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## Tax Incentives in The Philippines: A Regional Perspective

*Nigel A. Chalk*

**IMF Working Paper**

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**Tax Incentives in The Philippines: A Regional Perspective**

Prepared by Nigel A. Chalk<sup>1</sup>

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**Abstract**

The views expressed in this Working Paper are those of the author(s) and do not necessarily represent those of the IMF or IMF policy. Working Papers describe research in progress by the author(s) and are published to elicit comments and to further debate.
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The Philippines is faced with a policy dilemma in the area of corporate taxation. On the one hand, the country has, over the past few years, witnessed a decline in revenue as a share of output. On the other, it is operating in an increasingly competitive regional market for foreign direct investment. In order to remain competitive, the Philippines offers a broad array of fiscal incentives to entice inward investment and pursue the country's development goals. This paper looks at the fiscal incentives available in the Philippines, compares them with those available in the ASEAN region, and with the evidence on the efficacy of tax incentives in a global context. The paper provides some broad conclusions on the use of the various forms of tax incentives in the Philippines and on their administration.

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Author's E-Mail Address: [nchalk@imf.org](mailto:nchalk@imf.org)

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## I. INTRODUCTION

1. **The Philippines is faced with a significant policy dilemma in the area of corporate taxation.** On the one hand, the country has, over the past few years, witnessed a decline in revenue as a share of output (from 19 percent of GNP in 1996 to a likely 15 percent of GNP in 2000) and an increase in interest costs as a percentage of revenues (to almost 30 percent of revenues). On the other hand, the Philippines is operating in an increasingly competitive regional market for foreign direct investment. In order to remain competitive, and, to some extent, to compensate for a lack of competitiveness in other areas (such as corruption, infrastructure development, geographic location, etc.) the Philippines has been led to offer a broad array of fiscal incentives to entice inward investment and pursue the country's development goals.

2. **This paper looks at the fiscal incentives available in the Philippines,** compares them with those available in the ASEAN region and with the evidence on the efficacy of tax incentives in a global context. While several cross-country studies have shown that fiscal incentives, at most, have only a modest impact on investment flows there is little consensus on how such incentives should be best designed<sup>2</sup>. In the Philippine context this ambiguity is compounded by the fact that there is a lack of information on the relative costs and benefits of the various incentive programs on offer. As a result, while the paper provides some broad conclusions on the use of the various forms of tax incentives and their administration it is unable to provide precise recommendations on which tax regime is optimal for the Philippines. Ultimately that choice must remain a political decision that balances the benefits any particular incentive regime may offer with the revenues foregone that could otherwise be used to fund other budgetary needs.

### Box 1: Possible Rationales for Offering Investment Incentives

- *industrial policy* is typically the most common goal cited and reflects a desire to improve productivity and efficiency through attracting key industries which can then act as a catalyst for broader industrial development. However, this presupposes the policy maker can identify such "propulsive" industries
- *the transfer of proprietary knowledge or technology.*
- *employment objectives* to create jobs for the local labor force by attracting labor intensive industries.
- *training and human capital development* may be an explicit goal especially where human capital is lacking and is viewed as an important engine for economic growth.
- *economic diversification* which may be especially important for example when a country is exposed to volatility in the prices of primary commodities.
- *access to overseas markets* through the distribution network of a multinational corporation or by attracting export promotion or import substitution industries.
- *regional or locational objectives* which attempt to encourage industry to site in a particular area of the country.

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<sup>2</sup> Although there is a general acceptance that tax holidays are inefficient and that any regime that requires public officials to 'pick winners' is undesirable.

## II. THE OBJECTIVES OF INCENTIVE PROGRAMS

3. **The essential objective of any package of incentives is to influence an investment decision either by directly affecting the profit streams accruing to that potential investment or reducing the risks attached to it.** The aim of such policies is to persuade potential investors to invest in one country, region, or industry rather than not investing at all or investing elsewhere. Some possible objectives of the government are listed in Box 1. In the Philippines, almost all of these objectives have been cited as a rationale underlying the various tax concessions that have been adopted.

4. **In order to achieve this plethora of objectives a number of different policy instruments may be employed** (as shown in Box 2) to attract the “right” type of investment. There are a number of commonly cited conceptual pros and cons to the various incentives<sup>3</sup> which are summarized in Box 3 (based on Nellor and Keen (1995)).

### Box 2: Possible Investment Incentive Instruments

#### Corporate tax incentives

- Tax holidays or reduced corporate tax rates
- Tax credits
- Investment allowances
- Accelerated depreciation
- Reinvestment or expansion allowances
- Double deductions of certain expenses for tax purposes

#### Other tax incentives

- Personal income tax exemption on dividends paid out by companies receiving a tax concession
- Exemption from withholding taxes
- Duty drawback schemes
- Exemption from import tariffs
- Exemption from sales, property, and wage income tax

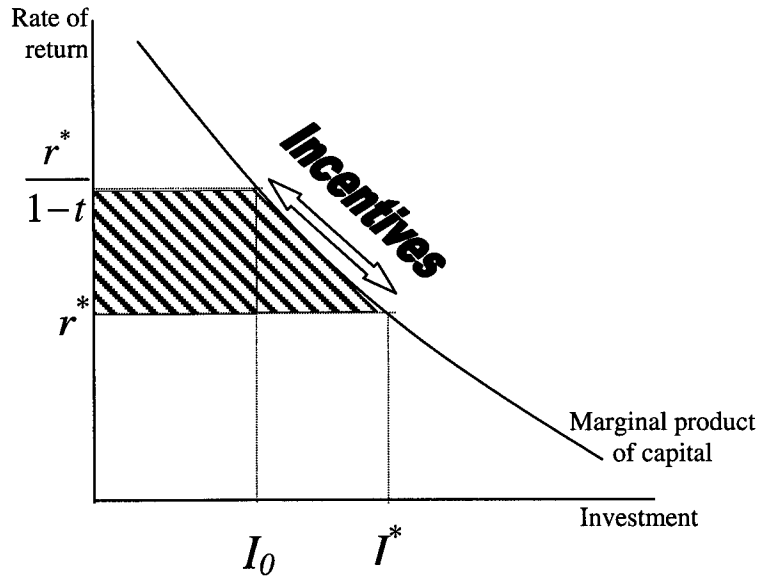
#### Nontax incentives

- Subsidized or concessional financing
- Loan guarantees
- Direct grants
- Provision of dedicated infrastructure

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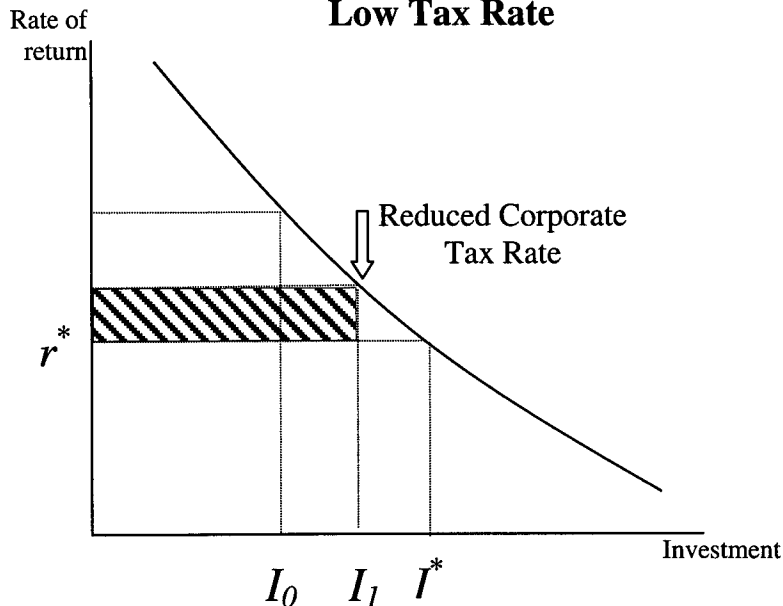
<sup>3</sup> See also McClure (1999) for a summary.

**Figure 1: First-best (Full Information) Incentive Policy**



There are, broadly speaking, two models of incentives for foreign investment that are typically adopted in practice. Figure 1, illustrates a structure of tax incentives that will succeed in attracting the optimal level of investment ( $I^*$ ). Under this scheme all investments are taxed at the statutory rate ( $t$ ) but those marginal investments ( $I^*-I_0$ ) which, under the statutory rate would not be undertaken (due to an after-tax profit that is insufficient to cover

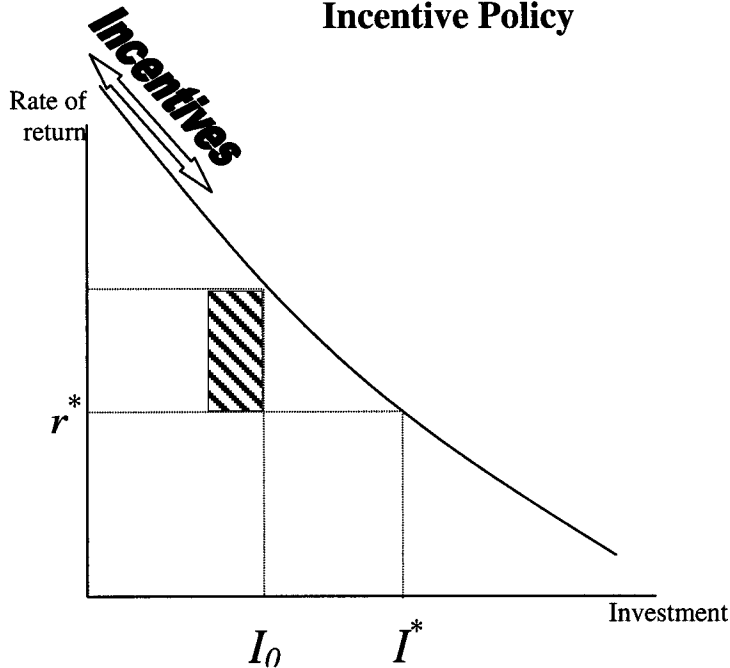
**Figure 2: No Incentives But Uniformly Low Tax Rate**



their opportunity cost of capital ( $r^*$ )), are offered a tax reduction that is sufficient to encourage them to invest. Total revenues received would be equal to the shaded area.

However, to implement this scheme, the policymaker would need to know, ex ante, exactly which are the marginal projects that would otherwise choose not to invest—which would likely prove a tall order. The alternative model is to tax all investors at a lower corporate rate, offer no incentives, and accept the fact that some otherwise profitable investments ( $I^* - I_0$ ) will not be undertaken (Figure 2).

**Figure 3: Stylized Representation of the Philippine Incentive Policy**



5. The Philippines can probably be characterized as somewhere in between these two approaches. It offers wide-ranging fiscal incentives which are not necessarily targeted at the marginal investors (indeed, it is often the very profitable “big ticket” projects that are more likely to receive tax concessions). As a result, it sacrifices revenues (as evidenced by the smaller shaded area) but does not necessarily attract additional investment (see Figure 3). Before examining the Philippines case in detail, it is perhaps instructive to briefly survey the findings in the literature on the efficacy of fiscal incentives in the international arena.

### Box 3. Pros and Cons of Alternative Forms of Tax Incentives

#### *Advantages*

- Simple to administer.
- Certainty for the investor of tax environment.
- Can provide an immediate and large benefit to start-ups who are profitable early in their life-cycle.
- Reduces the incentive to use debt finance (because the value of interest deductions is diminished).
- Allows taxpayer to avoid tax administration (which is important if administration is perceived as corrupt or inefficient).

#### *1. Tax Holidays*

- Does not attract firms with large start-up costs and benefits most footloose companies.
- Evasion possible if the firm is able to reincorporate once holiday expires
- Once granted holidays are difficult to abolish without creating competitive distortions between new and existing firms.
- High cost since all profits are exempted; the greatest tax benefit is to the high-return firms that are likely to have invested even without the incentive.
- Encourages the formation of new companies rather than desirables such as investment or training; new investment by existing companies is unlikely to benefit.
- Provides incentives for transfer pricing (intracountry and international).
- Revenue foregone is difficult to assess unless tax returns are filed and assessed (in which case administration costs are incurred without raising revenues)
- Finite period of tax holidays creates perverse effects since the value of the incentive diminishes as the holiday approaches expiration.

#### *2. Tax Credits and Investment Allowances*

- The tax benefit is given up front rather than over several years.
- Revenue foregone is easier to measure.
- Can be targeted towards specific kinds of investment or to promote investment in long-lived assets.
- On average, results in less revenue leakage than holidays by targeting current capital outlays.
- A given level of credit favors short versus longer-lived assets—if a credit is payable on each asset purchase.
- Greater administrative burden—the scope for fraudulent claims is higher if credits are not applicable to all investment.
- Offers no immediate benefit to loss-making firm and favors existing companies over start-ups (since the former are more likely to have profits to apply credit against).
- Discriminates against activities that are intensive in uses of capital but that do not benefit from credits.
- Encourages substitution of capital for labor.

#### *3. Accelerated Depreciation*

- More flexible since it permits an increase in the rate of annual write-off or provision of an initial allowance after which the value less the allowance is written off at standard rates.
- Does not necessarily discriminate in favor of short-lived assets, like tax credit or investment allowances.
- Similar to tax credits and initial allowances but typically provides a smaller benefit, and thus incentive (although depends on the degree of acceleration).
- Offers no immediate benefit to loss-making firms and favors existing companies (which are more likely to have profits to apply depreciation against).

#### *4. Low Corporate Rate*

- Simple to administer.
- Does not have end-point problem of tax holidays or favors short-lived assets like investment allowances.
- Does not create incentives for transfer pricing between companies in and out of the incentive regime.
- Provides strong signal of government's welcoming stance towards foreign investment.
- May be costly from a revenue perspective.
- May act as a weaker incentive since benefits accrue over life-cycle of project rather than up-front as with allowances or tax holidays.
- Acts as a windfall to existing investments
- Unlike specific incentives, may not be tax spared by home country tax authorities.

#### *Disadvantages*



### III. THE EFFECTIVENESS OF TAX INCENTIVES—INTERNATIONAL EVIDENCE

6. **Empirical studies that evaluate the impact of incentives have found a wide range of outcomes**<sup>4</sup>. For developed countries Guisinger (1985) finds that fiscal incentives are not important in investment decisions but that trade protection is a key factor. Hagaki (1979) and Root and Ahmed (1978) in a similar sample of OECD countries discover no statistically significant role for tax incentives although the latter study concludes the overall rate of corporate income tax may be an important factor. For the U.S., Clark (1993) and Auerbach and Hassett (1990) find weak estimates for the sensitivity of investment to tax incentives. A survey by the U.K. Inland Revenue (1987) finds investment incentives may generate additional investment but that it is significantly less than the cost of revenue foregone. In contrast, Young (1988) shows, in the U.S., incentives are important in their influence over subsequent investment decisions (such as the reinvestment of earnings).

7. **Looking at developing countries**, Lim (1983) finds a negative relation between incentives and investment (in a sample of both developed and developing countries) and concludes that incentives are symptomatic of an attempt to mitigate an otherwise unfavorable environment for investment. Agarwal, Gubitza and Nunnenkamp (1991) in a similar group of countries find the effectiveness of tax and tariff exemptions to be at best uncertain. Chen (1998), in a sample of 21 developing economies, finds that fiscal variables (such as the size of corporate tax revenues) and the existence of free trade zones are not significant in explaining FDI flows. On the other hand, Boskin (1987) finds that tax policy can play an important role in allocating investments among developing countries while Slemrod and Shah (1995) find that investment in Mexico was quite responsive to the tax regime. Carson and Pearce (1986), in a study of developing countries, conclude that incentives are more important for export oriented industries and, similarly, Reuber (1973) finds exporting industries in developing countries are much more sensitive to incentives than import substitution industries. Kumar (1994), however, finds for U.S. multinationals investing in export industries in developing countries, wage differentials, and not incentives, explain the firm's location decisions.

8. **Using survey data**, Allen (1979) and Lindsey (1981) find that political and economic stability, the size of the domestic market, and the availability of raw materials were the major factors in the location decision of foreign investors; fiscal incentives were not shown to be important determinants. Wallace (1990) finds that, in a sample of less developed countries, 60 percent of investors rated the overall tax policy as important in determining their investment decision while only 28 percent mentioned specific incentives as important. A comprehensive OECD (1995) study of transition economies concludes from surveys of the private sector that the tax system was relatively unimportant consideration in attracting FDI particularly when incentives are used to compensate for more fundamental economic, political, or institutional shortcomings.

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<sup>4</sup> For a summary see OECD (1989) and Easson (1992).

9. **In the Asian context**, Rana (1988) shows that FDI inflows are determined by a complex array of economic, political, and social factors but fiscal incentives do not appear to have a significant effect. Tanzi and Shome (1992) conclude that, in East Asia, incentives have only played an important role only in Taiwan, Korea, and Singapore while for Malaysia, Indonesia, Thailand, and the Philippines they did not achieve their original objectives. Agarwal (1986), on the other hand, provides evidence that for certain industries in ASEAN countries—in particular some services such as banking and high technology—there is a strong relation between incentives and capital investment. In country studies, Boadway, Chua, and Flatters (1995) look at tax holidays in Malaysia and find they have been of relatively little value to infant investors while Halvorsen (1995) believes incentives in Thailand have merely provided windfall gains to projects that would have been undertaken regardless of the incentive regime. FIAS (1999) concurs with this assessment finding that, on average, only 19 percent of all firms accessing the various investment incentives in Thailand were truly attracted by them. In a study of Taiwan, Chang and Cheng (1992) find no significant impact of tax concessions while for the Philippines, Aldaba (1994) and Lamberte (1991) finds that growth, productivity, and the real exchange rate but not the incentive regime are significant factors in explaining FDI inflows.

10. **To summarize, the international empirical evidence that incentives are an important component in investors decision-making is quite mixed.** There seems to be more evidence in the developing country context that incentives can matter—particularly for export industries—but also the evidence is quite strong that, particularly in the developing country context, the economic and political environment is key. As the OECD (1994) notes, “although tax incentives were important promotional tools they had not played an overriding role. Investors tended to look more seriously at the more fundamental conditions for their investments such as infrastructure, general business environment, human resources, the legal system, and other supporting services”. However, one caveat should be added to this summary. Most of the studies mentioned were carried out on pre-1990 data. There are few, if any, studies on the effectiveness of tax incentives on the electronics and technology industries that the Philippines has benefited from so greatly in the past several years. It may be the case that these high technology industries are particularly sensitive to tax incentive policies, even more so than the ‘old economy’ export industries examined in these studies.

#### IV. INCENTIVES IN THE PHILIPPINES

11. **The Philippines has a long history—of over 50 years—of using a wide range of fiscal incentives** in pursuit of the country’s industrial, sectoral and regional development strategy. These tax concessions included exemption for Government Owned and Controlled Corporations, incentives to aid the health or education sector, to promote culture, sport, and arts, as well as incentives designed with certain social welfare objectives. In this paper, we shall confine ourselves, broadly speaking, to incentives aimed at encouraging industrial ventures. Over time such incentives have escalated and seriously eroded the tax base, despite several attempts to curtail their usage. In 1984, in an attempt to rationalize the use of incentives, all tax and duty exemptions were withdrawn by Presidential Decree. However, the decree allowed incentives to be restored through the Fiscal Incentives Review Board or by Presidential order, and the situation quickly reverted to the previous proliferation of incentives.

**Box 4: Summary of The Main Fiscal Incentives Available in the Philippines**

**Omnibus Incentive Act**

- Corporate income tax holiday of 3–6 years depending on the type of firm; these holidays can be extended by 2 years under fairly general qualifying criteria.
- An additional deduction of 50 percent of the wage bill.
- Tax credit for taxes and duties on raw materials, supplies, and semi–manufactured products used in the manufacturing, processing, or production of exports.
- Exemption from taxes and duties on imported spare parts.

**Export Development Act**

- Duty–free import of machinery, equipment and spare parts.
- Exemption from advance payment of customs duties for goods imported to be used for the production of exports.
- Tax credit for duty paid on imported inputs and raw materials used in the production of export goods.
- Tax credit for an increase in export revenue.
- Tax credit of 25 percent of the duties that would have been paid for substituting domestic for imported raw materials or capital equipment.

**Special Economic Zones**

- A SEZ enterprise not in receipt of a tax holiday under the OIA is subject to a flat 5 percent adjusted gross income tax in lieu of all other local and national taxes.
- loss carry forward for 10 years
- accelerated depreciation
- exemption from local taxes and licenses and a tax holiday on the real property tax on machinery for the first three years of operation
- additional deductions for labor training expenses
- tax credit equivalent to the taxes and duties on supplies, and raw materials used in manufacture, processing, or production of export products

12. **In 1987 the Omnibus Investment Act, so–called Executive Order 226, was passed**, which again aimed to bring some order to the incentives regime. Under this Act, incentives are authorized by the Board of Investments (BOI)<sup>5</sup> and included in a list of economic activities as part of an annual Investment Priorities Plan (IPP), drawn up by the BOI and approved by the President. Incentives were still, however, allowed to be granted

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<sup>5</sup> The BOI is composed of Secretary of Trade and Industry (chairman), 3 undersecretaries of trade and industry, and 3 representatives either from other government agencies or the private sector (all of whom are appointed by the President).

outside the OIA framework under special laws, which began to proliferate following the introduction of the OIA.

13. **The incentives currently available to investors in the Philippines broadly fall into four categories:** the Omnibus Investment Act (OIA); incentives to exporting companies through the Export Development Act (EDA); incentives for companies locating in the Special Economic Zones (SEZ); and other ad hoc concessions to various industries (such as iron and steel, shipping, mining, agriculture, and others). Box 5 and Appendix 1 provides a summary of OIA, EDA, and SEZ incentive regimes. The numerous other concessions will not be dealt with in this paper but the legislation under which such incentives are available is listed in Appendix 2.

## V. FISCAL INCENTIVES IN A REGIONAL CONTEXT

14. While it is certainly true that part of the drive to supply investment incentives in the Philippines has come from domestic rent-seeking and lobbying by vested interests, there has also been a strong external influence. The Philippines competes for capital in a region that has long been typified by extensive recourse to fiscal incentives. The incentive provisions in Malaysia, Thailand, Indonesia, and Korea are summarized in Box 6 with a more detailed summary presented in Appendix 3.

### An Overview of the Region

15. **Some broad patterns can be seen in the countries of the region.** Malaysia has chosen a strategy of combining fairly narrowly available tax holidays with widely available investment allowances. In addition, the tax holidays which are granted are generally less generous and often amount to a reduction in rates rather than an outright exemption. In Thailand and Indonesia, on the other hand, like the Philippines, a full income tax holiday is the primary incentive on offer (although Thailand's incentives are very much geared toward regional development). Korea, takes a much more targeted approach, offering very generous incentives to a few key industries and then a favorable tax treatment for certain activities (e.g. for investment in machinery, for companies that relocate, etc.). In all countries of the region the proliferation of SEZs is commonplace. One thing that is notable in the Philippines is that the *scope* of the incentives appears to be wider with more projects being potentially eligible for the incentives available. It should also be noticed there appears to be a negative correlation in the region between the generosity of incentives and the strength of the macroeconomic and socio-political environment. The Philippines and Indonesia, which perhaps have a less attractive overall business climate than some regional competitors<sup>6</sup> also seem to offer the most generous and wide ranging fiscal incentives.

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<sup>6</sup> The World Competitiveness Yearbook (2000) ranks the Philippines and Indonesia at 38 and 45 respectively (out of 47 countries) on overall competitiveness. Malaysia (25) and Korea (28) score considerably higher.

**16. One problem that is common to all countries of the region is that they do not generate adequate information** on the scope, cost, or effects on investment and the economy that incentives have. Indeed, Korea is the only country that actually produces a tax expenditure summary on a regular basis (and is the country with the least recourse to fiscal incentives).

Table 1: Effective Tax Rate Calculation for Selected Countries

	The Philippines	Malaysia	Thailand
Effective tax rate (before incentives)	47	30	46
Reduction in effective rate due to:			
Tax holiday	19	0	28
Indirect tax concessions	7	8	11
Effective tax rate (after incentives)	21	22	7

Source: FIAS (1999)

**17. In the absence of any fiscal incentives, the effective tax rate<sup>7</sup> in the Philippines is high by regional standards** and has been estimated at 47 percent compared to 46 percent in Thailand and 30 percent in Malaysia<sup>8</sup> (see Table 1 and FIAS (1999) for details of the effective tax rate calculations). The Philippines high effective tax rates are due to the highest corporate tax rate in the region compounded by higher customs duties on capital imports, and less generous tax allowances on investment. When one looks at the incentive regime, the availability of tax holidays in the Philippines reduces the effective tax burden by 19 percent and customs duty concessions reduce taxes by a further 7 percent. The after-incentive tax rate in the Philippines therefore is similar to that of Malaysia—which, overall, offers less generous tax holiday provisions that have less value to investors due to the generous depreciation and investment allowances—but compares poorly with that of Thailand where generous tax holidays—including exemptions on withholding on dividend distributions—and a higher value of customs duties exemptions combine to reduce the effective tax rate with incentives to only 7 percent<sup>9</sup> (versus 21 percent in the Philippines). It has been estimated the net cost in Thailand of providing these incentives is around ½ percent of GDP.

<sup>7</sup> The effective tax rate is the difference between the pre-tax rate of return and the after-tax rate of return to those financing the investment (including the burden of personal and indirect taxes).

<sup>8</sup> See “Thailand: A Review of Investment Incentives”, 1999, by Foreign Investment Advisory Service. Note this calculation was based on the 1998 tax regime but since then the corporate income tax rate has been reduced by 2 percent.

<sup>9</sup> This comparison is, however, with respect to the most generous incentive regime in Thailand that applies to exporters who located in underdeveloped regions (see Appendix 3 for details). It should be noted that the effective after-incentive tax rate for companies locating in the more commercial areas of Thailand is considerably higher (as the length of the available tax holiday falls from eight to three years).

Box 5. Summary of Fiscal Incentives in Select Asian Countries

	The Philippines	Indonesia	Malaysia	South Korea	Thailand
CIT rate	32 percent	30 percent	28 percent	28 percent	30 percent
Tax holidays and rate reductions	<ul style="list-style-type: none"> <li>Up to 8 year income tax holidays for newly registered pioneer projects meeting certain conditions.</li> <li>3–6 year income tax holidays for non-pioneer projects, expansion projects, and for locating in less developed regions.</li> </ul>	<ul style="list-style-type: none"> <li>3 to 8 year income tax holiday for new pioneer enterprises in 22 specific sectors.</li> <li>Halving of income tax withholding on dividends to nonresidents for companies in economic development zones or in priority sectors.</li> </ul>	5 year tax holiday on 70 to 100 percent of statutory income (or 10 year holiday for companies of national and strategic importance).	<ul style="list-style-type: none"> <li>PIT and CIT holidays for 7 years for high-technology FDI.</li> <li>For foreign investors there are holidays on withholding tax (7 years) and on a number of local taxes (5 years)</li> <li>There are also reductions and exemptions in corporate income tax for SMEs valid for 5 years</li> </ul>	Corporate income tax holidays up to 8 years followed by a further 5 year holiday on 50 percent of the corporate income tax (for priority activities and companies in certain geographical areas).
Tax allowances and credits	Various tax credits on domestic breeding stocks and genetic materials, as well as for incremental export revenue.	<ul style="list-style-type: none"> <li>Doubling of depreciation rates for companies in economic development zones or investing in priority sectors.</li> </ul>	<ul style="list-style-type: none"> <li>Investment allowances for 60 to 100 percent of qualifying capital expenditure.</li> <li>Accelerated depreciation of computer, technology, and environmental protection investments.</li> </ul>	<ul style="list-style-type: none"> <li>Tax deferrals for investment reserve provisions</li> <li>Various tax credits for investment in machinery and equipment, advanced technology, energy-saving measures, or pollution control.</li> </ul>	Investment allowance of 25 percent for expenditures on infrastructure.
Import duty and VAT exemptions	Exemption from taxes and duties on imported supplies and spare parts.	<ul style="list-style-type: none"> <li>Capital goods are duty and VAT exempt.</li> <li>Reduction of import duty on machinery, spare parts, and raw materials.</li> <li>Special duty drawback and VAT exemption for companies with export ratio over 65 percent.</li> </ul>	<ul style="list-style-type: none"> <li>Duty-free import of raw materials and spare parts for re-export.</li> <li>Import duty and sales tax exemption on machinery and equipment that cannot be produced locally.</li> <li>Sales tax and excise exemption on locally purchased machinery and equipment.</li> </ul>	Concessions for custom duties, the excise taxes, and the VAT on imported capital goods for eligible companies.	Various import duty reductions for projects located in certain regions.
Other	Additional 50 percent deduction for labor expenses for 5 years for new projects above a certain ratio of capital equipment to workers.	<ul style="list-style-type: none"> <li>Loss carry-forward extended to 10 years for companies in economic development zones or in priority sectors.</li> </ul>	<ul style="list-style-type: none"> <li>Double deduction of various expenses (such as R&amp;D and training)</li> <li>Reduced tax rate of 3 percent for offshore companies in Labuan.</li> <li>Dividend distributions during holidays are from income tax exempt.</li> </ul>	<ul style="list-style-type: none"> <li>Tax concessions for foreign investors in Foreign Investment Zones.</li> <li>Reduction in local taxes for newly established SMEs.</li> </ul>	<ul style="list-style-type: none"> <li>Double deduction for utility and transportation costs in certain regions.</li> <li>Dividend distributions during holidays are tax exempt.</li> </ul>

## VI. AN ASSESSMENT OF INCENTIVES IN THE PHILIPPINES

18. **There is considerable disagreement as to the efficacy of fiscal incentives and whether they warrant their costs in terms of government revenue foregone;** this is true both in the Philippines but also in a global context. Some argue that a broadly available reduction in the corporate tax rate—the Hong Kong or Ireland model (see Box 6)—would be less costly and less distortionary than a wide-ranging network of tax incentives. Others believe that the governments efforts should be directed at improving, more broadly, the general investment environment by tackling corruption, investing in infrastructure, and providing a stable socio-political environment.

### Box 6: Tax Incentives in Ireland

Ireland has enjoyed considerable success in attracting foreign direct investment over the last several decades. It has benefited from its integration within the EU, a stable macroeconomic and socio-political environment, and an open trade environment. In addition, Ireland has had in place a generous system of incentives for inward investment and has managed to become one of the largest recipients of FDI in Europe (in 1999 Ireland received almost 20 percent of GDP in FDI).

From 1956 to 1990, Ireland offered tax holidays to exporters as the primary investment incentive; this benefit was revoked under pressure from the EU. In 1981, Ireland introduced a 10 percent corporate tax rate applying to manufacturing and certain service industries such as data processing and software development as well as to firms locating in the International Financial Services Center or the Shannon Free Zone. This low tax rate was intended to replace the system of tax holidays as they were being phased out. From 2003 all corporate income in Ireland—including non-manufacturing—will bear a 12.5 percent tax rate.

While Ireland's low tax rate is not tax spared for U.S. tax purposes, U.S. multinationals investing in Ireland, which make up the bulk of inward investment, have nonetheless benefited greatly from the low tax regime. They have been able to take advantage of global averaging tax rules to combine the lower taxed income received in Ireland with income earned in higher tax jurisdictions and, as a result, increase the size of the foreign tax credit recognized by the U.S. tax system.

Aside from the low corporate rate, other tax incentives in Ireland include generous depreciation schedules and quadruple deductions for research and development expenditures. In addition, Ireland offers a broad range of grants that are dependent on job creation, domestic value added, export potential and other factors determined by the Industrial Development Authority. These grants may partially cover the cost of fixed assets, training, research and development, and also the costs of employing additional employees. Ireland also provides office and building sites as well as pre-constructed factories.

19. **The answer to which approach to attracting FDI is preferred from a welfare perspective is an empirical question.** In the Philippine context, making such an empirical judgment is severely hampered by the lack of timely, adequate and pertinent information. While the statutory provisions of the incentive regime are clear (albeit complicated), various practical aspects are not. How wide-ranging actually are the incentives? To what extent do incentives attract investors or do they merely provide a windfall gain to investors that would

have come to the Philippines anyway? Which incentives are most valued by investors<sup>10</sup>? What is the extent of the revenue foregone in providing incentives? How much revenue does the government receive indirectly—such as withholding or personal income tax—from investments that are attracted by the incentive regime? To what extent are the costs of attracting FDI projects offset by lower government spending (such as through corporate provision of infrastructure or increased employment which reduces the budgetary costs of safety nets)?

20. **To resolve some of these informational deficiencies the government needs to,**
- **Quantify the extent to which incentives reduce the overall effective statutory tax burden for different cashflow profiles of investments.**<sup>11</sup> This calculation will make it clear both how high the overall statutory tax burden is on investors, how generous the incentive package is in reducing that burden, and how the value of the incentive varies across different types of investments.
  - **Enforce the provisions for companies receiving incentives to submit information** such as tax returns, financial reports and other information on their activities.
  - **Estimate the ‘redundancy rate’ of investment incentives**<sup>12</sup>. An often cited defense of incentives in the Philippines is that tax abatements, by encouraging investment, result in *increased* revenues to the budget (from personal income taxes, indirect taxes etc.). If, as is likely, the redundancy rate is high then the net loss of taxes from those companies that would come to the Philippines regardless of the incentive regime is likely to outweigh the higher revenues from those investments which would otherwise have gone elsewhere.
  - **Prepare and publish annual reports on the benefits generated by the foreign investment projects that are in receipt of incentives** including a quantification of the level of employment generated, the amount of infrastructure investment undertaken at the companies expense, net foreign exchange earned, gross and net exports generated, the size of local input content, and the impact of the investments on the local economy and environment.

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<sup>10</sup> For example, several commentators view relief on the taxation of capital inputs as very important. As OECD (1995) notes, “in Asia ... the most important tax relief for firms examining potential investment is relief from customs duties on imported capital equipment”.

<sup>11</sup> See McCutcheon (1995) for an example of such an exercise looking at the corporate tax system in Ireland.

<sup>12</sup> That is the proportion of investment that would have located in the Philippines anyway and for which the tax concessions are redundant.



- **More effectively monitor companies that are in receipt of tax abatements.** In addition, the monitoring function should be extended to incorporate those companies whose incentives have expired in order to assess whether fiscal incentives in the Philippines provide long-lasting benefits that extend beyond the duration of the incentives.
- **Determine what truly are the primary attractions for investment in the Philippines**—for example, the general tax regime, the level of tax incentives, publicly-provided infrastructure, the geographic location, the available human capital resources,<sup>13</sup> and others—and where the Philippines is viewed to be deficient relative to its competitors. Such information can be obtained by surveying the strategy divisions of corporations that invest in the Philippines but also those companies that chose to locate elsewhere in the region. A recent survey of the electronics industry in the Philippines (see Table 2), suggests that incentives are, at most, an ancillary consideration in a firm's investment decision<sup>14</sup>.

Table 2. Electronics Companies Reasons for Locating in The Philippines

	Percent of Respondents
Quality of labor	68
Cost of labor	62
Availability of labor	48
Following customers	41
Government incentives	16

Source: Semiconductor and Electronics Industry of the Philippines.

21. **In order to increase the accountability** of policymakers, the Philippines should,
- **Use the information provided by the corporations to compile comprehensive reports on the total costs of the tax expenditures** and also on which corporations

<sup>13</sup> For example, a recent survey by the META Group (2000) ranked the Philippines as first out of 47 countries in the availability of qualified information technology workers, engineers and senior management. Similarly the World Competitiveness Yearbook (2000) scores the Philippines highly on the availability of skilled labor and senior managers.

<sup>14</sup> Policy makers will argue that incentives are *very* important to potential investors but this is often colored by the fact that investors, while not ranking incentives as important in their location decision, will nevertheless bargain very hard with the relevant authorities in order to get the best possible tax regime they can before committing their investment.

are receiving this implicit public subsidy. These reports should be submitted to the public and the legislature as part of the annual budget.<sup>15</sup>

- **Require the annual approval of a tax expenditure budget by Congress**, as part of the annual budget, which would estimate the cost of existing incentives in the coming years and require explicit approval for the cost of any new incentives that are to be offered during the fiscal year. By incorporating the approval of tax expenditures into the budget the policy trade-offs—between offering new abatements to investors or higher spending on public functions such as health, education, and infrastructure—become clear.

22. **Turning to the structure of incentives** in the Philippines much of what can be said is summarized in Box 3. Whether the country would be better served by restructuring its tax incentive policy—such as by offering more generous depreciation or investment allowances with reasonable loss carry-forward provisions instead of tax holidays, or by eliminating tax concessions and instead giving out direct development grants<sup>16</sup>—or indeed by abandoning incentives and choosing further across-the-board reductions in the marginal corporate tax rate is difficult to say.<sup>17</sup> However, some areas of the current incentive regime deserve special mention.

- **Tax holidays, the centerpiece of the Philippine tax incentive structure, have built in a structural downward path for the ratio of corporate tax revenues–GNP.** Ironically, if the government is successful in picking winners, the policy of offering tax holidays will necessarily result in the untaxed sectors being the ones that will propel economic growth in the Philippines. The effect of such statutory holes in the corporate tax base has been compounded by the fact that the Philippine tax system has had a difficult time adapting to the recent structural changes and business practices associated with ‘new economy’ enterprises. A clear advantage of abandoning the tax holiday regime and choosing among the alternative incentive packages noted above, is that the budget will at least get to participate, through higher revenues, in the upside potential of successful investments projects.

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<sup>15</sup> This would be in-line with the standards of the IMF’s Code of Good Practices on Fiscal Transparency—Declaration of Principles which states “the minimum standard requires that budget documents should include a statement of the main central government tax expenditures ... to enable some assessment of their justification and fiscal significance”.

<sup>16</sup> While grants may be a more transparent incentive mechanism they would likely have a limited value in the Philippines since investors would question whether such expenditures would be appropriated in the annual budget and paid on time and as promised.

<sup>17</sup> A 1990 assessment of the Philippine investment regime (Sunley and Skilling (1990)), concluded that the tax holiday should be replaced with accelerated depreciation, net loss carryover and a reduced duty on imported capital equipment. In addition, incentives for R&D and pollution control could be made available to all firms.

- **The strong preference for tax holidays seems, in part, driven by a lack of confidence in the fairness and efficiency of the tax service.** It is common that in countries where the tax administration is weak, foreign investors show a strong preference for tax holidays over other incentives in order to avoid having to deal with the local tax authorities (which is an attractive benefit even if the holiday does little to reduce the overall tax burden). As a result, any reform of the structure of incentives must also go hand-in-hand with the ongoing reform of the tax administration. Important reforms to restore investor confidence in the tax administration would be to ensure the uniform application of tax regulations across the country, to eliminate corruption among tax officials, and to reduce taxpayer compliance costs.
- **More attention needs to be paid to the interface between corporate and personal income taxes.** The Philippines, unlike its neighbors in Thailand, Malaysia and, in part, Indonesia, does not exempt nonresidents from taxation of dividends paid out from profits that were accrued during a tax holiday. As a result, while exempting profits at the corporate level, this incentive is partially offset by trying to tax them through withholding. While such a system may be desirable in encouraging retained earnings it also leads to tax planning by individual trying to avoid the personal income tax liability. It would be better instead to replace the tax holiday with other incentives and tax the dividend at the individual level possibly with full imputation or other measures to alleviate the double taxation of dividends.
- **While a three year loss carry-forward is available to corporations, this does not apply to those subject to tax holidays.** The tax code states “any net loss incurred in a taxable year during which the taxpayer was exempt from income tax shall not be allowed as a deduction.”<sup>18</sup> This can result in the tax holiday actually *increasing* the effective tax rate on certain investments that have large up-front costs or low revenues in the early years of its operation (firms with such characteristics will clearly not view such a tax holiday as an investment incentive at all). The loss carry forward provision should be amended to apply to all corporations, whether in receipt of a tax exemption or not. However, such a proposal will require careful monitoring to avoid abuse. A precondition for implementing this recommendation is that companies in receipt of tax holidays report comprehensive and reliable financial accounts to the tax authorities and the BOI during the period of the holiday (in order the unused portion of the loss carry-forward can be properly assessed).
- **There are some incentives in the Philippine legislation that are likely to conflict with WTO rules.** The Uruguay Round agreement on Trade Related Investment Measures states that incentives which require “purchase or use by an enterprise of products of domestic origin”<sup>19</sup> as a qualifying criteria are not permitted. Thus the provision in the revision to the OIA (see Appendix 1) that attempts to reinstate tax

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<sup>18</sup> National Internal Revenue Code of the Philippines, Section 34.D.3.

<sup>19</sup> WTO Agreement on Trade Related Investment Measures, 1996, p. 143.

credits for the purchase of domestic equipment should be eliminated. Also, the WTO prevents non-agriculture tax preferences that are contingent on export performance. It is likely the EDA provision offering tax credits for improved export receipts would violate this provision.

- **While it is understandable that companies favor outright exemption for indirect taxes the government should instead choose a refunding regime rather than offering exemptions.** For example, a duty drawback scheme is preferred to an exemption of customs duties. Similarly zero-rating and refunding the VAT paid to exporters is better than offering VAT exemptions. A refund mechanism creates a paper trail to ensure less abuse, easier administration and less revenue leakage. However, drawback schemes and prompt refund mechanisms do require a strong tax administration that is focused on providing taxpayer service and lowering taxpayer compliance costs. Therefore, replacing exemptions with refund mechanisms should be viewed as a medium-term goal once the ongoing reforms to strengthening the tax administration have been seen to bear fruit.
- **Finally, there is a strong case to simplify the incentive regime in the Philippines.** An investor is potentially covered by numerous legislative acts (see Appendix 2) and different incentive regimes. Such complications can daunt potential investors but also offers opportunities for investors to “incentive shop” or to double-dip in the different incentive packages. This should be one of the primary aims of any revision to the incentive regime. It should aim to consolidate *all* the various tax abatement provisions into one piece of legislation and reduce the number of agencies involved in the process of granting exemptions in order to consolidate all tax preferences under one roof.

23. **Incentives also need to be viewed in an international context;** a country playing host to overseas investment does not have control over the ultimate tax burden on that investment. Instead it depends on the tax system of the home country and the double taxation treaty between the two countries. Therefore, it is unclear, at least for some projects, whether the various incentives being offered by countries in the region actually really are valued by the investor or merely serve to increase the home-country tax burden at the expense of the host-country’s treasury. As Table 3 shows, many capital exporting countries provide ‘tax sparing’ credits for investments in the countries of the region (by allowing foreign tax credits for taxes that *would* have been paid in the absence of incentives). However, it would be useful to have information on the proportion of investment in the countries of the region that comes either from the U.S. or from other countries without tax sparing agreements.<sup>20</sup> As an indication, in the Philippines, 22 percent of SEZ investment comes from the UK and US who do not tax spare.

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<sup>20</sup> Although, even without tax sparing agreements, tax preferences can have a value to U.S. investors since they allow the investor to defer the tax until the profits are repatriated and may also allow the investor to benefit from the averaging of the foreign tax credit with other higher tax jurisdictions (so avoiding a position of excess foreign tax credits).

Table 3. Tax Sparing Between Capital Exporting Countries and Select Asian Countries

	Australia	France	Germany	Japan	UK	US
The Philippines	•	•	•	•		
Indonesia	•	•	•	•	•	
Malaysia	•	•	•	•	•	
South Korea		•	•	•	•	
Thailand	•			•	•	

Source: IBFD Tax Treaties Database, OECD (1998)

24. **There is a clear need to reform the administration of fiscal incentives in the Philippines.** At present, the selection of firms qualifying for incentives under the IPP is somewhat discretionary and is decided by an interagency committee—consisting of BOI, NEDA, DOF, and Department of Agriculture—and approved by the President. For SEZs, PEZA or the other economic zone authorities, have considerable influence over the granting of SEZ status. As a result, the process of granting incentives is open to lobbying and political pressure as well as, at a minimum, the appearance of impropriety. This can serve to undermine investor confidence and worsen the overall investment climate.

25. **The process by which incentives are granted needs to be made more rules-based and transparent and with strict Congressional oversight.** Incentives should be approved only on the basis of clear and objective qualifying criteria. Such criteria should be clearly stated either in the statute or in accompanying regulations; eligibility should then be automatic, transparent and consistent across investment projects with similar characteristics. Rather than a ‘positive list’ of eligible projects being chosen by the annual IPP, consideration should be given to a short ‘negative list’ of areas where investment projects are not eligible with all other investments that satisfy the statutory requirements being able to avail themselves of the various incentives.<sup>21</sup> The agencies and committees that administer the various forms of incentives should have only a limited role in interpreting the legislation or deciding who can qualify under the various programs.<sup>22</sup>

26. **Some specific comments are warranted on the operation of the Special Economic Zones.** It is perfectly appropriate to exempt inputs into exported goods from duty—

<sup>21</sup> The proposal to replacing the IPP with a negative list to avoid the BOI ‘picking winners’ has been under consideration for some time (see Sunley and Skilling (1990)).

<sup>22</sup> There is a tension here since administrative discretion is often viewed as important for successful negotiations with foreign investors. However, if investors, knowing there is discretion, regularly use that to extract the maximum incentive (as in the Philippines), then the rationale for giving “negotiating room” disappears.

preferably through a refund duty drawback scheme—and for exporters to be exempt from VAT—either through zero-rating and prompt refund or, in the context of a secured SEZ, outright exemption from payment of VAT on imports. However, such exemptions need to be tightly controlled to ensure that they apply only to exporters and are not subject to abuse and tax evasion. As a result, greater efforts are needed to ensure that Philippine SEZs are strictly ring-fenced. No duty-free sales of products to residents should be permitted (for example to residents of the Subic and Clark SEZs) and all sales to the domestic market should be subject to normal customs duties and domestic taxes.

27. **It is quite clear that the Philippine budget is currently suffering the ill-effects of harmful tax competition.** The Philippines, like its regional competitors, is in the midst of a “race-to-the-bottom” to offer the most generous incentives possible to foreign investors. There is, thus, a clear role and need for a regional solution to this problem. Fortunately there is already a well-working regional forum in ASEAN where this coordination problem can be addressed. It would be to the benefit of all countries of the region to agree to limits on the size and scope of investment incentives to prevent countries undermining their budgetary position through regional competition for foreign investment dollars. Unfortunately ASEAN appears to be going in exactly the opposite direction with the 1998 Hanoi Declaration—which aimed to improve the investment climate in ASEAN countries following the Asian crisis—by establishing guidelines for a *minimum* level of tax incentives among ASEAN countries rather than trying to place limits on regional tax competition.

## VII. CONCLUSIONS

28. **Incentives in any country are costly and lead to an increase in other distortionary taxes to meet a given revenue target.** They are often inequitable across countries, geographical areas within a country, and time and they create an effective tax rate that varies between sectors and activities and with the discretion of several public agencies. All of these criticisms seem true of the Philippines. However, the Philippine government is locked in to incentives that have already been awarded (since they have contractual agreements upon which investors have based their capital allocation decisions) and is constrained by a regional bias towards generous tax treatment for FDI projects. While the exact design of the tax regime facing direct investors is ultimately a policy decision of the Philippine government these conclusions offer some ways to minimize the costs, maximize the benefits, and improve the transparency of the current regime.

29. **Ultimately, in a democratic system, the only way to contain the proliferation of tax incentives is to place into the public domain as much information as possible on the costs of these incentives and who receives them,** and make it clear the trade-offs between offering incentives and providing other public services. Through public scrutiny and pressure on the legislature fiscal incentives are no longer viewed as a ‘free lunch’ but, rather, as a budgetary allocation decision subject to the same Congressional oversight as other budget appropriations. This should be a key strand of any reform of the incentive regime and would imply,

- having tax expenditure budgets for newly offered incentives explicitly approved by Congress as part of the annual budget and have ex post reporting to Congress and the public on the cost of both existing and new incentives;
- compiling information on the cost and benefits of the various incentive programs (and their incidence) and improve the monitoring of those companies in receipt of tax concessions to better determine which incentives are truly productive;
- reforming the administration of incentives to codify the qualifying criteria and remove discretion from administrators.

30. **Fundamental restructuring of the system of incentives will require difficult policy choices.** Any reform will necessitate taking a broad, strategic view on what are the real deficiencies in the Philippine investment climate and whether high effective tax rates are truly an important factor in deterring inward investment. If taxes are viewed as a key impediment then the government needs to decide if it wishes to continue to offer tax incentives or instead choose a model of a lower but evenly applied corporate tax rate. If some form of incentive regime is viewed as a worthwhile policy tool then the government should aim to,

- greatly simplify the system of incentives preferably under one umbrella piece of legislation administered by a single government entity;
- ensure that the budget participates in some of the upside potential of profitable projects—such as through incentives such as investment allowances or accelerated depreciation rates rather than tax holidays—rather than merely accepting a structural downward bias in the revenue–output ratio;
- replace indirect tax exemptions with effective systems of tax refunding that are easier to monitor and prevent abuse;
- make efforts to improve the tax administration to increase the confidence of potential investors in the tax authorities;

31. **Finally, there is a clear role for a regional coordination effort** to constrain countries from pursuing harmful tax competition. ASEAN provides an ideal regional forum to address this issue.

## **Appendix I: Summary of Current Incentive Provisions in The Philippines**

### ***Incentive Provisions of The Omnibus Investment Act***

**The Omnibus Investment Act of 1987 aimed to encourage inward investment through a broad array of tax and duty abatements** that are available to enterprises registered with the BOI.<sup>23</sup> The premise, which is stated in the OIA itself, is “that fiscal incentives are important determinants in investment decisions as well as reliable instruments that enhance the country’s investment climate” (OIA, 1987). In pursuit of these investment projects, corporate income tax holidays have been the centerpiece of the fiscal incentive strategy. The incentives specified in the OIA include,

- A corporate income tax holiday for 6 years for pioneer firms,<sup>24</sup> 4 years for nonpioneer firms, and 3 years for expansion projects; these holidays can be extended by 2 years under fairly general qualifying criteria<sup>25</sup>
- An additional deduction of 50 percent of the wage bill (100 percent for projects in less developed areas) for 5 years provided the project meets certain capital–labor ratios.
- Tax credit for taxes and duties on raw materials, supplies, and semi–manufactured products used in the manufacturing, processing, or production of exports for 10 years.
- Exemption from taxes and duties on imported spare parts provided at least 70 percent of production is exported and that such materials are not locally available and are used only in the bonded warehouse of the enterprise.
- Tax and duty exemption on the import of capital equipment; for companies using domestic capital equipment, a tax credit is available that is equal to the tax and duty that would have been paid were such materials imported.<sup>26</sup>

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<sup>23</sup> These enterprises may include export–oriented industries, certain “catalytic” sectors of manufacturing and agriculture, sectors undergoing adjustment (such as textiles), infrastructure, telecommunications, iron and steel, and others.

<sup>24</sup> Pioneer enterprises are defined in the law as BOI registered firms engaged in manufacture, processing or production; firms introducing a new technology to the Philippines; agriculture, forestry or mining activities in pursuit of national goals; and firms producing nonconventional fuels or equipment that uses nonconventional sources of energy.

<sup>25</sup> Incentives can be extended if “the project has a gestation period which goes beyond the period of availment of needed incentives” and if the project meets prescribed capital–labor ratios, prescribed targets on the utilization of indigenous raw materials, and either earns or saves over \$500,000 in foreign exchange during the first 3 years of operations.



- Tax and duty exemption of importation of breeding stock and genetic materials for 10 years; for companies using domestic breeding stock and genetic materials for 10 years a tax credit is available that is equal to the tax and duty that would have been paid were such materials imported.
- Exemption from the contractor's tax.
- Various other incentives such as for multinationals which establish their regional headquarters or regional warehouses in the Philippines.

### *The Administration of the OIA*

**The administration of the OIA involves a considerable amount of discretion in determining who is eligible for tax preferences;** it does not give firms an automatic entitlement to receive the incentives specified in the law. Instead, the BOI must decide each year on an IPP that contains a listing of specific activities that can qualify for incentives which is sent to the President for approval. This listing is supported by detailed industrial analysis of the projects included in the plan. In considering which investments are to be listed in the IPP, the BOI takes into account the economic soundness of the plan, the contribution of the activity to specific development goals, indicators of comparative advantage, and other technical aspects. Criteria for deciding among investments include the extent of Philippine ownership, the expected rates of return, the measured capacity of the project, the amount of foreign exchange expected to be earned, domestic content, the technology to be used, as well as other criteria to be determined by the BOI. In addition to detailing the IPP, the BOI is also required to register qualifying enterprises and monitor their activities to ensure compliance with the conditions of the incentives.

**Since incentives in the Philippines are discretionary, award of incentives requires an assessment by the BOI staff and Board approval.** As a result, decisions are not always consistent across similar investors and the criteria by which decisions are made on the granting of incentives are not always clear, are unfocused (i.e., they pursue several, perhaps conflicting, development objectives), and are subjective rather than objective. Companies in receipt of the various incentives often do not comply with BOI regulations to supply information and financial statements and the BOI appears to have little resources to monitor and control the abuse of incentives (such as domestic sale of duty-free imports, transfer pricing, etc.). Aside from the initial qualifying decision, the incentive system goes largely unmonitored through the life of a given project (which is evidenced by the lack of timely information on the costs and benefits of providing OIA incentives).

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<sup>26</sup> These provisions, after being renewed in 1992, appear now to have expired.

### *The Export Development Act Incentives*

In addition to the OIA incentives, exporters—including those in the Special Economic Zones (see below)—can avail themselves of incentives under the Export Development Act of 1994 (EDA) which include,

- Duty-free import of machinery, equipment and spare parts.
- Exemption from advance payment of customs duties for goods imported to be used for the production of exports.
- Tax credit for duty paid on imported inputs and raw materials used in the production of export goods that are not available locally.
- Tax credit for an increase in export revenue.<sup>27</sup>
- Tax credit of 25 percent of the duties that would have been paid for substituting domestic for imported raw materials or capital equipment.

**To operationalize the EDA, a rolling three-year Export Development Plan (EDP) is prepared by the Department of Trade and Industry.** The Export Development Council<sup>28</sup> is then empowered to approve the EDP, coordinate and monitor its implementation, review the country's export performance and to formulate the detailed policies for granting incentives to exporters. The DOF also operates a "one stop shop" for exporters that handles all tax-related issues for existing or potential export projects. While all exporters can apply for the incentives they are only granted upon certification of eligibility by the Bureau of Export Trade Promotion of the DTI or an appropriate agency.<sup>29</sup> Claims for tax credits, however, need to be filed with the

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<sup>27</sup> The exporter is entitled to a tax credit of 2.5 percent of the incremental export revenue, for every 5 percent increase in its annual export revenue (up to a maximum of 10 percent of the incremental export revenue).

<sup>28</sup> The EDC is made up of the Director-General of the NEDA, Governor of the BSP, Secretaries of the Department of Finance, Trade and Industry, Science and Technology, Foreign Affairs, and Labor and Employment, and 9 private sector participants that are appointed by the President.

<sup>29</sup> The agency responsible may be the PEZA, BOI, Subic Bay Metropolitan Authority, Clark Development Corporation, Philippine Chamber of Commerce, or the Philippine Export Confederation depending on the circumstances of the firm in question.

one stop shop and the investor then receives a tradable tax credit certificate.<sup>30</sup> At present no claims for credits for incremental export revenues have been paid out pending a decision by the government on whether to honor this provision. For 1994–96 alone, P200 million in claims have been verified; given the rapid export growth in recent years (US\$ 15 billion from 1997 to 2000) the volume of such claims for subsequent years could be significant.

*Incentive Provided by Special Economic Zones (SEZ's)*

**SEZs, like tax incentives, also have a long history in the Philippines** with the first one having been established in Mariveles—which later became the Bataan Export Processing Zone—in 1969; at the time all foreign and domestic merchandise brought into the zone were not subject to the customs and internal revenue laws of the Philippines. In the late 1970s there was a flurry of SEZs created across the Philippines. These zones were largely operated as self-contained enclaves using imported materials for the processing, assembly, and manufacture of goods for export. In 1987 the OIA framework (described above) was intended to bring order to the haphazard creation of SEZs under the controlling authority of the BOI. However, in 1995 the government created a separate authority to manage the SEZs (The Philippine Economic Zone Authority or PEZA) and expanded the scope of such SEZs to include industrial estates, tourism or recreation complexes, free trade zones, and investment, commercial banking and financial centers. There are also a limited number of SEZs that have been created outside of the PEZA framework including those created under the Base Conversion and Development Act of 1992, the Zamboanga City SEZ, and the Cagayan SEZ; of these only the Subic and Clark SEZs (which were former U.S. military bases) are operational. As of August 1999 58 SEZs were operational in the Philippines (see Box 4 for a description of the Philippine SEZs).

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<sup>30</sup> In early 2000, the tax credit scheme was embroiled in a scandal whereby textile firms were found to have received P4.5 billion in tax credit certificates under fraudulent claims for duties paid on imported inputs to exported goods.

Box 7. Basic Indicators on SEZs in the Philippines	
Number of SEZs (1999)	58
Number of approved firms located in SEZs (as of 1999)	1,313
of which: PEZA publicly administered zones	399
PEZA privately run zones	305
Subic SEZ	370
Clark SEZ	239
Total investment in PEZA SEZs (1995–99)	P 530 billion
PEZA zone employment (1999)	617,690 persons
Share of total employment	2.2 percent
PEZA zone manufactured exports (1999)	US\$ 15.8 billion
Share of all Philippine manufactured exports	50 percent
Primary source of investment (1995–99)	Japan (46 percent) U.S. (15 percent) Filipino (15 percent) U.K. (7 percent)
Leading new industries in PEZA zones (1995–1999)	Electronics (51 percent) Electrical machinery (16 percent)

**The main objective in the creation of the SEZs was to act as a catalyst for socio-economic development and to attract investment, create jobs, and increase export growth** (particularly in rural regions). In addition, certain zones (notably the Subic and Clark SEZs) were aimed specifically at developing former military installations into civilian commercial use. The SEZs that have been established typically have had an accompanying investment in infrastructure by the government but for the most part are now owned and managed by private firms (only four PEZA SEZs remain in public hands).

**Firms locating within the SEZs are able to receive incentives either under the OIA (for those enterprises which qualify under the IPP) or the various SEZ laws.** If a SEZ enterprise chooses not to avail itself of the tax holiday under the OIA (or if the holiday lapses or the firm is not eligible for OIA incentives), then it becomes subject to a flat 5 percent adjusted gross income tax<sup>31</sup> in lieu of all other local and national taxes. In addition to the exemption from customs and internal revenue laws, Presidential Decree Number 66 (as amended) provides for other specific incentives for SEZs including,

<sup>31</sup> For manufacturing enterprises, the gross income tax is levied on gross sales revenue from activity within the SEZ net of allowable deductions for labor expenses, raw materials, supplies and fuels, depreciation of machinery and equipment used in production, rent and utility charges, and financing charges associated with fixed assets. There are different definitions of the gross income tax base for service and financial enterprises.

- loss carry forward for 10 years
- accelerated depreciation
- exemption from local taxes and licenses and a tax holiday on the real property tax on machinery for the first three years of operation
- additional deductions for labor training expenses
- tax credit equivalent to the taxes and duties on supplies, and raw materials used in manufacture, processing, or production of export products
- exemption of gross receipts from the contractor's tax
- exemption from all dues, fees, charges including wharfage and storage dues

**Up to 30 percent of the production of the SEZ may be made available domestically** although it becomes subject to customs duties and internal revenue taxes when sold within the Philippines. However, for the Subic and Clark SEZs, up to 30 percent of their revenue can come from sales within the customs territory without incurring taxes on those sales and there are duty-free shopping privileges for their residents. In 1996, it was estimated the number of duty free shoppers in Clark SEZ was 161,000. From January 1, 1999 this privilege was to be phased-out (by limiting it to \$100 per person) but this provision is, at present, being challenged in the court system.<sup>32</sup>

**PEZA requires companies to register and satisfy certain reporting requirements in order to avail themselves of incentives.** SEZ companies are required to provide audited financial statements, income tax returns, a statement of any change in equity ownership, and various corporate annual reports. There are, however, significant inconsistencies in reporting by SEZ companies resulting in a complete lack of information on the magnitudes of revenue foregone by the government in operating the SEZs. Also, there is an uneven application of the incentives themselves. For example, some SEZ firms paying the 5 percent gross income tax were also charged local taxes contrary to the legislation while other firms have chosen to pay the 32 percent corporate income tax instead of the 5 percent gross income tax (since it results in a lower tax liability for the firm).<sup>33</sup>

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<sup>32</sup> Duty-free operators in Subic and Clark were able to obtain a court injunction against Executive Order 44 which limits the monthly purchase privileges of domestic tourists. This has, as a result, left purchase privileges for nonresidents without limit.

<sup>33</sup> See NTRC Tax Research Journal, 1999 for a discussion of a survey on the implementation of privileges granted to SEZs.

## Appendix II: Laws Used To Claim Fiscal Incentives In 1999<sup>34</sup>

### *Executive Order*

- 63 Amendments to the Tariff & Customs Code of the Philippines, 15 January 1999
- 103 Food Security, May 25, 1999
- 133 Amendments of Tariff and Customs Code of the Philippines, 31 July 1999
- 226 Omnibus Investments Code, 1987

### *Presidential Decree*

- 66 Export Processing Zones, 20 November 1972
- 87 Oil Exploration and Development Act of 1972, 31 December 31, 1972
- 269 National Electrification Administration, 06 August 1973
- 273 Amending Philippine Medical Care of 1969, 14 August 1973
- 380 National Power Corporation, 22 January 1974
- 538 Phividec Industrial Estate Enterprises, 13 August 1974
- 660 International Development Association, 21 February 1975
- 972 Coal Development Act of 1976, 28 July 1976
- 1258 Importation of Certain Hospital/Medical Equipment, 02 December 1977
- 1442 Geothermal Exploration and Development, 11 June 1978
- 1590 Philippine Airlines, Inc., 11 June 1978

### *Republic Act*

- 7103 Iron and Steel Industry Act, 08 August 1991
- 7156 Mini-Hydroelectric Power Incentive Act, 12 November 1991
- 7160 Local Government Code, 10 October 1991
- 7220 Camarines Norte Provincial Hospital, 06 March 1992
- 7227 Bases Conversion Development Act of 1992, 13 March 1992
- 7229 Merger between Globe Mackay Cable and Clarecilla Radio Systems, 19 March 1992
- 7293 Pilipino Telephone Corporation, 27 March 1992
- 7294 Smart Information Technologies, Inc., 27 March 1992
- 7372 Isla Communications Corporation, 10 April 1992
- 7617 Telecommunications Technologies Philippine, Inc., 25 June 1992
- 7633 International Communication Corporation, 20 July 1992
- 7715 Looc Norte Barangay High School, 05 May 1994
- 7716 Expanded Value Added Tax, 05 May 1994
- 7718 Amending RA 6957: Financing, Construction Operation and Maintenance of Infrastructure Projects by Private Sector, 05 May 1994
- 7719 Promoting Voluntary Blood Donation, 12 May 1994
- 7844 An Act to Develop Exports as Key Towards the Achievement of the National Goals, 27 December 1994
- 7916 Philippine Economic Zone Authority, 24 February 1995
- 7918 Amendments to EO 226 Omnibus Investments Code, 24 February 1995
- 7925 Development of Philippine Telecommunication, 01 March 1995
- 8174 General Appropriations Act of 1996, 29 December 1995
- 8241 Amendments to EVAT Law, 30 December 1996
- 8424 Tax Reform Act of 1997, 11 December 1997
- 8425 National Anti-Poverty Communication, 11 December 1998

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<sup>34</sup> See CBO (2000).

- 8435 Modernizing Agriculture and Fisheries Sector, 22 December 1997
- 8436 Automated Election System, 22 December 1997
- 8437 Rent Control, Regulations and Stabilization, 22 December 1997
- 8438 Cordillera Autonomous Region, 22 December 1997
- 8439 Magna Carta for Scientists Engineers, 22 December 1997
- 8502 Development of Jewelry Manufacturing Industry, 13 February 1998

Section 1903–1904 and 2001–2004 of the Tariff & Customs Code

### **Appendix III: Summary of Fiscal Incentives in the Region**

#### ***Malaysia***

**Malaysia offers various incentives for investments in manufacturing, agriculture, hotel and tourism, research, development and training activities.** A company granted pioneer status<sup>35</sup> can choose to receive an income tax holiday of 70 percent of statutory income for 5 years (this can rise to 100 percent of statutory income for certain types of companies<sup>36</sup> or those locating in particular regions). Similar holidays are available to approved service projects, qualifying trading companies, operational headquarters of companies, and qualifying tour operators. Dividends paid out during these holidays are tax exempt.

**Companies that are not granted pioneer status, are eligible to receive various investment tax allowances** including<sup>37</sup> a 60 percent allowance for qualifying capital expenditure on factory, plant, machinery, equipment, or the costs of industrial adjustment activities (such as reorganization, reconstruction, or amalgamation) for five years (this can rise to 100 percent of statutory income for certain types of companies—mostly high technology companies or strategic projects—or those locating in particular regions); a 100 percent allowance on the cost of expenditure on infrastructure incurred by companies in certain regions; a 10 percent initial allowance and 2 percent annual allowance for capital expenditure on industrial buildings; and reinvestment allowances of 60 percent of qualifying capital expenditure for 5 years for manufacturing and agricultural companies undertaking expansion, modernization, or diversification activities.

**Other fiscal incentives are also available** such as:

- Double deduction of expenses on the promotion of exports, on research and development activities, on training provided by approved training institutes, on export credit insurance, or on overseas promotion expenditures.
- Accelerated depreciation of computer and technology investments, environmental protection equipment, and capital expenditure on approved agriculture projects.

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<sup>35</sup> Includes companies involved in promoted activities, located in certain promoted areas, that provide certain types of intermediate goods, or are of national and strategic importance.

<sup>36</sup> These include high technology companies, strategic projects, those companies participating in the “Industrial Linkages Program”, and contract research and development companies.

<sup>37</sup> There are however, some restrictions on the proportion of statutory income that can be offset in a given year by the investment tax allowance; unutilized allowances can, however, be carried forward until they are fully used up.



- Duty-free import of raw materials used for exports and on spare parts and raw materials for companies exporting 80 percent of production (where the import duty on such items exceeds 5 percent). For other companies, a drawback scheme for import duties, excises, and sales tax is available for materials used in goods that are subsequently exported.
- Import duty and sales tax exemption on machinery and equipment used directly in manufacturing process that is not available locally and sales tax and excise duty exemptions on locally purchased machinery and equipment.
- In Labuan there is a reduced tax rate of 3 percent of net profit for offshore companies while income from nontrading activities is not subject to any taxes. Management and technical fees, interest and royalties paid by offshore companies are exempt from withholding and expatriates are exempt from personal income tax on 50 percent of their gross income.

**Malaysia, like the Philippines, has also favored establishing Special Economic Zones** (governed by the Free Trade Zone Act of 1990) with 14 such zones existing at end-1999. The Minister of Finance can declare an area a SEZ after which goods and services entering the zone are exempt from customs and excise, sales tax or service taxes. Companies locating in such zones must export at least 80 percent of their products with any goods leaving the zone becoming immediately subject to tax. In addition, Malaysia has established a Multimedia Super Corridor (MSC) in a 9 by 30 mile zone south of Kuala Lumpur. Companies with MSC status can either operate tax-free for 10 years or receive a 100 percent investment allowance. The government also provides dedicated infrastructure (including an airport, rapid rail links, highways, and optical fiber telecommunication infrastructure) and permits duty-free import of multimedia equipment into the MSC.

### *Thailand*

**Thailand has offered a range of fiscal incentives for a number of years which were enhanced in the wake of the 1997 financial crisis** to offer inducements for inward investment. Incentives in Thailand are determined primarily by geography rather than industrial sector<sup>38</sup> and become progressively more generous the more underdeveloped is the region. Incentives have, however, been largely discretionary and awarded only following an assessment by the Thai Board of Investment.

**Tax holidays** range from 3 year tax holidays—available only for export industries in the most developed regions—up to an 8 year tax holiday, a 50 percent reduction in corporate tax for the

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<sup>38</sup> However, qualifying projects can only be in certain eligible activities that are identified by industry code and are dependent on regional location (i.e. a wider definition of eligible projects in less developed regions). Previously incentives in Thailand were also geared toward attracting export oriented companies and meeting employment objectives.

following 5 years, and double deductions for transportation and utility costs for companies that locate in the least developed regions of the country. Any dividend distributions during the course of the tax holiday are tax exempt.

**Companies also receive an investment allowance** of 25 percent for expenditures incurred on infrastructure. Import duty exemptions range from a 50 percent reduction in import duty on machinery and an exemption of duty on raw materials used to manufacture exports to outright exemptions on machinery and 5 year exemptions on raw materials (again depending on the geographic region in which the company is located).

**Companies locating in one of Thailand's seven export processing zones (EPZs)** established under the Industrial Estates Act also receive exemptions from import duties and VAT on raw materials, machinery, equipment, and spare parts. However, once goods are sold in the domestic market they then become dutiable.

### *Indonesia*

**There was an attempt to eliminate the use of tax incentives in Indonesia in 1984**, in particular the use of tax holidays, but such incentives were reintroduced in 1996 and then modified in 1999. At present, new enterprises in 22 specific manufacturing industries classified as pioneer receive 3 year tax holidays (5 years if outside of Java and Bali) that can be extended by one year each if the investment is more than \$200 million, employs more than 2,000 workers, and 20 percent is owned by cooperatives. Applications for incentives are made to the Investment Coordinating Board but are awarded only by interministerial committee based on objective (e.g., type of industry, region of investment) and judgmental criteria. In addition to these specific incentives, capital goods are both duty and VAT exempt.

**Indonesia also has numerous SEZs (called KAPETs)** where, for investments in certain fields of business, the government offers a doubling of regular depreciation rates, loss carry-forward for 10 years, and a 50 percent reduction in the tax on dividends paid to nonresidents. The importation of goods directly related to production activities within the zone are also exempt from both import duty and VAT. In addition, SEZ firms are allowed to deduct expenses incurred on local infrastructure.<sup>39</sup>

### *Korea*

**While tax incentives have been used in the past in Korea, currently the application of such incentives is quite narrowly defined** with only businesses incorporating advanced technologies, service businesses that support domestic industry, or companies locating in Korea's Free Trade Zone or designated Foreign Investment Zones (FIZs) being eligible. Such

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<sup>39</sup> It should be noted that the boundaries of the SEZs are not well secured leading to significant revenue leakage from these zones.

companies receive a seven year corporate tax holiday (with a 50 percent reduction in corporate tax in the following three years); a five-year exemption from acquisition, registration, land and property taxes (with 50 percent reduction in the following three years); and exemptions on customs duties, excises, and VAT on imported capital goods for three years. Enterprises designated as FIZs also receive, support for medical, educational, and housing facilities and the provision of infrastructure (roads, water, sewage) and rent reduction on government properties. All application for exemptions in Korea must be made to the Ministry of Finance and Economy and, to receive benefits under the FIZ regime, the business must also meet certain investment and job creation criteria and be designated an FIZ by the Foreign Investment Committee.

**In addition to these specific industrial incentives, Korea also provides various statutory tax abatements that are available to all companies** including a lower corporate tax rate for small companies, tax credits for investment in machinery or energy saving technologies, tax holidays on withholding on dividend distributions, tax credits to relocate companies to less congested areas, corporate incentives to dispose of business assets in order to repay corporate debt, and others.

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