. These should be reflected in the annual budget.**

Irony

- The continued registration by IPAs of redundant investments is hurting non-redundant investments! Non-redundant investments help the country.

- The BOI and other IPAs main yardstick for gauging their performance is the total value of investments they register. They should instead look at non-redundant investments (for BOI, just 5% - 10% of its portfolio of investments).

Irony

- The BOI and other IPAs are both national investment promotion agencies and incentives-giving bodies

- **The latter is clearly undermining efforts at the former!**

- Net benefits of IPAs are small (if any at all) to highly negative; BOI's is highly negative

Irony

- Suppose the BOI did not exist…
- **Many investments would have come in anyway! The incentives were redundant!**

Irony

- A tax system should ideally be equitable

- **The fiscal incentives system is not socially equitable: many large firms with redundant investments are tax-exempt for long periods of time, while wage and salary workers bear much of the burden of paying taxes**

Other IPAs

- All other investment promotion agencies and freeports: PEZA, SBMA, CSEZ, etc. operate on the same principles

- **They should also be scrutinized very closely. This study attributes a lower rate of redundancy to them, but their fiscal cost may also be high.**

This study…

- Explains the **LARGE AND RECURRING** source of part of recurring budget deficits of the Philippines since the 1980's

- Partly explains our historically heavy reliance on foreign and domestic debt and why RP is not attractive to foreign investors

- Explains much of the inequality we observe all around us and why people and provinces see no hope of getting out of poverty

- Shows that the redundant fiscal incentives problem is also a MORAL problem

Next steps…

- Not all incentives are redundant, as the study makes clear
- What type of incentives should be given to non-redundant investments? Should they be given at all?
- Need to improve screening and monitoring procedures at IPAs

Next steps…

- Income tax holidays encourage and reinforce redundancy by exempting from taxes firms expecting very large profits in the short-run
- That's why the ITH should be abolished
- Better: NOLCO and accelerated depreciation – encourages recurring investments over the long-term

Next steps…

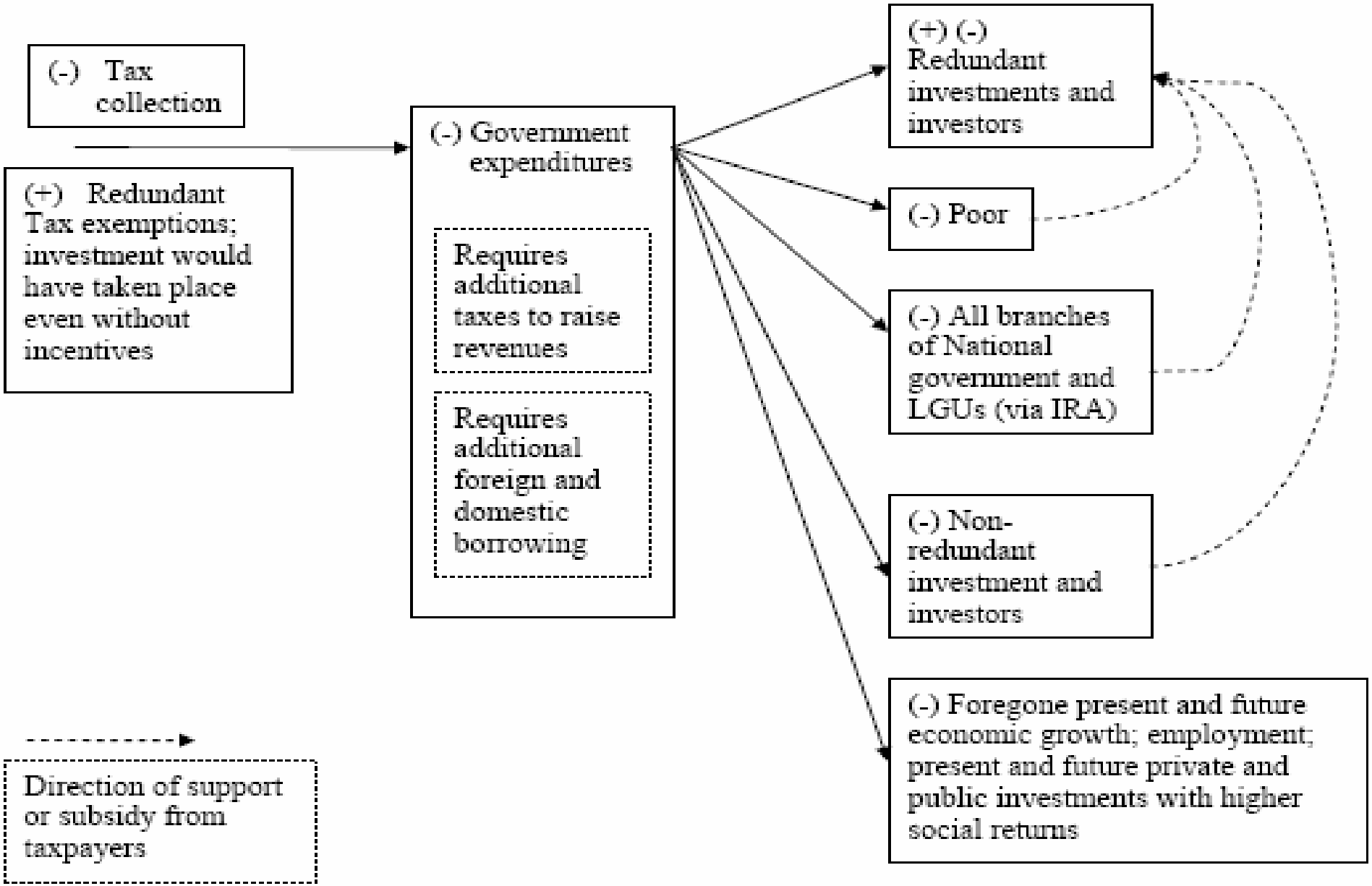
- Need to inform and educate; looming House, Senate and advocacy work

- **House Bill 3295 lists 40-45 industry-specific investment laws with incentives to be repealed. Will ALL industries SHARE in the burden of raising revenues? Incentives reform is ALL ABOUT VALUES.**

- Rehabilitating the IPAs

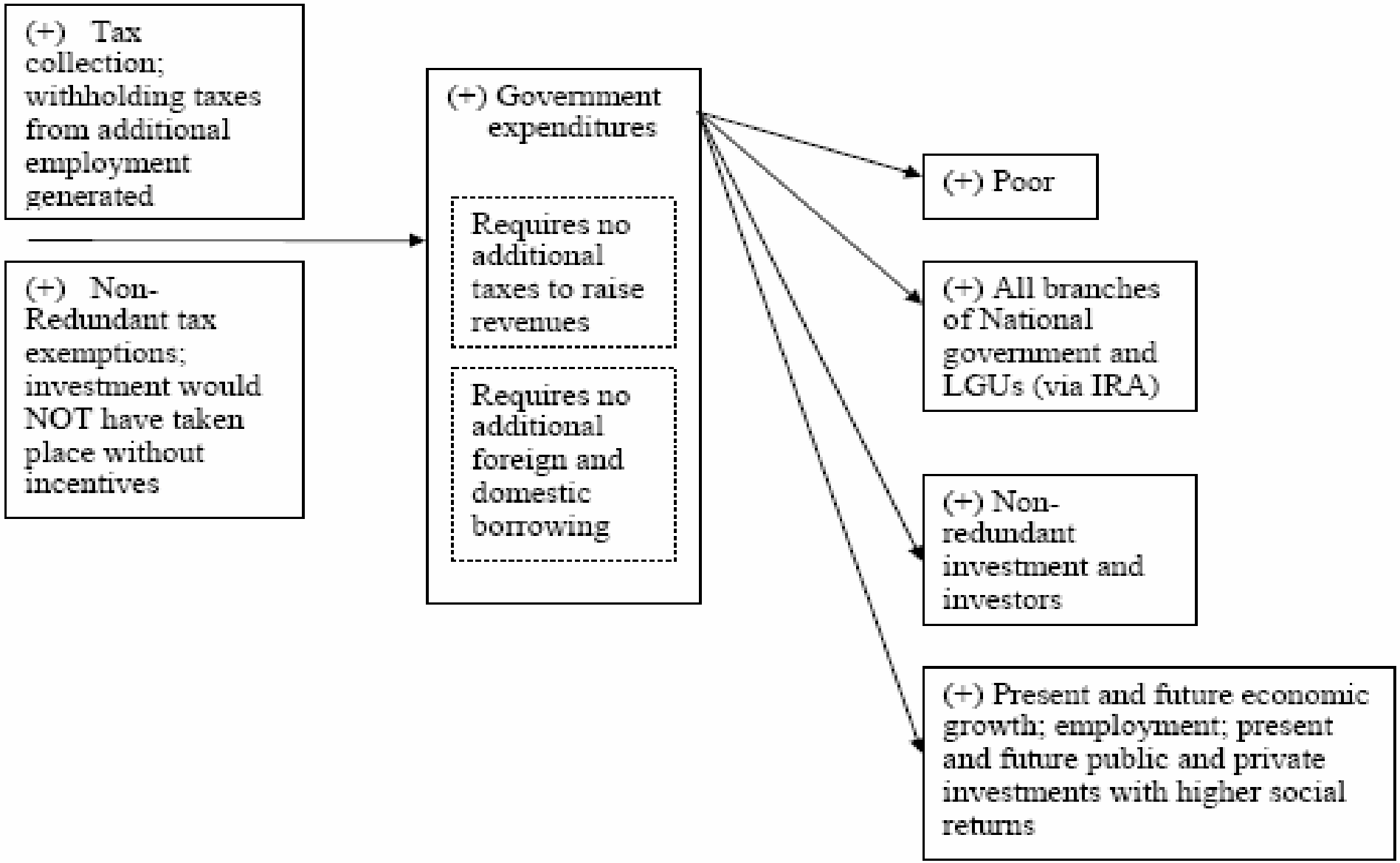
Bad incentives: Major reason for persistence of inequality

The tragic consequences of redundant fiscal incentives



Bad incentives: Major reason for persistence of inequality

The effects of proper rationalization and elimination of redundant incentives and tax exemptions:



Bad incentives: Major reason for persistence of inequality

The tragic consequences of redundant fiscal incentives: Perverse flow of BOI subsidies (based on the value of the registered-investment portfolio of the BOI); progressivity of tax system is completely offset by the tax exemption system; relative burden of taxation is heavier on the groups in the lower row. Exemptions unnecessarily enhance wealth of the groups in the upper row.

Flow of subsidies	Size of firm	Geographic	Provincial income	Number	Nationality	Class
Redundant and tax-exempt ↑	Big	Luzon	Richer	Few	Foreign Domestic	Firms
Tax-paying	Small	Mindanao, Visayas	Poorer	Many	Foreign Domestic	Workers

Bad incentives: Effects on resource allocation

By type of:	IPA	Target market	Underlying motivation for investment	Activity	Source of real growth	Type of good sold	Sector
In general, diversion of resources to redundant investors benefits these	BOI-registered investors	Non-exporters	Domestic-market- and resource-seeking investors	Redundant investments		Consumption	Private
In general, diversion of resources to redundant investors hurts these	Many PEZA-registered investors	Many types of exporters	Efficiency-seeking investors (mainly electronics and semiconductors)	Non-tax-exempt activities with high social returns Other tax-exempt activities with higher social returns	Future real growth and investment	Investment	Public Private

Bad incentives: Major reason for persistence of inequality

In view of the above, the following questions must be asked when preparing to grant a subsidy incentive to a firm or activity:

1) Is the incentive redundant? Will the firm invest even without the incentive?
2) What are the expected tax expenditures per year? In present value terms?
3) Is the applicant project expected to earn ex ante an above-average rate of return over its life?
4) Is it an export-oriented investment?
5) Is it efficiency-seeking?
6) Is the incentive time-bound?
7) Is the incentive locational? If so, who owns the location where investments benefiting from incentives locate? Are there unnecessary benefits generated or distortions created by locational incentives?
8) Is there a fiscal crisis?
9) Is there a debt crisis?
10) Will it reduce existing subsidy disparities across small and large firms?
11) Will it reduce existing subsidy disparities across geographic locations?
12) Will it reduce existing subsidy disparities across income classes for provinces?
13) Will it reduce existing subsidy disparities across income classes for individuals?
14) Will it help the poor?
15) Will it benefit just a few people or many?
16) Will it benefit just a few provinces or many?
17) What are the implications for short- and long-run resource allocation?
18) What are the implications for short- and long-run distribution of wealth?
19) Have incentives to the sector worked in the past? What are the past outcomes of subsidies targeted to the sector?
20) What is the present profitability of the sector?
21) What is the accumulated subsidy from government to the sector? To the firm? To the firm's other affiliates?
22) Is the tax expenditure a private expenditure substitute for actual government expenditures? If yes, how good a substitute is it?
23) Has this creeping privatization yielded positive outcomes?