CHAPTER 2

PHILIPPINE INVESTMENT CLIMATE

2.1 Philippine Investment Climate Macro Level View

Macroeconomic Fundamentals

→ The National Government's fiscal reform program has been making a significant development as evidenced by the increase in revenue collections of revenue generating government agencies.

→ In 2006, the National Government was able to increase its revenues by 20% with the implementation of the 12% EVAT (Expanded Value Added Tax).

→ The Gross Domestic Product (GDP) in 2006 grew by 5.45%. Over the last three years, the economy has been able to maintain a growth of at least 5%.

→ The surge in the growth of transport, retail trade and mining as well as the government's pump priming activities contributed to the GDP growth.

→ The Gross National Product (GNP) in 2006 grew by 6.10%. This is basically due to an increase in the Net Factor Income from Abroad (NFIA) of 13.33%.

→ In the first semester of 2007, the GDP grew by 7.28%, its fastest rate in the last 17 years.

→ The continuous inflow of OFW remittances helped the GNP to increase its growth in the first semester of 2007 at 6.6% as compared to 6.36% in the same period last year.

→ With regard to the country's debt position, as of May 2007, the total debt of the National Government decreased by 2.1% from the previous month's level. One of the reasons for the decline in foreign debt was the appreciation of the peso and the third currencies against the US$.

→ In July 2007, the National Government achieved a fiscal surplus amounting to Php 1.6 billion.

Infrastructure

→ Infrastructure Adequacy has a significant effect on private investments and access to transport, power and information & communication facilities are found to be critical factors affecting location decisions of both local and foreign firms.

→ Investors tend to concentrate on Metro Manila, Southern Luzon, Central Luzon, and Metro Cebu due to better infrastructure and proximity to product and factor markets.

- → The Comprehensive and Integrated Infrastructure (CIIP) has identified priority infrastructure projects in the Philippines which are estimated to reach Php 1.7 trillion for the period 2006-2010.
- → More than half, or around Php 889.2 billion, would go to transportation-related projects and Php 361.1 billion would fund power and electrification programs.
- → The rest of the investments would be channeled to projects related to water resources, social infrastructure, support to agrarian reform communities (ARCs), and communications.
- → Twenty percent or Php 337.4 billion worth of these infrastructure projects has already been started with the rest still in the pipeline.
- → Forty-four (44%) percent or around Php 775.3 billion of the total infrastructure spending would come from the National Government (NG) and Php 848.6 billion will be sourced from the private sector and government-owned and controlled corporations (GOCCs). Local government units (LGUs), through the financing schemes offered by Land Bank of the Philippines and Development Bank of the Philippines, would shoulder 2% of the total infrastructure spending.
- → Investment pledges to the sector mainly came from commitments to operate call centers and business process outsourcing (BPO) services.
- → PGMA's infrastructure-led development strategy comes after the implementation of new tax measures that increased government revenues and averted what could have been a fiscal crisis. These tax reforms and improved efficiency of revenue generating agencies are expected to result in a balanced budget by 2008, allowing for more room for infrastructure and social services spending.
- → For the year 2007, budget for infrastructure will amount to Php 83.8 billion.
- → To address issues on transport infrastructures (roads, etc.) public-private joint investments are invigorated like the build-operate-transfer or other cost-effective arrangements, as was stated in the President's Medium Term Philippine Development Plan (MTPDP) 2004-2010.
- → The MTPDP made mention also on addressing the transport infrastructures are the completion of the Nautical Highway System (Roll-on-Roll-off [RORO] ports and highways linking them) in the aims of reducing transport cost and cargo handling, Metro Manila decongestion and creation of new government centers in Luzon, Visayas & Mindanao, making the country's major tourist destinations accessible and an affirmative action on the peace and development of Mindanao and other highly impecunious areas.
- → The Roll-on-Roll-off (RORO) ports have been successful in encouraging the tourism activities and trade in coastal communities.
- → In decongesting Metro Manila, infrastructure projects were undertaken like the Northrail, South Luzon Expressway (SLEX)/STAR, Southrail and the final linkage of the Metrostar Railway Transit (MRT)/Lightrail Railway Transit (LRT). This has so far, been successful since its initial operations.

- → Philippines was beset by a major energy crisis prompting the government to take drastic measures, eventually solving the problem. This was made possible by the implementation of the Electric Power Industry Reform Act (EPIRA) in 2001 which aims to deregulate the power industry and draw in more private sector investments. Though the implementation of the EPIRA is behind schedule, structural reforms have been put into place and will be pursued by the said administration.
- → 86% of the Philippine population has access to water.
- → The telecommunication services sector has been liberalized resulting into its expansion & improvement.
- → Answering the call of digital infrastructure advancement, the cost of interconnectivity will be decreased via greater competition, and use of telephony as was also stated in the MTPDP 2004-2010. In this way, access to the internet is not only easy but also cheap.
- → Regulatory/legal framework would have to be established by way of the passage of the Convergence Bill to encourage cable technology dependent and ensuring that NTC is independent.

<u>Governance and Institution</u>

- → Available manpower increased by 1.57% in January 2007 while unemployment rate as of April 2007 was estimated at 7.4%, 0.8 lower than last year's estimate of 8.2%.
- → Intellectual Property Office (IPO) registered 4,766 patents received and 1,168 patents granted as of 2006 compared to 2005's 2,431 received patents and 1,666 granted patents.
- → Of the 4,766 received patents of 2006, 1,223 are locals whilst 3,543 are foreigners compared to 2005's 1,375 locals and 1,056 foreign.
- → The 1,168 granted patents consist of 143 locals and 1,168 foreign as of 2006 in comparison to 2005's 22 locals and 1,638 foreign.
- → Addressing corruption in government was done by the Macapagal-Arroyo Administration, one of which is the investigation of the lifestyle of high-ranking government officials to curb corrupt practices.
- → Apart from macroeconomic stability and economic openness, direct and indirect costs of doing business shape the investment climate, particularly policies on entry and exit procedures.
- → 21% of business financing in the Philippines is obtained through bank loans.
- → Access to Small Medium Enterprises (SMEs) financing will be increased.

<u>Investment Trends</u>

- → The Philippine is committed to developing simple, fair, transparent and predictable administrative rules that rationalizes investment incentives and reducing the cost of doing business by eliminating bureaucratic red tape and corruption.

- General theme of the incentive program is to encourage foreign capital and technology that supplements local resources.
- Foreign ownership is restricted to 40% in entities undertaking activities listed in the Foreign Investment Negative List (FINL) and those not listed on FINL, 100% foreign ownership is permitted.
- The government is dismantling investment restrictions to allow foreign investors to participate in an increasing number of sectors of the economy with 100% equity ownership.
- To address capability of local firms in hurdling global competition, the government is planning to adopt safety nets provision of support so local firms can prepare themselves eventually becoming competitive.
- Japan was the leading source of approved FDIs in the first quarter of 2007, registering Php 6.9 billion worth of pledges mainly to the manufacturing sector. Netherlands and U.S.A. followed at second and third places with pledges to inject Php 4.3 billion and Php 3.6 billion, respectively.
- Investment pledges to the private services sector grew by a robust 33.1% to Php 4.9 billion in the first quarter of 2007, increasing from its Php 3.7 billion level in the same period in 2006.
- Investment projects with foreign interest approved in the first quarter of 2007 was estimated to generate 27,494 jobs. An estimated 20,450 jobs, representing 74.4 percent of total jobs from approved investments with foreign interest are expected to come from PEZA-approved investment projects.

2.2 Philippine Investment Climate International Perspective

Macroeconomic Fundamentals

GROWTH RATES*
As of First Quarter of 2007

	Real GDP	Exports	Imports	External Debt Level in Billion US$	Exchange Rate As against US$**
Philippines	7.05%	9.76%	5.19%	54.0	-6.32%
Malaysia	5.53%	1.04%	5.54%	56.4	-6.16%
Indonesia	5.97%	14.68%	17.00%	135.0	-1.20%
Thailand	4.17%	18.41%	5.44%	59.3	-9.52%
Singapore	9.05%	9.86%	7.79%	281.3	-5.88%
Korea	4.03%	14.64%	13.32%	286.1	-3.31%
Taiwan	4.03%	8.64%	4.24%	84.6	1.84%
Sri Lanka	-	20.24%	15.83%	-	6.35%
China	-	27.90%	18.15%	331.6	-3.59%
India	9.27%	14.66%	17.31%	155.0	-0.52%
Vietnam	7.66%	18.58%	39.01%	-	-

* = Source: Bangko Sentral ng Pilipinas (BSP) website: As of October 24, 2007. All figures came from the website, were compiled and formed a table.

** = negative figure means appreciation, positive figure means depreciation

2.3 Philippine Investment Climate Micro Level View

Infrastructure

- → Technological innovations in product development, use of modern machinery and equipment and adoption of new techniques, among others, are equally important for enhancing firm productivity.

- → 61% of the firms has undertaken the upgrading of an existing product which, along with cost reductions, appears quite important to firms' ability to enter new markets and 51% of the firms has upgraded their machinery and equipment in the last 2 years and nearly half of firms claim to have developed a major new product and tapped into new markets.

Governance and Institutions

Business Procedures & Regulations

- → On the average, it takes about 14 days to obtain an operating license, 39 days for medium-sized firms and more than double for large firms.
- → It takes about 18 days in securing a construction permit, though on the average small firms wait for 20 days, 9 days and 18 days for medium-sized and large firms respectively.

- → Firm managers, in order to shorten bureaucratic red tape, personally transact with government authorities and the average management time spent weekly in dealing with government regulations is about 9%.

- → On average, getting an import license takes about 7 days in both CALABARZON (Cavite, Laguna, Batangas, Rizal, Quezon) and NCR (National Capital Region).

Regulatory Burden & Corruption

- → Streamlining the regulatory system not only diminishes the burden on business conduct but also reduces corruption. Because of stringent and complex regulations, corruption comes into the picture. Nevertheless, the government has taken action in simplifying the regulatory system and obliterating corruption.

- → The Philippine government is adamant in battling corruption. As a castigatory measure, the government will adopt lifestyle checks and bolster the investigative capacity of the Ombudsman, making it like HK-ICAC through a passage of law allowing such.

- → To prevent further stemming of corruption, the government will strengthen procurement reforms, the National Government Accounting System (NGAS), streamline frontline services procedures, identify and address corruption vulnerabilities, allow government projects to be analyzed and critiqued by all sectors and enacting the Whistle-blower act.

- → In line with the government's promotion of zero tolerance on corruption, conducting values seminar on government and school (Council of Values Formation) will be done, mobilize the formal and non-formal educational system, with the media and civic organizations to deliver the message of societal reforms and revision of educational curriculum to accommodate values formation.

- → To address bureaucratic reforms, the government aims to improve on the delivery of services and reduce cost of doing business which is considered a bottleneck in attracting in foreign investors.

- → Under Executive Order (E.O.) 366, all government agencies will do a strategic review of their fractions to identify functions, programs, projects that can be scaled down or abolished.

- → A reengineering bill with a silver parachute will be passed by the government for those who will be retiring and a salary upgrade will be given to those who will stay.

- → The Information and Communications Technology (ICT) will be used as a tool to improve access to and delivery of government services. Government agencies will be rationalized to augment their efficiency and effectiveness.

Labor

- → Philippines is home to a skilled and well-educated workforce and more importantly, are very fluent in the English language. It is also the world's fourth largest English-speaking nation and is the 14^{th} largest labor force in the world.

- → Philippine labor force's capabilities as professionals, blue-collar workers, managers and technicians are undeniably remarkable as seen in their employment in foreign firms both in the country and abroad.

→ Foreign investment and management are welcomed by Philippine labor, as foreign companies play a significant role in generating employment and training the national workforce. The labor sector welcomes foreign investments that aims to improve the lot of the poor, is environment conscious and respectful of the people. This sector also welcomes participative management that encourages dialogue with, and respects the rights of, employees.

→ The National Conciliation and Mediation Board (NCMB) has exerted its utmost efforts in settling labor cases resulting in a settlement rate of 75% during the first nine months of 2007, as compared to 67% percent of the same period last year, and has prevented it to become full-blown.

→ The efforts exerted by NCMB is in line with the government's goal of employment preservation, in that worker-employer relationship is enhanced and quick action is given to labor cases as well as quick response teams to assist workers.

Finance

→ Funds internally generated account for 60% of financing for working capital in contrast to a 9% of funds sourced from commercial banks and half of that in Indonesia (18%); commercial bank access by small firms is limited, in that only 7% is sourced from local banks for financing.

→ Another source of funds is trade credit in that small firms source 12% of their funding for working capital with it; family, friends and informal financing course are other alternative of small firms in obtaining financing.

→ Only 22% of small firms, in comparison to more than one half of medium size and 42% of large firms have available overdraft or credit line, imply the difficulty of small firms gaining access to financing and is made more difficult by numerous requirements for loan application, including collateral.

→ 70% of small and medium size firms, as compared to 47% of large firms were required collateral in their most recent loans with average loan rates for small and medium establishments at 10%-12% and 7% for large firms.

→ SMEs are known to have limited capacity in preparing project studies, that's why banks are hesitant to extend loan to them.

- → Cost of financing for domestic firms appears to be of a serious constraint than with foreign firms because the latter has probably access to foreign or foreign-denominated loans therefore having a natural hedge against foreign exchange risk, if they are exporting.

- → In comparison to Bangladesh, Indonesia and Pakistan, access to and cost of financing is not much of a constraint in the Philippines.

<u>Investment Climate and Productivity</u>

- → Total factor productivity and firms with some skills development programs are more productive than those without, larger than optimal workforce is associated with lower employment growth and labor productivity and a higher share of temporary workers (meaning hiring and firing flexibility) is linked with 18% higher total factor productivity.

- → Firms with easier access to credit (through overdraft facility or credit line) have 77% higher labor productivity than those without, firms having high finance index, measured in terms of access to banks for working capital and new investments, and having overdraft facility or credit line, tend to have 19% higher labor productivity and having an external auditor with better labor productivity.

- → Internationally integrated firms tend to have higher labor productivity and total factor productivity.

2.4 Planning Guide for the Investor

National and Local Government Policy Considerations

- → Inbound foreign investment is actively encouraged, and wide incentives are available for investment activities that will facilitate the country's development or export capacity. The general theme of the incentive program is to encourage foreign capital and technology that supplements local resources.

- → Balanced against this is the government's desire to limit foreign ownership and participation in certain activities for constitutional or national interest reasons. In broad terms, foreign ownership is restricted to 40% in entities undertaking activities listed in the Foreign Investment Negative List (FINL). For activities not listed on the FINL, 100% foreign ownership is permitted.

Investment Possibilities/Restrictions

- → The Philippine government believes that economic development is best led by the private sector, and is committed to developing simple, fair, transparent, and predictable administrative rules, rationalizing investment incentives, and reducing the cost of doing business by eliminating graft and corruption.

- → Foreign equity investments are preferred to foreign debt. Consistent with this theme, the government is continuing to dismantle investment restrictions to allow foreign investors to participate in an increasing number of sectors of the economy with 100% equity ownership.

Registration Requirements

- → Before commencing activities, businesses operated through corporations or partnerships must register with the Securities and Exchange Commission, while businesses owned by individuals must register with the Bureau of Trade Regulation and Consumer Protection.

Possible Business Structure

- → The main vehicles used by foreign investors are domestic corporations and Philippine branches. Joint ventures tend to be feasible investment vehicles only for construction projects and certain energy operations.

- → The regulatory environment in the Philippines tends to favor the establishment of a subsidiary over a branch, as foreign ownership restrictions preclude operation of a branch in certain industries. However, branches receive the most favorable tax treatment for foreign investors.

Investment Incentives

- → Wide incentives are available to foreign investment in activities that significantly contribute to national industrialization and socioeconomic development, and in export-oriented enterprises. It is also available to export oriented enterprises within ecozones administered by PEZA or similar agency.

- → Income tax holidays of three to eight years are a central feature in most incentive packages.

- → Enterprises locating in special economic zones may be entitled to a special 5% rate of tax on their gross income (sales less direct costs) in lieu of all other national and local taxes. Enterprises registered under Subic Bay Metropolitan Authority (SBMA), which administers the conversion of US Military based

Location/Industries

→ Foreign and local contractors may undertake infrastructure development projects under the BOT arrangement and other schemes.

→ Enterprises locating in special economic zones and less developed regions are entitled to incentives.

→ Subic Bay Freeport, a former United States naval facility, offers first-class commercial and industrial facilities that are available for immediate use.

Finance

→ Foreign owned enterprises licensed to do business with the Securities and Exchange Commission face no significant legal impediments when they seek to obtain local finance.

→ There are some restrictions on the purchase of foreign exchange through the banking system to meet the obligations on foreign currency loans.

Repatriation of Capital and Profits

→ Capital and profits may be freely repatriated, although registration with the *Bangko Sentral ng Pilipinas* will be required if foreign currency is to be obtained through the banking system.

Tax Planning Considerations

→ Branches are slightly more advantageous from a tax perspective than corporations.

→ Income from services rendered by an alien outside the Philippines, even if performed for a Philippine-resident employer, is exempt from Philippine income tax.

→ The provision of many fringe benefits is subject to more favorable tax treatment than equivalent cash compensation payments.

Labor and Labor Costs

→ The Philippines has a ready supply of highly skilled and trainable labor, including professional, technical, managerial, and skilled workers. In bolstering the country's labor, foreign investments and management, through foreign companies, provide employment and training to the national workforce.

- → Labor costs are in the moderate range for Southeast Asia, but are compensated by worker productivity and fluency in English.

Market Studies

- → Some regulatory agencies may require submission of a feasibility study before permitting enterprises to register.

- → Many foreign companies establish a representative office to undertake research on the market.

International Financial Center

- → Incentives are offered to multinationals that establish regional headquarters in the Philippines, and to foreign banks that establish offshore banking units.